

A Last Mile Strategy
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Should the Postal Service pursue a last mile strategy? A strategy that emphasizes delivery and deemphasizes the Postal Service's retail, processing, and transportation functions. The Postal Service's rate structure provides a very good reason for it to focus on a last mile strategy. Almost 80 percent of mail is workshared, and it receives discounts based on costs avoided in processing and transportation. Since there is virtually no overhead contribution associated with the implicit charges for upstream activities, almost all the overhead is generated by the delivery function. This is a consequence of the Efficient Component Price (ECP) method of setting worksharing discounts (i.e., discounts are set equal to the avoided USPS cost).

If we look at the most heavily workshared mail category, carrier route presorted and drop shipped at the delivery unit, there are virtually no upstream costs included in its rate. Essentially such mail is only being charged for delivery which includes the Postal Service's per piece overhead charge. Discounts for the remaining workshared mail categories are (with a few exceptions) based on avoided cost. So going backwards up the worksharing chain towards the mail categories that are the least workshared, we find that the implicit rates for the upstream functions include virtually no overhead contribution.

Discounts based on ECP allow the lowest cost provider (be it the Postal Service or the private sector) to perform that portion of the value chain where it is the lowest cost producer. This is good for society as a whole because it provides the lowest overall cost for end-to-end mail service. In economics it is known as "productive efficiency." Another politically significant feature of ECP pricing is that each piece in a subclass makes the same per piece contribution to overhead no matter how deeply presorted or drop shipped into the network. Thus, worksharing has no negative impact on overhead contribution.

Most presorting is done by sorting lists before the addresses are printed on mail pieces. Even when upstream processing is done by presort firms that use equipment similar to that used by the Postal Service, the Postal Service benefits when it is done at a lower cost than its own. Lower upstream costs induce mailers to increase volume, which ultimately goes through the delivery system. Thus, the Postal Service gets an increase in institutional cost contribution and net income.

Given its rate structure, a business strategy can be deduced from the fact that the large preponderance of the Postal Service's overhead is generated by the delivery function. In practice this means that the Postal Service should provide mailers with the maximum incentive to use its delivery system. It should keep upstream prices as low as possible by providing all reasonable worksharing incentives so that mailers can access the delivery system at the lowest possible cost.

A last mile strategy would mean that the Postal Service should provide worksharing discounts for dropshipping bulk First Class mail. This would benefit many bulk

First-Class mailers because the printing of their mail could be distributed around the country eliminating mail processing and transportation costs and delays. It would provide a greater incentive for First Class mailers to use the delivery system and research has shown that new worksharing discounts are highly stimulative to new volume.¹ Of course, drop ship discounts imply de-averaging bulk First Class rates according to distance, but this would affect only bulk mail senders and not single piece mailers. Standard mail was de-averaged in 1991 when dropship discounts were introduced. This was associated with a large expansion of Standard mail volume.

The strategy would also imply that the Postal Service should move towards 100 percent passthrough for all its worksharing discounts and thereby reduce upstream costs to the mailers. Again, this would maximize the incentive to use the delivery network. In some cases discounts are not set at 100 percent of avoided cost because these discounts are not defined well and lead to anomalous results. The Postal Service should reformulate discounts that are not strictly cost based such as Standard Mail dropship discounts that provide the same discount for a one-ounce and a three-ounce piece regardless of the difference in their transportation cost. As currently defined, some mailers get a discount larger than avoided cost and some get a discount smaller than avoided cost for the same worksharing activity.

The new Postal Accountability and Enhancement Act of 2006 may have given the Postal Service the opportunity to adjust worksharing discounts so that they no longer conform to ECP. Setting discounts that are *smaller* than ECP (avoided cost) adds small additional amounts of institutional cost contribution relative to the large amount included in the implicit price for delivery. It is, however, inconsistent with a last mile strategy because it increases upstream prices. Because price elasticities are low, setting discounts *greater* than ECP is in general irrational since it results in upstream activities losing money.

Looking at the Postal Service more broadly, the strategy would encourage contracting out upstream activities that can be done at a lower cost than in-house. It may be that savings and service improvements could be generated by contracting out significant portions of the ground transportation network in a way similar to the FedEx air transportation contract. There are presorters in almost every large city that would be prepared to sort single piece and bulk letter mail. This would be most attractive in cities where the Postal Service's processing productivity is comparatively low. Retail also deserves attention because much of this function could be contracted out. Selling some retail facilities and then contracting for retail services from the new owners could allow the full utilization of their commercial potential.

¹ Workshare discounts are larger than the cost to the mailer to workshare, otherwise mailers would not workshare. The mailer's end-to-end cost to mail is reduced by the difference between the discount and its cost to workshare. It would therefore be expected that volume would grow after a discount was introduced because of the mailer's own-price elasticity response. However, it was found that the volume response to new workshare discounts was larger than what could be expected from their own-price elasticity response. See "The Effects of Worksharing and Other Events on U.S. Postal Volumes and Revenues" by Edward S. Pearsall. (2005). *Regulatory and Economic Changes in the Postal and Delivery Sector*, edited by M.A. Crew and P.R. Kleindorfer. Boston: Kluwer Academic Publishers available at www.prc.gov.

Worksharing began as presorting in the 1970s and was a significant move in the direction of a last mile strategy because it allowed the bypass of some upstream activities. Over the years worksharing has been further developed so that it now encompasses almost all upstream activities. The result has made mail service in the U.S. a collaboration between the Postal Service, mailers, and third party providers. A rate structure was created around worksharing that put virtually all the institutional cost contribution of workshared mail in the implicit charge for the delivery function and the one thing the Postal Service reserves to itself is the delivery of mail to the mailbox. An explicit last mile strategy would simply be a continuation of the successful outsourcing strategy that began over thirty years ago.