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POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Institutional Cost Contribution
Requirement for Competitive Products

Docket No. RM2017-1

PUBLIC REPRESENTATIVE COMMENTS IN RESPONSE TO
NOTICE OF PROPOSED RULEMAKING

(April 16, 2018)

I. INTRODUCTION

These Public Representative Comments, together with the Declaration of Dr. Soiliou Daw Namoro, an economist in the Commission's Office of Accountability and Compliance,[1] are filed pursuant to the Commission's February 8, 2018, Notice of Proposed Rulemaking.[2] The Notice established the date for comments on the Commission's proposed rules to re-establish the minimum percentage contribution of institutional costs required to be provided by the Postal Service's competitive products. Order No. 4402 at 100. The appropriate share currently specified in the Commission's rules is 5.5 percent. 39 CFR § 3015.7(c).[3]

[1] Declaration of Dr. Soiliou Daw Namoro, April 16, 2018.

[2] Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, February 8, 2018 (Order No. 4402).

[3] *See* Docket No. RM2007-1, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, October 29, 2007, at 91, 138 (Order No. 43). *See also*, Docket No. RM2012-3, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, August 23, 2012, at 27 (Order No. 1449).

II. SUMMARY OF PUBLIC REPRESETATIVE COMMENTS

With these comments, the Public Representative, together with the Declaration of Dr. Namoro, explains that the Commission's proposed formulaic methodology, under certain conditions of changing Postal Service costs and prices as well as under various industry-growth scenarios, would yield results opposite to its intended purpose and is therefore arbitrary. There being no sound alternative basis for selecting one minimum contribution over another, the Public Representative, therefore, recommends the Commission take no further action, but that it retain the 5.5 percent minimum contribution requirement currently in its regulations.

III. PROCEDURAL HISTORY

This rulemaking proceeding commenced on November 22, 2016, when the Commission issued an Advance Notice of Proposed Rulemaking to evaluate the Postal Service's required institutional costs contribution for competitive products.[4] It was initiated pursuant to the statutory requirement that every five years the Commission shall review "the institutional costs contribution requirement under subsection (a)(3)" of 39 U.S.C. § 3633. 39 U.S.C. § 3633(b). Subsection (a)(3) requires the Commission review to "ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service." The Commission's review must determine whether the appropriate share specified in the Commission's regulations "should be retained in its current form, modified or eliminated." 39 U.S.C. § 3633(a)(3). To carry out the evaluation, § 3633(b) prescribes that "the Commission shall consider all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products."

In response to Order No. 3624, the undersigned Public Representative filed comments contending that the Commission should retain its current 5.5 percent

[4] Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, November 22, 2016 (Order No. 3624).

contribution requirement.[5] The Public Representative also filed Reply Comments responding throughout to United Parcel Service (UPS) comments which contended the Commission should significantly increase the contribution requirement.[6] Other commenters, primarily Amazon Fulfillment Services, Inc., recommended entirely eliminating the requirement and reducing it to zero percent contribution.

IV. REPLY COMMENTS

A. Order No. 4402

In Order No 4402, the Commission traced the development of the current 5.5 percent minimum contribution required from competitive products, collectively. In Docket No. RM2007-1, the Commission used the historical contribution of competitive products to set the initial appropriate share percentage. In Docket No. RM2012-3, the Commission examined the requirements of 39 U.S.C. § 3633(b) with an analysis that blended qualitative and quantitative factors, the result of which led the Commission to maintain the appropriate share at 5.5 percent. Five years later in Order No. 4402, the Commission is proposing to change its approach to setting the minimum appropriate share by using a formula that would annually update the required amount based on market conditions. (Order No. 4402 at 11).

The Commission notes that the Postal Service's market share, competitive volumes and competitive contribution as a percentage of institutional costs have increased steadily since 2007. As a result, the Commission is determining that the static 5.5 percent appropriate share should be modified to "reflect the modern competitive market." *Id*. at 12. The Commission states that given that it now "has over 11 years of data related to competitive products, a formula-based approach that more directly, accurately, and frequently incorporates prevailing competitive conditions in the market and other relevant circumstances can be constructed and applied." *Id*. The

[5] Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, January 23, 2017, at 2.

[6] Public Representative Reply Comments in Response to Advance Notice of Rulemaking, March 9, 2017 (Reply Comments).

Commission's formula-based approach uses two components to annually capture changes in the market and the Postal Service's position in the market: (1) the Postal Service's Lerner Index[7] and (2) the total Competitive Market Output.[8]

In Order No. 4402, the Commission determines that revenue, rather than volume, is the better measure of the overall size of the competitive market. The rationale is that the data sources are revenue based and that revenue data for both the Postal Service's competitive products and competitors offering similar products are directly comparable as they constitute the value of all transactions. In contrast, volume data would have to be adjusted for intra-industry transactions. Finally, the revenue data are also available for all firms in the relevant market, whereas volume data for the Postal Service's competitors are unavailable.

B. The Formula Proposed in Order No. 4402 is Flawed Because it Leads to Arbitrary Results and the Initial Minimum is Undefined and Arbitrary

The Public Representative recognizes that the Commission has attempted to incorporate into its methodology market structure considerations that the Public Representative has noted in previous comments. Nonetheless, the Commission's approach suffers from a lack of data from which to compute an "appropriate" minimum share. This lack of data has led to formulation of a model that could generate counter-intuitive results in several circumstances of future industry growth. In addition, if the mathematical characteristics of a minimum are not precisely defined, then there could be multiple choices which could qualify as a minimum. No single one minimum might be any better than another, and, hence, the choice is arbitrary, all as described in further detail in the attached Declaration of Dr. Namoro.

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[7] The Lerner Index is defined as Price - Marginal Cost/Price. It is a direct measurement of a firm's pricing power. Marginal cost data are seldom available for private sector firms, but are available for the Postal Service. *See* Order No. 4402 at 17.

[8] Competitive Market Output measures the overall size of the competitive market. It encompasses two groups: the Postal Service's competitive products and "similar products" offered by the Postal Service' competitors. It excludes any competitors' products that the Postal Service does not actually compete with. *Id*. at 22.

In his declaration, Dr. Namoro analyzes the Commission's proposed formula to annually update the appropriate minimum contribution to institutional costs from competitive products. Dr. Namoro reviews both of the individual variables, or factors, *i.e.*, the Postal Service's Lerner Index and Competitive Market Output, as well as the interaction between the factors to evaluate the proposed formula's effectiveness in capturing the competitive environment and its effect on the appropriate (minimum) contribution to institutional costs. Based on Dr. Namoro's Declaration, the Public Representative concludes that the formula-based approach is potentially inaccurate in several circumstances and therefore arbitrary. His Declaration and mathematical examples demonstrate the following:

1. The Lerner Index used by the Commission in its proposed formula is subject to an anomaly in that if both price and marginal cost increase by the same dollar amount, the Lerner index will in fact decrease.[9] By the same token, if both the price and marginal cost decrease by the same dollar amount, then the Lerner Index will increase. In either event, it appears that the Lerner index should be unchanged, but such is not the case. Dr. Namoro states: "However, if both the volume-variable costs and the revenue are augmented by the same positive amount, the Lerner Index decreases. Symmetrically, if both decrease by the same amount, the Lerner index increases." He also provides a mathematical illustration of this point. Namoro Decl. at 6 n.8. He further states that "changes in the Lerner Index, in particular temporal changes, do not always have intuitive and obvious interpretations." *Id*.

2. The lack of volume data for competitor's output necessitates the use of revenue (which equals price times quantity) in the Commission's formula which introduces *competitors'* pricing as a factor influencing the proposed minimum institutional cost contribution for the Postal Service. Thus, coordinated price increases by the Postal Service's competitors, with quantity

[9] Order No. 4402 acknowledges the occurrence of another anomaly: if a significant decrease in volume-variable costs, combined with a much smaller decrease in average unit revenue, resulted in an increase in the Postal Service's Lerner Index." Order No. 4402 at 21. However, the change in the Postal Service's Lerner Index, in fact, has nothing to do with market power.

held constant, would have the effect of causing the Postal Service's minimum contribution to increase. Dr. Namoro states "the direction of change in the appropriate share is driven by the sign and magnitude of the percentage change in the competitors' revenue and the competitors' share of total revenue." He concludes, "This leaves open the possibility that competitors pricing behavior determines the change in the appropriate share." *Id*. at 11.

3. In the Commission's proposed formula, the Lerner Index and the Competitive Market Output are treated as if they are independent, but they are *not* independent*.* The Postal Service's influence is counted twice in the Commission's proposed formula. It is first factored in through the Lerner Index, but then is also factored in by its inclusion by definition as a part of the total market. Dr. Namoro points out that given the percentage change in volume-variable costs, "Equation (4-1) implies that the percentage changes in the Lerner Index and the CMO are not independent." *Id*. at 25.

4. The linkage between the changes in each variable in the Commission's formula and the resulting change in the proposed computed minimum also leads to arbitrary results in the annual minimum contribution calculation. The Commission's proposed formula adds up the changes in two variables, the Lerner Index and the Total Competitive Market. It then augments the minimum contribution by multiplying the existing required minimum share of 5.5 percent by 1 plus the exact sum of the percentage changes. However, no rationale is put forward to justify the assumed one-to-one correspondence that is used. *Id*. at 26.

5. There are explicit mathematical properties which define a minimum. If a minimum is not precisely defined, then any number of possible choices could be assumed. Dr. Namoro states that "without stating the properties that this lower bound should bear, it is hard, if not impossible, to define the criteria according to which the equation should be assessed." *Id*. at 18. He continues, "there are an infinite number of conceivable alternative ways to

design a lower-bound curve to the curve corresponding to historic shares." *Id*. at 25.

Order No. 4402 relies on the premise that, "a formula-based approach that more directly, accurately, and frequently incorporates prevailing competitive conditions in the market and other relevant circumstances can be constructed and applied." Order No. 4402 at 12. Unfortunately, it appears that the Commission's formula as proposed does not correctly incorporate the elements of market structure into the calculation of the appropriate share. Likewise, as a result of his analysis, Dr. Namoro concludes the proposed formula does not improve on the current 5.5 percent and recommends retaining the 5.5 percent minimum. Namoro Decl. at 26.

C. .As an Alternative to Order No. 4402 Methodology, the Minimum Contribution of 5.5 Percent Should Remain

1. Increased Competitive Product Prices Would Benefit the Postal Service's Competitors but not Consumers and would Add Risk for the Postal Service

In view of the arbitrary nature of the methodology proposed in Order No. 4402, the Public Representative believes that when taking into account the conditions existing in the Parcel Shipping Industry, the Postal Service's precarious financial situation, and the trends expected during the next five-year period, particularly when balanced with other factors previously considered relevant by the Commission, it would be unwise at this time for the Commission to take any action to raise the minimum contribution level currently in effect for competitive products.

Under the current industry structure, there is no assurance that any action which might cause the Postal Service to raise its competitive prices will benefit anyone other than the current industry participants whose own rates may be able, and likely, to track any upward movement in Postal Service rates, and who, by most measures, are quite profitable. A recent research note by a highly-regarded Wall St. firm calculates that, "Assuming the Postal Service needs to raise rates meaningfully to capture its *true costs*, we see a large $15-19b revenue opportunity for FedEx and UPS." (Emphasis supplied.)[10] It is also interesting to note that this research, in making this calculation, explicitly assumes that "both FedEx and UPS are able to maintain their absolute dollar/package spread over the USPS' yields in the new pricing environment." *Id*. at 5.

As far as capturing its "true costs" goes, the Commission has determined that the Postal Service is *already* covering its incremental costs on competitive products. Hence the figures reported above by the Wall Street Firm essentially represent an estimate of the value of coordinated pricing among the major carriers in the parcel industry. The Public Representative suspects that in the event of an upward push on the minimum contribution share that leads to increased Postal Service competitive product prices, the final consumer, *i.e.*, the general public, will end up footing much of the resulting bill across the entire industry.

The competitors' (UPS and FedEx) package volumes are growing to such an extent that published reports indicate their ability to meet recent peak Christmas season deliveries posed increasing challenges. This suggests a secondary benefit for them from an increase in the Postal Service's competitive product prices followed by their own lock-step rate increases. It would, in some measure, relieve the pressure on their end-of-year delivery bottleneck as the elasticity effect of higher prices slightly lessens their demand but increases their revenue.

In contrast, the Postal Service's much less stable financial condition will tend to encourage the Postal Service to maximize its revenues from competitive product mail, even absent any new rule on the part of the Commission raising the percentage share of institutional cost contribution. In order for the Postal Service to underprice its rivals to gain market share, thus reducing revenues in the process, an adequate stream of revenues would be required in the first place. This is problematic in the case of the Postal Service. The Wall Street Firm research note seems to concur predicting that "a day of reckoning is approaching where the USPS will need to raise the overall yields on its suite of competitive parcel products in order to maintain its own solvency and continued participation in this growing market." *Id*. at 4.

[10] Citi Research, Division of Citigroup Global Markets, Inc.("Firm"), "The Free Shipping Tax", April 18, 2017.

It also should be noted that there is simply too little margin for error in the Postal Service's pricing of competitive products to risk promulgating a codified minimum contribution level that might be too high and cause a loss of otherwise profitable volume of competitive products. The Public Representative also echoes the concerns of another Public Representative previously expressed in Docket No. RM2012-3 regarding the uncertain future of the Postal Service. He pointed out concerns still relevant today: excessive Postal Service Retiree Health Benefit Fund payments, declining volumes, proposed legislation and other unknown impacts, many of which could have a profound effect on the Postal Service's cost structure and institutional costs. Until most of these questions are answered, it would be premature to recommend any changes to the current appropriate share contribution for competitive products.[11] Furthermore, it would be unwise of the Postal Service to adjust competitive prices too frequently in an effort to maximize revenues from competitive products, as advocated by some, since this would cause an increased level of uncertainty with its customers.

2. Legislative History and Commission Orders Provide Reasons for Maintaining the Minimum Contribution at 5.5 Percent

In response to Order No. 3624, the Public Representative recommended that the Commission should retain the current 5.5 present contribution requirement. Particularly in view of the arbitrary nature of the Commission's proposed formula, the reasons for retaining the 5.5 percent remain. This conclusion is based not only on legislative history and the potential impact on the various stakeholders, but also on the Commission's statements in previous notices and orders, the market conditions and the prevailing competitive conditions in the market for competitive products; the level competition in the market; and, pursuant to section 703 of the PAEA,[12] consideration of changes in

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[11] Docket No. RM2012-3, Comments of the Public Representative in Response to Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, April 9, 2012, at 5.

[12] Uncodified section 703 of the PAEA requires the Commission, when revising its regulations pursuant to section 3633, to consider the net effect of changes in laws since the FTC's 2007 Report that affect the Postal Service and others differently. For ready reference, section 703 also appears in the notes immediately following 39 U.S.C.A. § 3633.

laws since the 2007 FTC Report required by the PAEA to consider laws favoring the Postal Service or its competitors.[13] These reasons continue to be applicable.

It is useful to note the history of on H.R. 4341, introduced prior to the PAEA that provided for competitive products to collectively make a "reasonable contribution" to institutional costs rather than collectively cover "an appropriate share" of institutional costs as provided in current § 3633(a)(3).[14] The underlying intent of that section can fairly serve as guidance. The Report on H.R. 4341 stated that, "With respect to the requirement that competitive products collectively make a reasonable contribution to overhead, it is a flexible standard, not intended to dictate a particular approach that the Postal Regulatory Commission should follow." (Emphasis supplied.) Id. at 86. Thus, it is fair to conclude the drafters §3633 did not intend for the Commission to follow a particular approach when establishing the contribution standard.

Of additional significance is that several alternative methodologies for calculating the appropriate contribution were rejected several years ago in Order No. 26.[15] Those rejected methodologies were based on comparisons of various statistics for market dominant and competitive products. The comparisons involved an equal per-piece (unit contribution) basis or equal percentage (markup) basis such as a markup on the sum of competitive products' attributable costs. Also rejected was a markup based on competitive products' percentage of total revenues. *Id.* at 69-70. The Commission did not reconsider those rejected methodologies when issuing its final regulations on the matter.[16] In the Public Representative's view, there was no reason to reconsider those rejected methodologies.

[13] Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors, A Report by the Federal Trade Commission, December 2007 (FTC Report).

[14] *See* Report of House Committee on Government Reform to Accompany H.R. 4341, Postal Accountability and Enhancement Act, 108th Congress, Rept. 108-672, Part 1, September 8, 2004, at 86 (H.R. 4341 Report).

[15] Docket No. RM2007-1, Order Proposing Regulations to Establish a System of Ratemaking, August 15, 2007 (Order No. 26).

[16] Docket No. RM2007-1, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, October 29, 2007 (Order No. 43).

The Public Representative also finds support for this recommendation within other reasons originally cited by the Commission as support for the 5.5 percent that have not changed since its initial adoption in 2007: (1) The method does not imply a pricing technique; *e.g*., a particular coverage level, Order No. 26 at 70; (2) The method is more easily understood, *Id*.; and (3). Differences in the rate-setting process under the PRA and the PAEA enable a lower contribution requirement. *Id.* at 71.

Order No. 26 also explained that under the superseded section of the Postal Reorganization Act (PRA), 39 U.S.C. § 3622, rates were set as maximum rates and were not designed to generate a surplus. *Id*. at 72. However, under the PAEA, the appropriate share for competitive products is now a "floor" for all competitive products' contribution, not a maximum contribution level. Because earnings may be retained, the Postal Service has an incentive to exceed the threshold floor, thereby reducing rate pressure on market dominant rates, encouraging continuation of universal service and the possibility of bonuses. *Id*. The incentives for the Postal Service to exceed the floor reduces the need to mandate a higher level of contribution.

The following risk factors considered in the 5.5 percent decision also remain relevant to the Commission's determination.

- *Risk of setting the minimum contribution too high.* The Postal Service's market share of competitive products was "relatively small," and the Postal Service needed some *flexibility to compete*. The appropriate share was set below the estimated 6.9 percent share of total institutional costs that competitive products were expected to provide for the next test year, TY2008. Order No. 26 at 70-1. After 5 years in 2012 by Order No. 1449, the Commission found no reason to modify its conclusions.

- *Risk of setting the contribution too low*. If the required contribution is set too low, the Postal Service would have a competitive advantage. *Id.* at 73. In 2012, there was a lack of evidence that the Postal Service had a *competitive* *advantage* over its competitors. This lack of evidence supported the conclusion the 5.5 percent minimum is not too low. Order No. 1449 at 16.

3. Market Considerations and Assessment

Finally, three prevailing conditions in the market are particularly relevant to maintaining 5.5 percent as the appropriate share: 1. *industry structure*, 2. *conduct of the participants* in the industry, and 3. *results of that conduct* (performance) on the part of the participants.[17]

1. Market Structure: Markets overlap to some degree, but the market participants themselves are involved in multiple interactions. For instance, FedEx engages in air transportation on behalf of the Postal Service, and the Postal Service, in turn, performs "last-mile" deliveries for both UPS and FedEx. Also, the ascendency of a vertically integrated Amazon has also introduced both an element of buyer power and the potential of logistic/shipping competition. Moreover, most market dominant parcels have been transferred to competitive products. Thus, to some degree this alteration of federal law and consequent further leveling of the parcel market playing field changed the previous net effect of federal law treating the Postal Service differently than other companies. Together, these new relationships change the net effect of federal law treating the Postal Service. The Postal Service can compete more directly with its competitors without price constraints on its products transferred from the market dominant to the competitive products list.[18] There is no indication that the playing field needs to be further leveled through modification of the 5.5 percent contribution requirement.

2. *Conduct of the Market Participants.* In Order No. 1449, the Commission found that the lack of a significant increase in market share, either by volume or by

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[17] For a more detailed description of this paradigm, *see* F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, Houghton Mifflin Company, 1990, at 5.

[18] For this reason, the Public Representative respectfully disagrees with the conclusion in Order No. 4402 the Section 703 is not relevant to the Commission's review under § 3633. *See* Order No. 4402 at 66.

revenue over the period 2006-2011, minimized concerns of a Postal Service artificial advantage over its competitors. Order No. 1449 at 18. The Postal Service's market share over the period 2011-2016 has not changed significantly.

3. Market Performance In Order No. 1449, the delivery market volume was expected to expand by about 40 percent between 2009 and 2020. The Commission noted in Order No. 1449 that if competitive volumes substantially increased relative to market dominant volume, a change in the share level could be considered in the right circumstances. In the intervening period since Order No. 1449, the competitive volumes have not substantially increased relative to market dominant volume.

By FY 2017, competitive products' share of total volumes increased to only about 3.4 percent, largely due to the rapid expansion of Parcel Select volumes.[19] Nevertheless, this remained a relatively minor share of the Postal Service's mail volume. These changes do not suggest a basis for modifying the current 5.5 percent requirement.

Another factor to consider is the profits derived by each of the major market participants competing with the Postal Service. Even before the recent strong demand for parcel delivery service and the anticipated future surge, UPS and FedEx profits in 2014 and 2015 demonstrated that they have been competing effectively in their markets and earned substantial profits at a rate far greater than the Postal Service.[20] More recently, in FY 2017, UPS reported significant profits on only it's Domestic Package Operations of $4.280 billion, up from $3,017 billion in FY 2016.[21] Similarly, for year-end May 31, 2017, FedEx reported a Consolidated Operating Income of $5,037 billion and Net Income of $2,997 billion on revenue of $60,319 billion, less revenue than the Postal

[19] Financial Analysis of United States Postal Service Financial Results and 10-K Statement FY 2017, April 5, 2018, at 37, 40.

[20] Docket No. RM2016-2, Public Representative Comments, January 27, 2016, at 51-52.

[21] UPS Form 10-K, U.S. Securities and Exchange Commission, Fiscal Year ended December 31, 2017, at 24.

Service's annual revenue.[22] Thus, their profits have not been endangered by the Postal Service's pricing.

Moreover, the Public Representative is concerned that Commission ordered increases in the appropriate share might force Postal Service price increases to ensure that it meets the appropriate share regulation that may simply fuel industry-wide across-the-board price increases for those products where competition is alive and well.

V. CONCLUSION

As demonstrated by Dr. Namoro, the Commission's formula in Order No. 4402 can lead to arbitrary results and its undefined criteria also leads to its arbitrary application. He, therefore, recommends maintaining the 5.5 percent minimum requirement.

For all of the factors discussed above, considering conditions in the Parcel Shipping Industry, the Postal Service's precarious financial situation, and the trends expected during the next few years when balanced with other factors previously considered relevant by the Commission, the Public Representative recommends that the Commission take no action at this time to modify the 5.5 percent requirement.

There is no assurance that an increase in competitive prices will benefit anyone other than the current Postal Service competitors whose own rates are likely to track any upward movement in Postal Service rates, and who are very profitable. Also, there is too little margin for error in the Postal Service's pricing of competitive products to risk a minimum contribution rule level that might cause a loss of otherwise profitable volumes of competitive products.

Respectfully submitted,

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[22] FedEx Form 10-K, U.S. Securities and Exchange Commission, Fiscal Year ended May 31, 2017, at 83.

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