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## The Technical Aspects of DOT's Role in Setting Intra-Alaska Mainline Mail Rates

### STATEMENT OF

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before the

Subcommittee on Federal Workforce, US Postal Service and the Census,  
Committee on Oversight and Government Reform,  
U.S. HOUSE OF REPRESENTATIVES

March 4, 2014

Chairman Farenthold, Ranking Member Lynch, and Members of the Subcommittee:

### Introduction

I appreciate the opportunity to appear before you to discuss the technical aspects of the Department's role in setting intra-Alaska mainline mail rates. The Department has performed this role for many years at the direction of Congress. For intra-Alaska mail rates, 49 U.S.C. Section 41901 requires the Department to:

"Prescribe and publish after notice and an opportunity for a hearing on the record, reasonable prices to be paid by the Postal Service for the transportation of mail, and the services related to the transportation of mail..."

The Department's role has nothing to do with the price that a shipper pays to the Postal Service for stamps. Rather, the Department's set the rates the Postal Service pays airlines to carry intra-Alaska mail, including "bypass" mail. In addition, the Department's role is limited to *intra*-Alaska mail rates; the Department plays no role with respect to mail that either begins or ends outside of Alaska.

### Overview of the Intra-Alaska Mail System

When Congress deregulated the airline industry in 1978, an exception was made for intra-Alaska mail rates. The mail system in Alaska comprises both what is considered "regular" mail and "bypass" mail. Regular mail in Alaska is treated the same as it is in the rest of the country, i.e., the shipper delivers the goods to the Postal Service, pays the postage, and the Postal Service takes possession of the shipment and ensures its delivery. Bypass mail, on the other hand, takes its name from the fact that the mail bypasses all physical

handling by the Postal Service. When a shipper wants mail to be transported to a destination, the shipper contacts the Postal Service and the Postal Service instructs the shipper to deliver the mail to a specific air carrier. Bypass mail is a subcategory of nonpriority mail. Approximately 85 percent of the nonpriority mail is bypass, and the remaining 15 percent is referred to as "in-house nonpriority." In-house mail is delivered directly to a Postal Service facility, which physically handles it and disburses the mail to a carrier.

While the focus of my testimony is on mainline mail carried on mainline aircraft, the Department also sets mail rates carried by bush aircraft, known as the bush rates. Mainline aircraft are defined as having a payload exceeding 7,500 pounds while bush aircraft payloads are 7,500 pounds or less.

The mainline mail rate comprises two elements -- the linehaul rate and the terminal rate. The linehaul rate varies with the distance that the airlines fly the mail and is expressed as dollars per revenue ton of mail, and the Postal Service pays the airlines on the basis of how many revenue ton miles of mail they carry.

The terminal rate relates to the cost of loading mail onto an aircraft, irrespective of distance, and is typically expressed in dollars per ton of mail enplaned. The Postal Service, in fact, pays the airlines on the basis of mail tons enplaned.

### Methodology

In establishing the current mail-rate structure, the Department conducted an exhaustive investigation to determine the actual costs incurred by airlines in carrying the mail. While Congress intended the system to promote an integrated passenger, freight, and mail system, the Department is tasked solely with determining the cost of moving the intra-Alaska mail, and setting the rates accordingly. The Department determined the cost drivers of carrying the mail, by way of a formal hearing in front of an Administrative Law Judge, which included exhibits submitted by stakeholders. The Department addressed myriad issues such as the directionality of mail, the fact that mail can displace cargo if the aircraft is full, debt/equity ratios and returns on both debt and equity, mark-up for income taxes, circuitry etc. At the end of the process, the Department issued an order setting what it still refers to as the "base rates."

Subsequently, the Department has updated the base rates in much the same way that other rates are indexed to the Consumer Price Index (CPI). Rather than using the CPI, the Department has used the changes in unit costs of Alaska mainline carriers to adjust the rates up or down. Specifically, for the linehaul rate, the Department compiles all the costs of the Alaska mainline carriers associated with flying the aircraft -- fuel, pilots, maintenance, lease costs, etc. -- and divide by total capacity, defined as available ton miles (ATMs), commonly referred to as the cost per ATM. The Department takes the result and compare it to the base year's results and weight each carrier's unit costs by the amount of intra-Alaska mail that each airline carries. In other words, if there are two carriers of the same size but one carries twice as much intra-Alaska mail as the other one, it would be weighted double.

The Department then derives an aggregate change in unit cost per ATM. Simply put, if the total cost per ATM increases two percent, the Department increase the linehaul rate by two percent. As a final adjustment, the Department recognizes that it is setting rates for a future period based on historical data. Therefore, the Department runs a regression to determine what the long-term (10-year) trend has been in unit costs and adjust the historical data accordingly to project the new rate at the midpoint of the future rate period.

This methodology includes measuring the change in unit costs of *all* traffic -- passengers, freight and mail. The underlying assumption is that, as the airlines' unit costs change due to newer, more fuel-efficient equipment, different labor contracts, insurance rates etc., those changes apply equally to passengers, mail and freight.

The Department follows the same methodology with the terminal rate by examining the total costs of loading traffic onto the airplanes and then divide by total tons enplaned.

The most recent refinement the Department made to the mail-rate system was the introduction of a fuel surcharge in 1999, primarily at the request of the carriers because, at that time, fuel prices were rapidly increasing. It is important to note that, even without the quarterly fuel updates, airlines would ultimately be made whole for the fuel price increases. However, with only *annual* updates and the lag in getting data, it would have taken a year or more for the carriers to recoup rapidly increasing fuel costs. The quarterly adjustments make the rates more responsive to actual fluctuations in costs.

In addition, the Department sets a separate priority and non-priority rate for the linehaul and terminal elements. These rates were established in our original base-rate investigation and they rise or fall together based on the changes in unit costs. Priority rates are significantly higher than nonpriority, and reflect the greater costs of carrying mail on a flight-specific, more time-definite basis; nonpriority rates are lower because they provide the carrier with more flexibility to determine when the mail will move, thus allowing the carrier to efficiently utilize aircraft payload and human resources.

Below is a chart showing all of the current mail rates set by the Department, both mainline and bush. All mainline bypass mail moves on a nonpriority basis.

[CHART NOT FOUND]

### **Statewide Class Rates**

The different mail rates in the classes above are calculated by the Department and applied by the Postal Service on a statewide basis. The Department uses the class rate concept to ensure that the carriers have incentives to control their costs. Under the class rate concept, a single class rate is developed for all of the members of that class of carriers. For mainline carriers the Department currently includes the costs of five carriers – Alaska Airlines, Era Aviation, Everts Air Cargo, a/k/a Tatonduk, Lynden Air Cargo, and Northern Air Cargo. If an airline's costs are above the average of the class, its profits are reduced. If an airline's costs are below the average of the class, then it enjoys additional profits.

### **Process**

Once a year, the Department issues a show-cause order fully laying out all our calculations and rationale for the rates that the Department is proposing. That order takes the publicly available Form 41 financial and T-100 traffic information provided by the carriers, calculates a "tentative" rate and directs the parties to show cause, within approximately two weeks why the Department should not make those rates final. Any party may comment on any aspect of the order or object to the show-cause order, raising any issue that it believes should be handled differently. Other parties then have an opportunity to respond to the comments submitted in the record by stakeholders. After considering all the comments, the Department then issues a final order establishing the new mail rates for a new year. Of course, if no parties object to the show-cause order, that order is simply made final.

The data supplied by the carriers – Form 41 and T-100 traffic -- are not special data, but are the same data that all large certificated carriers are required to provide. Thus, there is no additional reporting requirement on the carriers. As with all air carriers, the mainline carriers are required to certify that their data are true and accurate, and the data are periodically reviewed by Department staff.

### **Transparency**

The Department emphasizes transparency in the administration of the intra-Alaska mail rate system. The Department has sought to minimize the administrative costs of the program to the carriers and the Postal Service by using a fully public process in setting the mail rates, while also encouraging all parties to submit comments on the record. While any party can at any time request a full oral evidentiary hearing before an administrative law judge, no party has chosen to do so. The Department believes this reflects the fairness of the system, the accuracy of the rates, and the recognition of that fact by stakeholders.

### **Conclusion**

I hope that I have helped bring some clarity to the Departments' role in setting intra-Alaska mail rates.

Chairman Farenthold, this concludes my testimony. I would be happy to answer any questions you may have regarding the rate-setting methodology DOT uses in establishing intra-Alaska mail rates.

### **Witness**

Dennis J. Devany, Deputy Director, Office of Aviation Analysis, U.S. Department of Transportation

### **Testimony Date**

Tuesday, March 4, 2014

### **Testimony Mode**

FAA



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