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Comments of American Consumer Institute
Center for Citizen Research
Regarding Docket No. RM2017-3
Submitted to the Postal Regulatory Commission, February 23, 2018

Summary

The United States Postal Regulatory Commission's ("Commission") Notice of Proposed Rulemaking addresses the 10-year review of the system for regulating the rates and classes of market dominant products and services for the United States Postal Service ("USPS"), as specified in 39 U.S.C. 3622(d)(3) – namely, the Postal Accountability and Enhancement Act ("Act"). In its analysis, the Commission proposes a new price cap mechanism that permits rate increases in excess of inflation, as measured by the Consumer Price Index ("CPI").

Our analysis concludes that the commission does not have the legal authority under the Act to raise rates faster than the rate of inflation. The Act clearly sets an upper limit on price increases to the CPI and it considers only instances where rate increases may be lower than the CPI. The Act does not contemplate increases faster than the CPI.

In addition, the proposed price cap modifications would allow for rate increases to exceed inflation – essentially establishing a negative productivity offset. Those modifications would allow the USPS to decrease its operational efficiency in violation with the first objective of the Act – "to maximize incentives to reduce costs and increase efficiency" – thereby removing the USPS' incentives for increasing operational efficiency.

The financial problem facing the USPS is not due to the price cap mechanism; it is due to a failure within the USPS management itself. Because the USPS does not use a full cost accounting method, it is incented to engage in affiliate transactions abuses – including shifting revenues and profits from market dominant services to competitive services, as well as shifting costs and risk from competitive services to market dominant services. Our analysis shows that, by volume, the USPS' trucks likely delivery more competitive products than market dominant products. While doing this, competitive products contribute 8 cents for every dollar of revenue, while market dominant services contribute 58 cents for every dollar of revenue. This is clearly a misallocation of resources and demonstrates affiliate transactions abuses.

A full cost accounting system guided by strict affiliate transaction rules, would address these abuses as it has for many regulated industries in the past, including price capped

industries. In addition, a full cost allocation model that would provide management with the correct information to judge whether market dominant services need price increases or whether certain competitive services should be expanded or discontinued. Currently, USPS management does not have the correct information to make those decisions, nor does the Commission have the correct information to regulate and revise the current price cap mechanism as part of the 10-year review.

A full cost allocation method, full disclosure of financial information and contracts, and implementation of clear affiliated transactions rules would provide the USPS the right signals to "maximize" operational efficiency. That, in turn, would set the USPS on the right path for financial improvement.

Until these steps are taken, the Commission does not have the correct financial information it needs to regulate the USPS, nor does it have the financial information its needs to competently modify the existing price cap mechanism established by Congress. The Commission should immediately insist on this financial data.

About ACI

The American Consumer Institute Center for Citizen Research ("ACI") is a nonprofit (501c3) educational and research institute with the mission to identify, analyze and protect the interests of consumers in select policy and rulemaking proceedings related to information technology, health care, retail, insurance, energy, postal and other consumer issues.

Prior to becoming president of the ACI, Steve Pociask worked for a consultancy, Joel Popkin and Co., that specialized in postal issues and productivity measurements, among other things. During this time, he conducted and filed a total factor productitivity (TFP) study with the Federal Communications Commission ("FCC") on behalf of the United States Telecom Association in connection with its price cap proceeding.[1] Prior to this, he was chief economist at the Bell Atlantic Corporation, where he conducted over one hundred TFP and benchmarking (process improvement) studies.

The comments here are based, in part, on our knowledge and experiences with regulatory reform within various industries.[2] These comments will address how reforms can best meet the public interest objectives for a modern postal system.

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[1] For a sampling of presentations and papers on price caps prior to joining ACI, see the TFP results filed by Steve Pociask in "Reply Comments of the United States Telecom Association," FCC, CC Dockets 94-1 and 96-262, January 24, 2000; Steve Pociask, "Productivity and Pricing," U.S. Telecom Association, Annual Conference, Kansas City, MO, 1986; Steve Pociask, "San Diego Gas & Light Productivity Study: A Critique," Rutgers University Advanced Workshop in Regulation and Public Utility Economics, Monterey, CA, July 1988; and "Direct Testimony of Stephen B. Pociask on Price Caps Before the North Carolina Utilities Commission," Docket No. P-55, Sub 1013, July 16, 2002.

[2] While ACI is a member of the FCC's Consumer Advisory Committee and chairs one of its working groups, the comments here are ACI's alone.

The Current Price Cap System is Not the Problem

Originally referred to as *automatic revenue adjustment clauses*, price caps have been used to set rates of regulated industries as far back as 100 years.[3] The purpose of price cap mechanisms are twofold: 1) to simplify and make transparent rate changes, thereby reducing onerous regulatory surveillance typical in rate-of-return proceedings; and 2) to provide an incentive for increased operational efficiency. To that end, the Act clearly states that the price cap system will be predictable, transparent and less administrative, and it sets as its first objective to "maximize incentives to reduce costs and increase efficiency."

For a regulated firm, the price cap formula takes a generalized form, where the annual change in service rates is equal to the annual change in input prices minus the historical average in TFP growth. The historical annual average percent change in the firm's productivity is often referred to as the *X-Factor* or *productivity offset*. In the case of the USPS, the Act sets the productivity offset to be zero.

Price caps provide an incentive for increased productivity improvement, because it allows firms to keep any additional income earned when its actual TFP exceeds the established productivity offset. This income can either be taken as additional profit or reinvested, or it can create "headroom" by reserving a portion of the allowable price increase. The Act allows the USPS this option, effectively deferring a price increase. In effect, firms are incented to increase productivity beyond historical rates by benefiting from additional earnings.

In many instances, regulators will establish a higher productivity offset by adding a "stretch factor," which makes regulated firms share a portion of their additional earnings in terms of lower consumer rates.[4] This means that regulated firms with a 1% historical rate of TFP growth and a 0.5% stretch factor will have its offset set at 1.5%. If annual inflation, as measured by the CPI, increases by 2.0%, the regulated firm would be able to increase its rates by 0.5% (2.0% minus 1.5%). If it able to exceed its historical rate of TFP, it can increase its net income and keep the difference. In this way, the firm is incented to increase operational efficiency, benefiting both consumers and the regulated firm.

The USPS has historically measured its annual average TFP to increase by 1% or more. For example, one Office of Inspector General report showed the Postal Service to be averaging 1.3% per year in total factor productivity improvement since 2009.[5] Even without a stretch factor, the USPS price cap should have been set at CPI minus 1.3% per year or thereabouts, but it was set to zero. Effectively, the USPS was given all the opportunity it needed to increase

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[3] H. A. Latimer, "The Cost and Efficiency Revenue Adjustment Clause," *Public Utilities Fortnightly*, August 15, 1974; John W. Kendrick, "Efficiency Incentives and Cost Factors in Public Utility Automatic Revenue Adjustment Clauses," *The Bell Journal of Economics*, volume 6:1, 1975, P. 299-313.

[4] For telecommunications price cap models, U.S. and Canadian regulators often set a stretch factor at one-half percent and one percent, respectively.

[5] "Peeling the Onion: The Real Cost of Mail," United States Postal Services, Office of Inspector General, RARC-WP-16-009, April 18, 2016, Table I, p. 5.

operational efficiency, build reserves, payoff prefunding of retiree benefits, and stand on very stable financial footing going forward. Yet, it failed to do so.

In summary, the price cap mechanism provides an incentive for regulated firms to increase their operational efficiency beyond historical levels. This advantage was clearly the intent in the Act.

The Commission's Proposed Negative Productivity Offset Would Eliminate Efficiency and Cost Reduction Incentives

In terms of modifying the price cap, the Act does not contemplate a price cap system to permit price increases faster than inflation. It specifically sets the percent change in CPI increase as a limit for an increase in postal rates. The Act also makes clear that the USPS can reserve a portion of its unused rate adjustment (as headroom), meaning that it can increase rates by less, but not more than the CPI.

The Act does specify that the Commission can make modifications to the system "as necessary to achieve the objectives in subsection (b)." However, under the Commission's proposal, the Postal Service would be allowed to raise rates 2.0% or 3.0% on top of the rate of inflation for each year over the next five years. This means that the productivity offset would become negative. In other words, the USPS could reduce its operational efficiency each year and still increase earnings.

To be clear, if the Commission chooses to allow the USPS ability to raise prices faster than inflation, it is completely eliminating the incentive to reduce costs and increase efficiency. Setting a negative offset would indisputably mean that the Commission has modified the system in a manner that does not meet the first objective outlined in the Act – "to maximize incentives to reduce costs and increase efficiency."

To summarize, the Commission should not "build-in" inefficiency into the price cap system. Our finding is that the Commission does not have the authority to modify or design a system in a way that violates the objective of the Act and thwarts the incentives to increase operational efficiency.

On What Problem Should the Commission be Focused?

If the problem does not rest on the current price cap mechanism or formula, as the previous section demonstrates, what is the problem to be fixed? Answering that question requires looking more closely at the financial reporting and results of the USPS.

On February 9, 2018, the USPS announced that it sustained $540 million in losses for the first fiscal quarter. These losses have resulted without making any payments toward prefunding retiree health benefits, and this follows $2.7 billion in losses during 2017. With the previous 4 years of losses exceeding $5 billion per year, the USPS has seen more than $65

billion in losses over the last decade, while continuing to miss quality of service targets year after year.

The USPS has a core mission to deliver letter mail and is granted a monopoly in return for ubiquitously serving the nation. The irony, however, is that letter mail services are generally profitable. According to the Annual Compliance Review, First Class domestic mail collects $2.16 in revenue for every dollar in attributable costs.[6]

While some of its other market dominant services may be losing money or facing lower margins, not much can be definitively said about the USPS' competitive services, because reporting details on these services are scant, compared to market dominant services. This is the problem that the Commission needs to investigate.

Gross Inequity: 8 Cents vs. 58 Cents Contribution to Fixed Costs

Competitive services account for 30% of the USPS' revenue, but these services are only required to cover only 5.5% of fixed and institutional overheads. In terms of sharing these overheads, competitive services pay 8 cents on every dollar of revenue toward these fixed overheads, or $1.7 billion divided by $20.7 billion.[7] On the other hand, market dominant services pay 58 cents on every dollar of revenue, or about $29 billion divided by $50 billion.[8] To emphasize, market dominant services pay 58 cents per dollar of revenue toward fixed and institutional costs, while competitive services pay only 8 cents per dollar of revenue.

This divergence represents a gross inequity and an excess burden placed on market dominant services for the financial benefit of non-mission services. This also suggests a high degree of revenue shifting and profit shifting from market dominant services to competitive services. It also suggests a high degree of risk shifting and cost shifting from competitive services facing market rivalry to monopoly services now subject to financial collapse.

If the mission of the USPS is to deliver letter mail, why should it be carrying an additional cost burden for the benefit of competitive services? The only rational reason to allow the USPS to offer competitive services in the first place is so that it can carry an *equal or larger share of overheads for the benefit of its monopoly services*. In other words, the objective of the Commission should be to protect market dominant services, not competitive services. To do otherwise undermines the mission of the Postal Service and violates the intent of the Act.

If the USPS were required to stop providing all of its competitive services, while continuing its provision of monopoly services, consumers could still buy these competitive services from other rivals. If the USPS stopped writing money orders, existing financial

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[6] "United States Postal Service: FY 2017 Annual Compliance Report," USPS, Docket No. ACR2017, submitted December 29, 2017, p. 8.

[7] See USPS-FY17-1, where the numerator is $1.698 billion (at p. 73) and the denominator is $20.689 billion (at p. 68).

[8] The numerator is $30.872 billion times the 94.5% institutional cost share (See USPS-FY17-1, p. 73) and, by adding up service categories, the denominator is approximately $50 billion in revenue.

institutions would still provide them; if the USPS stopped delivering food, Giant's Peapod, Instacart and Fresh Direct could still provide them; if USPS stopped package delivery, others would deliver these packages, including FedEx, DHL and UPS; and if USPS stopped same day delivery, small business couriers could still deliver them.

On the other hand, there are no substitutes for market dominant services, and this fact serves as the prime reason that the Commission must protect these services and not expose them any financial manipulations that serve to prop up competitive services.

In fact, not only should competitive services pay a full share for fixed and institutional costs, they should pay more. For example, a service like Sunday delivery should pay its fair share of overheads plus additional overheads because many other dominant service activities are idle on Sunday. Most importantly, competitive services should pay more because these services are only possible because of the existence of the USPS letter mail services.

In addition, these competitive services use the USPS logo and brand, its website, its employees, its trucks and so on – all of which are inextricably tied to its fixed costs. These competitive activities are receiving a financial benefit that a structurally separate entity would not receive.

One frequent argument supporting why package delivery should not pick up as much fixed cost is that these packages help fill a mail truck to its capacity, thereby increasing efficiency. However, many mail trucks hold only or mostly competitive products and services. In fact, packages now account for 45% of USPS' weight for delivered products and likely more than half the volume of a mail delivery truck, compared to market dominant services.[9] Moreover, the USPS is currently shopping for delivery trucks specifically designed for package delivery at a cost of $6.3 billion over the next seven years.[10] It would seem that competitive services should share the brunt of these costs, not market dominant services, like First Class Mail.

This also means that the USPS is buying more fixed costs, and more trucks and equipment, and then shifting these fixed costs to market dominant services for cost recovery. This freeloading of market dominant resources does not make the USPS more efficient, nor does it make the USPS more financially stable – but just the opposite.

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[9] During the first quarter of 2018 the total weight of First Class, Standard, Periodicals, Package Services, USPS and Free Mail equaled 3,755,826,000 pounds, while Competitive Mail equaled 3,073,009,000 pounds. See "Revenue, Pieces & Weight (RPW) Quarter 1 FY 2018," Tables 1-4, at http://about.usps.com/who-we-are/financials/revenue-pieces-weight-reports/fy2018-q1.pdf, downloaded on February 21, 2018.

[10] Some news reports indicate that the USPS is seeking to replace as many as 180,000 of its delivery trucks. These trucks are expected to be adapted to serve its growing competitive package business. These trucks, reportedly, would allow a six-foot-five USPS employee to stand in the vehicle. See Jim Parker, "Five vehicles in running for 'next generation' mail carrier," January 13, 2018, at https://www.postandcourier.com/automotive/five-vehicles-in-running-for-next-generation-mail-carrier/article_2d07aef6-ef66-11e7-8065-5f02f7455e43.html; and Craig Guillot, "The Trucks Competing to Be the Next USPS Delivery Vehicle, Third Prototype Spotted," Trucks.Com International, November 6, 2017, https://www.trucks.com/2017/11/06/trucks-compete-next-usps-delivery-vehicle/.

A competently managed competitive firm should want to know its total costs for providing all of its products and services. How else could a firm know where to increase prices and what competitive services need to be discontinued or expanded?

For this Commission, knowing the full cost of service is essential to protecting regulated mail services and preventing a practice of shifting revenues, costs, risks and profits between market dominant and competitive services. Until there is full disclosure and transparency, as well as a full allocation of costs, the problems that the USPS faces cannot be fixed.

Moreover, increasing market dominant prices is clearly not the answer, since it is not known if these services are covering costs or not. Therefore, as far as market dominant services are concerned, none of current data provided to the Commission on its service revenue and cost are accurate, because they do not properly allocate these costs. This means that this financial data is insufficient to be actionable by competent management and certainly by this Commission in its 10-year review, as addressed in this NPRM.

The price cap mechanism has not failed, the USPS management has. A solution that requires full transparency and full cost allocation, even if just based on a one-time study, is needed before altering the current price cap mechanism. Until then, we cannot establish which services are profitable and which are not. The current allocation of costs is not suitable for decision-making. A first step is to establish safeguards for all affiliate transactions, as has been done for other regulated industries.

Potential for Affiliate Transaction Abuse

The USPS has been lobbying for the ability to increase its prices on dominant services, and the Commission proposes this option. While some of the USPS competitive services are low-profit and unprofitable, as noted, its regulated core First-Class Mail Services are its profit engine, bringing in more than twice the revenue compared to its delivery costs. Because the proposed price increases would be applied to some of the most profitable services, there is a growing belief that the USPS is diverting revenue and profits from its regulated services to fund and support forays into competitive services. Without knowing the cost of services by product, these competitive services could be low margin or no margin businesses. Without full cost accounting, we cannot know the real profitability of any of these services – market dominant or competitive.

If the USPS is shifts revenues and profits, it is throwing away good money for bad; it is turning its back on its core mission – letter delivery. The Postal Service claims that, by law, competitive products and services cover their costs. However, the meager requirements to be transparent about market-dominant products, leaves a wealth of competitive ventures susceptible to the Postal Service's creative accounting measures and anachronistic stipulations. Doing so ultimately produces misrepresentations about the Postal Service's finances, and the Commission is potentially being duped.

The postal service also has many exclusive sweetheart deals that likely lose a lot of money, but the terms and prices of these deals are never made public. Each new income statement from the Postal Service detailing billions of dollars of losses is just a reminder that some form of below cost pricing must be occurring somewhere. This means that market dominant products are implicitly picking up the tab for competitive ones. It also means that consumers are paying too much for their regulated services, the same services that the Postal Service wants to increase its consumer prices.

Fixing the Postal Service's financial challenges first begins by resolving the agency's contempt for transparency. Obtaining more information about business dealings and costs for sustaining all services will give the USPS management and Commission the best chance to make operational fixes, including ceasing services that add to their skyrocketing debt. This will potentially require the establishment of strict affiliated transactions controls.

"Competitive Entities Must Pay the Higher of Either the Prevailing Market Price or Fully Allocated Price"

The USPS should be directed by the Commission to develop better financial measures that fully allocate costs. Full costing will drive the correct behavior for management and prohibit the transfer of support from market dominant services to competitive ones. The Act specifies that all costs – direct, indirect and "a portion of other costs" – be allocated. This requires that costs be properly allocated to nondominant services, to avoid cost shifting, risk shifting and anticompetitive behaviors, including cross-subsidization between dominant and competitive services. This also would require costs to be fully allocated to each service, product and asset.[11]

Costs need to be fully traceable, documented and consistent with a uniform system of accounts. This may require regulations to treat the competitive and market dominant services as separate entities or line-of-business. If comprehensive affiliated transaction rules cannot be implemented, then the only other option is to structurally separate the USPS' dominant services from its competitive services, if consumer protection is important.

There is long history on the proper treatment of transactions between regulated public utilities and its nonregulated affiliates.[12] Specifically, a service provided by an unregulated entity to a regulated entity must be priced at the <u>lower</u> of either the prevailing market price or fully allocated costs; and a service provided by the regulated entity to an unregulated entity must be provided at the <u>higher</u> of either the prevailing market price or fully allocated costs.[13]

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[11] This may require analyses of actual time, time and motion studies, and space used in buildings and delivery trucks.

[12] A good example is the Telecommunications Act of 1996, which directs the states to establish rules for "protection against abusive affiliated transactions." See Telecommunications Act of 1996, Pub. LA. No. 104-104, 110 Stat. 56, 1996.

[13] For some examples, see "An investigation of the Need for Affiliate Transaction Rules and Cost Allocation Requirement for all Jurisdictional Utilities," Before the Public Service Commission, Commonwealth of Kentucky, Case No. 369, September 3, 1998; "Affiliate Transactions Price Guideline for Transactions between Verizon

These affiliate transaction rules would allow competitive services to subsidize monopoly services, but not the other way around. If the USPS is shifting competitive service costs to market dominant services, then the Commission needs to use its authority to end this financial manipulation.

Affiliate transactions rules, as noted above, are precisely how price capped regulated incumbent local exchange carriers (traditional telephone companies) were originally required handle affiliate transactions, as required by the FCC and state public service commissions. These regulations were necessary to prevent telephone rate payers from cross-subsidizing nonregulated services. These rules are now necessary to prevent the USPS from shifting revenues and profits from regulated services to unregulated ones, and from shifting risks and costs from unregulated services to regulated ones.

Market dominant services do not exist for the purpose of propping up competitive services. The economic argument that some business operations only need to cover their variable costs to stay in business is only true in the short run. After 10 years, the Commission should have the data it needs properly evaluate the profitability of all of the USPS' services and potentially exit these competitive services if they are not profitable.

To summarize, in order to prevent shifting of revenues, costs, profits and risk, as well as prevent anticompetitive cross-subsidies, USPS' competitive services should pay the highest price of either: 1) the fully allocated price; or 2) prevailing market price. Later, as time and motion studies are developed, these rules can be fine-tuned.

Maximizing Operational Efficiency

As the Commission conducts its 10-year review of the system for regulating the rates and classes of market dominant services for the USPS in accordance with the Act, the Commission should establish strict affiliated interest restrictions between regulated and unregulated services, and full cost accounting. These changes by the Commission would provide the right information for it to regulate the USPS, but it will also provide USPS management the right signals to operate efficiently and more like a profit-seeking firm.

In addition, the USPS should give the Commission a strategic plan that details its path to becoming more operationally efficient. This plan may propose closures of post offices, cuts in daily delivery, reductions in force, and ending services that do not recover fully allocated costs. Once it knows the actual profitability of its services – both competitive and market dominant – it can identify services that need price increases, and others that need expanding or cutting.

To execute this plan, the USPS needs to be given the tools necessary to cut costs, streamline operations, and reorganize its workforce, where possible. In the end, the USPS

Incumbent Local Exchange Carriers and Verizon Non-Regulated Affiliates," January 17, 2002, at http://docs.cpuc.ca.gov/word_pdf/FINAL_DECISION/19734.pdf; and for a federal example, see "Cross-subsidization Restrictions on Affiliate Transactions," United States Federal Energy Regulatory Commission, Docket No. RM07-15-000, Order No. 707, final order issued February 21, 2008.

should operate like a profit-maximizing firm. The plan should include provisions that give management incentives or put pay at risk, including bonuses, if and when the USPS achieves improved financial and quality of service. This may require wholesale changes to management that will bring in the talent necessary to carry out its strategic plan, including a restructuring of the current calcified hierarchy within the USPS.

The plan should also consider process improvement benchmarking studies that will lead to radical changes in functions, processes and performance, not just incremental improvement. We fully support the Commission giving the USPS the tools it needs to reduce its costs and return it to financial stability.

These changes, if executed properly, will give the USPS the tools to affect change and be fully incented to maximize its operational performance, as required by the Act and within the existing price cap mechanism.

Summary of ACI's Analysis

The current price cap mechanism should not be altered. Allowing for rates to increase faster than inflation amounts to a negative productivity offset, which eliminates incentives to reduce costs and undermines the first goal of the Act. The price cap mechanism has not failed; the USPS has failed. It has failed because it cannot properly evaluate the profitability for its lines of business. This deficiency invites cost, revenue, profit and risk shifting, effectively subjecting its dominant market services to prop up competitive activities.

If competitive services are permitted to chip in only 8 cents for every dollar of revenue while market dominant services must set aside 58 cents for every dollar of revenue, regulated resources are being misallocated. That is harmful to the public interest. If the volume of delivered competitive services nearly matches or exceeds the volume of delivered market dominant services, a 5.5% cost coverage requirement is not only unfair but constitutes regulatory malpractice. The Commission needs to step in and rectify this problem.

The USPS needs to set up a transparent financial system that tracks dollars used for affiliate transactions, including full cost accounting. When this is done, it can determine which services need price increases, and which services need to be weeded out. This also requires the USPS to get competent upper management to cut costs and make radical improvements to its quality of service.

Better financial information would be valuable for management and regulators, thereby permitting each USPS product to be evaluated in a similar fashion. Even if the USPS' management does not want this information, the Commission should insist on it.

To summarize, the financial data provided by the USPS regarding its revenues and costs by product are erroneous and insufficient for proper regulatory oversight. The incomplete release of competitive financial data, hidden contracts and failure to allocate full costs encourages profit, cost and revenue shifting; it does not encourage the maximizing the productivity of market dominant products.

Therefore, the data used in the 10-year review of the system for regulating the rates and classes of market dominant products for the United States Postal Service, as noted in this NPRM, are erroneous. Until a full cost accounting is used to prevent affiliate transactions abuse, the Commission's proposals to modify the system for regulating rates are grossly premature. Failure to address the concerns raised in these comments will put consumers and taxpayers at considerable risk.

In closing, we strongly urge the Commission to act in the public's interest, protect the consumers of market dominant products and services, impose strict affiliated transactions rules, and demand detailed financial data that fully reflect the allocated costs of operating the USPS, so that the Commission can properly conduct the 10-year review.

Respectfully submitted,

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