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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

STATUTORY REVIEW OF THE SYSTEM	)	
FOR REGULATING RATES AND CLASSES	)	Docket No. RM2017-3
FOR MARKET DOMINANT PRODUCTS	)	

REPLY COMMENTS OF ALLIANCE OF NONPROFIT MAILERS, AMERICAN CATALOG MAILERS ASSOCIATION, INC., ASSOCIATION FOR POSTAL COMMERCE, DATA & MARKETING ASSOCIATION, IDEALLIANCE, AND MPA—THE ASSOCIATION OF MAGAZINE MEDIA

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SUMMARY

The initial comments in this proceeding confirm several facts.

First, all parties agree that the Commission's proposal cannot stand. The proposal is fundamentally arbitrary: as USPS, the Public Representative, labor, and the mailers all point out, the existing record cannot support a finding that the proposed above-CPI increases proposed by the Commission would solve the problems with the current system identified in Order No. 4257. Even the comments that advocate steeper price increases than proposed in Order No. 4258 underscore the basic flaws in the Commission's approach.

Second, while some commenters have suggested alternative approaches that would balance the Objectives of PAEA better than would the Commission's proposal, adoption of *any* particular proposal at this time—especially one that would differ radically from the Commission's—would be unlawful. The record is insufficiently developed to support alternative proposals, and the thirty day period for reply comments is insufficient for the public to analyze adequately every proposal embedded in the nearly 200 initial comments submitted in this phase of the case. Accordingly, the Commission has only one option now: withdraw the proposed rules, specifically the proposals to provide the Postal Service with pricing authority above CPI.

Third, even if the Commission remains convinced that it must adopt *some* alternative system, the existing record cannot support the system proposed in Order No. 4258. Developing a system that improves on the current system, better meets and balances each of the objectives of PAEA, and complies with the statutory requirements of PAEA will require further study and a

collaborative process. Importantly, the Commission must do more work to understand the likely effect of alternative systems on volume. This analysis can best be undertaken through off-the-record technical conferences where mailers can share internal data confidentially with Commission staff. Fortunately, the Commission has time to conduct this review. The Commission itself has found that the Postal Service is not in danger of failing to deliver the mail tomorrow or in the foreseeable future. Order No. 4257 at 159-65.

Fourth, the introduction of S. 2629, the Postal Service Reform Act of 2018, a bipartisan bill introduced on March 22, 2018, is another reason not to take precipitous action in this docket. The bill represents the kind of balanced solution that only Congress can enact. The bill, while restoring half of the exigent surcharge, would also reform the funding of Postal Service retiree health benefits; formally relieve the Postal Service of the unrealistically accelerated prefunding requirements; and integrate the Postal Service's retiree health benefit system with Medicare. Moreover, the bill, while authorizing the Commission to impose above-CPI increases on "underwater" products in certain circumstances, would require that the Commission first "determine whether any operational decisions of the Postal Service have caused any direct or indirect costs to be inappropriately attributed to any underwater product"; "quantify the impact of any such operational decision"; and net out any costs so inflated or inappropriately attributed before imposing any surcharge on "underwater" products; among other requirements. S. 2629, §§ 207(c)(2), (3).

Except for the study of underwater products required by Section 207 of the bill, the Commission has no power to take any of these steps. The Commission's proposal, unlike the above-CPI rate increase included in the bill, would be a stand-alone fix. It would not be part of a comprehensive package, carrying at least the promise of treating the underlying causes of the Postal Service's difficulties. The Commission's proposal would simply raise rates, leaving the Postal Service's needlessly high costs undisturbed.

In the absence of any short-term crisis, the most prudent course for the Commission is to proceed in a more deliberate fashion in parallel with legislative consideration of the Senate bill and its House counterpart. For all of these reasons, the Commission should withdraw its proposed rules, convene technical conferences and engage in further study, then propound revised proposals that better reflect the objectives of PAEA and the market conditions mailers and the Postal Service face.

We discuss each of these issues in more detail below. We also explain why adopting the Postal Service's proposals would effectively and illegally deregulate the Postal Service, an outcome prohibited by the PAEA and federal court precedent. Additionally, we comment on several of the proposals offered by other parties, including the suggestion of National Associations of Letter Carriers to replace the current CPI-U price cap with one tied to the CPI-Delivery Services ("CPI-DS") index. Finally, we encourage the Commission to move forward with revisions to the rules governing workshare discounts to require the Postal Service to pass through as nearly as possible 100 percent of the costs avoided when the private sector performs presorting, preparation, and dropship activities.

COMMENTS

I. THE INITIAL COMMENTS CONFIRM THAT THE PROPOSED ABOVE-CPI RATE INCREASES ARE FUNDAMENTALLY ARBITRARY.

Despite the commenters' disparate conceptions of an ideal ratemaking system, the most striking feature of the initial comments is their near unanimity that the proposals offered in Order No. 4258 would not comply with PAEA, are not a reasoned solution to the problems found by the Commission in Order Nos. 4257, and would not withstand judicial review.

A. The Commission Has Failed to Establish a Logical Nexus Between Its Proposed Additional Rate Authority and The Revenue Needs It Has Identified.

The Commission's proposal cannot withstand appellate review because there is no principled basis for the additional rate increases that the Commission would allow the Postal Service to impose on captive mailers. As the Public Representative correctly notes, there is a "fundamental lack of any analytical framework that utilizes economic principles to support the Commission's determination to modify the price cap with a 2 percent annual supplemental rate authority." Public Representative at 15. "[P]rice cap adjustments should be based upon guiding principles of price caps," *id.*, and in general, the PRC must look to established economic theory to justify its proposals.

In the present case, the question is moot: Congress prohibited the Commission from allowing the Postal Service to raise the average rates for any market-dominant class faster than the annual change in CPI-U. 39 U.S.C. § 3622(d); ANM *et al.* at 9-29; NPPC at 19-41; American Bankers Ass'n at 4-6. But even if Congress had authorized the Commission to allow the Postal Service to raise market-dominant rates faster than the CPI, the Commission would have to exercise this authority in a reasonable manner. The Commission would, at a minimum, need to make some showing that the additional rate increase authority would solve the deficiencies that Order Nos. 4257 and 4258 profess to find in the current ratemaking system. In particular, the Commission would need to show that additional rate increases would provide the Postal Service with the revenue it claims is necessary to return the Postal Service to financial stability. But neither the Commission nor the parties who seek even bigger increases than the Commission proposes have made such a showing.

As the Public Representative points out, the Commission has made "no demonstration that the increase of 2 percent per year is more reasonable than 3 percent, or any other number that is likely to increase revenues." Public Representative at 18. The Commission has provided "no calculation in either text or by library reference" to support its claim that five years of 2 percent above CPI increases are equivalent to a one-time 5.7 percent increase, which the Commission claims would recover the $2.7 billion in FY 2017 losses when coupled with 4 additional years of CPI increases. *Id.* Hence, as the Public Representative's witnesses observe, "the ad hoc 2 percent annual price relief is mathematically unrelated to the underlying nature of the problem" identified by the Commission. *Id.*

The above-CPI rate increases proposed by the Postal Service and its allies suffer from the same defect. They are also unsupported by any showing that *those* increases would cure the revenue shortfalls that the same parties contend must be bridged for the Postal Service to achieve long-run financial stability.

This failure of proof is underscored by comparing the Postal Service's analysis of Objective 5 with the Postal Service's analyses of other objectives and issues. For Objective 3 (high quality of service), the Postal Service proposes a reasonable four-step approach to determine whether the current system of regulation adequately furthers the objective. The Postal Service correctly observes that the Commission's assessment of the current system and the proposed surcharge of 0.25 percent was flawed by skipping steps 3 ("is that because of the ratemaking system's 'design'?") and 4 ("what is the design flaw, and how should it be fixed?"). *See* USPS at 27, 31-32. As the Postal Service explains, "objective 3 requires a determination not only that 'high quality' service standards were not 'maintained,' but that that failing is due to a flaw in the design of the system." *Id.* at 31. *See also* ANM *et al.* at 82-84.

But the Postal Service fails to apply the same analysis to Objective 5 (financial stability). While the USPS more or less correctly identifies some of the causes of its financial problems,[1] it does not answer these same questions—

[1] *See* USPS Comments at 26-27 (identifying these causes as the Universal Service Obligation, collective bargaining and arbitration processes that limit

are these issues caused by the design of the ratemaking system, what is the design flaw, and how can the flaw be fixed? In fact, it declines to even ask them. The current system did not create the prefunding requirements, cause the trend of declining volumes, establish the collective bargaining process, or define the USO. Apart from declining volumes (an overstated concern, as we have explained), these are all Congressional problems. It is fruitless to attempt to resolve them by modifying the ratemaking system—the obligations will remain regardless of the system put in place. Yet this analysis does not factor into the Postal Service's assessment of the Commission's findings regarding financial stability at all.

Similarly, the Postal Service argues that, because the noncompensatory character of Inbound Letter Post "cannot be fixed by the regulatory system, Inbound Letter Post should be excluded from the system." USPS at 155. Yet for the retiree prefunding benefit obligations, which are likewise beyond the control of the regulatory system, the Postal Service argues that they must be *included* in the scope of the regulatory system by awarding the Postal Service additional pricing authority to meet these exogenous costs. USPS at 14-16.

The failure to prove a causal link between the regulatory system and the Postal Service's alleged revenue inadequacy is fatal to all of the proposals in this docket for above-CPI rate increases. Even if (contrary to fact) Section 3626(d)(1) permitted the Commission to approve above-CPI rate increases *and* the record showed that the Postal Service genuinely needed more money, "the

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labor cost reduction potential, retiree benefit payment obligations, and volume decline).

Commission [would] still [need to] provide adequate justification for its choice of a particular increment" above the cap; a mere "general assertion that [the Commission] could not find that the [Postal Service] had achieved revenue adequacy" would be insufficient. *Cf. San Antonio, Texas v. United States*, 631 F.2d 831, 852 (D.C. Cir. 1980) (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968)) (quoted in ANM *et al.* at 79). A "general allusion to the need to consider the revenue requirements of the" Postal Service "is so broad as to be meaningless as a standard—this rationale could be put forth just as readily in an attempt to justify a 1%, 21%, 45%, or even a 99% additive." *Id.*

B. The proponents of above-CPI rate increases ignore the risk that they will cause a large enough decline in volume to be self-defeating.

Compounding this irrationality, the Commission and the commenters who propose to allow above-CPI rate increases have failed to account for the volume declines the above-CPI increases would cause. ANM *et al.* detailed these likely effects in their initial comments, and the initial comments of other parties confirm these effects. Price increases of the magnitude the Commission has proposed could be devastating to mail volume, accelerating the pace of decline and permanently driving mail from the system. If volume leaves at this rate, there will be no "harmonious cycle." There will be no recovery of past losses. There will be no additional revenue available to meet prefunding requirements. There will instead be exponentially growing losses. Because the Commission has failed to weigh the negative volume effects of the proposed above-CPI rate increases against the projected increase in unit revenue, adoption of the proposals would be arbitrary and capricious. ANM *et al.* at 79-82.

The risk of radically negative volume effects is underscored by the mass of industry comments from associations, individual marketers, mail service providers, nonprofits, and magazine publishers. The survey results presented by EMA perhaps best encapsulate this reaction. This independent survey of 380 large mailers averaging 12.3 million pieces each in 2017 demonstrates that the higher prices rise above CPI, the more mailers will reduce their volumes. EMA at P2-P3. Whereas 34% of companies anticipate reducing volumes in response to a rate increase of CPI alone, indicating that the Postal Service should already be wary of raising rates above existing levels, this number would grow to 41% at CPI plus 2 percent and 45% at CPI plus 3 percent. EMA at P3. It follows that rate increases above this level, such as those urged by the Postal Service and APWU, would cause even more mailers to reduce their volumes.

Idealliance also surveyed its members to assess the likely effect of the Commission's proposals. Idealliance at 1. Idealliance found that its members and their clients projected volume decreases of 7.4 percent, over 2 billion pieces, in reaction to the Commission's proposals. *Id*. It further found that, in addition to reducing frequency of delivery and targeting mailings more narrowly, 37 percent of member clients would begin exploring the use of alternative delivery and 7 percent would leave the mail completely. *Id.* at 2. Again, the even larger price increases proposed by other parties would likely cause even more mailers to consider leaving the mail completely.

The American Catalog Mailers Association ("ACMA") reports even more extreme results. AMCA reports that 90 percent of the respondents to a catalog industry survey would decrease their volumes through selective targeting if the Commission's proposals are enacted. ACMA at 4. And 80 percent of respondents indicated they would use more digital marketing as a replacement for mail, a change that could lead to permanent loss of volume. *Id*. at 4-5. Because catalog mailings are a strong driver of highly profitable multiplier mail,[2] this volume loss could be devastating.

IWCO Direct likewise reported significant volume declines from its customers in 2017 in response to CPI-limited increases. IWCO at 1. IWCO Direct is rightly concerned that above-CPI increases would drive out even more volume. *Id*. at 1-2.

The initial comments of individual companies reinforce these findings. Meredith Corporation, for instance, conservatively estimates that its periodicals volume would decline by 32 percent, or 310 million pieces a year, with further reductions to associated First Class and Marketing Mail. Meredith Corporation at 2. Moreover, at industry average rates of multiplier mail, the Postal Service would also lose approximately 180 million pieces of presorted First-Class and Marketing Mail. ANM *et al*. Phase 1 comments (March 2017), Cohen Decl. at 8, Exhibit 1.

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[2] MC2005-3 Op. & Rec. Decis., *Rate and Service Changes to Implement Baseline Negotiated Service Agreement with Bookspan* (May 10, 2006) at 3, 6, 9, 43, 45, 50-53, 80.

ESPN the Magazine states that it would simply stop producing a print version of its magazine if rate increases at the level allowed by the Commission's proposal were implemented. ESPN the Magazine at 2. If so, the Postal Service would lose not only the efficiently prepared Periodicals volume serving ESPN's 2 million paid subscribers, but also its associated renewal notices, Business Reply cards, and First Class invoices, among other multiplier mail. *Id.* at 1.

Bottom Line Inc. states that each yearly rate increase of 5% for letters and 7% for Flats would decrease its direct mail volume by 10-14%, with further reductions in multiplier mail. Bottom Line Inc. at 1-2.

Credit One Bank predicts its mail volume, despite growing 7% over the past year, would decrease by 37% over the next five years if the PRC's proposal is implemented. Credit One Bank at 1.

The Commission may believe that mailers are overstating the effect of these price increases. But the Commission, unlike EMA, Idealliance, ACMA or IWCO Direct, has performed no analysis whatsoever of the effect on volume of CPI+2, 3, 5, or any other increase, and therefore has no data suggesting the opposite.[3] Nor is it in a better position than the mailers themselves to predict

[3] The Commission's failure to analyze the volume effects of the rate surcharges proposed in Order No. 4258 stands in stark contrast with the heavy burden of proof regarding elasticity effects that the Commission imposes on the proponents of market-dominant NSAs—and the penalties and loss of discounts that mailers face if they do not reach the projected volume targets. *See* Order No. 2410 in Docket No. MC2015-3, *Market Dominant Prices—First-Class Mail & Standard Mail—Discover Financial Services* (Mar. 24, 2015); DFS Comments at 4.

what effect price increases will have on mail volume. Mailers plan their campaigns based on return on investment, and are best positioned to know how postage increases will impact that return and, consequently, mail volume.

In any event, even if the specific magnitude of these volume effects is unknown, the Commission's proposal is arbitrary because it does not account for the impacts of volume reduction and diversion *at all*. Even the Postal Service and the Public Representative agree that the Commission has failed to account for volume declines in evaluating the impact of the proposed rates. *E.g.*, USPS at 52-55; Public Representative at 20-22. The Public Representative concludes that "due to both continuing volume decline and elasticity impacts, the proposed supplemental rate authority would bring approximately 10 percent less in additional revenues than the Commission anticipates by its proposals." Public Representative at 25; *id*. at 26 (recognizing that when "price increases are substantial . . . Market Dominant Mail classes and products might become more elastic"); *id.* at 26 n. 25 (stating that "'[t]he constant elasticity assumption is unsupported when used for volume levels substantially outside the range of actual experience'" (quoting Order No. 3506 at 8)). While these parties suggest the volume effect can be offset by still larger increases, these parties overlook the possibility that the opposite may be true: larger rate increases may have still larger volume effects, and *no* rate surcharge of *any* size can close the revenue gap that these parties claim.

The Postal Service tries to finesse this problem by disclaiming any intention to raise prices to a level that drives enough mail from the system to become counterproductive. USPS at 45, 79. But the Postal Service's barrage of attacks on the Commission's proposals as inadequate implies that the Postal Service would implement rate increases *exceeding* CPI+5. *Id*. at 48-131. The Postal Service cannot have it both ways. Either the Postal Service is bluffing when it claims that the rate increases contemplated by Order No. 4258 are inadequate, or the Postal Service intends to raise its rates as much as the Commission allows.[4] Either way, the Postal Service has provided no more documentation for its underlying elasticity assumptions than has the Commission. It has not identified a level of price increase that it believes would be counterproductive. And, as discussed further below, the Postal Service has identified no principles that would bound its discretion to raise prices. Its

[4] The comments of the postal labor organizations are in the same vein. On the one hand, the unions contend that the above-CPI surcharges proposed by the Commission are grossly inadequate. *See*, *e.g*., APWU at 13 (arguing for a revenue increase of $4.8 billion, not $2.7 billion); NALC at 3-4, 9 (asserting that the two percent surcharge proposed by the Commission reflects a "grave underestimate of the depth of USPS's medium-term financial instability"); NPMHU at 3-4 (arguing that the $2.7 billion target for additional revenue is grossly insufficient because the "average net loss over the past eleven fiscal years has been $5.9 billion"). Yet the unions simultaneously insist that, "because of market constraints and competitive forces that apply to all USPS products, the grant of additional pricing flexibility will not lead to unnecessary or unwarranted price increases." NPMHA at 3. "Mailers have alternatives (electronic or otherwise) for nearly every market dominant product. That reality would likely have constrained USPS price increases." NALC at 24. "Permitting the Postal Service rate authority is not the same as the Postal Service using that authority. The Commission should rely on the Postal Service to settle on a rate increase that makes the most sense with regard to economic conditions, demand, and service. The Postal Service will not pursue suicidal rate increases." APWU at 12. In short, the Postal Service desperately needs massive rate increases, but can be trusted not to impose them even if permitted. To mailers, assurances of this kind bring to mind a line from the Lewis Carroll poem *The Walrus and the Carpenter*: "Now if you're ready, Oysters dear, we can begin to feed."

justification for removing the price cap limitation on its rate authority relies entirely on market constraints that have not been shown to exist.

The Postal Service did provide, under seal, an Appendix purporting to show volume impacts at CPI+2. But it has failed to disclose sufficient underlying data to enable any party to test and verify this claim or model the effects of other price increases on volume under the Postal Service's assumptions. *See* Appendix B, *infra*. Still less has the Postal Service provided any credible analysis of the volume effects of its alternative request to gain *unlimited* pricing flexibility.[5]

The Public Representative has at least tried to predict the volume effects of the CPI+2 proposal by extrapolating from existing elasticity estimates. Public Representative at 22-28. But as ANM *et al.* and NPPC discussed in their initial comments, predictions drawn from these elasticity estimates are unreliable because the Commission is proposing to allow rate increases that exceed CPI to an extent far greater than has ever occurred since the enactment of PAEA. All available elasticity estimates have been developed during a period of essentially no real (*i.e.*, inflation-adjusted) price changes. These estimates cannot be reliably applied to increases of the magnitude the PRC has proposed, which are far outside the range of this experience. ANM *et al.* at 79-

[5] This omission is particularly troubling in light of the Postal Service's repeated failure to anticipate the pace of its decline in market-dominant mail volume in recent years. *See*, *e.g.*, USPS FY2017 Annual Report to Congress at 22 ("Our FY2017 total revenue of $697.7 billion was $1.0 billion less than planned, largely due to higher-than-expected First-Class Mail diversion and an unexpected drop in Marketing Mail.").

82; NPPC at 63-65; Public Representative at 26. Additionally, there is evidence from individual mailers in the docket suggesting that these elasticity estimates are not universally applicable and may understate volume impacts in certain situations. For instance, Bottom Line Inc. states that it has studied its reaction to price changes at various points in time and consistently found elasticities of 1.5 to 2—a factor up to four times the price sensitivity predicted by the Postal Service's model. Bottom Line Inc. at 1.

The response of mail volume to the temporary exigent surcharge implemented in 2013 is also an unreliable guide. The exigent rate increase was definite in both amount and duration—and much smaller than the cumulative increases proposed in Order No. 4258. Mailers knew that the exigent surcharge would be rolled back once the specified contribution target was achieved, and further rate increases would be limited to changes in the CPI. Most mailers (albeit with much effort) managed to reduce other input costs to offset postage increases enough to stay in the mail, knowing that the surcharge would be removed and the status quo restored in time. *See, e.g.*, American Mail Alliance at 7-8. By contrast, the rate increases proposed in the present case would be baked permanently into the rate base, and the Commission has left open the possibility of even greater rate increases in the future. This potential presents a very different decision tree to mailers.

And in any event, the exigent increase did affect the industry. PCH, for instance, was forced to cut promotional volumes by 10%. PCH at 1. Total nonprofit Standard Mail declined by about 4.5 percent. These volume losses occurred even though mail service providers cut costs throughout the supply chain to limit the overall cost increase borne by mailers to much less than the 4.3 percent increase in postage. *See* Quad/Graphics at 1-2 (explaining how decreases in manufacturing costs as a total percentage of postal spending have at least partially offset increases in postage since 2006); IWCO Direct at 2.

The current record makes clear, however, that the Commission's proposals (and the alternative proposals of the Public Representative, the USPS, and APWU) would cause volume to decline. Existing elasticities, common sense, and the comments from industry suggest the rate increases will accelerate volume declines over the current trend. Hence, even if (contrary to fact) PAEA allowed the Commission to implement a system of ratemaking that allowed the Postal Service to increase rates above the annual change in CPI-U, the Commission could not adopt such a system without examining the effects of any additional allowed rate increases on mail volume. The Commission also would need to perform the same analysis of changes to the pricing authority available to the Postal Service that comply with PAEA, such as requiring above-CPI increases on certain products while maintaining class-level authority at CPI-U. Otherwise, the Commission could not predict whether its proposals will be successful or self-defeating, and could not reach a reasoned determination regarding the appropriate level of pricing authority to provide the Postal Service.

For all these reasons, if the Commission still contemplates changing the formula for calculating the rate authority available to the Postal Service in any manner, a prudent first step would be to hold off-the-record technical conferences where the Commission can receive confidential information regarding price elasticities and the likely reaction of mailers to specific levels of price changes. Doing so will provide the Commission with information necessary to evaluate the likely volume impacts of any rules it ultimately promulgates. As ANM *et al.* suggested in their Initial Comments, such information is better developed, at least initially, through informal discussions and off-the-record proceedings than in a public, high-stakes, litigious rulemaking proceeding that allows for only two rounds of comments.

II. THE ABOVE-CPI RATE INCREASES PROPOSED IN THIS DOCKET ARE UNJUSTIFIED BY THE POSTAL SERVICE'S REVENUE NEEDS (OBJECTIVE 5).

The initial comments of the undersigned parties showed that the analysis of Objective 5 (revenue adequacy) in Order No. 4258 is flawed in two respects. First, the Commission has improperly elevated Objective 5 over all other statutory objectives: Section 3622(b) requires that Objective 5 be considered in tandem with the other objectives. ANM *et al.* at 29-34.

Second, the Postal Service's revenue needs could not justify the rate surcharges proposed in Order No. 4258 even if (contrary to fact) revenue adequacy were the sole or paramount statutory objective. ANM *et al.* at 71-82. As discussed in the previous section, the Commission has failed to provide a reasoned basis for the specific amounts of additional pricing authority it proposes to grant the Postal Service—*even assuming (contrary to fact) that the Postal Service actually needs to impose above-CPI rate increases on market-dominant products*. ANM *et al.*, the Public Representative, and the Postal Service and its allies all agree on this point. But contrary to the claims of the Public Representative, the Postal Service, APWU and NALC, the record demonstrates that the CPI-based price cap allows the Postal Service to attain and maintain revenue adequacy under efficient management.

A. The Postal Service has achieved short-run financial stability.

As the Commission found in Order No. 4257, the Postal Service has achieved short-term financial stability. ANM *et al.* at 71 (citing Order No. 4257 at 4 & 162). Arguments to the contrary from the Public Representative and the Postal Service are unavailing.

The Public Representative argues that the Commission's analysis on this point is flawed because "Objective 5 is not limited to consideration of 'positive adjusted operating profit' or to the ability 'to operate continuously without interruption.'" Public Representative at 11. Noting that the Commission's measure of short-run financial stability "is more akin to the Postal Service's annual calculation of 'controllable (loss) income,'" the Public Representative further states that "[t]he Postal Service has candidly admitted that controllable costs is a 'non-GAAP measure.'" *Id.* Further, it points to the Commission's determination in Order No. 4257 that end-of-year cash reserves "have accrued because of the Postal Service's limiting of its capital investment and its nonpayment of statutory employee benefit payment obligations." *Id.* at 12. The Public Representative argues that because "private enterprises" that default on their obligations or defer investments "that are critical to their near-term continued operation" cannot be considered financially stable, the Postal Service cannot be considered financially stable, even in the near term. *Id.* These claims are without merit.

The Public Representative's comparison of the Postal Service's financial condition to that of a private enterprise is instructive. The obligations on which the Postal Service has "defaulted" are not obligations that any private enterprise would undertake. Unlike a private enterprise, the Postal Service is required to prefund its obligations to future retirees. And its retiree benefit funds, unlike those of many private (and governmental) enterprises, are actually well funded. *See* ANM *et al.* at 75-77; ANM *et al.* Phase 1 comments (March 2017) at 40-44; NPPC at 57-58. The Postal Service's "default" on its nominal prefunding obligations to the Treasury does not impair in any way the Postal Service's ability to actually meet underlying obligations to current or future retirees. Moreover, the Federal Government has informally forgiven the accelerated prefunding obligations. The Postal Service has "not incurred any penalties or negative financial consequences as a result of not making the PSRHBF prefunding payments"; does not "anticipate any legal consequences, under current law, from its inability to make the required payments"; and "expects" that "additional legislation will be enacted to address the short-term funding requirements" of the Postal Service and "address regulatory restrictions that have not allowed the Postal Service to adjust its operations to levels commensurate with its current revenue base." USPS Form 10-K for FY 2017 at 5 & 43.[6] One might ask whether the failure to make these payments represents a "default" at all.

[6] As discussed in the conclusion to these comments, Congress recently began considering legislation that would make this forgiveness explicit.

As for capital investments, there is no evidence that the Postal Service has a backlog of capital investment projects that have been foregone for lack of funding. We discuss this issue in more depth in section III.B, below. For now, it is enough to note the complete absence of any evidence on the record that the Postal Service has deferred investments "that are critical to [its] near-term continued operation." Public Representative at 12. The Postal Service continues to operate, pay its vendors, meet its obligations to retirees, and meet its short-term capital investment needs. The Postal Service is generating a large and growing supply of cash on hand that can be used to make even more capital investments. Moreover, as NPPC notes, the Postal Service has many real estate assets that it could monetize to raise more capital without endangering continuing operation even if (contrary to all current projections) the overall demand for postal services were to decline significantly. NPPC at 55-57; ANM *et al*. Phase 1 comments (March 2017) at 35-36, 44-46. The Postal Service is, in short, financially stable in the near term.

The Postal Service's assessment of its short-term financial condition is predictably hyperbolic, and compounds its exaggerated portrayal of its financial woes by overstating the "requirements" of Objective 5. In the end, its arguments confirm that, apart from any nominal obligation to prefund retiree benefits, the Postal Service is financially viable. Because there is no reason to believe the Postal Service will be forced to make good in the near term on the unrealistically accelerated prefunding obligations specified in the PAEA (but effectively released by Congress and the executive branch in recent years), the

Commission was correct to conclude the current system of ratemaking has allowed the Postal Service to achieve financial stability in the short term.

The Postal Service's remaining attacks on the Commission's findings of short-term financial stability are equally wide of the mark. The Postal Service attempts to brush off the importance of its proven ability to achieve positive "controllable income" on the theory that neither this measure nor the Commission's "net income without non-operating expenses" metric "present a comprehensive measure of financial stability that can justify binding legal determinations as to the achievement of objective 5." USPS at 14; *id*. at 13 ("'Short-term stability' has no place in determining achievement of objective 5"). This is an attack on a straw man. The Commission did not offer its analysis of the Postal Service's short-term financial stability to "present a comprehensive measure of financial stability," but also examined the Postal Service's medium- and long-term financial stability in evaluating Objective 5. Nor did the Commission treat "controllable income . . . as a leading player in the objective 5 determination"; if the Commission had done so, it would have found that the current system is meeting Objective 5.

The Postal Service nevertheless insists that the concept of short-term financial stability should play no role in the Commission's analysis because "objective 5 clearly inheres an expectation that the Postal Service must cover its costs." USPS at 14. "Otherwise, it could not generate retained earnings, and that statutory phrase would be surplusage." USPS at 14. This reasoning is inscrutable. Regardless of what costs the Postal Service must cover to remain profitable, the fact that the Postal Service might not generate retained earnings does not render the statutory language surplusage. As NPPC explains, "Congress included the term 'retained earnings' in the PAEA to make clear that the 'breakeven' requirement in the former law was no more." NPPC at 51. PAEA did not guarantee the Postal Service retained earnings. It simply permitted them. As ANM *et al.* explained in their initial comments, this change was made not to ensure that the Postal Service would cover its costs, but to incentivize it to *reduce* them. ANM *et al.* at 43.

Given this purpose, the Commission was perfectly justified in considering the Postal Service's "controllable income" as an element of financial stability. If the purpose of allowing retained earnings is to encourage the Postal Service to reduce costs, then it is reasonable to examine whether the Postal Service was able to reduce those costs under its control. Such an examination necessarily requires excluding those costs outside of the Postal Service's control, such as the prefunding obligations.

In the end, though, this discussion simply highlights that Objective 5 is not a foundational or supreme requirement of PAEA. Rather, it is just one of several objectives, and the regulatory system must be designed to achieve all of them. And whatever the meaning of "financial stability" under Objective 5, the Commission cannot design a system that would allow the Postal Service to recover more of its costs than the market will allow. The Postal Service is saddled with obligations that a private sector business would not be, including retiree benefit prefunding requirements. These obligations will necessarily limit the Postal Service's profitability. There is a limit to how much even an unregulated monopoly can charge for its services.

The Postal Service, however, does not limit its attack to the standard the Commission has applied to its analysis of Objective 5. Instead, it attempts to manufacture an immediate financial crisis that simply does not exist. First, it argues that the Commission's finding of short-term financial stability erroneously relies on the existence of liquidity when that liquidity would not exist had the Postal Service paid all of its legally mandated prefunding obligations. USPS at 15. It claims that had it made these payments, it "would not have the very cash that the Commission views as supplying 'short-term stability.'" USPS at 16. But the premise of this claim is counterfactual. The fact is that the Postal Service did not make these payments. It is also a fact that the Postal Service has strong cash reserves. The Postal Service calls its "defaulted" prefunding obligations "past-due but thus-far uncalled debts to the U.S. Treasury." *Id.* But the Postal Service knows that there is essentially no risk that these debts will be "called." The Congress and the U.S. Treasury are not going to put the Postal Service out of business. The very idea is absurd—even if Treasury did call these debts, *someone* would deliver the mail.[7] *See* ACMA at 2-3.

[7] For similar reasons, the Postal Service's concern that it has "only 39" days of theoretical liquidity should be dismissed. *Cf*. USPS at 17. As ANM *et al*. noted last year, this level of liquidity is a significant improvement over just a few years ago, indicating the Postal Service has the ability to improve its financial position under the current ratemaking system. ANM *et al*. Phase 1 comments (March 2017) at 35. Moreover, as the USPS OIG has noted, the Postal Service could generate massive additional liquidity if necessary by tapping into the value of its real estate. *Id*. at 35-36 (citing OIG analysis). Third, and in any event, the number of days of cash on hand has limited relevance for an enterprise like the Postal Service, which will never be turned off completely

The Postal Service further claims that if it continues to miss its prefunding payments, "the pension and RHB funds' assets will be progressively drawn down until they are completely exhausted." *Id.* at 16 n.32. As ANM *et al.* related in their initial comments, these funds are in no danger of becoming "completely exhausted." Even without the prefunding payments, they are funded much more fully than most private sector funds and are capable of paying benefits for future retirees who have yet to be born. ANM *et al*. Phase 1 comments (March 2017) at 38-44 & Nadol Decl. The adequacy of the funding of the Postal Service's retiree obligations is not a short-run issue.

B. The longer-run loss projections of the proponents of above-CPI rate increases are unsupported.

The claims of the Postal Service, its allies, and the Public Representative concerning the Postal Service's medium- and long-run financial prospects are also flawed. These commenters (1) ignore the increasing contribution of competitive products; (2) ignore the expected benefits of total factor productivity growth; (3) ignore the ability of the USPS to cover "exogenous costs" in FY 2017 if the USPS had not let its productivity growth collapse after the implementation of the exigent surcharges; and (4) overstate the effect of delivery point growth on costs.

The Postal Service and the Public Representative argue that market-dominant rates should be allowed to increase faster than the CPI for two main reasons: (1) to make up for the existing "baseline loss"; and (2) to offset the

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unless a policy decision is made by the federal government to shut down the enterprise. *Id.* at 36-38.

headwinds resulting primarily from projected declines in the volume of market dominant mail and the projected growth in the number of delivery points. Neither claim withstands scrutiny.

1. No "baseline loss" adjustment is warranted.

The Postal Service and the Public Representative argue that the above CPI-surcharges proposed in Order No. 4258 are too small to enable the Postal Service to achieve revenue adequacy because its "baseline" losses are larger than the $2.7 billion figure calculated by the Commission. Specifically, the Postal Service contends that:

(1) The net loss reported by the Postal Service in FY 2017, the basis for the $2.7 billion loss figure used by the Commission, is unrepresentative because the losses reported by the Postal Service were reduced by a non-cash adjustment of $2.2 billion in workers' compensation liability arising from "an increase in the discount rate and changes in actuarial assumptions." USPS at 58. This adjustment, while consistent with generally accepted accounting principles ("GAAP"), "does not impact the Postal Service's cash position" or "represent income earned in the normal course of business." *Id.* at 58-59.

(2) Instead of a one-year "snapshot," the Commission should base its projections of the Postal Service's "baseline loss" on the Postal Service's performance during FY2013 through FY2017, "the most recent five-year period." *Id.* at 61. But the Commission should

adjust the five-year figure by backing out the contribution from the exigent surcharge that took effect in FY 2014 and the effect of revising in FY 2013 and FY 2016 the estimated value of the postage in the hands of the public ("PIHOP"). *Id.* at 61-63.

(3) The net effect of these adjustments is to produce an average annual loss during FY 2013 through FY 2017 of $6.0 billion, not $2.7 billion. *Id.* at 63-64. Recovering this larger amount would require an across-the-board above-CPI surcharge of four percent per year, twice the amount proposed by the Commission in Order No. 4258. *Id.* at 63 and App. B.

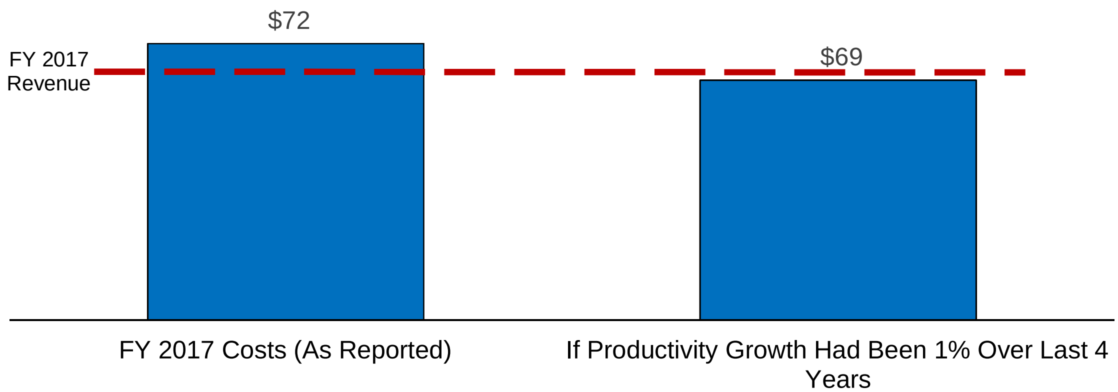
The Public Representative argues that the Commission's baseline loss assumptions are inadequate for similar reasons. Public Representative at 17-28.

These arguments fail on several grounds.

(1) The Postal Service's losses in FY 2017 were due entirely to the collapse of Postal Service productivity growth since Fiscal Year 2014, when the exigency surcharge took effect. ANM *et al.* at 48-50.[8] As we noted in our initial comments, if productivity had risen by just *one percent* annually from FY 2014 to FY 2017 (as it previously had), the $2.7 billion loss experienced in FY 2017 would have been a small surplus.

[8] Furthermore, after adjusting for changes in mail mix, the unit attributable costs of market dominant mail in FY 2017 were actually *higher* in inflation-adjusted dollars than in FY 2008. Appendix A to these reply comments provides supporting details.

Figure 1



Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Figures 1 & 3".

Offsetting the losses incurred by the Postal Service in Fiscal Year 2017 with above-CPI rate increases thus would violate Objectives 1, 2 and 8 even if 39 U.S.C. § 3622(d)(1) did not make the CPI cap binding. ANM *et al.* at 34-71.

The poor productivity performance beginning in FY 2014 cannot be excused on the theory that total factor productivity growth is difficult when volume is declining. *Cf.* USPS at 23. The dismal productivity performance beginning in FY 2014 occurred when volume was relatively stable. ANM *et al.* at 48-50. Rather, the sudden drop in productivity growth corresponded to the implementation of the exigent rate surcharge in FY 2014. The table below illustrates this point vividly by comparing the rates of volume decline and TFP growth in the years before and after the implementation of the exigency surcharge:

Table 1

	Annual Volume Decline	Annual TFP Growth
FY 2007 – FY 2013	-4.2%	0.91%
FY 2014 – FY 2017	-1.4%	-0.08%

Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Tables 1 & 2"

(2) The Commission's refusal to inflate the $2.7 billion loss figure reported by the Postal Service for FY 2017 by reversing the $2.2 billion adjustment for the Postal Service's reduction in workers compensation liabilities was entirely appropriate. As the Postal Service concedes, this adjustment, which resulted mainly from increases in discount rates that decreased the net present value of the Postal Service's workers compensation liabilities, was required by generally accepted accounting principles ("GAAP"). USPS at 58; see also USPS Form 10-K for FY 2017 (Nov. 14, 2017) at 17.

The Postal Service objects that the adjustment should be disregarded as "myopic," despite its adherence to GAAP, because the adjustment "does not reflect actual charges or expenses paid in" FY 2017. USPS at 58-59. This objection is incoherent. The same is true of the far larger prepayment amounts nominally due under the unrealistically accelerated PAEA prefunding schedule—amounts that the Postal Service has insisted must be treated as actual losses even though they were not paid in FY 2017 (and several previous years) and reflect cash outflows to retirees that the Postal Service will not be required to pay for decades to come.[9]

[9] The Postal Service's position on the controlling authority of GAAP depends on whose ox is gored. For valuing the Postal Service's real estate holdings, the

In any event, the $2.2 billion amount represents about two years of the annual growth in contribution from competitive products that the Postal Service ignores in its loss calculations in this proceeding. ANM *et al.* at 71-78.[10]

(4) The five-year average loss calculated by the Postal Service also provides an inappropriate baseline for calculating future revenue needs. The annual contribution from competitive products today is several billion dollars higher than the average contribution during the five-year period, and almost certainly will be still higher in each succeeding year in the future. *Id.* at 71-75. Moreover, the five-year loss calculation offered by the Postal Service, and the similar calculation by the Public Representative, assume that the Postal Service will make retiree health benefit prefunding payments much larger than dictated by the current actuarial funding approach. ANM *et al.* at 75-77;

Postal Service insists that "statutory accounting requirements" require the Commission to use depreciated original cost, the measure normally used under GAAP. USPS at 8-9 n.5. The Postal Service studiously ignores the distinction noted by the undersigned parties in their Phase 1 comments: GAAP valuation, while the correct approach in most ratemaking contexts and in financial reporting to shareholders, is not an appropriate measure of the financial stability of an enterprise when the question is its ability to pay its debts if the enterprise should fail and its assets are liquidated. In that specific context, precedent makes clear that the relevant valuation is current market value, not depreciated book cost. ANM *et al.* Phase 1 comments (March 2017) at 45 (citing authorities).

[10] The $2.2 billion adjustment for FY 2017 was also partially offset by an actuarial adjustment of approximately $500 million in the same Fiscal Year that cut the other way. USPS Form 10-K for FY 2017 at 17 (row of table labeled "Change in normal cost of retiree health benefits due to actuarial assumptions"). The Postal Service ignores this adjustment.

USPS at 5-6; Public Representative at 46-68. But the payment due from the Postal Service to the Treasury Department to prefund retiree health benefits in Fiscal Year 2017 was much lower than in previous years, and will remain lower throughout the five-year period of the proposed surcharges. *See* USPS Form 10-K for FY 2017 at 32; USPS FY 2018 Integrated Financial Plan (Nov. 22, 2017) at 3 (last full paragraph). Correcting for these two factors produces a net loss figure that is smaller than the $2.7 billion FY 2017 net loss, even without backing out the Postal Service's needlessly high costs.

(5) Likewise, because the FY 2017 net loss figure already includes amortization payments for retirement benefits, the Public Representative errs in claiming that the cap should be adjusted upward to explicitly include prefunding costs ($4.1 billion) as "the starting point for considering adjustments to the price cap." *Cf*. Public Representative at 44; USPS Form 10-K for FY 2017 at 5, 27, 28 n.2, 31,

(6) The absurdity of the alternative test period proposed by the Postal Service is underscored by its results. The adjusted average loss over the five year period, $6.0 billion per year, by the Postal Service's own admission "exceeds the adjusted loss that the Postal Service experienced in FY2017 or its projected net loss for FY2018." USPS at 63. And increasing the basic across-the-board surcharge from CPI+2 to CP+4 would yield cumulative five-year rate increases of as much as 54 percent for underwater products and 40 percent for all other products (assuming annual inflation of two percent).

2. The financial "headwinds" projected by the USPS and the Public Representative are far smaller than the financial tailwinds that the same parties ignore.

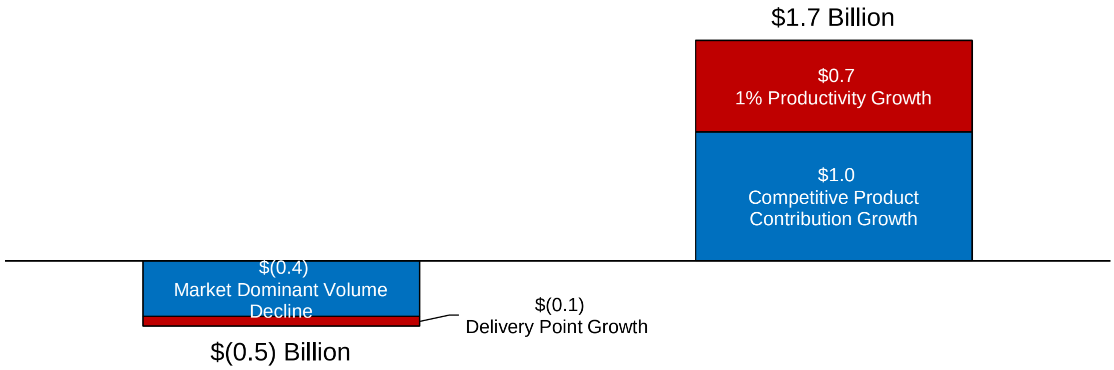
The Postal Service and Public Representative further argue that above-CPI rate increases are also warranted by financial "headwinds" that the Postal Service supposedly will face in the near future. In particular, these parties argue that (1) further declines in market-dominant mail volume are likely; (2) this will deprive the Postal Service of economies of density; (3) the mail mix is shifting away from higher-contribution mail (like First-Class Mail); and (4) the number of delivery points is increasing. USPS at 71-72. These trends, the Postal Service and the Public Representative argue, should be offset by an annual additive to the CPI cap. *Id*. at 71-74; Public Representative at 55.

We agree that these trends would reduce the Postal Service's earnings, all other things being equal. However, this financial drag is more than offset by countervailing favorable trends—tailwinds, to use the same metaphor—that the Postal Service and the Public Representative have ignored in their analyses.

Market dominant volume declines and delivery point growth reduce the Postal Service's net contribution by about $500 million each year (about $400 million per year from the decline in market-dominant volume, and about $75 million per year from the increasing number of delivery points). ANM *et al.* Phase 1 comments (March 2017) at 27-30. But the tailwinds from the ongoing growth in contribution from competitive products (about $1 billion per year) and the growth in total factor productivity that the Postal Service has shown it can achieve when given proper incentives (about one percent or $700 million per year) are more than three times the magnitude of the headwinds. ANM *et al.* at 48-50, 71-75, 77-78.

The net positive effect of the offsetting trends is large enough to fill the entire revenue shortfall estimated by the Commission.

Figure 2



Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Figure 2".[11]

Moreover, this analysis assumes away many other steps the Postal Service could take to improve its financial position. Many of these do not require action by Congress or the Commission. ANM *et al.* at 77; ANM *et al.* Phase 1 comments (March 2017) at 47-63.

[11] The Commission's Annual Compliance Determination Report for FY2017, issued on March 29, 2018, uses a different methodology for estimating the attributable costs of competitive products than in the past (the incremental costs of competitive products taken together, rather than the sum of the incremental costs of each competitive product individually). *Id.* at 8-10. The revised methodology produces slightly different estimates of the contribution from competitive products than did the earlier methodology. *Id.* at 92. The difference in methodology is immaterial to the trends in competitive product contribution that we have highlighted.

Further, USPS *et al.* arbitrarily assume that Postal Service productivity growth will remain at its recent low level even if the Commission resumes enforcing the CPI cap. Indeed, the Postal Service seems hard pressed to identify *any* cost-cutting or productivity-enhancing measures it could take to improve its financial condition. *See* pp. 44-47, *infra*. As discussed further below, this exclusive focus on additional revenue is erroneous. PAEA was designed to force the Postal Service to identify and exploit opportunities to cut costs by limiting its ability to solve problems by raising prices.

3. The Postal Service's own financial projections confirm that it would earn a healthy profit by taking advantage of readily available revenue sources and available cost savings.

Appendix A to the Postal Service's initial comments consists of two charts, both filed under seal, illustrating the losses and negative liquidity that the Postal Service supposedly would suffer under the existing regulatory system and even under the alternative system proposed in Order No. 4258. The charts provide a substantial part of the Postal Service's case for being allowed to impose above-CPI rate increases on captive mailers. USPS at 7-8, 54-55, 63-64, 66 n. 170, 68 n. 173, 70 n. 175. The documentation of the charts is too deficient to allow them to receive any weight as evidence of the Postal Service's alleged financial shortfalls. Even taken at face value, however, the charts confirm that the Postal Service does not need above-CPI rate increase authority.

(A)

The data, assumptions and calculations underlying the charts are largely a black box. The Postal Service's original filing on March 1 included no workpapers for the charts at all. *See* USPS at 54-55 (listing some variables supposedly modeled in Appendix A without revealing their values or the formulas in which they were used). On March 8, 2018, three of the undersigned parties moved for issuance of an information request for the workpapers.[12]

On March 18, the Postal Service responded by filing under seal a purported description of the "data and the quantitative assumptions underlying the net-loss figures reflected in Appendix A."[13] The Postal Service asserts that the documents "will be more than adequate to assist ANM *et al.* in preparing reply comments."[14]

In fact, they are not. The supposed "workpapers" provided by the Postal Service in response to the mailers' March 8 motion for full documentation of Appendix A are stonewalling. As detailed in nonpublic Appendix B to these reply comments, many of the most critical data, assumptions and calculations underlying the loss and liquidity projections in USPS Appendix A remain unverified and unverifiable. The black box is still largely a black box.

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[12] Motion of ANM *et al.* for Issuance of Information Request (Mar. 8, 2018).

[13] Response of the USPS to Motion of ANM *et al.* for Issuance of Information Request (March 15, 2018); Notice of the USPS of Filing Non-Public Materials (March 16, 2018).

[14] Notice of the USPS of Filing Non-Public Materials (March 16, 2018) at 1.

The Postal Service, undoubtedly aware that encouraging the Commission to rely on Appendix A without providing adequate workpapers for it was a mistake, has backpedaled from its original claims about the probative value of the appendix. The Postal Service now maintains that its purpose for offering Appendix A was "limited"; the appendix merely "illustrates the general magnitude to which the Commission's proposed alteration of the system is deficient based on the assumptions" of that model; and the Postal Service "did not propose that the Commission design a modified system predicated on the set of projections in Appendix A" and never intended to have the Commission "rely on projected volumes or costs for purposes of establishing an appropriate revenue target or rate design over the next 5 years." Notice of the USPS of Filing Non-Public Materials (March 16, 2018) at 1 & 3; *accord*, USPS Response to Motion of PostCom *et al.* for Early Termination of Non-Public Status of Two Documents Filed Under Seal (March 23, 2018) at 3 ("Appendix A is used only to 'illustrate the likely impact of … the shortcomings' in the Commission's proposed system, not as an independent basis for those shortcomings.").

The Postal Service's belated[15] downgrading of the role of Appendix A to a mere "illustration" that lacks probative value is an offer that the Commission should accept. Section 4 of the Administrative Procedure Act, 5 U.S.C. § 553,

[15] The original role of Appendix A in the Postal Service's case was hardly as modest as the Postal Service now claims. *See* USPS at 7-8 (stating without qualification that "Appendix A contains two charts projecting the Postal Service's losses and liquidity over five years, assuming the continuation of the current system or, alternatively, the addition of 2 percent points of supplemental rate authority"); *id.* at 54-55, 63-64, 66 n. 170, 68 n. 173, 70 n. 175.

bars an agency from relying on "technical studies and data" in a notice-and-comment rulemaking without "reveal[ing]" them "for public evaluation." *American Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008) (citations omitted). "Public notice and comment regarding relied-upon technical analysis ... "are '[t]he safety valves in the use of … sophisticated methodology.'" *Id.* (citations omitted). It is "a fairly obvious proposition that studies upon which an agency relies in promulgating a rule must be made available during the rulemaking in order to afford interested persons meaningful notice and an opportunity for comment." *Id.* at 237; *accord, California Wilderness Coalition v. U.S. Dept. of Energy*, 631 F.3d 1072, 1090-91 & n. 12 (9th Cir. 2011). "To allow an agency to play hunt the peanut with technical information, hiding or disguising the information that it employs, is to condone a practice in which the agency treats what should be a genuine interchange as mere bureaucratic sport. An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary." *Connecticut Light and Power Co. v. NRC*, 673 F.2d 525, 530-31 (D.C. Cir. 1982). *See also TNS Media Research, LLC v. TRA Global, Inc.*, 984 F.Supp.2d 205, 238-39 (S.D.N.Y. 2013) (dismissing a party's claim because of the party's "Dance of the Seven Veils" tactics in response to the requests of opposing parties for documentation of the claim).

(B)

As ill-documented as Appendix A is, it nonetheless amounts to a powerful if inadvertent admission by the Postal Service. The appendix confirms the hollowness of the Postal Service's claimed need for steeper rate increases on market-dominant mail products. As explained above, a valid estimate of the Postal Service's legitimate financial needs must reflect the Postal Service's actual projected growth in revenue and reasonable assumptions about the productivity growth and cost control that the Postal Service could reasonably achieve. Modifying a few of the stated assumptions of Appendix A in this direction, while leaving the other values and assumptions underlying the appendix unchanged, transforms the Postal Service's projected financial results during the period at issue from the losses projected in the appendix to healthy profits. Because the Postal Service has filed both the appendix and the "workpapers" ostensibly supporting it as nonpublic documents, we cannot disclose our analysis or results here. But they are set forth in nonpublic Appendix B, *infra*. We urge the Commission to review it.

III. THE SYSTEM OF RATEMAKING MUST BE DESIGNED TO MAXIMIZE INCENTIVES TO REDUCE COSTS AND INCREASE EFFICIENCY (OBJECTIVE 1), NOT MAXIMIZE CAPITAL FOR INVESTMENT.

A. The proposed across-the-board surcharges would devastate the Postal Service's incentives for efficiency.

Not only are the above-CPI surcharges unnecessary to resolve "baseline losses" and establish financial stability, but the potential for extra revenue from the above-CPI rate increases proposed in Order No. 4258 would eviscerate the Postal Service's incentives to control its costs and improve its productivity.[16] Nothing in the Commission's proposal would require the Postal Service to invest any of its additional revenue on productivity improvements. Far from triggering a "harmonious cycle," the rate increases would have the opposite effect. This fact is confirmed by the collapse of the Postal Service's productivity growth since the effective date of the exigency surcharge in Fiscal Year 2014 and the slackening of productivity growth experienced by several foreign postal operators since the recent relaxation of price cap regulation abroad. ANM *et al.* at 34-52.

We are not the only commenters to notice this. The Software & Information Industry Association notes that "the proposed rate increases would fail to incentivize cost savings and efficiencies within the Postal Service" because the Proposed Rules "would create a system where the Postal Service can increase rates to enable cost coverage . . . regardless of what these cost were." SIIA at 8. Quoting Commissioner Hammond, SIIA cautions that "if the Postal Service's costs . . . increase unexpectedly, the logic of [Order No. 4258] would require ever-increasing prices, even if that would drive away mail volume." *Id.* NPPC emphasizes that the CPI+2 authority "is totally unearned" and "not conditioned on cost improvements, efficiency gains, service improvement, or anything else." NPPC at 9. The Public Representative makes the same point with respect to the additional 0.75 percent of performance-based rate authority. *See* Public Representative at 33-34.

[16] This section assumes that the proposed rate increases would actually increase the Postal Service's net earnings. As discuss above in section I.B, the proponents of above-CPI rate increases ignore the risk that they would depress volume enough to be self-defeating.

As we explained in our initial comments, the Proposed Rules fail even to acknowledge the weakening of incentives to reduce costs and increase efficiency that will result from giving the Postal Service unconditional above-CPI pricing authority. The Postal Service and its allies do not cure this omission with their initial comments. Instead, like the Commission, the Postal Service and labor organizations actually propose to weaken those incentives further through the grant of *even greater* unconditional pricing flexibility. To the extent the Postal Service acknowledges that it needs to increase efficiency or reduce costs at all, it follows the Commission's lead and focuses solely on its purported need to increase capital investment in unspecified cost-saving improvements. This myopic focus on capital investment to the exclusion of any discussion of the change to incentives represented by the Commission's proposal is a critical flaw in those parties' arguments.

B. The record does not support the Postal Service's claim that insufficient investment capital is the main reason for the Postal Service's poor productivity and cost control.

Even if they were not inappropriately dismissive of the need for external incentives, the parties' proposals to provide the Postal Service with additional revenue for capital expenditures are unsupported. The premise of these proposals—that declines in productivity and failure to reduce costs have resulted solely from a lack of capital investment—is without foundation. ANM *et al*. at 41-52; *cf*. USPS at 24, 1, 9-10, 24-25. Indeed, the Postal Service fails to identify *any* investment capable of materially reducing the Postal Service's costs that has been canceled or delayed by a lack of funds. The only delayed capital investment that has been identified on the record relates to upgrading the Postal Service's vehicle fleet. Order No. 4257 at 220; ANM *et al*. at 45-46 & n. 21. As we have noted, the Postal Service has plenty of money for new vehicles. OIG Report No. DR-MA-14-005, *Delivery Vehicle Fleet Replacement* 6-7 (June 10, 2014).

Moreover, the insufficient-investment-capital theory ignores the decline in the Postal Service's volume and workload in recent years:

Table 2

	Annual % Change in Volume
FY 1997 – FY 2007	1.1%
FY 2007 – FY 2017	-3.4%

Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Tables 1 & 2"

It would make no sense for USPS to invest as much (or as high of a percent of revenue) in a declining volume environment as the USPS invested in a growing volume environment.

The Public Representative recognizes that since "[v]olume has fallen by almost one-third since FY 2006 . . . . some reduction in assets is appropriate." Public Representative at 31. As the Public Representative recognizes, the appropriate level of net assets is determined by the operational needs of the Postal Service, and as volumes decline, capital requirements will change. *Id.* Neither the Commission nor the Postal Service has shown "that net asset holding should . . . be returned to FY 2006 levels or that 5 years or any other period of time is appropriate to reach that level." *Id.* Declining capital expenditures, on their own, cannot justify increasing the rate authority available to the Postal Service.

Even the Postal Service has conceded that it does not need to invest as much now as before the enactment of PAEA, when mail volumes were still increasing. The Postal Service's Vice President of Network Operations acknowledged this in late 2011: "Additional structural changes are necessary to realign the mail processing network and eliminate excess capacity." Direct Testimony of David E. Williams in Docket No. N2012-1, *Mail Processing Network Rationalization Service Changes, 2012* (December 4, 2011) at 4. "These volume declines have resulted in an acceleration of excess capacity in the Postal Service's mail processing and transportation networks." *Id.* "[C]ontinued volume declines will result in ever-increasing excess capacity within mail processing facilities." *Id.* at 8.

Since then, the Postal Service has sold or scrapped many of its capital assets in an attempt to match network capacity better with the declining workload:

> In FY 2017, the total pieces fed through the Automated Flats Sorting Machine 100 (AFSM 100) operations declined 6.0 percent, while the aggregate productivity value decreased 7.1 percent, when compared to FY 2016. Similar declines were experienced between FY 2015 and FY 2016. It would appear that the loss of economies of scale related to volume declines has had a negative impact on the productivity values for AFSM100 operations. In response to these changes, the Postal Service removed 50 AFSM 100 machines from processing plants in FY 2017. Additional removals may be required in the future as the organization adjusts to declining mail volumes.

FY 2017 ACR at 27. More recently, the Postal Service has auctioned off delivery bar code sorters ("DBCSs"), its workhorse letter sorting machine, in 26 separate lots on govdeals.com. ANM *et al.*-LR-RM2017-3-5.xlsx, "DBCS". But the downsizing has been insufficient. "That's why we continue to adjust our infrastructure, removing excess equipment and adjusting staffing and scheduling to better match volume." Statement of PMG Megan J. Brennan (March 13, 2018), http://postalnews.com/blog/2018/03/14/pmg-discusses-workplace-safety-mail-and-package-volumes-and-other-topics-in-her-latest-business-focus-video/ (downloaded Mar. 29, 2018), at 1:39-1:46.

Finally, the Postal Service has ignored its ability to raise the funds for new assets by selling assets that are no longer needed. A recent example involved the construction of a massive new mail processing plant in Portland, Oregon. The new plant has the second largest work room of any USPS plant – big enough to hold 12 soccer fields. When opened, the $92.6 million building will house a massive package-sorting machine, 52 letter-sorting machines, 92 truck loading docks and a large vehicle maintenance facility.[17] The plant was funded in large part by a real estate swap. The City of Portland paid the Postal Service $88 million for its previous plant on a downtown site that is surrounded by a rapidly gentrifying urban historic district. The Postal Service used those proceeds, plus $69 million of additional funds, to buy a 47.5-acre site (formerly

[17] David E. Williams, USPS Leadership Forum for Stakeholders (Feb. 27, 2018); http://www.postal-reporter.com/blog/usps-93-million-mail-processing-center-set-to-open-soon-in-portland-oregon/; Linn's Stamp News (March 7, 2018), https://www.linns.com/news/postal-updates/2018/march/usps-mail-processing-plant-set-open-soon-portland.html.

a golf course) near the Portland International Airport and build an 818,000 square foot project on it.[18]

Given these facts, the conclusion is inescapable that the Postal Service's current capital investment levels do not justify above-CPI rate increases.

C. The Postal Service and its allies have ignored the major cost savings that the Postal Service could achieve without major new investment spending.

In reality, it should be unnecessary to evaluate exactly how much additional capital the Postal Service needs or how it intends to spend that capital. The price cap itself is designed to provide the proper incentives for the Postal Service to make sound decisions about how to spend its capital. Admittedly, the results to date have not always been encouraging. The FSS debacle is a glaring example of misguided, and costly, capital investment that has *reduced* efficiency.

But the price cap does not just provide incentives to invest in efficiency-enhancing capital improvements. It also provides incentives to cut costs and increase efficiency in other ways. That is the beauty of a price cap—it provides incentives to reduce costs and increase efficiency, but it is agnostic as to how those improvements are achieved. The Postal Service and the Commission, however, are not so irreligious. They have acted like acolytes at the altar of capital expenditures.

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[18] *Id.*; Korte Projects We've Delivered, https://www.korteco.com/construction-projects/usps-processing-distribution-center-portland-or; http://www.oregonlive.com/portland/index.ssf/2016/01/portland_oks_88_million_purcha.html.

The Postal Service argues that this position is justified because "it has become more challenging for the Postal Service to achieve productivity gains." USPS at 24. The Postal Service refers specifically to the Alvarez & Marsal report it submitted as Appendix C to its March 20, 2017 comments, which it claims demonstrates that "opportunities for further cost savings come nowhere close to filling the net-income gap." *Id.* at 65-66. The Postal Service's reliance on the report is misplaced for several reasons.

First, as the Postal Service concedes, the Commission did not rely on the report in Order Nos. 4257 or 4258. USPS at 67. Nor could the Commission have lawfully done so. The report was an advocacy piece commissioned by the Postal Service for use in this litigation, not a disinterested report of which official notice could be taken. Accordingly, the Commission could give weight to the claims in the report only if adverse parties had been given an opportunity to test its claims through discovery, including discovery of analyses prepared by the Postal Service in the ordinary course of business that might contradict the litigation claims in the Alvarez & Marsal report.

The Postal Service, however, uniformly opposed all efforts by mailers to obtain discovery in this docket, and the Commission ruled in favor of the Postal Service each time. Order No. 3763 (Jan. 30, 2017); Order No. 3807 (Feb. 24, 2017); Order No. 4397 (Feb. 6, 2018). In the Commission's words, it "did not contemplate discovery within this proceeding, and its view remains unchanged at this time. If, however, the Commission later determines that additional information is necessary to facilitate its review, it will consider requesting such information in accordance with its regulations." Order No. 3763 at 3. The

Commission did not do so. Instead, it chose to base its analyses of the Postal Service's revenue needs solely on the Postal Service's *historical* levels of spending—*i.e.*, spending incurred when the scale of the Postal Service's operations was larger than today:

> [The] Commission's proposals in Order No. 4258 are based on the Commission's analysis of what would be appropriate general capital spending levels . . . These levels are based on the Postal Service's historic spending levels, and not on any specific initiative that the Postal Service has previously undertaken.

Order No. 4397 at 4-5. Given the Postal Service's successful efforts to shield the business issues covered in the Alvarez & Marsal report from further discovery, the Postal Service may not be heard now to ask the Commission to rely on the report.

In any event, as the Postal Service acknowledges, Alvarez & Marsal identified approximately $3.9 billion in costs that the Postal Service could remove over the course of FY2017-FY2021. *Id.* This figure is a lowball number. Alvarez & Marsal excluded any costs savings that would "require labor, regulatory, and/or political consensus," indicating that there may be even more cost savings available if the Postal Service achieves successful regulatory results or reaches consensus with labor on certain issues. *Id.* Alvarez & Marsal also excluded any cost-savings opportunities that it did not identify as saving at least $100 million or opportunities that it could not specifically quantify "due to data and time constraints." *Id.* at n.169. The $3.9 billion figure, in other words, clearly represents the low end of the cost savings the Postal Service could achieve if it actively pursued available opportunities for cost savings.

Further, as NPPC notes, it is absurd to think that a $70 billion enterprise cannot find some additional cost savings or operational efficiencies. NPPC at 15. NPPC points to a recent rise in administrative and supervisory staff even while total employees declined. *Id.* at 15-16. In fact, the Postal Service has many ways to cut costs or increase efficiency without making any additional capital investments whatsoever. *See* ANM *et al.* at 86-101. For example, a number of existing workshare discounts are less than avoided costs, causing the Postal Service to perform work that could be done more efficiently by the private sector. Simply aligning these discounts to avoided costs would result in significant savings to the Postal Service with no capital expenditures at all. *Id.* at 94-97. The Postal Service also has many ways to grow volume, such as through innovative pricing, better customer service, or new products that better meet market needs. ANM *et al.* Phase 1 comments (March 2017) at 47-59. A properly motivated postal operator would pursue these other solutions aggressively instead of claiming that their potential has been exhausted.[19]

The Postal Service refuses to acknowledge these options, however. Rather, it insists that all declines in efficiency result from declining capital

[19] In fairness to the Postal Service, the Commission has itself served as an obstacle when the Postal Service has attempted to take advantage of these opportunities. As Discover Financial Services ("DFS") shows, the Commission's unduly stringent oversight of a proposed NSA caused DFS to divert more than $100 million in spending from direct mail to other channels—an amount far greater than the $20 million the Commission was concerned the Postal Service might "lose" from the proposed NSA. DFS at 4. Decisions like this one serve as a further disincentive to Postal Service innovation and encourage the fatalism the Postal Service displays in its comments.

investment, that only by increasing capital investment can the Postal Service improve efficiency, and that the only hope for financial stability lies in massive rate increases for captive mailers. This mindset is precisely the kind of passive and unimaginative thinking that incentive ratemaking is designed to prevent.

D. The Postal Service's comments inadvertently expose the fundamental illogic of the Commission's "harmonious cycle" theory.

Although the Postal Service heartily endorses the Commission's "harmonious cycle" justification for providing it with additional revenue, it takes issue with the Commission's application of the theory in the context of the proposed Performance Based Rate authority ("PBR") (a/k/a surcharge) of 0.75 percent per year. The Postal Service's reasoning exposes significant flaws in the Commission's approach that should cause the Commission to withdraw and reconsider its proposal.

The Postal Service correctly points out that "Order Nos. 4257 and 4258 link the PAEA-era development of operational [in]efficiency to a lack of means, rather than a lack of incentives." USPS at 90. The Postal Service has identified a key flaw in the Commission's reasoning. Objective 1, by its terms, requires that the ratemaking system be designed to "*maximize incentives* to reduce costs and increase efficiency," not to actually reduce costs or increase efficiency. As discussed above, it is these incentives the Commission's analysis in Order No. 4257 should have focused on, and its proposals in Order No. 4258 should have, to the extent necessary, strengthened these incentives. Instead, the Commission concluded that the current system did not meet Objective 1 because the Postal Service did not sufficiently reduce its costs due in part to a lack of funds for investment, Order No. 4257 at 222-26, and it proposed rules that weaken the incentives while attempting to provide these supposedly missing funds. Order No. 4258 at 52-53. This approach bears no relation to the language of Objective 1, as even the Postal Service recognizes.[20]

The Postal Service insists that "in the market environment that has prevailed for the last two decades, the Postal Service has strong inherent efficiency incentives." USPS at 26. It argues that "the best thing that the rate-regulation system can do is to give the Postal Service the flexibility to make capital investments and other business decisions necessary to fulfill its universal service mission in an efficient and effective manner." *Id.* (In plain English: give us the captive mailers' money and leave us alone.)

This position is curious. Whether the Postal Service's incentives to reduce costs and increase efficiency are "inherent" or not, the Postal Service seems to believe that the incentives *are* maximized under the current ratemaking system. And if these incentives are unrelated to the ratemaking system, it would seem that changing the system would not maximize them further. Like the Commission, it fails to tie the incentives provided (or not) by the ratemaking system to the changes it would propose to that system.

But as the Postal Service recognizes, the payoff from the above-CPI surcharges proposed by the Commission would not be the incentives they

[20] *See* USPS at 21 ("While it is true that the Postal Service was unable [to reduce costs and increase efficiency enough] to maintain 'financial stability,' that fact does not provide a logical reason to conclude that the Postal Service lacked maximum incentives.")

would provide, but the revenue the Postal Service hopes they would generate. The Postal Service later latches on to the logic of the "harmonious cycle" theory, explaining, "[if] the Commission's position is that additional revenue is needed to enable the Postal Service to make investments that might improve operational efficiency, then it makes no sense to withhold additional rate authority until after the Postal Service has improved operational efficiency, which—according to that same Commission position—the Postal Service cannot do without the additional revenue." *Id.* at 83-84.

The Postal Service's logic would be impeccable if there were any factual support for the premise that the Postal Service cannot increase operational efficiency without additional revenue. As explained above, however, its current inefficiency is not the result of a lack of capital, and its future efficiency growth is not dependent on additional capital. In fact, the Postal Service itself contradicts this premise with its repeated assertions that it has limited remaining opportunities to reduce costs or increase efficiency. If the Postal Service is already operating as leanly as possible, how will additional revenue improve its efficiency? What would it use the funds for?

The Postal Service's discussion of its natural incentives to improve efficiency does have one virtue however: it serves as a *reductio ad absurdum* of the Commission's proposals in Order No. 4258. The Postal Service has followed the Commission's reasoning to its logical conclusion. If the only path to financial stability is to shower the Postal Service with more revenue, triggering a "virtuous cycle" of more capital investment, improved operational efficiency, and greater volume and earnings, then there is no good reason to condition additional rate authority on actual productivity improvements or to set "reach" productivity goals that the Postal Service might not meet. If the Commission is unconcerned with the Postal Service's abuse of its market power, unconcerned with volume losses in response to increased prices, and confident that additional revenue will be used solely to improve operational efficiency and service performance, then the Commission should simply let the Postal Service charge whatever it wants, no questions asked.

The Commission recognizes that this reasoning cannot be correct: there must be some limit to the Postal Service's freedom to raise its prices on captive mail products. *See* Order No. 4258 at 34 ("[i]t would be inappropriate to design a system that lacks a mechanism to limit the magnitude of price adjustments. Such a mechanism is necessary to create predictability and stability, as required by Objective 2."); *see also* section IV.A, *infra*. But the Commission fails to reconcile this finding with the logic of the "harmonious cycle" theory. The Postal Service's comments vividly illustrate the deficiencies in the Commission's logic and the mistaken factual analyses underlying its premises.

The Commission must withdraw its rule because these opposing principles cannot be reconciled. Any level of rate authority below "unlimited" would be arbitrary if the "harmonious cycle" justification were correct, especially since neither the Postal Service, nor the Public Representative, nor the Commission have identified specific capital investments the Postal Service cannot make now but will make if given additional rate authority. But providing unlimited rate authority to the Postal Service is inconsistent with PAEA and federal court precedent, as described in Section IV, *infra*. The proposed surcharges are arbitrary and capricious because there is no principled basis for bounding the additional rate authority that the "harmonious cycle" theory would justify.

E. The proposed surcharge of 0.75 percent for achieving specified productivity targets would not cure the problem.

The weakening of incentives for cost control resulting from the proposed breaches of the CPI cap therefore cannot be remedied by the one element of the proposals in Order No. 4258 that the Commission portrays as an incentive proposal—the proposal to allow the Postal Service to surcharge rates by another 0.75 percent above CPI on meeting specified productivity goals. Any benefits from the incentive would be overwhelmed by the adverse incentives created by the other proposed surcharges. In any event, the proposal turns incentive ratemaking on its head. Regulated monopolies are expected to share some of their productivity gains with captive ratepayers, not demand a matching grant for productivity gains at the mailers' expense. ANM *et al.* at 52-57.

Further, the benchmark selected by the Commission—total factor productivity growth of 0.606, equal to the average efficiency gains of the past five years—provides no incentive to improve productivity at all. ANM *et al.* at 52-57. As the Public Representative explains, "The proposed rate allowance does not provide any incentive to increase the operational efficiency to a level greater than the gains of the last few years." Public Representative at 33. Dr. Lyudmila Bzhilyanskaya explains that "the operational efficiency-based standard should be higher than the average TFP growth in the most recent 5 years." Bzhilyanskaya Supp. Decl. at 7 (cited in Public Representative at 33-34). This conclusion should be obvious in light of the Commission's determination that the total factor productivity growth in the past 5 years was "neither sufficient to maximize efficiency under Objective 1 or to address financial stability under Objective 5 of the PAEA." Public Representative at 33.[21]

Indeed, the Commission's selection of the total factor productivity benchmark for its 0.75 percent "productivity" surcharge proposal is arbitrary for the same reasons as its supplemental rate authority proposal. Order No. 4258 "does not include any analysis to demonstrate that 0.75 percent additional rate authority will be sufficient to encourage the Postal Service to maintain the average 0.6 percent productivity growth." Public Representative at 34. Nor is there any "record analysis to determine the appropriate level of adjustment for efficiency gains." *Id.* And "[t]he order does not explain why or whether the proposed amount is adequate to encourage the Postal Service to strive to maintain its recent unsatisfactory level of efficiency gains." *Id.* As with its CPI+2 proposal, the Commission might as well have picked the 0.606

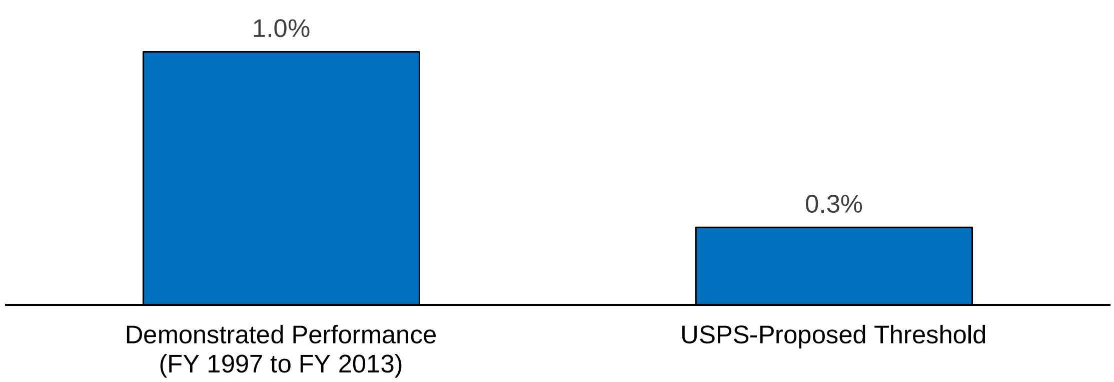
[21] ANM *et al.* reiterate that the Commission's finding that the total factor productivity gains were not sufficient to maximize efficiency is a misconstruction of the statute and the purpose of the 10-year review. Objective 1 requires the Commission to maximize *incentives* for efficiency. Declining total factor productivity growth may be evidence that the incentives were not maximized, but it also may be evidence that the incentives *were* maximized, but the Postal Service failed to respond properly to them. The Commission failed to establish in Order No. 4257 that the Postal Service's recent decline in total factor productivity resulted from the system of ratemaking (including the CPI cap) rather than the Postal Service's suboptimal response to its incentives.

total factor productivity target and the 0.75 percent additional rate authority out of a hat. *See also* NPPC at 66-69.

The Postal Service identifies problems with the Commission's productivity incentives as well, particularly its use of total factor productivity as the prime measure of efficiency. But the ostensible productivity incentives proposed by the Postal Service are even worse than those proposed by the Commission. The Postal Service's first proposal is for the Commission to allow additional above-CPI increases without having to meet or exceed any productivity benchmarks at all. USPS at 113. How this additional rate authority would provide an incentive to do anything is left unexplained.

The Postal Service's alternative proposal would be nearly as bad: the Postal Service would be allowed to charge the surcharge merely for achieving an annual rate of productivity growth of 0.294 percent. USPS at 107. This target, however, is a fraction of the levels of productivity growth that the Postal Service routinely achieved before the Commission allowed an exigent surcharge to take effect in FY 2014:

Figure 3



Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Figures 1 & 3"

Moreover, the Postal Service would be eligible for the surcharge if *either* its single-year or annual average TFP growth equaled or exceeded the meager benchmark. Further, the Postal Service would have it both ways: underachieving single years would not count against it (USPS at 118), but overachieving single years should be "banked as insurance against future years." *Id.* at 121.

This absurdly undemanding standard is inconsistent with Objective 1. Additionally, there is no theoretical basis for picking "CPI+1" as the proper level of productivity-related surcharge. And there is even less reason when the Commission has already provided the Postal Service with CPI+2, which the Postal Service could conceivably use for capital investments as well. Neither the Postal Service nor the Commission acknowledge the impact of the CPI+2 rate authority on the existing incentives provided for by the CPI cap, nor do they recognize that, to the extent this additional authority actually results in additional revenue, it could be used to increase capital investment if warranted to increase efficiency.

Performance-based rate authority should be tied to improvements in performance. This principle seems obvious, but neither the Commission's nor the Postal Service's proposals recognize it. The Commission has already proposed to allow the Postal Service a two percent rate surcharge with no conditions; a 0.75 percent "productivity" surcharge with no improvement in productivity growth; and a 0.25 percent service performance surcharge with no change in service performance. For the Postal Service, this is not enough. It wants more pricing authority for doing even less. The Commission's proposal is arbitrary. The Postal Service's is absurd.

IV. THE POSTAL SERVICE'S PROPOSALS WOULD NOT MERELY VIOLATE OBJECTIVES 2 AND 8 BUT WOULD MAKE THE POSTAL SERVICE AN UNREGULATED MONOPOLY.

In their initial comments, the undersigned parties explained why the alternative regulatory system proposed in Order No. 4258 would also violate Objective 2 (rate stability) and Objective 8 (just and reasonable rates). ANM *et al*. at 57-82. The statutory term "rate stability" requires that rates not increase in real (*i.e.*, inflation-adjusted) terms. ANM *et al.* at 57-62. And the "just and reasonable" (or "reasonable and equitable") standard of Objective 8 and 39 U.S.C. § 404(b) protects captive ratepayers from having to pay for needlessly high costs or needlessly low efficiency. The massive rate increases that the standards proposed in Order No. 4258 would allow are flatly at odds with these objectives. ANM *et al.* at 62-71.

The Postal Service's proposals in its initial comments, however, make the Commission's proposal seem reasonable by comparison. Even the more modest of the Postal Service's proposals would allow rate increases far beyond what Order No. 4258 would allow. USPS at 48-80. And the most extravagant of the Postal Service's proposals would amount to *de facto* deregulation of all market-dominant mail. USPS at 40-48.

The Postal Service exposes its agenda when it states that it "remains deeply skeptical of any price cap's ability to achieve the statutory objectives in light of the statutory factors." *Id*. at 77. The Postal Service has never accepted the price cap as a legitimate form of regulation, despite its widespread acceptance in economic literature, and accordingly has never operated as if it would be forced to abide by the cap if it suffered losses. The Postal Service seems at times to have spent more effort over the past ten years asking Congress and the Commission to loosen the price cap than evaluating the Postal Service's operations, management structure, and business philosophy to develop a strategy for success within the cap.

The Postal Service's initial comments reflect the same oppositional mindset. As discussed above, the Postal Service absurdly contends that it has exhausted all the potential efficiency improvements that may have once existed and is now condemned to a future of inexorably rising costs and declining volumes. The only solution to its overstated woes is a constant injection of more revenue—not in exchange for better service or improved product offerings, but unconditionally. This defeatist assessment of its financial condition is coupled with legal arguments that are similarly focused on achieving one goal: more revenue, without conditions. This exclusive focus on obtaining more revenue manifests in arguments that are inconsistent and self-contradictory. But more fundamentally, the result the Postal Service seeks is incompatible with its status as a monopoly service provider under PAEA.

A. The Postal Service Is a Monopoly And Must Be Subject to Stringent Rate Regulation.

The most radical of the Postal Service's proposals, dubbed "streamlined monitoring," amounts essentially to deregulation of the maximum rate level of all market-dominant products. USPS at 40-45. Market-dominant postal rates would be constrained, if at all, only by "the current market environment" and "the threat of intervention" by the Commission in unspecified future scenarios. *Id*. at 44-45. The Postal Service defends this *laissez-faire* approach on the theory that the market "supplies maximum incentives for the Postal Service to reduce costs, increase efficiency, maintain high-quality service standards, and restrain price increases." *Id.* at 45.[22]

This is the same system of deregulation that the Postal Service proposed in its Phase 1 comments and the Commission rejected in Order Nos. 4257 and 4258. *Cf*. USPS at 44; Order No. 4257 at 103; Order No. 4258 at 34. The Postal Service dismisses the Commission's reasoning as "dubious on its face" and a "non sequitur," USPS at 37. In fact, the Commission was correct to recognize

[22] The Postal Service dresses up its proposal by inviting the Commission to "conduct robust monitoring of rates, costs, financial condition, cost reduction initiatives, efficiency improvements, and service performance, in order to assess whether and when to intervene." USPS at 45. But the inherent difficulty of effectively overseeing the costs and efficiency of a large regulated enterprise from the outside is one of the main reasons that lawmakers and regulators have abandoned cost-of-service regulation in favor of index ratemaking. *See*, *e.g*., SANFORD V. BERG & JOHN TSCHIRHART, NATURAL MONOPOLY REGULATION 305 ((1988) ("Many analysts have concluded that … the regulator not only must be a watchdog on waste but also must monitor the firm's effort in seeking least-cost solutions. However, effective monitoring is virtually impossible short of duplicating the firm's managerial functions."). *See also* STEPHEN BREYER, REGULATION AND ITS REFORM 49 (1982); P. Joskow and R. Schmalensee, "Incentive Regulation for electric utilities," 4 *Yale J. on Regulation* 1 (1986); MICHAEL EINHORN, PRICE CAPS AND INCENTIVE REGULATION IN TELECOMMUNICATIONS 3 (1991); JEAN-JACQUES LAFFONT AND JEAN TIROLE, A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION 2, 84, 514-16 (1993).

that "it would be inappropriate to design a system that lacks a mechanism to limit the magnitude of price adjustments." Order No. 4258 at 34. The reasons, however, are far more basic than "predictability and stability" of rates. *Id*. Freeing the Postal Service from oversight and allowing "the current market environment" (USPS at 44) to substitute for aggressive regulation of rates and practices would be illegal.

The Postal Service enjoys statutory monopolies over the delivery of letters and access to the mailbox. Private carriage of most letters on public roads is a crime, and the Postal Service has defined "letter" expansively. 18 U.S.C. §§ 1693-1696; 39 U.S.C. §§ 601-606 ("Private Express Statutes"); *Associated Third Class Mail Users v. USPS*, 600 F.2d 824 (D.C. Cir. 1979). The Postal Service has also asserted an exclusive right to insert mail in the mailboxes owned by the public. DMM § 508.3.1; *cf.* 18 U.S.C. 1725 ("mailbox monopoly"). By definition, the Postal Service faces no competition for these activities.

The plain text and structure of PAEA require the Commission to protect mailers against the Postal Service's abuse of this monopoly power. PAEA established two kinds of products—market dominant and competitive. It defined market dominant products as "each product in the sale of which the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products." 39 U.S.C. § 3642(b)(1). A product over which the Postal Service has market dominance is subject to maximum rate regulation. 39 U.S.C. § 3621. A product over which the Postal Service lacks market dominance is not. 39 U.S.C. § 3633; *USPS v. PRC*, 816 F.3d 883, 884 (D.C. Cir. 2016).

Products covered by the postal monopoly are conclusively presumed to be market dominant as a matter of law. 39 U.S.C. § 3642(b)(2). Any other product classified as market dominant by PAEA may be reclassified as competitive on a showing that the product faces competition strong enough so the Postal Service cannot set its prices "substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products." *Id.*, §3642(a)(1). The Commission has exempted products from maximum rate regulation when the Postal Service has shown that they face effective competition. *USPS v. PRC*, 842 F.3d 1271, 1272-73 (D.C. Cir. 2016) (citing cases). But the Commission has declined to exempt a product from maximum rate regulation without such a showing. *See* Order No. 2306 in Docket No. RM2013-57, *Competitive Product List Adding Round-Trip Mailer* (Dec. 23, 2014), *aff'd*, *USPS v. PRC*, 816 F.3d 883 (D.C. Cir. 2016).

The Postal Service has also conceded, if tacitly, that competition is too weak to restrain the Postal Service's market dominance over many products *not* covered by the Private Express Statutes. If the Postal Service truly believed otherwise, it could have demonstrated that it faced competition for these products and asked the Commission to reclassify them as competitive. Hence, those products remaining on the Market Dominant product list can be assumed to lack sufficient competition to constrain effectively the Postal Service's power to raise prices or decrease the quality of service.

In short, Congress and the Commission have already evaluated the Postal Service's argument and found it wanting. That is why market-dominant products are subject to a CPI-based price cap: to simulate the effective competition that these products lack. And it is why these products must continue to be subject to regulation. As the D.C. Circuit stated in holding the Interstate Commerce Commission could not exempt market dominant rail transportation from maximum rate regulation as if the transportation faced effective competition, "The legislation [that authorized the deregulation of services that faced effective competition] did not strip the Commission of its power and duty to protect shippers from the unreasonably high rates of carriers with market dominance." *Coal Exporters Ass'n of the United States v. United States*, 745 F.2d 76, 81 (D.C. Cir. 1984) (quoting *Burlington Northern Inc. v. United States*, 661 F.2d 964, 973 (D.C. Cir. 1981)). As the same court held in another case, "presumed market forces may not comprise the principal regulatory constraint" keeping a regulated monopoly's rates "within the 'zone of reasonableness.'" *Farmer Union Cent. Exchange v. FERC*, 734 F.2d 1486, 1530 (D.C. Cir. 1984). "Presumed market forces" are all the Postal Service offers to justify its alternative proposals.

The Postal Service and its unions, evidently aware of the unattractiveness of seeking *de facto* deregulation of maximum rates on market-dominant products, insist that "the mere *authorization* of additional pricing flexibility by no means suggests that the Postal Service will necessarily *use* all of the authority it is given. Its actual pricing decisions will be informed by changes in demand and other market forces." USPS at 79; *accord*, *id*. at 2; APWU at 12; NALC at 24; NPMHA at 2-3; *see also* p. 13 n.4, *supra*. In the words of the Postal Service, the regulatory "community has seen this movie before." USPS at 46. In 1983, the major Eastern railroads petitioned the ICC to exempt from maximum rate regulation the transportation of coal from Appalachian mines to ports in Tidewater Virginia for export abroad. The theory advanced by the railroads was analogous to the one advanced by the USPS here: despite the railroads' market dominance, market forces, including competition in export markets from foreign sources of coal, would protect Appalachian coal shippers from gouging. The ICC agreed. Ex Parte 346 (Sub-No. 7), *Railroad Exemption—Export Coal*, 367 I.C.C. 570 (1983). The D.C. Circuit disagreed. It held that the Commission's finding that the railroads would not abuse their market power by pricing more than the market will bear was "unreasonable in that it largely ignores the protections Congress meant to guarantee to shippers." *Coal Exporters Ass'n*, 745 F.2d at 99; *see generally id*. at 84-85, 90-93, 95, 98-99.

The postal community has also "seen this movie before." In Docket No. MC2013-57, the Postal Service asked the Commission to transfer round-trip DVD mailers to the competitive product list, thereby exempting them from maximum rate regulation. The Postal Service argued that competition for viewers with content provided via other distribution channels (*e.g.*, digital streaming services) constrained how much DVD rental companies could charge consumers, and thus indirectly constrained how much the Postal Service could charge DVD rental companies. The DVD rental companies, like the coal shippers, argued that end-market competition and the Postal Service's incentive not to charge more than the market would bear were inadequate substitutes for robust maximum rate regulation. The Commission agreed with the mailers, as did the D.C. Circuit. Order No. 2306 in Docket No. MC2013-57, *Competitive Product List—Adding Round-Trip Mailer* (Dec. 23, 2014) at 52-54, *aff'd*, *USPS v. PRC*, 816 F.3d 883, 886-87 (D.C. Cir. 2016).

Finally, the Postal Service's reliance on recent experience with looser regulation of maximum postal rates in Great Britain, and variations on index ratemaking involving other industries in the United States and Canada, is also misplaced. Lawmakers in some other regulatory jurisdictions have loosened incentive regulation. Congress has not done so for the Postal Service. ANM *et al.* at 9-29.

In any event, the performance of Royal Mail and several other foreign postal operators since the abandonment of price cap regulation in the United Kingdom is a chilling lesson about what would lie in store for mailers in the United States if the Commission were to follow the British lead: massive above-inflation rate increases for captive mailers, and a collapse of efforts to control costs and improve productivity. *See* ANM *et al.* at 51-52. That prices may have increased more slowly after the initial surge is no solace. *Cf.* USPS at 48 n.126. This pattern is exactly what one would expect from a deregulated monopoly—an immediate increase in prices to raise them to the profit-maximizing monopoly level, then a subsequent leveling as increases *above* this level would lessen profits. Monopoly power does not involve the ability to increase prices without limit. Even a pure monopoly has a profit-maximizing price above which profits fall off. N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS 307 (6th ed. 2012); GEORGE J. STIGLER, THE THEORY OF PRICE 195-96 (3d ed. 1966). But the monopoly can raise prices above what would exist in a competitive market at the expense of captive consumers. Royal Mail did just that, and the Postal Service wants to follow suit.

The Postal Service's discussion of alternative approaches to regulating maximum rates for other electric utilities and other network industries is instructive in another way. The Postal Service advocates for the elements of other regulatory systems that would provide it with more revenue, but ignores or argues against applying any of the features of those systems that protect mailers or restrict the pricing flexibility of the regulated monopoly.

For instance, the Postal Service urges the Commission to adopt the "unconditional" capital funding method, the "K-bar," employed by the Alberta Utilities Commission ("AUC"). USPS at 92-93. But AUC's Performance-Based Regulation includes multiple parameters carefully designed to constrain rates and promote efficiencies in ways that are more limiting than what the Commission has proposed for the Postal Service. Further, these plans recognize the need for continuing, *ex ante* regulation of the monopoly provider. *Cf.* USPS at 45. The Postal Service ignores most of these restrictions.

Most notably, the K-bar is coupled with a price cap featuring an X-factor that limits price increases below the rate of inflation—a far cry from the unrestrained additional pricing authority the Postal Service is requesting in this docket. *See* Errata to Decision 20414-D01-2016, 2018-2022 Performance-

Based Regulation Plans for Alberta Electric and Gas Distribution Utilities, at 4. In fact, the Postal Service expressly states that the Commission should not incorporate features of the AUC's system that would limit the funds available to the Postal Service, "such as distinguishing between 'type 1' and 'type 2' capital expenditures, using a capital tracker for certain expenses, or setting the K-bar on the basis of historical investment levels." USPS at 92 n.227. In other words, the Postal Service seeks all of the revenue, but none of the oversight.

The Postal Service's decision to cherry pick the AUC precedent is ironic, to say the least. As the AUC itself admonished, "a PBR plan must be viewed and considered as a whole. It is not enough to pick one element of the PBR plan, argue that it should be eliminated, left unchanged or fixed and consider that to be the end of the conversation. All of the elements of the plan must be considered together in order for the Commission to design a PBR plan that satisfies" the applicable regulatory principles. Decision 20414-D01-2016 at 6.

B. The alternative systems of regulation proposed by the Postal Service and other parties also violate Objective 2.

The undersigned parties showed in their initial comments that the proposals in Order No. 4258 would violate Objective 2 (rate stability). Rate stability means that rates may not increase measurably faster than inflation. The Commission, in redefining rate stability as predictability of rate increases, has erroneously confused the two concepts. ANM *et al.* at 57-62. The Postal Service and other proponents of above-CPI rate increases commit the same error. USPS at 37-44. The Public Representative does not mention Objective 2 at all.

C. The Postal Service and its allies fail to reconcile their proposals with Objective 8 and 39 U.S.C. 404(b) (just and reasonable rates).

In their initial comments, the undersigned parties explained that the alternative system proposed in Order No. 4258 would allow rate increases that would devastate mailers, thereby violating the just and reasonable standard of Objective 8 and 39 U.S.C. § 404(b). ANM *et al.* at 62-71. Most of the mailer comments filed in this proceeding focus on this issue.

The Postal Service and the Public Representative, which propose even steeper increases than the Commission has, largely ignore the just and reasonable standard. The Postal Service focuses solely on whether its existing market-dominant rates are *high enough*. Except for an off-hand assertion that an "unconditional capital-funding mechanism of one percent" would "not be excessive," USPS at 94-95, the Postal Service ignores the issue of whether its proposed systems of regulation would result in rates that are unreasonably high and ignores the separate question of whether its proposals would result in rates that are *too high* to comply with Objective 8. USPS at 9, 68. The Public Representative does not mention Objective 8.

D. The proposed rate increases are unjustified by Objective 3 (high service quality standards).

The undersigned parties also showed in their initial comments that the Commission's treatment of Objective 3 (service quality standards) is arbitrary.

Service quality cannot be assessed in isolation, but only in the context of what ratepayers are willing to pay. Nothing in the record indicates that mailers value greater service quality enough to be willing to pay the higher rates proposed in this docket. ANM *et al.* at 82-83 (PRC begs question of whether any improvement in service is warranted). On this issue, the Postal Service is generally in agreement. USPS at 27-32 (the "mere incidence of service standard changes is not *per se* proof that the system failed to allow for the maintenance of 'high quality' service standards").

The Commission's proposal to authorize the Postal Service to collect an additional surcharge of 0.25 percent for maintaining existing nominal service standards is irrational in two respects. First, the Postal Service would qualify for the surcharge merely by maintaining its existing nominal standards; whether actual service quality satisfied those or any other service standards would be irrelevant. Second, the proposal violates Objectives 1, 2, and 8 because it is inconsistent with basic principles of incentive ratemaking. Regulated monopolies are not entitled to this kind of financial participation trophy merely for holding service quality constant without reducing costs. ANM *et al.* at 83-84. Significantly, the Postal Service states that the performance standard would be so easy to satisfy that the Postal Service does not object to it despite claiming that it is based on "problematic premises." USPS at 130-31.

V. ADDITIONAL SURCHARGES FOR PERIODICALS MAIL AND MARKETING MAIL FLATS ARE ALSO UNWARRANTED.

The initial comments also confirm that the additional rate surcharges proposed for "non-compensatory" products and classes are also unlawful. The proposal violates Objectives 1, 2, and 8, and cannot be excused by Objective 5. The failure of Periodicals Mail and Marketing Mail Flats to cover attributable costs is a cost-control problem, not a revenue problem. These products lose money because of a series of Postal Service management bungles: (1) failing to scale down its operations in response to declines in mail volume; (2) making and then doubling down on a misguided investment in the FSS; (3) deliberately mispricing Carrier Route Basic flats; and (4) failing to address the Postal Service's longstanding personnel compensation issues. Eliminating the first two of these unforced errors would allow flats to become fully compensatory, or nearly so—even without considering the related contribution from First-Class Mail, letter-shaped Marketing Mail and package volumes that periodicals and catalogs generate. ANM *et al.* at 84-104.[23]

The Commission continues to recognize in other dockets the need for further attention to "cost and service issues" in Periodicals Mail and Marketing Mail Flats. The Commission's Annual Compliance Determination Report for FY 2017 acknowledges that these issues have not been resolved:

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[23] The Commission noted in its FY 2017 Annual Compliance Determination Report that unit transportation costs for flats decreased by 11 percent between FY 2016 and FY 2017. *Id.* at 179. This apparent improvement, however, was caused by a change in costing methodology. ANM *et al.* at 89 n.50; USPS Annual Compliance Report for FY 2017 (Dec. 29, 2017) at 31.

> With respect to Periodicals In-County, Periodicals Outside County, and Standard Mail Flats, the Commission finds that additional transparency is necessary to hold the Postal Service accountable. The Commission will continue to explore cost and service issues related to flats in Docket No. RM2018-1.

FY 2017 ACD (March 29, 2018) at 2. Moreover, the Commission anticipates that the proceedings in Docket No. RM2018-1 "will lead to the development of measurable goals to decrease the costs and improve the service of flats." FY 2017 ACD (March 29, 2018) at 2. Findings like these make all the more baffling the Commission's proposal here to prejudge the issue by adopting a two percent rate surcharge on Periodicals Mail and Marketing Mail Flats before Docket No. RM2018-1 is resolved. ANM *et al.* at 103-04.

The Commission's meat-axe approach to "non-compensatory" mail products in the present docket also contrasts with the far more balanced approach of the surcharges proposed in the 21st Century Postal Service Act of 2012 (S. 1789) and the Postal Reform Act of 2013 (H.R. 2748). ANM *et al.* at 104-108. The Commission's approach is also at odds with the approach taken in S. 2969, the Postal Service Reform Act of 2018, a bill introduced by a bipartisan group of Senators on March 22, 2018. Section 202(c) of the bill would authorize the Commission to impose above-CPI increases on "underwater" products in certain circumstances. But the remedy proposed by the bill is far more balanced than the one-dimensional approach of Order No. 4258. Section 202(c) would require the Commission, before imposing any surcharge on "underwater" products, to "determine whether any operational decisions of the Postal Service have caused any direct or indirect costs to be inappropriately attributed to any underwater product"; quantify the impact of any such operational decision"; and net out any costs so inflated or inappropriately attributed before imposing any surcharge on "underwater" products.

The initial comments of other parties offer no lawful basis for implementing the proposed underwater surcharge. The Postal Service, while supporting the surcharge with some modifications, USPS at 142-46, offers no explanation of why the Postal Service should be allowed to surcharge captive mailers to recover losses that were caused by Postal Service mismanagement. The Public Representative and Valpak, while arguing that the underwater surcharge is too small to make Periodicals Mail cover attributable costs, also ignore this threshold question. Public Representative at 28-30, 57-61 and Kwoka-Wilson Decl. at 15-17; Valpak at 4-8.

VI. THE COMMISSION MAY NOT (AND SHOULD NOT) ABANDON THE CPI-U IN FAVOR OF THE CPI-DS.

NALC contends that the "CPI-U is flawed as a PAEA price cap benchmark. As an index of all consumer prices, it is far too broad a measure for postage rates." NALC at 22. Instead, NALC urges the Commission to abandon the particular CPI series prescribed by Congress in 39 U.S.C. § 3622(d)(1)(A), the Consumer Price Index for All Urban Consumers, with a much narrower CPI index series, the CPI index for delivery services ("CPI-DS"). NALC reasons that "the same factors that drive private-sector delivery prices—energy, transportation service expenses, and labor costs—also drive postal prices." NALC at 22. "[A] CPI-DS price cap would require USPS to seek to match the efficiencies of private-sector delivery companies. CPI-DS reflects prices charged by private-sector delivery companies, including the two national logistics and delivery companies most similar to USPS: UPS and FedEx." NALC at 23. The Commission will be unsurprised to learn that "CPI-DS outpaced CPI-U over the decade from 2006 to 2016, increasing a total of 60.7%, compared to CIP-U's total increase during the same period of 19.6%." NALC at 23.

The Commission should reject this proposal for several reasons. First, the Commission has no power to entertain the NALC proposal. 39 U.S.C. § 3622(d)(1)(A) specifies the CPI for All Urban Consumers, not the CPI-DS or some other CPI index, as the sole legal basis for the benchmark index mechanism that PAEA required the Commission to establish and maintain.

Second, the CPI-DS would be an inferior substitute for the CPI for All Urban Consumers even if the PAEA left the choice of CPI index to the Commission's discretion. The CPI-DS accounts for only a very small percentage of the costs that are included in the CPI-All Urban Consumer. As a result, the CPI-DS has a wide range of error. Moreover, the services captured in the CPI-DS are limited to retail package services. This is a small and unrepresentative sample of all delivery services, let alone all market dominant mail. Retail parcels and business parcels also carry a different mix of contents than do the letters and flats that dominate market-dominant mail. The Bureau of Labor Statistics has noted the danger of relying on an index defined by as narrow and specialized a range of products as those covered by the CPI-DS:

> An escalation contract should specify which CPI item category is to be used in the escalation. Generally, users are encouraged to

> specify a broad item category, such as the all items index, when writing an escalation contract because broader item categories have larger sample sizes and are typically subject to smaller sampling error.

Bureau of Labor Statistics, Writing an escalation contract using the Consumer Price Index (Nov. 2012), *available at* https://www.bls.gov/opub/btn/volume-1/writing-an-escalation-contract-using-the-consumer-price-index.htm. CPI-Delivery Services represents 0.013% of the CPI-U index. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers (Feb. 2018), *available at* https://www.bls.gov/news.release/cpi.t02.htm.

Finally, the formulation of the CPI-DS index necessarily means that it is dominated by the prices and volumes of UPS and FedEx, the two largest private package carriers. Hence, changes in the CPI-DS can be driven as much by the two carriers' pricing decisions as by costs. Adopting the CPI-DS index would mean that the regulatory ceiling on postal rates would be determined by the pricing decisions of the Postal Service's private competitors. This anticompetitive effect would occur *even if the private carriers did not want this degree of coordination*. They would have no way to opt out of the linkage.[24]

VII. THE COMMISSION'S CHANGES TO WORKSHARE DISCOUNTS ARE WORTH PURSUING.

The Commission's proposals to change workshare discounts are worth pursuing. If they are properly implemented, they could resolve some of the

[24] UPS and FedEx are not only major competitors of the Postal Service, but two of its largest customers. Hence, adoption of the CPI-DS index would have the effect of basing market-dominant price changes in large part on changes in competitive package prices.

problems USPS is facing by encouraging more efficient mail preparation, which would reduce the all-in cost of using mail and promote the growth of mail volumes. For this reason, ANM *et al.* generally agree with Pitney Bowes and NPPC that the proposed rules should go further in forcing the Postal Service to bring workshare passthroughs that are currently well below 100% of avoided costs up to the 100% level. Passthroughs below 100% are just as inefficient as passthroughs above 100%, and there is no reason for the Commission or the Postal Service to police passthroughs above avoided costs more stringently than those below avoided costs.

In pursuing this goal, the Commission should not be dissuaded by PAEA's one-sided prohibition on passthroughs that exceed 100% of avoided costs. The PAEA did not forbid the Commission from continuing to apply the Efficient Component Pricing Rule, a longstanding principle of postal regulation.[25] PAEA leaves the Commission free to exercise its plenary rulemaking authority by establishing rules requiring the Postal Service to deepen worksharing discounts to as close to avoided costs as possible.

The Commission should exercise this authority. As the Commission noted yesterday in its Annual Compliance Determination Report for FY 2017, "Although passthroughs below 100 percent are lawful, they send inefficient pricing signals to mailers. Passthroughs set as close as possible to 100 percent promote pricing efficiency, lower the total combined costs for mailers and the

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[25] See *also* R2006-1 Op. & Rec. Decis. ¶¶ 4004-05; FY 2015 Annual Compliance Determination Review at 18-19; Order No. 4257 at 135-36; Order No. 4258 at 27.

Postal Service, and encourage the retention and growth of the Postal Service's most profitable products." *Id.* at 15. "Although 39 U.S.C. § 3622(e) does not prohibit the Postal Service from offering workshare discounts with passthroughs that are less than 100 percent, other statutory requirements and objectives focus on sending efficient pricing signals to mailers. This concept is relevant to all passthroughs." *Id.* at 21. Such a rule is also consistent with Factor 5, which requires the system of ratemaking to take into account "the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service." 39 U.S.C. § 3622(c)(5).

Nor should the Commission be deterred by claims that an evaluation of workshare discounts is outside the scope of this proceeding or somehow beyond the Commission's statutory authority. *Cf.* Greeting Card Association at 19. While the Commission lacks authority to modify or disregard the language of section 3622(e) because that language itself is not part of the "system" of regulation the Commission established, the Commission's rules implementing section 3622(e) and governing workshare discounts *are* part of the "system." Although the rules must still comply with section 3622(e), there is nothing in the proposed workshare rules that would not meet this standard.

Indeed, Section 3622(e) permits workshare discounts to exceed 100% of avoided costs in several instances, including when reducing the discount "would impede the efficient operation of the Postal Service," 39 U.S.C. § 3622(e)(2)(D), or "lead to a loss of volume in the affected category . . . and reduce the aggregate contribution to the institutional costs of the Postal

Service from the category." 39 U.S.C. § 3622(e)(3)(A). Establishing bands within which such discounts would be presumed to be lawful is consistent with this standard. Forcing the Postal Service to reduce discounts due to swings in avoided costs driven by the vagaries of costing and imprecise data rather than clearly identified increases in the actual cost of performing specified activities would lead to more inefficient preparation of mail and would undermine the predictability and stability of rates that keeps mail in the system.

The Commission should therefore proceed to require that worksharing discounts comply with the Efficient Component Pricing Rule as quickly as possible. As ANM *et al.*, NPPC and Pitney Bowes have explained in their comments, the ECP Rule calls for worksharing discounts that are set at a full 100 percent of avoided costs, not less. Nothing in Section 3622(e) or any other provision of PAEA requires otherwise.

CONCLUSION

The initial comments reveal a striking industry consensus that the alternative regulatory system proposed in Order No. 4258 should not be adopted. For the reasons explained above, the proposed system is fundamentally arbitrary and inconsistent with PAEA. Even the comments that advocate greater rate surcharges than proposed in Order No. 4258 underscore the basic flaws in the Commission's approach.

Second, there is no immediate crisis that requires immediate adoption of final rules. As the Commission found in Order No. 4257—and the Postal Service acknowledged in its most recent Form 10-K—the Postal Service has sufficient funds to continue providing mail service in the short run and for the foreseeable future. The Commission has time to pull back and rework its proposals.

Moreover, for the reasons discussed above, the proposals would need to be revamped so thoroughly to meet the requirements of reasoned decisionmaking under PAEA that the Commission could not prudently adopt final rules without further comment from interested parties. Trying to ram through final rules now would merely invite a judicial remand on the ground that the result was not a "logical outgrowth" of Order No. 4258. *Allina Health Services v. Sebelius*, 746 F.3d 1102 (D.C. Cir. 2014); *Ass'n of Private Sector Colleges v. Duncan*, 681 F.3d 427, 461-63 (D.C. Cir. 2012); *CSX Transportation, Inc. v. STB*, 684 F.3d 1076 (D.C. Cir. 2009); *American Federation of Labor v. Donovan*¸757 F.2d 330, 338 (D.C. Cir. 1985). Moreover, even apart from the dictates of the Administrative Procedure Act, the most practical way to resolve many of the factual issues raised by the Commission's proposals is likely to begin with informal consultation between the Commission and postal stakeholders. Hence, if the Commission decides to move forward with changes to the ratemaking system, it should do so only after extensive informal consultation with stakeholders and another opportunity for formal comment.

Finally, there is another reason why the Commission should avoid rushing out a final rule. That reason resides at the eastern end of Pennsylvania Avenue. Two recently introduced postal reform bills, H.R. 756 and S. 2629, reflect a growing recognition in Congress that comprehensive postal reform must deal with issues that are beyond the Commission's control, and therefore requires legislation.

The recently introduced Senate bill illustrates this. The bill would reinstate half of the 4.3 percent exigent rate surcharge temporarily implemented in Docket No. R2013-11. S. 2629, § 207(a). But this provision would be only part of a broad set of reforms. For example, the bill would also do the following:

1. All unpaid prefunding obligations imposed on the Postal Service by current 5 U.S.C. § 8909a(d)(3)(A) would be cancelled. S. 2629 § 102(c).

2. The Postal Service would be allowed to amortize any remaining health care obligations over 40 years. *Id.* § 102(b) (to be enacted as proposed 5 U.S.C. § 8909a(d)(3)(A)).

3. The Postal Service would be allowed to ask the Commission to waive an annual installment payment—and extend the 40-year period for amortizing retiree benefit obligations—if the Service achieved specified levels of financial stability and service quality. *Id.*, proposed § 8909a(d)(4)(C)(i)-(ii). If the Postal Service failed to make a prefunding payment without seeking a waiver, the bill would protect captive mailers against a rate increase. *Id.*, proposed § 8909a(d)(3)(C)(iii).

4. The postal retiree health benefit system would be integrated with Medicare. *Id.* § 101. "This reform would significantly reduce or eliminate the Postal Service's projected unpaid health care liabilities and would be fully paid

for." *See* The Postal Service Reform Act of 2018: Improving Postal Operations, Service, and Transparency Highlights (March 22, 2018).

5. While the Commission would be authorized to impose above-CPI increases on "underwater" products in certain circumstances, the Commission would first need to "determine whether any operational decisions of the Postal Service have caused any direct or indirect costs to be inappropriately attributed to any underwater product"; quantify the impact of any such operational decision; and net out any costs so inflated or inappropriately attributed before imposing any surcharge on "underwater" products; among other requirements. S. 2629, § 207(c)(2). And the Commission would be required to "account for the cultural and information value that underwater products … have to the mail." *Id.*, § 207(c)(3).

6. If the Commission were to finish the current proceeding before the Senate bill became law, Commission would be required to reopen the case for reconsideration and revise any final rule and supporting findings to account for the effects of the legislation. S. 2629, § 207(c)(4).

The pendency of the Senate and House bills underscores what the record in this case should independently make clear. The Commission should not—and need not—issue final rules in this docket before remedying the deficiencies in the current proposal. A rush to judgment would benefit neither mailers nor the Postal Service. Rather, the Commission should work jointly with Congress, the mailers and the Postal Service to seek the comprehensive solution that a solo Commission effort cannot produce.

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Appendix A

As NPPC *et al.* noted in their initial comments, most of reduction in the unit attributable costs of market dominant mail in recent years has been due to the shift in the market-dominant product mix from higher-cost to lower-cost products, not increased efficiency.[26] We agree with this assessment. Several trends in product mix have lowered the unit cost of market dominant products.

First, transfers of several kinds of parcels to the competitive product list caused a sharp decline in the volume of higher-cost market dominant parcels. Specifically:

- First-Class Mail Commercial parcels shifted to the First-Class Package Service competitive product category as of October 1, 2011.[27]
- Essentially all Standard Mail Machinable and Irregular parcels shifted to a Lightweight category under Parcel Select as of January 22, 2012.[28]
- Parcel Post shifted to the new Standard Post competitive product category as of January 27, 2013.[29]

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[26] Comments of National Postal Policy Council, Major Mailers Association, and National Association of Presort Mailers (March 1, 2018) ("NPPC comments") at 12.

[27] Revenue, Pieces & Weight (RPW) FY 2012.

[28] Revenue, Pieces & Weight (RPW) FY 2012.

[29] Revenue, Pieces & Weight (RPW) FY 2013.

- First-Class Mail Retail parcels shifted to the First-Class Package Service competitive product category as of September 3, 2017.[30]

Second, the product mix market dominant mail also experienced a major shift from higher-cost First-Class Mail to lower-cost Standard Mail. First-Class Mail went from 45 percent of Market Dominant Mail in 2007 to 41 percent in 2017, while Marketing Mail increased from 49 to 54 percent over the same period. ANM *et al.*-LR-RM2017-3-5.xlsx, "Tables 1 & 2".

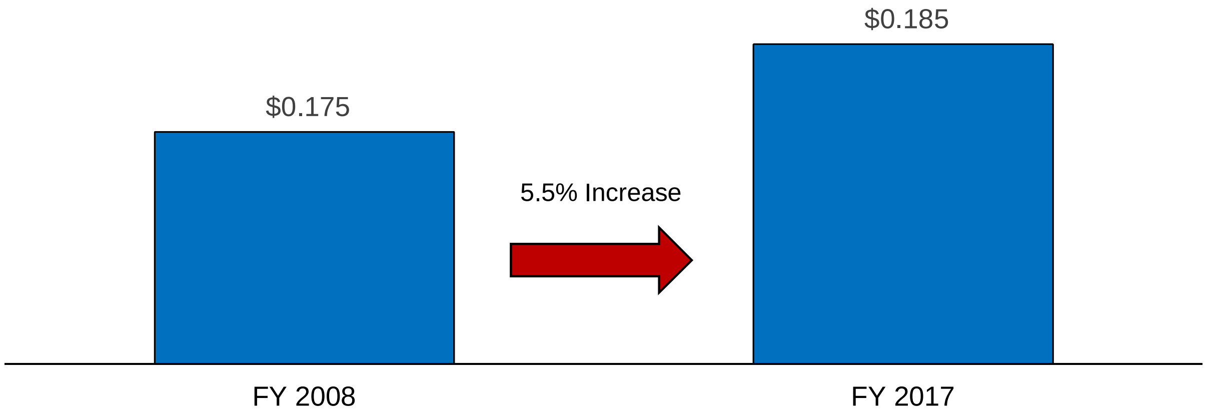
Third, First-Class Mail experienced a sizeable shift from Single Piece Letters to Presort Letters. Single Piece Letters dropped from 45 percent of First-Class Letters in 2007 to 33 percent in 2017, while Presort Letters increased from 56 percent to 67 percent of First-Class Mail over the same period. *Id.*

In fact, holding product mix constant (at the FY 2017 product mix), real market dominant unit prices increased over the last decade:[31]

[30] Revenue, Pieces & Weight (RPW) FY 2017.

[31] We analyze the change from FY 2008 to FY 2017 because of the substantial redefinition of products between FY 2007 to FY 2008, which makes a constant-mix comparison difficult for a period starting in FY 2007.

Real Unit Market Dominant Attributable Cost at FY 2017 Product Mix



Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "FY08 v FY17 (FY17 Distribution)".

The above comparison does not take into account the reductions in unit market dominant costs resulting from increased worksharing of each product. The increased worksharing reduces the Postal Service's workload within each product, so even with no productivity increase, the real unit market dominant attributable cost (holding product mix constant) should have declined over the last decade.

Notable Changes in Presort Mix

	FY 2007	FY 2017
% of First-Class Mail Automation Letters Sorted to 5-Digit	41%	67%
% of USPS Marketing Mail Automation Letters Sorted to 5-Digit	47%	73%
% of Periodicals Outside County Pieces Sorted to FSS/Carrier Route	52%	68%

Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Worksharing"

Notable Changes in Destination Entry Mix

	FY 2007	FY 2017
% of USPS Marketing Mail Letters Entered at DSCF	36%	73%
% of USPS Marketing Mail Flats Entered at DSCF/DFSS	37%	58%
% of USPS Marketing Mail Carrier Route Entered at DSCF	76%	91%
% of USPS Marketing Mail HD/Sat Letters Entered at DSCF	74%	95%
% of Periodicals Outside County Pounds Entered at DSCF/DFSS	59%	73%

Source: ANM *et al.*-LR-RM2017-3-5.xlsx, "Worksharing"

Appendix B

Analysis of Appendix A to the Postal Service's Initial Comments filed on March 1, 2018

This appendix has been marked non-public and filed under seal because it discusses information that the Postal Service has claimed to be nonpublic under 39 C.F.R. § 3007.21(c). Notice of the USPS of Filing Non-public Materials (March 16, 2018). Hence, the rest of the appendix should treated as confidential and not posted on the Commission's website.