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BEFORE THE
POSTAL REGULATORY COMMISSION

Rate Adjustment Due to Extraordinary or Exceptional Circumstances	:	**DOCKET NO. R2013-11**

INITIAL COMMENTS OF UNITED PARCEL SERVICE ON RENEWED EXIGENT REQUEST OF THE UNITED STATES POSTAL SERVICE (November 26, 2013)

Pursuant to Commission Order No. 1847 (September 30, 2013), United Parcel Service ("UPS") hereby comments on the Renewed Exigent Request of the United States Postal Service (September 26, 2013) ("Request").

The Postal Service seeks an increase in Market-Dominant Product rates above the statutory price cap. The above-cap increase would raise an additional $1.78 billion annually in institutional cost contribution from Market-Dominant Products. Request at 2, 10.

SUMMARY OF POSITION

UPS does not agree that the Postal Service's effort in this case to obtain $1.78 billion in additional contribution from Market-Dominant mailers is "reasonable and equitable and necessary." See 39 U.S.C. § 3622(d)(1)(E). The Postal Service cannot continue to rely on declining Market-Dominant Product volumes to bear the vast majority of institutional costs. That is an unsustainable business model which can only lead to continued postal deficits and more requests to exceed the rate cap, which in turn "could threaten the financial health and, possibly, even the survival of key [Market-Dominant] customer segments and industries." Statement of Altaf Taufique on Behalf of the United States Postal Service (September 26, 2013) ("Taufique Statement") at 2.

Mr. Nickerson states that because "Competitive [P]roducts' revenues are less than 20 percent of total revenues, the price increase [for Competitive Products] does not materially impact [the Postal Service's] liquidity or the analyses in this filing." Revised Statement of Stephen J. Nickerson on Behalf of the United States Postal Service (November 22, 2013) ("Revised Nickerson Statement") at 15-16. UPS takes issue with the notion that Competitive Products, a line of business which currently represents about one-fifth of total postal revenues and which is growing at an impressive rate -- a rate far greater than that at which the economy is growing -- cannot provide additional, much-needed relief to the Postal Service and Market-Dominant mailers.

To illustrate the potential impact an increase in Competitive Products' required contribution can have, in FY2012 alone Competitive Products generated over $525 million in revenue <u>above</u> their 5.5% contribution and the assumed Federal income tax, or 30% of the Postal Service's requested rate increase in this case. <u>See</u> FY2012 Annual Compliance Determination (March 28, 2013) ("FY2012 ACD") at 174. Yet, in Docket No. R2013-10 and this case combined, the Postal Service proposes a Market-Dominant average rate increase of more than 5.9% (Request at 7), while it proposes a Competitive Products average rate increase of only 2.4%, with no rate increase for Priority Mail overall (and even rate decreases), in Docket No. CP2014-5. See United States Postal Service Press Release No. 13-086 (November 13, 2013); 78 Fed. Reg. 69554 (November 20, 2013) ("Overall, Priority Mail prices will average a net zero percent price increase.")

The Postal Service seems to hope for legislative relief to solve its financial crisis. But that relief may not come. Even if it does, Congress may not address all of the fundamental realities of the postal industry that have led to the Postal Service's current situation.

The Postal Service and the Commission should take more permanent actions within their current statutory authority to help mitigate the present crisis, rather than expecting shrinking Market-Dominant volumes to continue to bear about 94% of institutional costs. Those actions include a wholesale review of cost attribution methods of the type currently underway in Docket No. RM2011-3, and a reconsideration of the allocation of institutional costs between Market-Dominant and Competitive Products. As Postal Service witness Taufique states,

> "We cannot afford to adopt a short-term perspective and take actions that will 'fix' a coverage problem by permanently driving [Market-Dominant] mail -- mail that we believe will become profitable as the Postal Service and the mailing community adjust to operational and marketplace realities . . . -- out of the system."

Taufique Statement at 6.

Before approving an above-cap increase on Market-Dominant mailers, the Commission should consider adjusting the allocation of total institutional costs between Market-Dominant and Competitive Products to decrease the institutional cost burden currently imposed on Market-Dominant Products. See 39 U.S.C. §§ 3622(b)(9), 3633(a)(3).

DISCUSSION

I. The Current Postal Business Model Is Broken: It Is No Longer Feasible to Rely Almost Exclusively on Market-Dominant Products to Pay Institutional Costs.

The postal business model "has historically assumed that increasing revenue from growing mail volume will cover the increasing costs of an ever expanding delivery network." Docket No. R2010-4, Statement of Stephen J. Masse on Behalf of the United States Postal Service (July 6, 2010) at 5-6. But Market-Dominant mail volumes are now declining, with the most profitable Market-Dominant volumes declining at an especially rapid pace. As Mr. Thress indicates, "From FY2010 to FY2012, . . . First-Class Mail volume declined at an average annual rate of 5.8 percent." Further Statement of Thomas E. Thress on Behalf of the United States Postal Service (September 26, 2013) at 7. And as Mr. Nickerson states, "[i]t is also extremely likely that mail volumes will continue to decline beyond FY2014. First-Class Mail volumes have decreased every year since 2001, and there is no reason to believe this trend will change." Revised Nickerson Statement at 11. Those volume decreases in Market-Dominant Products can only accelerate with rate increases above the cap. See Taufique Statement at 36 (recommending "a long-term view" that does "not attempt to fix the problems quickly, heedless of the consequences of sharp price changes" for Market-Dominant mailers).

Because First-Class Mail has traditionally generated the lion's share of the Postal Service's institutional cost contribution, its volume decline is especially damaging. First-Class Mail contributed $15.4 billion to institutional costs in FY2012, compared to $19.1 billion in FY2008 -- a 19% decline in just four years. FY2012 ACD at 80; FY2008 Annual Compliance Determination (March 30, 2009) ("FY2008 ACD") at 48. That has resulted in serious harm to the Postal Service. In part because of Market-Dominant volume declines, the Postal Service is incurring large operating deficits, it has reached its legally allowed borrowing capacity, and its cash flow has reached the point where it is in danger of not meeting its payroll costs. See Request at 13-14. All this has occurred despite impressive efforts by the Postal Service to reduce costs and improve productivity. See Request at 22-31.

As this proceeding shows, the status quo also harms those Market-Dominant mailers who, if this exigent request is granted, have little or no alternative to paying above-cap rates. These are the mailers Congress sought to protect when it adopted the rate cap. Other Market-Dominant mailers may be "permanently driv[en] . . . out of the system." Taufique Statement at 6.

In short, it is unsustainable for the Postal Service to continue to rely on shrinking Market-Dominant volumes to pay the vast majority of institutional costs. The Commission should require growing Competitive Product revenues to contribute a more equitable share.

II. Increased Contribution From Competitive Products Can Make a Meaningful Difference.

An increase in Competitive Products' required institutional cost allocation could, along with other factors, have a material impact on the Postal Service's fiscal health and especially on reducing the burden now shouldered, unsuccessfully, by Market-Dominant mailers. To illustrate that potential impact, Competitive Products are already earning enough revenue above their 5.5% institutional cost contribution level and the assumed Federal income tax ($525 million) to reduce the annual revenue sought from Market-Dominant mailers in this case by nearly 30%. See FY2012 ACD at 174.

Unlike Market-Dominant revenues, Competitive Products' revenues are growing at an unprecedented pace. Since PAEA took effect, Competitive Product revenues have grown by more than 40%, while Postal Service mail and services revenues as a whole have fallen by about 13%. See chart below. The following chart compares Competitive Products' strong revenue growth to the consistent declines in Market-Dominant revenues:

Market-Dominant and Competitive Revenue Year-to-Year Changes

Fiscal Year	Market-Dominant Revenue ($000)		Competitive Revenue ($000)	
2007	66,806,103	-	7,908,902	-
2008	66,447,433	-0.5%	8,381,705	6.0%
2009	59,911,648	-9.8%	8,132,417	-3.0%
2010	58,285,268	-2.7%	8,677,108	6.7%
2011	56,625,618	-2.8%	8,989,942	3.6%
2012	53,750,495	-5.1%	11,425,875	27.1%

FY2007-FY2012 ACDs at 24, 11-12, 29-30, 30-31, 31-32, 206-07, respectively. This trend has continued through the first three quarters of FY2013, during which

Competitive Products gained another 18.6% in total revenue over the same period in FY2012. See FY2013 Q3 Revenue, Pieces, and Weight Report (August 23, 2013), YTD Change FY2013 over FY2012.

Moreover, based on current costing and Competitive Products' current 5.5% institutional cost allocation, these increased Competitive Product revenues have led to increased Competitive Product "profits," i.e., Competitive Product revenues over and above attributable costs, the required 5.5% contribution to institutional costs, and the assumed tax. Those additional revenues have grown each year under PAEA:

Competitive Products' Income and Fund Balance, 2008-2012

Fiscal Year	Income After 5.5% Contribution	Assumed Federal Income Tax	Net Income After Contribution and Assumed Tax	Balance in Competitive Products Fund
2008	14,385,000	(4,935,000)	9,450,000	9,450,000
2009	368,228,000	(128,880,000)	239,348,000	248,798,000
2010	550,785,000	(192,775,000)	358,010,000	606,808,000
2011	691,131,000	(241,896,000)	449,235,000	1,056,043,000
2012	808,560,000	(282,996,000)	525,564,000	1,581,607,000

FY2012 ACD at 174. In FY2012 alone, Competitive Products generated well over $525 million in additional revenue after payment of their institutional cost contribution and the assumed tax.

There is every reason to believe that the growth in Competitive Products revenue will continue. As the Postal Service states in its Request in this case (at 32), "[t]he Postal Service's Five-Year Plan projects that revenue from [competitive] shipping and parcel products will increase by $4.8 billion from FY2012 to FY2017."

Much of the growth to date has come from the transfer of substantial volumes of formerly Market-Dominant mail to the Competitive Product list. As a result of those transfers, substantial additional revenues have also been transferred from the Market-Dominant to the Competitive side since the Commission set Competitive Products' appropriate share allocation at 5.5%. Yet, Market-Dominant Products' resulting 94% contribution allocation has remained the same, even though there is substantially less Market-Dominant volume to shoulder that contribution: fewer mailers are being asked to pay the same amount of contribution.

To make matters worse, because Competitive Products' required contribution is set at a fixed amount equal to 5.5% of each year's institutional costs, the revenues that the transferred volumes contributed to institutional costs when they were Market-Dominant Products no longer contribute toward meeting Market-Dominant mailers' institutional cost burden. Instead, that revenue goes into the Competitive Products Fund and may be used only to pay Competitive Products' attributable costs and "other" costs "to the extent allocable to competitive products." 39 U.S.C. § 2011(a)(2). Since PAEA was adopted, the Postal Service accumulated over $1.58 billion in the Competitive Products Fund before its questionable transfer of those funds to the Postal Service Fund as an alleged "pre-payment" of Competitive Products "future years' institutional costs." See FY2012 ACD at 174-75; Docket No. PI2013-1, Notice Establishing Docket Concerning the Competitive Products Fund (July 19, 2013) at 2-3.

The Commission has recognized that substantial transfers from the Market-Dominant Product list to the Competitive Product list should lead to an adjustment in the "appropriate share" allocation of institutional costs. See Docket No. RM2007-1, Order No. 26 (August 15, 2007) at ¶ 3061 ("The Commission anticipates that [the] need [to revise the appropriate share] may arise for any number of reasons, *e.g.,* additions or deletions to the competitive product list and market conditions.") But Competitive Products' appropriate share allocation remains at 5.5% despite the substantial volume and revenue transfers, while Market-Dominant Products must make up the lost contribution. It is no wonder that the smaller base of Market-Dominant mailers have been increasingly unable to keep pace with their contribution allocation.

The surge in Competitive Product revenues is not due solely to product transfers -- although the transfers alone are sufficient to require higher competitive contribution. As the Postal Service notes,

> "[t]his growth [in Competitive Product revenues] is very strong even when one excludes the impact of products that have been transferred to the competitive side: for the 'legacy' competitive products of Express Mail, Priority Mail, Parcel Select, and Parcel Return Service, revenue has grown by 14.1 percent from FY2010-FY2012. The largest competitive product in terms of revenue, Priority Mail, saw revenue growth of 9 percent in that time period . . . ."

Request at 32.

Competitive Products' share of total Postal Service revenue has risen from approximately 11% in FY2008 to over 18% in FY2012. FY2008 ACD at 11-12; Revised Nickerson Testimony, Attachment 16. Again, this trend is likely to continue, with Competitive Products expected to account for more than 20% of total postal revenue in FY2013 and over 23% in FY2014. Id.

Nevertheless, as the Commission has recently recognized, each year the Postal Service transfers only 5.5% of total institutional costs plus the assumed tax from the Competitive Products Fund to the Postal Service Fund, even though higher contribution shares have been reported. See Docket No. RM2012-3, Order No. 1449 (August 23, 2012) at 25-26. Because revenues in the Competitive Products Fund may be used only to pay Competitive Products' attributable costs and other costs "to the extent allocable to competitive products," 39 U.S.C. § 2011(a)(2), Competitive Products Fund revenues left after payment of the assumed tax may not be used to pay institutional costs that the Commission has not allocated to Competitive Products. Perhaps that is why the Postal Service characterized its recent $1.58 billion transfer from the Competitive Products Fund as a "prepayment" of "future" Competitive Products institutional costs rather than as an additional contribution to current institutional costs. See FY2012 ACD at 174-75.

The only way to ensure that additional competitive revenues provide additional contribution to institutional costs is to increase Competitive Products' required appropriate share allocation of institutional costs. Otherwise, Market-Dominant mailers must bear the remaining 94% institutional cost burden no matter how much additional revenue Competitive Products generate, whether all competitive revenue above attributable costs and the assumed tax is characterized as "contribution" or not. Under the current contribution approach, Market-Dominant mailers can benefit from Competitive Products revenue in excess of Competitive Products' 5.5% contribution and the assumed tax only if the Commission increases Competitive Products' required institutional cost contribution.

In FY2012 alone, Competitive Products generated more than $525 million above their attributable and institutional cost allocations and the assumed tax. FY2012 ACD at 174. When that additional revenue is compared to the annual contribution of $600 million expected from Market-Dominant mailers as a result of the rate increases within the rate cap recently announced by the Postal Service (Request at 15, fn. 24), the potential benefit to Market-Dominant mailers of increasing Competitive Products' required contribution is apparent. See Presiding Officer's Information Request No. 6 (November 6, 2013), Question 2 (inquiring about the contribution of Competitive Products) and Postal Service revised response thereto (November 18, 2013). Indeed, the $525 million added to the Competitive Products Fund in FY2012 alone is almost 30% of the annual additional contribution of $1.78 billion sought from Market-Dominant mailers in this case.

That, we submit, would be a "material impact" to the benefit of Market-Dominant mailers were the Commission to adopt the approach of reallocating institutional costs.

CONCLUSION

As the Postal Service notes, "[t]he modest increase in cash flow accomplished by the exigent price increase represents merely one, albeit important, step in alleviating the Postal Service's financial difficulties so that it can continue to provide effective and regular postal services, as it will allow the organization to pay down some of its debt in the short term." Revised Nickerson Statement at 12. Increased contribution from Competitive Products cannot by itself solve the Postal Service's dire financial situation. The Postal Service's continued losses and unsustainably low liquidity underscore the need to consider all opportunities to rationalize the Postal Service's costs. That includes the reexamination of attributable costs the Commission is conducting in Docket No. RM2011-3; any change in cost attribution necessarily affects the amount of institutional costs that Market-Dominant Products and Competitive Products must pay.

However, adjusting the relative shares of contribution required of Market-Dominant mailers and competitive mailers is a step that, along with other steps, can make a meaningful difference to the Postal Service and especially to Market-Dominant mailers.

UPS is aware that the questions before the Commission in this proceeding are relatively narrow. But that should not obscure an inescapable fact: continuing to ask Market-Dominant mailers to pay a share of institutional costs they have been unable to pay -- and will still be unable to pay even if the instant exigent rate increase is granted -- is a failed approach. UPS files these comments so that this underlying reality does not get overlooked in the haste to address the Postal Service's immediate request.

We urge the Commission to address the broader question of how best to reallocate institutional costs so as to make up for contribution losses due to declining Market-Dominant volumes.

Respectfully submitted,

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