Netflix Inc. (Netflix) submits these Reply Comments to address the following issues raised by initial comments filed in this docket:

1. The Commission cannot solve all the Postal Service’s problems through Market Dominant rate increases. In light of possible Congressional action, it should refrain from ordering far-reaching changes that could cause serious, irreversible harm to the industry.

2. The Commission’s use of $2.7 billion as a starting point for establishing Postal Service need is not arbitrary and capricious; the Postal Service’s estimate of $5 to $6 billion, however, is excessive because it ignores the $3 billion reduction in its annual RHB (and CSRS) prefunding obligations that took effect in FY 2017.
3. The Commission should take into account growth in contribution from Competitive Products. Additional contribution will likely amount to the equivalent of a Market Dominant rate increase of 1.1% per year for five years.

4. The 1% Performance Incentive Mechanism (PIM) cannot be justified either as an incentive or as a source of funds for capital investments.

I. THE COMMISSION NEED NOT – AND CANNOT – SOLVE ALL OF THE POSTAL SERVICE’S PROBLEMS AT THIS TIME.

Postal reform is not new. It has been debated in postal circles since the late 1990’s. Intrinsic tension arises from, on the one hand, the Postal Service’s responsibility to provide the services of a government agency\(^1\) and, on the other, the expectation that it be self-supporting and operate with the efficiency of a private enterprise. This identity crisis has given rise to many of the Postal Service’s struggles, and it continues today.

In 2006, Congress established a price cap system that improved the predictability of rates, reduced administrative costs, and gave the Postal Service more pricing flexibility.\(^2\) But Congress did not foresee the Great Recession, eight years of low inflation, and the explosive growth of e-commerce and smart phones. Perhaps the most glaring miscalculation was the accelerated payment schedule for prefunding Retiree

\(^1\) These include the Universal Service Obligation, the ECSI requirement, and keeping local post offices open.

Health Benefits (RHB); this alone resulted in USPS net losses for ten years. The Postal Service struggled mightily during this time to cut costs, realign operations within its control, and grow its Competitive Products, eventually defaulting on its RHB prefunding obligations. But it is beyond the Postal Service’s ability to change the underlying structural problems.

Nor can the Commission fully address the root problems. The Commission now has an opportunity to “do something,” but only with respect to the Market Dominant rate system, and even there, its legal authority to change the CPI cap is limited.\(^3\) In any event, modifying one part of the rate system is a far cry from fixing the Postal Service’s identity crisis as a quasi-governmental, quasi-private entity. Only Congress can address this through reform legislation.\(^4\)

Ambitious plans that purport to offer a magic elixir to cure all the Postal Service’s problems are bound to fail. They may even harm the Postal Service if rate increases push mailers to a tipping point and cause flight from the network, thus precipitating a death spiral. To avoid this risk, the Commission should realistically assess what goals

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\(^3\) See Comments of the American Mail Alliance \textit{et al.} (AMA Comments); Comments of the National Postal Policy Council \textit{et al.} (NPPC Comments); Comments of the Alliance of Nonprofit Mailers \textit{et al.} (ANM Comments), all in PRC Docket No. RM2017-3 (March 1, 2018). Unless otherwise indicated, citations herein are to documents submitted in PRC Docket No. RM2017-3, on March 1, 2018.

\(^4\) Additionally, as discussed in Netflix’s Initial Comments, RM 2017-3 (March 20, 2017), the Commission does not have legal authority to set rates to recover the $34 billion of defaulted RHB obligations. Only Congress can resolve the default issue. \textit{Id.} at 19-22.
are within its power to achieve and then choose a measured course of action, monitoring the industry’s response to each step before taking the next one.

This is particularly true in light of recent Congressional action on postal reform. On March 22, 2018, a bipartisan group of Senators introduced S. 2629, The Postal Reform Act of 2018. The bill would, *inter alia*, enroll postal retirees in Medicare, modify the Postal Service’s RHB obligations (including cancellation of the defaulted obligations), and impose a one-time 2.15% rate increase on Market Dominant products. It would also require that the Commission reconsider any changes ordered in this docket to take into account new legislative mandates. At a time when Congress may be poised to act, the Commission should refrain from ordering sweeping changes. Instead, it should follow a graduated approach and schedule a mid-course review in three years, as recommended in our Initial Comments.6

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6 Initial Comments of Netflix Inc., RM2017-3 (March 1, 2018) (Netflix March 1 Comments) at 3-12.
II. THE COMMISSION’S USE OF $2.7 BILLION AS A STARTING POINT FOR ESTABLISHING POSTAL SERVICE NEED IS NOT ARBITRARY AND CAPRICIOUS.

In Order No. 4258, the Commission used the FY 2017 net loss of $2.7 billion as a starting point. The Public Representative has asserted that the $2.7 billion is “a snapshot of one year’s loss” and that its use is “arbitrary and capricious.” We demonstrate here that the $2.7 billion starting point is supported even by the USPS’ figures – when the effects of changing RHB and CSRS obligations are properly taken into account.

The Postal Service argues that a multi-year average is a better predictor of revenue needs going forward than a snapshot of one year. It sets forth the following net losses for FY 2013 to FY 2017:

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7 Order No. 4258 at 38. In stating that the Commission’s use of the $2.7 billion is not an arbitrary and capricious reference or starting point, we are not conceding that $2.7 billion is the correct amount of additional revenue needed by the Postal Service or the appropriate amount to be recovered through Market Dominant rate increases. In fact, Section III, *supra*, argues that the revenue needed from Market Dominant rate increases should be much less than $2.7 billion, i.e., before Market Dominant rate increases are set, the $2.7 billion starting point should be adjusted downward to account for growth in Competitive Product contribution. Additional adjustments could be made for expected cost savings and increased productivity. Moreover, other starting points not based on past years’ performance could turn out to be more appropriate. Our analysis here is focused on rebutting the Public Representative’s allegation that the $2.7 billion is arbitrary and capricious and the Postal Service’s reliance upon net losses from the past five years unadjusted for the change in RHB/CSRS obligations.

8 Comments of the Public Representative (PR Comments) at 18-19.

9 See Initial Comments of USPS, RM2017-3 (March 1, 2018) (USPS Comments) at 60-61 & n. 159. Scenario One in Appendix B falls under the USPS’ own criticism that “no one-year snapshot … will perfectly capture the Postal Service’s expected financial performance.” *Id.* at Appendix B, “Baseline Loss.”

10 *Id.*
<table>
<thead>
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But using losses from 2013 to 2016 to predict post-2017 revenue is simplistic: The losses for 2013 - 2016 include annual RHB obligations of $5.6 to $5.8 billion.\(^\text{11}\) Under the PAEA, the annual RHB obligation after 2016 was reduced from around $5.6 billion to $0.995 billion. The PAEA also called for annual payments for the unfunded CSRS liability to begin in 2017 (no CSRS payments had been required from 2006 to 2016), and OPM calculated the new annual CSRS payment to be $1.7 billion. Thus, these annual prefunding obligations going forward were **reduced in 2017 by $3 billion** — from $5.6 - $5.8 billion to $2.7 billion.\(^\text{12}\)

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\(^\text{11}\) The Postal Service has repeatedly claimed that much of the losses for these years was due to the onerous RHB payments mandated by the PAEA. See, *e.g.*, USPS 2016 Annual Report at 4 (“[e]xcluding the impact of a $5.8 billion mandated Retiree Health Benefits prepayment, the Postal Service would have recorded net income for the year.... Among the mandated costs, the Postal Service operates with a requirement to prefund retiree health benefits, but that requirement is unaffordable unless those benefits are fully integrated with Medicare”); USPS 2015 Annual Report at 20 (“[o]ur operating results are impacted by items that are not under our control and that are not reflective of our normal operations. These items include the annual legally mandated Postal Service Retiree Health Benefits Fund (PSRHBF) prefunding expense”); USPS 2014 Annual Report at 5 (“[t]he Postal Service’s operational achievements in 2014 are impressive and argue well for a strong future, but they cannot overcome the impacts of a broken business model. The Postal Service recorded a net loss of $5.5 billion in 2014, and we continue to face serious financial challenges. Moreover, there is an overwhelming liability burden. These liabilities include retiree health benefits”).

\(^\text{12}\) See USPS Notice of Supplemental Information, RM2017-3 (August 10, 2017) at 1-2. The PAEA also required that, starting in 2017, the PSRHBF pay current premium expense for beneficiaries, an expense that the Postal Service had previously paid. At the same time, the Postal Service was to begin paying the normal costs of the RHB, which OPM assessed as $3.3 billion. *Id.* at 1 n.3. The 2016 premium expense was approximately $3.3 billion. USPS 2016 Report on the 10-K Form at 58. Because the two amounts seem to generally offset each other, we did not add this adjustment to our calculations. See also USPS 2017 Report on Form 10-K at 31-32. The Postal Service has also paid OPM its FERS contribution over the years, and the PAEA did not change that obligation.
The alleviation of approximately $3 billion in obligations to OPM renders the average net loss from 2013 – 2017 an inaccurate predictor. Past years’ operating losses must be adjusted to reflect this change in prefunding obligations: First, the pre-2017 RHB obligations should be removed to determine the average net loss without RHB. Then, the post-2016 RHB/CSRS obligation should be added in. Without the RHB obligations, the average net profit/loss for the five years becomes +$0.3 billion:

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<td>1.7</td>
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<tr>
<td>Adj.Gain/Loss</td>
<td>0.6</td>
<td>0.2</td>
<td>0.6</td>
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**Average = +0.3**

When the new prefunding obligation of $2.7 billion is added to the $0.3 billion, the resulting net loss is $2.4 billion.\(^{13}\) The Commission’s starting point of $2.7 billion falls close to this amount and cannot be considered “arbitrary and capricious”.

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\(^{13}\) In predicting future years’ operating profit, it would make no sense to add to the $0.3 billion the average RHB/CSRS obligation for 2013-2017 ($5.1 billion). Instead, the *future* RHB/CSRS obligation should be added to predict *future* years. But that is essentially what the Postal Service does in Scenario #2 when it computes the five-year average loss without adjusting for the $3 billion reduction in future RHB/CSRS obligations.
III. GROWTH IN COMPETITIVE PRODUCTS CONTRIBUTION WILL PRODUCE REVENUES THAT ARE THE EQUIVALENT OF A MARKET DOMINANT RATE INCREASE OF 1.1% PER YEAR FOR FIVE YEARS.

Revenue and contribution from Competitive Products (CP) have grown impressively from FY 2011, and it seems reasonable to expect growth to continue. Figure 1, plotted from PRC-LR-RM2017-1-1.xlsx, shows Competitive Products revenue for the period FY 2007 through FY 2017.

![Figure 1: Revenue of Competitive Products](image)

The average growth rate of CP revenue since FY 2011 was 14.9%. The CP contribution has increased from 25.7% of competitive revenue in 2011 to 34.6% in 2017. In the following analysis, we conservatively assume future CP revenue growth of only 7.45%, one-half of the past five-years’ average. We also assume that the
contribution proportion will remain constant at 34.6% (although it has increased significantly in the past five years).\textsuperscript{14}

Based on these assumptions, Figure 2 shows estimates of the additional contribution from Competitive Products for each of the next ten years. These estimates are expressed as percentages of the base revenue for Market Dominant products, as though 2018 were the first year under the proposed rules. For example, a level of 5\% on the vertical axis, as shown by the blue “4” box for Year 4, represents an additional contribution in Year 4, relative to 2017, of $2.4\ billion (5\% of the base revenue of $47.8 billion).\textsuperscript{15} The area under the Year-4 step, then, represents the additional CP contribution in Year 4, and the area under all of the steps (i.e., under the entire curve) represents the additional CP contribution through Year 10.

\textsuperscript{14} While other projections are possible, we believe these assumptions are reasonable and conservative. Accord Initial Comments of the Greeting Card Association (GCA Comments) at Appendix A.

\textsuperscript{15} The Market Dominant base revenue is taken from cell 8 of USPS Comments, Appendix B, “Baseline Loss.”
Figure 3 below is similar to Graph C in Netflix’s Initial Comments. The scales on the vertical and horizontal axes are unchanged and align with those of Figure 2. Consistent with Figure 2, the vertical axis may be thought of as the additional revenue caused by new rates, expressed as a percent of the base revenue. As before, the area under each line represents the additional revenue resulting from that rate increase. For example, the area under the red line up through Year 5 is $15.5 billion, an average of $3.1 billion per year. (The discounted value of $3.1 billion is close to the Commission’s

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As in the original Graph C, the lines in Figure 3 do not include CPI effects, although it is assumed that CPI increases will continue. The rates build on the CPI and have their own effect. The blue line is the Commission’s 5.8% one-time increase, which Order No. 4258 deems to be adequate. The red line and the purple line are, respectively, the Commission’s proposals of 2%-for-five-years and 2% + 1% PIM for five years. The small increases after Year 5 are due to building on the CPI increases of the previous year. See Netflix March 1 Comments at 17 for further explanation.
$2.7 billion.) As noted in our Initial Comments, unless rates decrease significantly at the end of Year 5, the areas under the red and the purple lines through Year 10 are substantially larger than the area under the blue line (the additional revenue from the Commission’s one-time increase of 5.8%).

Through any year selected, the area under the line in Figure 2 shows the additional CP contribution, and the area under each line in Figure 3 shows the additional revenue from Market Dominant products for the specified rate increase. In Figure 4, we combine these two. The red 2%-for-5 line is combined with the CP

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17 *Id.* at 12-18. Use in these graphs of the 5.8% one-time increase, the 2%-for-5 increase, the 2%+1%-for-5 increase, all proposed in Order No. 4258, should not be interpreted as agreement that any of these increases are appropriate or justified. The increases are included here as references and to show that, relative to the revenue generated by these proposed increases, revenue from CP contribution growth is quite large.
contribution line, and the result is shown by a new double red line. The blue 5.8% one-time line and the red 2%-for-5 lines are retained for reference.18

Through the end of Year 5, the area under the blue line is $14.4 billion, the 5.8% one-time amount needed. The area under the double red line, however, is $24.4 billion. This far exceeds what is needed. And if rates are not reduced after Year 5, the areas through Year 10 are even greater. Specifically, the area under the double red line

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18 We have removed the purple 2%+1% line in Figure 4 for simplicity. The vertical scale has been extended to 30%. The green vertical line shows the end of Year 5.
through Year 10 is $81.1 billion while the corresponding area under the blue line is only $30.4 billion.

Figure 4 vividly illustrates that the growth in CP contribution will have a huge effect on revenues in the next five to ten years – even under the conservative assumptions that CP growth will slow to only half of the past five years’ average and that the CP contribution proportion will remain unchanged (although it has been increasing). In determining the Market Dominant rate increases needed to generate $2.7 billion, the Commission cannot ignore the level of CP contribution shown here.

In fact, this level of contribution almost closes the gap between the Commission’s proposed rate increases and the Postal Service’s counter-proposal. The Postal Service suggests that, if the Commission’s five-year approach is used, the “absolute minimum” rate increase should be 3.3% for five years.\footnote{USPS Comments at 60 and Appendix B, “Estimated 5-yr Authority.”} Figure 5 below shows the Postal Service’s 3.3%-for-five proposal as a black line superimposed on Figure 4.
Figure 5 shows that, through Year 5, the double red 2% + CP line (the PRC’s 2%-for-5 taking into account growth in CP contribution), is nearly equal to the USPS’ 3.3% solution. The area under the double red line (i.e., additional revenue) is roughly the same as the area under the black USPS line. And both areas are far greater than the corresponding area under the 5.8% one-time line (i.e., additional revenue that the Commission deemed necessary in Order No. 4258). For years beyond Year 5, the additional revenue under either the double red or the black lines far exceeds the needed revenue. Through Year 10, the double red line achieves an additional $81.1 billion and the black line achieves an additional $74.6 billion (as compared to the blue line’s $30.4 billion). Rates should be adjusted downward at the end of Year 5 to correct this overage.
Another way of analyzing the effect of CP contribution growth is to ask what portion of the $2.7 billion need will be met by the growth in CP contribution. Figure 6 shows the original 2%-for-5 line (red) and the CP contribution line of Figure 2 (orange).

In Figure 6, the CP contribution line (orange) will supply a large portion of the revenues needed to meet the PRC’s $2.7 billion target. Specifically, through the end of Year 5, the average area under the 2%-for-5 line is $3.1 billion per year. Over the same period, the CP contribution line supplies an average of $1.8 billion per year. To the extent that the 2%-for-5 line is a valid target (as proposed in Order No. 4258), the rate increase of 2% on the Market Dominant products may be reduced by the amount supplied by CP contribution growth. That amount is the equivalent of a 1.1% annual
rate increase for five years, allowing the Commission to reduce its proposed increase of 2% to 0.9%.\textsuperscript{20}

Netflix believes that reducing the 2% increase to 0.9% for five years would be a reasonable modification supported by the record. Alternatively, if the Commission chooses to retain the 2%, then it should recognize that growth in Competitive Product contribution, even conservatively estimated, will achieve almost all of the Postal Service’s requested 3.3% increase. The point is that the increase in CP contribution will be so large that it cannot be dismissed as unimportant or irrelevant – the Commission must analyze and quantify the expected growth in CP contribution before imposing new rate increases on Market Dominant products.\textsuperscript{21}

\textsuperscript{20} In its Initial Comments, Netflix suggested a decrease in rates after Year 5. Netflix March 1 Comments at 12-19. The Competitive Products contribution is further support for such a decrease. Netflix has also urged the Commission to schedule a mid-course review in Year 3. \textit{Id.} at 11. This review could help the Commission monitor and take into account the amount of Competitive Products contribution in the first two years.

\textsuperscript{21} Specific estimates may vary depending on different projections of growth, contribution proportion, etc., but we believe our analysis is reasonable and on the conservative side. The Commission can conduct its own analysis, but it should not ignore the contribution growth of Competitive Products.
IV. THE PIM CANNOT BE JUSTIFIED EITHER AS AN INCENTIVE OR AS A SOURCE OF FUNDS FOR CAPITAL INVESTMENT.

An overwhelming majority of the March 1 comments found flaws in the Performance Incentive Mechanism (PIM). The service quality component was faulted for conditioning the 0.25% reward on published service standards rather than on actual service performance; the Postal Service would earn the reward even if it failed to achieve the service standards. The operational efficiency component was condemned as unworkable in practice and criticized for using the Total Factor Productivity (TFP) index, an unreliable and inappropriate measure.

The Public Representative also voiced concerns about the Commission’s secondary justification for the PIM, i.e., that the additional revenues could be used to fund capital investment. Specifically, he cites the Commission’s statement that the PIM “would produce enough cumulative additional revenue to allow the Postal Service to replace the $7.8 billion decrease in net capital assets that occurred in the PAEA era.” We agree with the Public Representative that the “aim[] to return the Postal Service to investment levels of the past and to the same level of net asset holdings as in the distant past of FY 2006” is “misdirected.”

22 See, e.g., NPPC Comments at 77-79.

23 See USPS Comments at 86-88. See also PR Comments at 32-35, NALC Comments at 17-18; NPPC Comments at 66-69.

24 Order No. 4258 at 54.

25 PR Comments at 31.
There is nothing in the record to support – and it is counterintuitive to assume – that net asset holdings should return to 2006 levels. Market Dominant volume has fallen by almost one-third since that time, and operational needs have changed. “As volumes decline, capital requirements shift so they will not necessarily remain at the level of 12 years ago.”

Each investment “need” should be supported by more than the desire to replace a depleted asset. Sound business practice requires showing an expected ROI for each project and proving that the investment is critical and current in light of shrinking volumes and the changing market environment.

The current record does not justify an additional 1% increase for capital investments, and the Commission may not achieve this result by making the incentive reward unconditional. It must first hold a separate proceeding to compile an adequate record.

26 Id.

27 Moreover, the Commission’s “Financial Health Cycle,” Order No. 4258 at 47, leaves out the role of depreciation. Revenues covering depreciation flow to unrestricted cash, which can be used for investment. See ANM Comments at 41-48.

28 Some commenters have proposed removing the incentive condition from the PIM and making it a virtual certainty. The Postal Service states “[i]t would be simple enough to adapt the Commission’s [PIM] proposal into an unconditional capital-funding mechanism.” USPS Comments at 90. NALC would give the entire 1% just for maintaining service standards, which would effectively render the 1% an unconditional rate increase. NALC Comments at 4, 27. APWU would give funds when the USPS presents a capital investment plan. APWU Comments at 19-20.
V. CONCLUSION

The Commission should take a measured approach to changing Market Dominant rates in this proceeding. It should adjust its $2.7 billion starting point to take into account the expected growth in contribution from Competitive Product revenues, which is equivalent to a 1.1% annual increase for five years on Market Dominant products. In addition, the Commission should refrain from imposing a PIM or any additional increase to fund capital investment until it has compiled an adequate record on investment needs.

Respectfully submitted,

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March 30, 2018