

APPENDIX L — Transforming Pricing in the United States Postal Service

In the ongoing debate over the need for postal reform in the United States, there appears to be a consensus among stakeholders that the current ratemaking process could be vastly improved. As a result, there is the possibility that, even under a relatively moderate reform proposal, the Postal Service will be given more freedom to set prices, subject to some kind of constraint or oversight.

In the following sections this appendix describes, citing examples, how pricing reform might alter the Postal Service as an organization, along with some of the implications for the Postal Service and its stakeholders. The goals of this section are to:

- Clarify the issues surrounding the need for pricing flexibility;
- Promote discussion among the many constituents regarding what changes are necessary; and
- Describe concrete steps to improve the ability to price products in the current environment and under various reform scenarios.

To achieve these goals, today's Postal Service is compared with the kind of organization it needs to become in order to thrive in its changing environment. By contrasting the Postal Service's pricing practices with firms in the private sector, the appendix illustrates the potential increase of value to the Postal Service's various stakeholders.

Introduction: The Importance of Pricing to the Firm[†]

"Pricing is the moment of truth – all of marketing comes to focus in the pricing decision."¹

Prices are economic signals that firms use to accomplish objectives and corporate strategic missions. For unregulated profit-making firms, the primary long-term goal is generally considered to be maximizing shareholder value. However, depending on the firm, and the market in which it operates, prices can be used to further a number of more specific tactical aims in support of the long-term goal.

In describing the Postal Service's pricing strategy, both in the near term and in the future, the appendix discusses how the Postal Service might use prices to support a number of different corporate objectives. To frame the discussion, reform of Postal Service pricing practices should adhere to the following principles:

[†] Research on private sector pricing practices was based on publicly available media and marketing information. This information was not validated with the individual private companies discussed.

¹ E. Raymond Corey, *Industrial Marketing: Cases and Concepts* (Englewood Cliffs, N.J.: Prentice Hall, 1962).

Principle 1: Prices should reflect the organizational strategy

Compaq

Compaq successfully reinvigorated sales in the crowded personal computer market by implementing a new high-volume, low-price strategy. In order to implement this strategy, Compaq embarked upon a bold targeted cost-cutting program that reduced operating costs by up to 50 percent. Basing its price on its newly lower costs plus a markup, Compaq was able to underprice most competitors while improving profits on volume.

AOL

AOL's corporate strategy is to provide easy-to-use dial-up Internet service for a premium price to that segment of customers who value a simplified product. By addressing the needs of this segment, AOL surpassed its competitors who offered Internet service for lower prices or even for free, to become the nation's number one dial-up Internet service provider. Indeed, AOL now sets prices for the industry: when it raises fees, so too do competitors focused on other market segments (e.g., DSL providers).

The Postal Service, like any other organization, exists to create value for its customers, by providing universal communications to all people residing in the United States. Today this is reflected in its publicly mandated universal service obligation. The Postal Service must balance goals of capturing value against its break-even requirement. Pricing is the tool used to capture value in earnings, and in that sense is a potent strategic lever. This fact may be obvious but not trivial. Many large companies clearly create great value for their customers, but fail to capture related earnings.

There is a myriad of pricing strategies an organization can pursue, including cost-based, competitive-based, value-based, and combinations of each. The cost-based approach, historically the most common for regulated firms, carries an aura of financial prudence and equity, and is the required approach used by the Postal Service in the current legal environment. In theory, it is a simple and a fair way to ensure products cover costs; in practice, it can create disincentives that lead to mediocre financial performance. The competitive-based approach can be an appropriate tool if the corporate strategy is to achieve sales objectives, and/or market share, and is desirable only to the extent that these goals improve the financial performance of the firm. The value-based approach is the most effective in capturing value in earnings. The goal of this approach is to maximize the difference between the value created for the customer and the cost incurred by the firm, and to price accordingly. This approach may be most desirable for a firm wishing to maximize its value.

The relationship between strategy and pricing ought to be dynamic. Any pricing strategy should influence corporate, and product, strategies. In developing a strategy for a certain product line, pricing will undoubtedly have to integrate its understanding of costs, customers, and competition. For example, if recommended market prices are set below costs in order to remain viable in the market, the organization may implement a strategy to reduce product costs. If cost reduction is not feasible, an exit strategy may be more appropriate, or an attempt to add perceived value to the product. Obviously, pricing should have the flexibility to be able to effectively maintain this

dynamic relationship with corporate strategy. The more the Postal Service has control over the price signals it sends to its customers, the more it is able to execute strategic plans.

Principle 2: Prices should reflect the specific competitive goals of products or groups of products

Jeep

In 2001, facing a saturated SUV market and increased comparison shopping via the Internet, Jeep changed its pricing strategy in order to reposition its products relative to competitors. Across-the-board price cuts and the introduction of several new products are intended to preserve Jeep's dominant place in the SUV market.

Kodak

In the U.S. film industry over the past decade, Fuji has relentlessly turned up the heat on its primary competitor, Kodak. Fuji has continually offered a product of similar quality to Kodak's, but always for a lower price. Faced with declining market share, the fear of commoditization and a resulting deterioration of its valuable brand name, Kodak set out to reposition its products relative to Fuji. Kodak avoided a price war by holding firm in the pricing and positioning of existing brands, while introducing new brands in different price bands and offering products via new channels.

As there are different pricing strategies to pursue, it is essential that the strategies chosen be consistent with the overall organizational strategy. However, pricing is typically done at the product or service level. This means that pricing can actively position a product (or service) in the marketplace based on corporate strategies. The implication of this principle is that the organization's current and/or desired position within the marketplace (or relevant market segment) are the strongest determinants of prices. For example, if the Postal Service wishes to protect its dominant position in a declining correspondence and transaction market segment, it may want to ensure that prices remain affordable and competitive. On the other hand, it may want to deliberately charge high prices for a premium forwarding service. A low cost penetration strategy might be pursued for a new product or service if the goals are to reach critical mass rapidly (by accelerating adoption rate) and to establish a stable leadership position in that market space. The important point here is that different pricing strategies are appropriate in different circumstances, and as circumstances change, the ability to adapt or modify pricing is critical.

While the existing rate-making criteria allow a means for any of these strategies to be pursued, the political and regulatory environment in which the Postal Service operates creates constraints. In part these constraints reflect well-intended public policy goals; for example the requirement that rates be set to ensure that the revenues earned by specific products are sufficient to cover attributable costs. The procedures for rate and classification changes now restrict the organization's ability to respond to emergent situations and has negative economic consequences for the Postal Service and its many stakeholders.

Principle 3: Prices should reflect the value that customers place on the product or service

The Airline Industry

Rather than segmenting the market and offering separate flights for customers with different needs and budgets, the airline industry created a sophisticated tiered pricing system that gave access to virtually the entire market. By offering different packages of luxuries and conveniences to customers with varied perceptions of value, the airlines have been able to discriminate amongst customers based on their own preferences.

DuPont

In a largely commoditized chemicals industry, DuPont differentiates products by offering chemicals at both a standard offer price and a premium offer price, allowing customers to select the grade of product they prefer. This graded pricing strategy gives special attention to the market opportunities presented by the diverse perceptions of value among DuPont's customers.

Successful pricing strategies are continuously refined depending on changing costs, product life cycle considerations, price sensitivity, value-addition, and competitive factors. Throughout this process, the market(s) in which the firm operates can be segmented into groups of customers who value specific elements differently. Customer segmentation allows for value-based pricing strategies that provide flexibility in pricing products to meet the differing needs of segmented markets.

Value based pricing depends on the ability to segment prices along multiple dimensions; by category, purchase location, time of purchase, quantity, product design, or product bundling. In fact, a large organization with multiple product lines may incorporate a seemingly unlimited set of variables in its pricing decisions; stopping at the point where additional transaction costs exceed the gains from additional pricing complexity. The important point is that segmented pricing enables a company to develop pricing strategies that are more appropriate for the customer in each market segment.

The Postal Service's current pricing strategy is based on nine fundamental criteria, which affect prices differently from subclass to subclass. Value of service is one of the principles used in determining a suitable price for a subclass. However, there are problems with the current use of 'value of service' in that it encompasses too broad a spectrum of customers and products. For example, value of service is generally considered at the sub-class level, while the relevant value drivers may not be on the sub-class level but rather on the product level. Moreover, other criteria may act as countervailing factors and overwhelm the ability to reflect market value through pricing.

Principle 4: Prices should reflect the costs of the organization

Amazon.com

Amazon.com has shied away from a cost-plus pricing strategy that guarantees profits to many commodity sellers. Instead, the company has focused on building brand name, trust, and sales volume. Although they have achieved only one modest quarterly profit ever, Amazon.com veritably owns the market and continues to rank as one of the most-visited sites on the Internet.

Webvan.com

Webvan.com's ambitious strategy was to provide everything to everyone, every day of the week—online. It chose the grocery industry first, charging a premium over bricks-and-mortar grocery stores, but less than its online competitors. Webvan.com was essentially a massive warehousing, distribution, and same-day-delivery service that hoped to eventually compete against the likes of Amazon.com based on speed of delivery and lower shipping prices, but was faced with a greater and more immediate challenge of changing decades-old consumer shopping behavior in the grocery industry. Unfortunately Webvan.com's hub-and-spoke business model was capital intensive, rivaling its bricks-and-mortar competitors, with pressure to deliver extremely high levels of service, while its pricing strategy was limited by the need to attract customers to this new way of shopping. Unable to execute even the most basic cost-plus pricing model to achieve profit, Webvan.com finally succumbed to the pressure, declaring bankruptcy in 2001.

In the long run, every organization must price its products in such a way as to cover its costs, support capital expenditures, and return a sufficient net return on investment. The Postal Service, which does not earn a rate of return on its investments because of the statutory break-even requirement, still must ensure that it covers its ongoing costs while fulfilling its obligation to provide universal service. In the thirty years since the Postal Reorganization Act, the Postal Service has built elaborate costing systems designed to provide information in a form designed to serve the requirements of the existing regulatory regime. Moreover, thirty years of precedent have resulted in a number of conventions that inform how costs determine prices. As this appendix discusses how the Postal Service's approach to pricing will change, the legislative and internal changes that affect the Postal Service's financial goals and have implications for pricing will be addressed in the relevant section.

In the following sections, the pricing principles and concrete steps needed to help the Postal Service improve its ability to price its products and services in both the short and the long term will be described. The discussion will provide illustrative examples of how to price a specific existing product—in this case advertising mail.

Pricing in the Near-Term

The Current Situation: Postal Service Pricing Today

Under the Postal Reorganization Act of 1970, the Postal Service has to comply with a set of nine statutory pricing criteria (see 39 U.S.C. 3622(b); 3623(c)). These criteria ensure, among other things, that prices are set such that revenues exceed costs and that the resultant rates are fair and equitable. Deciding which product gets what markup has been one of the most contentious issues in rate cases and has been heavily influenced by dominant outside interests, including mailers and competitors.

Advertising Mail

A “rough” customer segmentation by proxy

Mail preparation requirements and legally-mandated subclasses are a form of customer segmentation—albeit a “rough” segmentation.

Level of mail preparations

- *Enhanced Carrier Route (ECR)*: High volume, high level sortation, deeply drop shipped saturated mail. A low hanging fruit.
- *Regular*: Lower volume, nonsaturation with same level of preparation as ECR.

Legally-mandated segmentation

- *Nonprofit mail*: A “preferred” segmentation for nonprofit mailers.

Strategic Considerations

Even under the current regulatory constraints, in many respects the Postal Service has already gone a long way toward achieving market segmentation. This has been accomplished through the development of extensive worksharing discounts. These discounts encourage private sector agents to take over part of the Postal Service’s traditional role. The effect of this has been a quiet, de facto commercialization of certain upstream postal activities and some guarantee of relative efficiency. In the 1970s, the Postal Service introduced presort discounts. The 1980s and 1990s brought more presort, drop-ship, and other discounts. The discounts are based on the cost savings the Postal Service achieves. An estimate by one analyst showed that the value of work sharing discounts exceeded \$15 billion in 1999. Perhaps more importantly, that same analyst calculated that had worksharing not been instituted, the costs of the Postal Service would have been more than 20 percent higher in that year alone.²

The pricing strategy behind work sharing discounts is called “lowest combined cost” because the goal is to minimize the combined cost of the mailers and the Postal Service. A mailer may choose to use the Postal Service from induction through delivery or receive a discount by doing part of the work themselves. For example, the cost to large businesses of meeting the requirements for automation rates is smaller than the discount provided. The key point here is that many of the most obvious benefits of increased pricing flexibility have already been exploited under the current rules.

Worksharing has had positive impacts on Postal Service mail volume and contribution by targeting customers more willing to share in the sorting and movement of the mail. The largest effect has been with advertising mail where volume has grown 240 percent since 1978 when the first discounts were introduced there. Econometric analyses have shown that work sharing discounts do generate new mail volume.³

Still, the Postal Service’s ability to use pricing to achieve strategic aims is currently hampered by many factors.

- Substantial effort and lead-time are required to prepare and litigate a rate or classification case.

² “The Impact of Using Worksharing to Liberalize a Postal Market”, February 2001, Cohen, et. al., Office of Rates, Analysis, and Planning – US Postal Rate Commission

³ Ibid.

- The rate-making process can create a contentious environment and distract management focus away from the customer.
- There is an over reliance on costs as a determinant of prices.
- The lack of a profit motive dampens innovation and does not provide incentives for creativity and change.
- Consequently, the Postal Service has been unable to fully take advantage of the potential strategic value of pricing.

Competitive Considerations

Typically, firms use price to further competitive goals and improve their position in the marketplace. In the regulated Postal environment, this goal is turned on its head. The rate-making criteria explicitly requires the Postal Service, and the Postal Rate Commission (PRC), to mitigate against potentially harmful impacts on competitors when setting rates, despite potential benefits for customers from an increasingly competitive market. In addition, competitors propose alternative pricing scenarios that must be considered in the regulatory process. While these considerations are consistent with good public policy, in reality they have important implications on Postal Service prices.

Pack and Send

In 1996, the Postal Service began testing a service that offers customers the opportunity to have packages wrapped for shipment—a service commonly offered by shipping outlets such as Mailboxes Etc. This offering evolved from popular customer feedback, which requested that retail outlets become more convenient. Shortly after testing began, a complaint was filed with the PRC, and consequently the Postal Service decided to suspend the service while an experimental classification case could be litigated.

Despite the presence of rules designed to expedite litigation for small-scale experiments, the litigation of the Pack and Send case (MC97-5) consumed more than eight months, and required extensive use of internal resources. The PRC recommended fees for the service that were higher than those proposed by the Postal Service, thereby responding to concerns raised by small companies that the pack and send service would cause financial harm to their businesses. Moreover, the PRC made fundamental alterations to the product by requiring that insurance be incorporated into the service, irrespective of customer preference. The result was that although the PRC recommended the Postal Service be authorized to offer a provisional classification, the Postal Service found the recommended fees to be inconsistent with market conditions and customer expectations and did not implement the service.

The ability to launch successful new initiatives is important to any organization for several reasons: to meet changing customer needs and generate new revenues, among others. In order to do so, firms need the ability to quickly introduce products in response to changing market conditions and to employ pricing strategies designed to spur customer adoption. With more regulatory freedoms, the Postal Service could introduce experiments efficiently and offer them at prices, such that, customers would determine their viability.

Price changes are not the only competitive tool companies use to enhance their market position. New product introductions are commonly used to enable corporations to remain competitive as customer needs evolve. For example, the Postal Service recently proposed offering free delivery confirmation for customers using branded shipping services during the holiday season. Given the need to adhere to a procedural schedule that gives great latitude to competitors' due process rights, the Postal Service had to withdraw free delivery confirmation as proposed. The lead time and expense required to litigate cases has a dampening effect on product innovation.

Customer Value/Segmentation Considerations

Value of service is one of the statutory rate-making criteria that is used to set postal rates and an important reason for the range of cost coverages in the existing rate schedule. Today, however, the primary unit of analysis in determining appropriate cost coverages is the subclass. Intended to prevent cross subsidization across classes of mail, this requirement may have the effect of limiting the Postal Service's ability to reflect different customer perceptions of value within a subclass.

Currently legislative and political interests of competitors and customers may also hinder the Postal Service in its ability to price products efficiently. For example many new products are priced using the cost coverage ratios that are used for existing products. Furthermore once cost coverage ratios are set, it is difficult for the Postal Service to either lower or raise the coverage as market demand changes. The evidentiary burden necessary to support long-term pricing strategies hampers the ability of the Postal Service to take the product life cycle into consideration in the pricing equations and create prices that are suitable for entry products (Pack and Send) or fully developed (First-Class Mail®). Furthermore because individual products within a sub-class are in different stages of their lifecycles, it becomes impossible to take this element into consideration when dealing with subclass pricing.

In addition to limiting the Postal Service's ability to match price with customer value, current application of the value of service criteria may create other perverse incentives. For example, if management perceives cost coverage for a given sub-class to be fixed and low, it may be unwilling to make investments related to such products because cost coverage acts as an artificial upper boundary on return on investment.

Cost Coverage Considerations

In the current environment, the Postal Service's overall financial goal is to breakeven over time. The underlying incentive to cover costs does not necessarily correspond to cost minimization. To be fiscally responsible while continuing to operate, the Postal Service files a rate case when total costs exceed revenues by a significant amount. While long-term profitability is the goal of private businesses, the Postal Service, by law, was not established for profit-making purposes.

For example, rates are based on cost estimates developed through hearings at the PRC. Active rate case intervenors (outside organizations or individuals) fight for higher or lower discounts often based not on the actual savings, but based on their particular perspective or vested interests. Rates are set based on the PRC's estimate of true savings. If costs or cost savings for discounts end up in practice being significantly different than expected, there is no way to change the rates in the short term. The rates

are set until the decision of the next rate hearing at the PRC. Also, if significant cost changes occur in the economy such as higher fuel rates, no changes can be made. This may result in a substantial decrease in the contribution of various products and may even cause costs to exceed rates in some cases.

In the current environment, rates are set based on the current classification system. The current classification system may not correspond well to market conditions and customer needs. In some instances, there are numerous products with significant cost and market differences all within the same subclass. The Postal Service has made efforts to correct examples of cost averaging and the PRC has been relatively supportive where solid cost information has been provided. For example, it was determined that within the Parcel Post subclass, costs are largely based on size while rates are based on weight. In some areas it was found that costs for some Parcel Post pieces paying identical rates differed by a factor of ten. The Postal Service instituted both size-based and nonmachinable surcharges to attempt to deal with these concerns. While these extreme examples have been dealt with gradually, significant cost averaging still exists within product categories or subclasses. Many perceive this cost averaging to be perfectly acceptable because the long run goal is breakeven, but it creates a situation where some users contribute relatively more than other users apart from any business or fairness goals. It can also create a system where the Postal Service handles the most expensive pieces because competitors appropriately surcharge these segments while the Postal Service historically has not.

The data systems of the Postal Service generally do an excellent job of providing data to support the current regulatory environment. For example, there is substantial data regarding the price sensitivity of various subclasses of mail. Revenue and cost systems provide data to comply with requirements developed over many years of litigation at the PRC. While these systems are not perfect, they do function extremely well given the incredible complexities they face. The Postal Service spends a large amount of money to operate these systems. In some ways the current systems provide more detailed data than most private businesses would have. However, this does not mean that the data systems provide the right types of data to run a business. In fact, the need to maintain these systems in order to produce information in support of litigation may act to discourage necessary investments to modernize the Postal Service's management information systems.

In the current legal/regulatory environment each subclass of mail must set prices in a future "test year" such that the forecasted revenues equal the forecasted costs. In fiscal year 2000, this resulted in almost all products covering their variable (attributable) costs. Based on this regulated pricing regimen, some rates are set well below what the market would bear and contribution margin is sacrificed.

Meeting the Challenge

It has been observed that the Postal Service appears to have significant freedoms under the present law that it does not currently employ. If the Postal Service is to make a successful transition to a less monopolistic, more competitive organization it is likely necessary to begin immediately identifying the freedoms that exist and to consider their pricing implications. A crucial part of this analysis is the examination of the constraints that currently prevent this from happening and the specific steps needed to move forward.

For the purposes of this discussion, the break-even assumption remains intact. Pricing emphasis is likely to be on small experiments permissible under current regulatory structure: small negotiated service agreements (NSAs) (customized pricing), targeted experimental products, and phased rates.

Advertising Mail

Refine segmentation of the base case: render it less “rough”

Provide seasonal pricing: For example, offer a price premium for peak-volume accounting periods, or a price discount for off-peak volume accounting periods.

Strategic Implications

Absent some form of legislative change, major strategic shifts are unlikely. Thus the key pricing strategy in the short term is to look for opportunities to experiment more aggressively with pricing innovation and flexibility that is allowed under current law. Emphasis will be on a number of initiatives that are either in development, or dormant, but that can be attained under current law. For example:

- **Phased rate changes.** Support the strategy of developing a flexible market-facing organization by requesting the PRC to develop rules for a phased rate proposal that will establish a PRC recommended schedule for incremental rate changes. Develop a workable plan for recommendation to the Commission.
- **Operationally targeted experiments.** Support full use of operational resources by developing experimental rate offerings that encourage the strategic usage of resources.
- **Major reclassification effort.** Alter strategically the current classification scheme by incorporating additional factors into the existing classification scheme.
- **Segmentation for major products.** Reclassify major products into commercial and retail categories by pricing them differently. For example, reclassify First-Class mail into customer segments using indicia (permit, meter, and stamps) as a proxy for large volume, small office/home office (SOHO), and individual consumers and price accordingly.
- **Negotiated service agreements (NSA).** Develop beneficial and valid NSA that is compensatory and offered to all parties on equal basis. For example, offer a discounted rate for periodicals mailers who are willing to pay directly for forwarding.

- **Use of volume discounts.** Offering a discount structure designed to promote volume and contribution growth by tying discounts to volume growth.

Competitive Considerations

The Airline Industry

Using First, Business, and Economy classes, airlines discriminate across the entire range of customer segments, taking advantage of individual price elasticities. Recognizing that the flying experience may be more important for the business traveler, while ticket price is often most critical for the leisure or family traveler on a limited budget, airlines customize pricing by significantly differentiating services, luxuries, and conveniences between the classes. In effect, the airlines work to build a high enough fence between the classes that customers falling into the premium segments will continue to pay for the associated benefits. Further, airlines maximize their profit in situations during which the customer must use their service (e.g., a last-minute long trip) by pricing these seats very high. At the same time, when capacity is not filled, airlines offer last-minute deals and “e-savers” to fill seats, taking advantage of the low incremental cost of serving an additional passenger. Understanding the different segments’ price thresholds, as well as managing capacity utilization and the resulting fluctuation of air fares requires an airline to use top-of-the-line technology and to constantly monitor competitors’ service offerings and prices, as well as trends in customers’ responses to its own services.

Of the categories of initiatives outlined above, segmentation by products has the most obvious competitive implications. Indeed, the Postal Service has already begun to differentiate between business customers by categorizing between large operations and small office/home office (SOHO) customers. These customers can then be targeted for various mixes of existing products and services, under the assumption that an appropriate pricing strategy can be crafted for each segment. In order to be successful, this effort will require a moderate reorientation of Postal Service capabilities and commitments. For example:

- There needs to be selective “bundling” of products and services, specific to the needs of particular customer groups.
- Customer response to products and services needs to be more explicitly incorporated into pricing and product decisions.
- Product definitions need to be realigned to reflect market segmentation: For example, a reclassification proposal might consolidate similar product lines across current rate categories. This is fundamentally different from the current structure in which rate class and subclass definitions are largely the result of the rate structure existing prior to the Postal Reorganization Act. A more comprehensive examination of the Postal Service’s product lines could result in a modernization of the product lines by considering how the products and services interrelate and are perceived by the market. For example, shape-based, market segment, or service based groupings may be more appropriate than the current mail classifications.

- The Postal Service will presumably require more extensive market and competitive intelligence capabilities and will need to use these in developing pricing strategies.

In some cases, these priorities may have greater utility in the long term where some form of legislative reform places the Postal Service in a more competitive environment, but it will be necessary to begin the process of developing necessary capabilities in anticipation of such a change.

Customer Value Considerations

AOL

Using market surveys and watching the competitive environment closely, the founders of AOL observed that even free dial-up Internet service providers were not attracting many novice customers. By talking with its own subscribers as well as competitors' subscribers and nonsubscribers, AOL discovered that a large number of people perceived Internet technology to be difficult to use and therefore intimidating. Further, most people did not consider the technology an easy and friendly means of communicating with friends and family. In direct response to this customer feedback, AOL developed a product that offered ease of installation, step-by-step real-time online instructions, a friendly user interface, and short-cuts for communicating with other subscribers, all for a flat fee that allowed users unlimited time to become familiar with the technology. AOL employed more skilled programmers and help desk staff than most of its competitors, but was able to charge a premium for its enhanced services, making it the dominant dial-up Internet provider in the nation.

In the current environment, value is considered to be reflected almost exclusively in terms of service.

In the transition to a more flexible pricing regime, the Postal Service will need to explore the other variables that customers consider when purchasing postal services, and how to incorporate such variables into its pricing strategy. For example, it may be possible to segment customers along multiple dimensions:

- Segmenting by buyer identification requires the seller to collect data and distinguish between its clients. Occasionally pricing differently among segments is easy because customers have obvious characteristics that distinguish them. For the Postal Service this would entail, for example, distinguishing between high-volume, frequent mailers and those who mail less regularly. The Postal Service currently has the ability to distinguish between its clients and determine what value mailers place on value-added services, yet it has been unable effectively to utilize this data in developing its pricing strategies. The problems that arise with segmenting by buyer identifications is that sometimes it is very difficult to develop customer segments for the different products.
- Purchase location segmentation requires that customers be segmented according to area of purchase or service. This would mean the Postal Service could charge a premium for its services in areas where it was more influenced by locality factors, which resulted in higher fixed or operating costs and are specific to that locality. The

Postal Service currently does not offer destination entry discounts for First-Class mail service. However, current post office box fees, which reflect underlying cost differences based on locality, provide an example of how such pricing might work.

- Time of purchase segmentation allows for companies to offer more attractive prices during off-peak work times. One form of time segmentation is yield management, which simultaneously integrates differences both in the costs and in price sensitivity. The purpose of yield management systems is to help sellers determine how much of their unused capacity they can afford to sell at discount prices without negatively affecting their ability to serve those customers who are willing to pay the full price. The Postal Service could utilize yield management in pricing for large mailers if they agree to enter the mail into the delivery system during nonpeak times.
- The ability of private companies to negotiate rates with large, low-cost customers allows these companies to segment and offer incentives to their more profitable clients who are continually doing business with them. The Postal Service currently is unable to reward its prized clients with such incentives, which would allow the Postal Service to retain and build its relationship with this customer segment. Furthermore, many large companies offer customized incentive plans to individual clients. While the flexibility to price independently on a customer-by-customer basis may, or may not be the answer for the Postal Service, there is a need for an ability to provide universal discounts open to all customers for volume and repeat business.

Cost Coverage Considerations

In the near term, the Postal Service assumes no change in the statutory requirements that all subclasses cover their costs and assumes that the Postal Service retains the break-even financial goal. All rate proposals remain subject to review by customers who generally argue for lower rates, and competitors who generally argue for uniformly higher rates. In addition, the PRC operates under its own legal and political constraints and attaches significant value to precedent. It is possible, however, for the Postal Service Governors to modify a PRC recommended decision with a unanimous vote.

More modest changes could be accomplished under current law, but have not been implemented because of various political and public policy concerns. However, a number of actions have been taken to charge segments below the subclass level more appropriately. For example, nonmachinable surcharges have been instituted for Parcel Post service. Other opportunities for similar discounts and surcharges remain but have not been attempted for various reasons. For instance, the possibility exists that targeted price changes can be used to align costs and prices more appropriately outside of the context of an omnibus rate case. Such cases involve a nontrivial use of resources and are therefore not a practical solution in all cases. However, this approach was used successfully when the Postal Service changed prices for a number of special services in a recent classification case (MC 96-3).

Perhaps under current law, the Postal Service could propose a subclass-specific energy price inflator on mail categories where transportation costs are a significant portion of the attributable costs. For example, Priority Mail rates, set at “X”, could decrease as fuel prices go below a specific level within a set time period. The law would presumably allow this type of adjustment if supported with compelling cost evidence. A completely different approach allowable under current law would be to

manage fuel price risk by financial hedging. The PRC's willingness to use a pricing formula for Mailing Online indicates that potential exists to experiment with more innovative approaches.

Pushing Ahead

While the Postal Service believes that a cooperative approach could yield significant gains under current law, it is possible that some initiatives will prove impracticable and require some form of moderate regulatory reform. Postal Service reform has been actively pursued for several years, and various proposals have been presented. Moreover, the recent histories of foreign posts and other domestic firms in deregulated industries provide a wide array of reform models for consideration. In describing possible pricing strategies under some form of regulatory reform, the Postal Service would continue to assume the universal service obligations remain, and that the fundamental structure of the organization is largely unchanged. However, the ratemaking process would be streamlined to allow reasonable pricing changes to occur without extensive regulatory hearings. As a result, the Postal Service would be better able to react quickly to changing market conditions and focus directly on the needs of its customers.

Strategic Implications

The existing cost-of-service regulation could be replaced with some form of incentive regulation. Under this scenario, the Postal Service would receive some pricing flexibility for competitive products subject to some specified rules designed to protect the market from anticompetitive Postal Service actions. Incentives for efficiency would be enhanced because limits would be placed on the extent to which cost increases could be passed routinely to customers via rate increases. Incentive regulation would also give the Postal Service more control over the price signals it sends to its customers, enhancing its ability to execute strategic plans. This new pricing flexibility would afford the Postal Service more incentives than under current law.

Under this scenario, price changes are likely to be more orderly and predictable, as prevailing macroeconomic trends govern price changes. This lack of price shock should help customers plan and budget their own business cycle. Nonetheless, the cumulative effect of even small and predictable price changes can have dramatic impact on rate levels and relationships. A strategic pricing plan for existing products would need to be developed and implemented consistently and with discipline over time.

DuPont

DuPont has created value for customers by offering standard chemicals in a variety of gradations of quality or characteristics, allowing customers to select and pay corresponding prices for the product option they prefer. DuPont has worked closely with customers to develop appropriate product offerings, and in the process, has developed strong, long-term relationships that serve to further differentiate DuPont from its competitors. To develop viable prices, DuPont closely tracks competitors' product offerings and prices, often by buying samples of their products. To establish and communicate the rationale behind the tiers of pricing, DuPont clearly enumerates the enhancements over the standard product and attaches a corresponding value, for example: DuPont offers Standard Grade Chemical A for \$100. The Premium Grade product includes the following enhancements:

Premium Characteristic	Value
10 times fewer impurities	\$1.40
Delivery time cut in half	\$0.25
Additional R&D support	<u>\$0.35</u>
	\$2.00

Thus, the customer who wants the Premium Grade product will pay \$102 for the additional value provided. At times, the customer may ask for some, but not all of the added values. DuPont may unbundle the premium offer and the customer will pay for only the chosen added values.

Pricing flexibility subject to some specified rules will determine prices for competitive products. Experimental products, negotiated service agreements, and methods to provide pricing incentives for larger volume commitments, such as declining block rates, would be vigorously pursued. To accomplish this, the Postal Service needs to develop a quick response capability to identify opportunities in the marketplace. In contrast to the old regime of relying on costing systems, market research analysis, and econometric forecasting in support of cost-of-service regulation, a new supporting data system needs to be developed. The system must be designed to provide management with timely data to make a decision on the return expected from an experimental new product and negotiated service agreements. Moreover, the Postal Service needs to develop some criteria to protect the current revenue base from unjustified revenue leakage. Experience with new product development and negotiated service agreement costing and pricing of international mail, plus the experience and the practice of other entities offers guidance on how to design and manage a pricing program at the tactical level. Some initiatives likely to be considered include:

- **Contract/customized pricing.** Negotiate rates for mailers, which offer win-win opportunities for the customer and Postal Service.
- **Bundle pricing.** Develop a bundling price for mailers who use multiple postal products or services.
- **Seasonal discounts and premiums.** For example, price premium on Standard Mail for two peak-volume accounting periods and a price discount for two off-peak-volume accounting periods.

Jeep

For 2002 models, Jeep is reducing Grand Cherokee pricing by \$2,000 across the board, while creating a more affordable Jeep Wrangler model and launching an all-new Jeep Liberty and a Jeep Cherokee Overland model to compete in the luxury class. These measures are in response to crowding in the SUV marketplace and the resulting erosion of Jeep's share in that market. Because Jeep tenaciously analyses internal and competitor sales data to identify areas in which it is losing ground as well as opportunities to regain share, it was able to identify incursions by its competitors before the situation became desperate. Recognizing that price is a powerful differentiator in this tight market, Jeep implemented a rigorous cost-reduction program a few years ago that is now paying for its price reduction.

Competitive Considerations

Prices, because they are more likely to reflect market conditions, may provide information that can be used to guide competitive strategies. For example, under intense price pressure in the personal computer segment, IBM sought new pricing strategies and value-adding opportunities to build loyalty and market share. In addition to introducing lower-priced products with limited success, IBM introduced computers with more internal memory at a slightly lower price. One possible outcome of having to operate in a more competitive environment would be to force the Postal Service to reposition selectively various products and in response to increased competitive pressure.

In the current environment, the Postal Service has been partially sheltered from aggressive competitive campaigns. Pricing freedoms would place the Postal Service in a highly competitive environment among private enterprises, which are generally thought to be more agile in responding to market trends and consumer buying habits. In recent years foreign posts have undertaken privatization efforts in varying degrees, with target objectives of liquidity, profitability and efficiency in service. For a variety of reasons, the Postal Service has not developed a consistent, thorough, competitor-monitoring program. The Postal Service would need to develop a position and identity, which drives all other functions of an efficient organization. The Postal Service would have to identify objectives, based on competitive advantages, and use price as a tactical element in achieving them.

Customer Value Considerations

In the discussion of the near-term pricing, this appendix discussed a number of different ways to segment markets effectively as a way to capture value through pricing. Under the reform assumptions, the Postal Service would be allowed to pursue experimental service offerings designed to reflect customer value more explicitly in its prices. Among other possibilities, this envisions the ability to:

- Customize product and service offers according to the needs of customers; and
- Allow prices to be negotiated apart from a published tariff structure.

Of course the Postal Service would still be subject to regulation, but it would be better able to offer innovative products and services without the burden of extensive litigation. This would require the Postal Service to reexamine the way it collects and uses customer and cost information and would require the Postal Service to make better use of market information in developing its product and operations strategies.

Cost Management Considerations

In the long term, the financial incentives of the Postal Service would change. It is essential to note that cultural changes and the concrete actions associated with those changes will take time. In the meantime however, a number of actions could be taken and these are discussed below. However, the largest financial impacts may be those that are unknown at this time, but would take place across the vast and complicated organization that is the Postal Service. Structuring financial incentives appropriately will be critical to maximize the organizational transformation.

Presumably under moderate reform, the Postal Service would gain some pricing flexibility, but if political constraints remain, the financial value of modest reform may be limited. It also must be remembered that appropriate incentives must be in place for Postal Service management to ensure that increased pricing flexibility is used in ways that benefit the Postal Service bottom-line. For example, private sector companies that employ best practices carefully set compensation for sales people to encourage them to make pricing decisions consistent with the best interests of the organization. This might entail rewarding managers based on profitability as opposed to revenue.

Presumably under moderate reform, an appropriate source of funds for capital investment would start to open up. A recent blue ribbon panel complained that the Postal Service does not invest nearly enough in capital spending and spends substantially less than similarly sized private organizations. The panel further noted the fundamental illogic of merely breaking even in a future test year with no ability to raise rates based on increasing costs. Without the ability to raise funds through shareholders or profits, the Postal Service is limited to replacing existing equipment through depreciation and increasing debt. Modest pricing flexibility would provide a source of funds for new equipment and facility updating and replacement.

Modest reform would allow the Postal Service to move quickly in markets where competition demands price flexibility. It might allow for some geographic, season-based, or entry time-based prices that would have numerous financial and operational advantages. Again, cultural change and incentives will be necessary to ensure that flexibility allows changes to maximize the Postal Service's financial value as a whole rather than that of a particular district or area. This is a common problem in large, national, geographically dispersed private sector organizations. For example, McDonald's Corporation receives no or potentially negative benefit if advertising and promotion dollars are spent to merely take business from one local franchisee to another.

Modest legislative reform might allow for a more appropriate view of pricing across the product life cycle. Currently, pursuant to statutory requirements, the Postal Service has limited ability to implement marketing strategies consistent with standard business practices, and limited ability to vary prices based on the product life cycle. The Postal Service cannot consider market conditions facing mature products or offer low introductory prices on new products to gain a foot hold in the marketplace. In some cases, the PRC has assigned much higher prices on new/experimental products than was desired or would make marketing sense for any private business. This can result in killing the product before it starts, or handicapping it so much that it never achieves its full potential. In modest reform, it is hoped that new products could be priced with long run financial success in mind.

Preparing for the Future

The Postal Service's structure and role in the economy are less easy to define precisely in the long term beyond moderate reform as they depend on a variety of comprehensive legislative reforms. Irrespective of the specific reform legislation that is implemented, the Postal Service is expected to operate in a very different context. For example:

- The Postal Service faces a turbulent environment at home and abroad on many fronts: technology, changing business environment, and regulatory framework.
- Current and emerging technologies will provide challenges to mail volume. The Internet, telephone, and fax machine will become increasingly viable alternative to mail. As security issues are resolved, this threat could increase. Also, changes in the business environment (mergers, acquisitions, focus on cost and cycle time 24/7/365 business) will effect demand for mail services.
- Mail volume will be facing severe pressures in key segments (e.g., bill payment and business correspondence).
- Speed and sources of change are multiplying.
- Market opportunities have a finite and shorter time horizon, creating a need for increased agility in markets and services. This also implies the ability to penetrate new and financially attractive markets and exit existing and unattractive ones.

Kodak

Kodak and Fuji are the principal film manufacturers in the U.S. market, with Kodak maintaining a share that is more than double Fuji's. Despite Kodak's relative dominance, Fuji has been a very tough and aggressive competitor over the years, causing Kodak to assiduously monitor Fuji's marketing policies and any incursions on its market share in preparation to respond immediately to any advances by Fuji. Using scanner data and customer surveys, Kodak has been able to identify means of competing directly with Fuji without inciting a price war for its near-commodity film products. Kodak introduced new products, like Kodak Fun Saver film, which was sold in bulk at prices below Fuji's, thus preserving Kodak Gold's price level and brand image. In addition, Kodak added channels, including large discount stores like Wal-Mart, as well as grocery stores, thus making its products available to a wider range of customers.

Customized Pricing for a Niche Market Segment

The Postal Service may identify a potentially lucrative distinct market segment and create a customized pricing for a mailer, or a set of mailers, serving it. Records have shown there are forty million addresses, which have not yet purchased items through the mail. Due to perceptions of low response rate, mailers have ignored this niche market segment. The Postal Service can work with mailers to develop prices that encourage them to enhance the effectiveness of their solicitation effort, eventually enticing them to target this market segment.

Strategic Implications

In light of this rapidly changing business environment, pricing would evolve into a quickly deployable tool. As a Commercial Government Enterprise, the Postal Service would no longer be limited by the break-even requirement that currently exists. Thus, the Postal Service would be allowed to increase its net income. The financial impact of this change should result in a gain in new volume/revenue that could be achieved through a more business-like pricing approach and other changes in the ability to serve customers directly. A lingering issue would be the degree that the Postal Service is constrained by previous precedent and political concerns. For example, could the Postal Service make appropriate service/price changes where costs exceed revenue in various segments, or, would they be compelled to limit businesslike changes because of statutory requirements or political concerns? It is possible that a future Postal Service might resemble a utility in some ways in that the goal of financial maximization is constrained by fairly tight regulation. Many of the fundamental financial design failures of the Postal Reorganization Act that have been documented could be solved by changing the Postal Service goal from break-even to further commercialization and earnings retention.

Another issue is that a reasonable net income assumes a stability of costs that would likely be inaccurate in the actual business climate in which the future Postal Service would operate. The Postal Service would make changes on a number of fronts. In some areas there might be dramatic cost decreases, while in other areas costs might go up as additional services were found to be necessary or desirable for customers. Therefore, the underlying costs might change in ways wholly unrelated to other costs, such as wage rates. Finally, it must be recognized that pricing in the future would start from the current pricing base, which is far from ideal from a business perspective. In some instances prices should be higher for various products and in other cases they should be much lower. As prices change, political pressure might be exerted that would diminish the advantages of more flexible pricing.

As a Commercial Government Enterprise, however, flexible and innovative pricing would be the prevailing paradigm of the organization. The Postal Service would develop and employ ancillary tools and data systems on costs, customers, and competition at the market segment and product level. Below are some of the pricing principles that would govern the new paradigm:

- Adopt value-based pricing to maximize value.
- Base strategy on market segments and products and not on postal rate classifications.
- Pricing strategy should accompany Postal Service products and services through their life cycles, from the introduction to the harvest phases.
- Develop all the necessary tools and data systems (on costs, customers, and competition) to support pricing.
- Develop and implement an internal transfer pricing mechanism to ensure that cross-functional products are optimally priced.
- Integrate information on costs, customers, and competition into a pricing strategy quickly.

- Pricing would be a tool that could be deployed quickly.
- Pricing would be an important signal in the marketplace. It would reflect customer perceptions of value.
- Pricing would be a signal of Postal Service competitive advantages.
- Pricing could be used as a promotional tool for new products—no other weapon in a marketer’s arsenal can boost sales more quickly or effectively than price.
- The infrastructure for deploying a variety of customized pricing arrangements would be implemented throughout the postal system. The current infrastructure presumes a uniform pricing change every couple of years. This would need to change.

Advertising Mail

Customized Pricing for a Niche Market Segment—Sophisticated Segmentation

Under this phase, the Postal Service identifies a potentially lucrative distinct market segment, and creates a customized pricing for a mailer, or a set of mailers, serving it. Records have shown there are forty million addresses, which have not yet purchased items through the mail. Due to perceptions of low response rate, mailers have ignored this “niche” market segment. The Postal Service can work with mailers to develop prices that encourage them to enhance the effectiveness of their solicitation effort, eventually enticing them to target this market segment.

Illustrative Examples

There are no limits to the kind of innovative pricing scenarios that could be utilized here. Here are some examples for illustration purposes:

- Pricing to optimize capacity
 - Develop a variable pricing system based on standard daily peak and nonpeak hours (i.e., charge a premium price during busiest time, and a discount during slow times) to help level workload.
- Competitive pricing
 - Provide new customers some incentive (a gift, limited free or discounted service) for customers who switch from a competitor’s service.
- Membership-based pricing
 - Charge a fee for noncustomers (those who have not paid for membership privileges), similar to an ATM fee structure.
 - Introduce corporate accounts as a standard option allowing major customers to pay monthly.
- Cost- and volume-base pricing
 - Develop prices based on the cost of goods/services sold (e.g., stamps sold on the Internet—a low cost channel—would have lower transaction costs than stamps sold in a post office.

- Mark-up prices by channel or location (e.g., like gas stations with price based on the willingness to pay of individuals in a geographic area). For example, post office boxes located in areas with vanity addresses (e.g., Beverly Hills) would be priced relatively higher.
- Other pricing innovation
 - Consider auction pricing for certain services, as well as excess capacity.
 - Utilize “complex” pricing to make price comparison difficult.
 - Allow various business units to offer “competing” products with differential pricing (e.g., one business unit may focus on premium customers, another on “average” customers—offering similar products with different pricing and positioning.)

Competitive Considerations

In the long term, while some portion of the postal monopoly is liable to remain, a significant portion of the Postal Service would operate as a commercial entity and would therefore be free to use some of the initiatives outlined above to serve specific competitive goals not feasible today:

- The Postal Service may elect to enter new lines of business where it perceives the potential to successfully serve an emerging market. If a cost advantage exists, the Postal Service would compete directly on price.
- Postal Service sales personnel would be free to negotiate with strategically important accounts and to offer price incentives (subject to management rather than regulatory controls) where it makes sound business sense.

Effective use of these capabilities depends on the operational and other changes outlined elsewhere in this report and on developing the market intelligence capabilities described above.

Customer Value Considerations

As mentioned above, customer perceptions of value become the primary consideration in pricing. In addition to determining prices, the dynamic interaction between the Postal Service and its customers influences a wide array of strategic and operating decisions, e.g., which markets to enter, whether operational changes are required to serve particular markets, and what wage rates are feasible for specific services.

Cost Coverage Considerations

In the current regulated world, prices are based on estimated costs plus a reasonable markup with a break-even requirement. In an essentially nonregulated world, prices would no longer be cost-based, but costs would still be very important. Very different cost data than those available now would be required. The Postal Service would need a cost system based on products, rather than subclasses. It would need data sliced in many new ways and the ability to quickly provide data as requested by those responsible for pricing.

Improvements and changes would be very important in using new pricing flexibility appropriately. Alternately, it would be very expensive, time consuming, and all but impossible to produce the necessary data accurately using the current costing systems. In the long term, the Postal Service must have a product-based costing system to provide data for business pricing decisions. For example, data broken out geographically, urban vs. rural, by mail shape, mail size, delivery distance, customer, and any number of other categories, would be required to support pricing decisions based on the competitive environment and the value to the customer. The Postal Service needs to know their costs based on market/customer segment, not classification category. Former UPS CEO Kent “Oz” Nelson said the most important benefit of focusing on customers “was learning what our true costs were”. He also suggested that the key to negotiating rates with customers is understanding what the costs are. Clearly, even where costs may bear little resemblance to the final prices charged, good cost data is a critical element in developing prices that maximize shareholder and organizational value. The Postal Service would not be able to take advantage fully of increased pricing flexibility unless good product cost data can be extracted.