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WASHINGTON, D.C. 20268-0001

INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS	Docket No. RM2017-1

COMMENTS OF THE UNITED STATES POSTAL SERVICE IN RESPONSE TO ORDER NO. 4402

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Table of Contents

INTRODUCTION

The package delivery market is robustly competitive and rapidly evolving. Consumers increasingly expect quick and affordable delivery of their parcels, while shippers are adapting to the exponential growth in e-commerce by seeking alternative delivery channels and expanding their own delivery capabilities. Within this dynamic competitive environment, the Postal Service operates at a net competitive disadvantage compared to its private-sector competitors, which are free from the federally-imposed obligations and constraints that increase the Postal Service's costs. Nonetheless, the Postal Service has worked hard to achieve the competitive product volume growth and revenue growth that have become increasingly important to our bottom line. For the past several years, competitive products have contributed far more to the Postal Service's institutional costs than the required minimum contribution.

At the same time, however, ongoing changes and uncertainties in the market, including a shift among major retailers toward developing in-house logistics capabilities and a surge in the number of firms providing last-mile delivery, could easily threaten the Postal Service's ability to sustain its recent competitive product contribution levels over time.[1] As both the Commission and many of the Postal Service's customers have explained, setting the minimum contribution level too high could force the Postal Service to raise prices artificially in order to meet the new requirement – a result that would harm the Postal Service, its customers, and American consumers. In concert with the

[1] *See generally* Initial Comments of the United States Postal Service, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 14-17 [hereinafter *Initial Postal Service Comments*].

overwhelming majority of mailing-industry stakeholders that submitted comments in the earlier phase of this proceeding, the Postal Service believes that thoughtful consideration of all relevant circumstances continues to support the conclusion that the minimum contribution requirement should be reduced or eliminated. For those reasons, the Commission should reconsider its proposed new approach, which would impose a new (and, in all likelihood, higher) contribution level every year based on a formula.

The proposed formula would calculate the sum of year-over-year changes through two variables, the Postal Service's Lerner Index and the Competitive Market Output (CMO). The formula is apparently intended to measure the overall potential of the Postal Service's competitive products to contribute to institutional costs by analyzing two factors: (1) the Postal Service's pricing power as to competitive products (represented by the Lerner Index); and (2) the total size, by revenue, of the domestic package delivery market in which the Postal Service competes (represented by CMO). In explaining the proposed formula in Order No. 4402, the Commission properly dismissed proposals by certain interested parties that failed to address Section 3633(b)'s required statutory considerations. That said, however, no single measure purporting to reflect both Postal Service market power and prevailing competitive conditions is a perfect indicator of what the appropriate share should be. Even if the Lerner Index and CMO may be preferable to other variables that the Commission considered and rejected, their application would remain prone to potential inaccuracy in attempting to predict the contribution capacity of the Postal Service's competitive products. The Commission should be aware of these risks before it issues a final rule establishing the minimum contribution requirement for the next five-year period.

To summarize, the Postal Service continues to believe that the current appropriate share requirement should be eliminated, because it is not currently a necessary regulatory tool. Alternatively, should the Commission decide to implement the proposed new approach, the Postal Service recommends two refinements in an effort to mitigate the risks noted above concerning potential inaccuracy and unfairness: (1) measuring CMO in real, inflation-adjusted dollars rather than nominal dollars; and (2) using FY 2017, rather than FY 2007, as the baseline year to begin calculations under the new formula.

I. CONSIDERATION OF ALL RELEVANT CIRCUMSTANCES CONTINUES TO SUPPORT REDUCTION OR ELIMINATION OF THE APPROPRIATE SHARE

A. The Commission's Task Under Section 3633(b) is to Set the Minimum Contribution Competitive Products Must Cover

With the Postal Accountability and Enhancement Act (PAEA), Congress intended to give the Postal Service pricing flexibility comparable to the private sector for its competitive products, while also protecting the public interest against unfair competition in the markets within which competitive products are offered.[2] Subsection 3633(a)(1) therefore prohibits the subsidization of competitive products by market dominant products; subsection 3633(a)(2) requires that each competitive product cover its attributable costs; and subsection 3633(a)(3) tasks the Commission with promulgating regulations to "ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the

[2] *See* H.R. Rep. No. 109-66, pt. 1, at 46 (2005); *see also* Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, PRC Docket No. RM2007-1 (Aug. 15, 2007), at 72.

Postal Service."[3] The statute authorizes the Commission to retain, modify, or eliminate the minimum contribution requirement as circumstances evolve, specifically requiring that the Commission conduct a review of the requirement every five years.[4] In other words, the requirement should be adjusted over time based on its own merits; it need not serve as an independent check against cross-subsidization or as a method for achieving cost attribution, since those purposes are already served by the other two provisions within Section 3633(a).

Following enactment of the PAEA, the Commission considered a variety of proposals for determining the initial minimum contribution requirement, ultimately setting the required contribution level at a fixed 5.5 percent.[5] The Postal Service has consistently exceeded this target. Most recently, Postal Service competitive products contributed approximately 23 percent to institutional costs in FY 2017 – more than four times the required minimum.[6]

B. A Broad Mix of Shippers and Mailers Agrees with the Postal Service that the Minimum Contribution Level Should be Reduced or Eliminated

In explaining the rationale underlying its decision to set the initial minimum contribution requirement at 5.5 percent, the Commission considered the risks inherent

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[3] 39 U.S.C. § 3633; *see also* Order No. 26 at 64.

[4] 39 U.S.C. § 3633(b).

[5] *See* Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, PRC Docket No. RM2007-1 (Oct. 29, 2007), at 91; Order No. 26 at 69-74.

[6] *See* Annual Compliance Determination Report for Fiscal Year 2017, PRC Docket No. ACR2017 (Mar. 29, 2018), at 92 [hereinafter, "FY 2017 ACD"].

in any such quantitative floor.[7] The Commission has repeatedly emphasized that "setting it too high could hinder the Postal Service's flexibility to compete, while setting it too low could give the Postal Service an artificial competitive advantage."[8] A contribution level that is set too high could result in the Postal Service being "forced to raise its prices to non-competitive levels in order to meet the minimum contribution," at which point "consumers would likely stop using the Postal Service and transfer their volume to cheaper competitors."[9] The Commission asserts that its formula-based approach is designed to address these risks, but as shown below, its proposed approach is not only inconsistent with the views expressed by many commenters in this docket, but also fails to align with many of its own findings.

In comments on the Advance Notice of Proposed Rulemaking,[10] several parties highlighted the risks of setting the minimum contribution requirement too high. For example, the National Association of Letter Carriers, AFL-CIO (NALC) warned that setting an excessively high contribution level "could make the Postal Service vulnerable to a price war waged by its competitors."[11] The Public Representative expressed the concern that any "Commission ordered increases in the appropriate share that might force Postal Service price increases . . . may simply fuel industry-wide across-the-board

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[7] *See* Order No. 26 at 73.

[8] Order No. 4402, Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Feb. 8, 2018), at 7 (paraphrasing Order No. 26 at 73); Order No. 4402 at 50-51.

[9] Order No. 4402 at 50.

[10] Order No. 3624, Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Nov. 22, 2016).

[11] Comment of the National Association of Letter Carriers, AFL-CIO, Docket No. RM2017-1 (Jan. 23, 2017), at 4 [hereinafter *NALC Comments*].

price increases for those products where competition is alive and well."[12] A broad coalition of market dominant mailers and competitive shippers (collectively, MDMCS) emphasized that "increasing the minimum contribution requirement enough to influence competitive product prices could harm the Postal Service, its customers, and American consumers."[13] In short, a "constraint that forced the Postal Service to raise its package delivery prices would directly harm both parcel shippers and ultimately consumers through higher prices and shipping costs."[14]

Moreover, as the Commission itself has pointed out, under the PAEA, the Postal Service has built-in incentives to exceed any minimum requirement the Commission may set. "Because it may retain earnings, the Postal Service has incentives to exceed this threshold, including reducing rate pressure on market dominant rates, continuation of universal service, and the possibility of bonuses."[15] Noting that the Postal Service has in fact exceeded the requirement by substantial margins in recent years, many stakeholders attested to these strong incentives in their 2017 comments. The American Catalog Mailers Association (ACMA), for example, pointed out that overachieving against any minimum contribution requirement is "consistent with competition and profit-

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[12] Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Docket No. RM2017-1 (Jan. 23, 2017), at 17.

[13] Comments of Parcel Shippers Association et al., Docket No. RM2017-1 (Jan. 23, 2017), at 1-2 [hereinafter *MDMCS Comments*].

[14] *Id.* at 7.

[15] Order No. 26 at 72.

seeking."[16] MDMCS, in concluding that the Postal Service has not cross-subsidized competitive products or acted in a manner suggesting it is enjoying a competitive advantage, remarked that the Postal Service in fact "has increased competitive product prices rapidly, substantially increasing the contribution of competitive products to institutional costs."[17]

These facts led the majority of parties submitting initial comments in this proceeding to join the Postal Service's recommendation that the minimum contribution requirement should be reduced or eliminated.[18] As eBay Inc. aptly stated, after obtaining over 32,000 signatures on a petition asking the Commission to eliminate the minimum contribution requirement: "USPS should factor in financial performance, investments, costs, and competitive forces to determine the cost of competitive products instead of having to account for an arbitrary number."[19]

The Commission's Notice of Proposed Rulemaking suggests that it agrees with the commenters on many of these points. Specifically, the Commission concluded that (1) the Postal Service continues to operate at a net competitive disadvantage in offering competitive products;[20] (2) there is no indication the Postal Service has engaged in

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[16] Initial Comments of the American Catalog Mailers Association, Docket No. RM2017-1 (Jan. 23, 2017), at 3 [hereinafter *ACMA Comments*].

[17] *MDMCS Comments* at 3.

[18] *See ACMA Comments* at 3; *MDMCS Comments* at 1; *NALC Comments* at 1; Comments of Amazon Fulfillment Services, Inc., PRC Docket No. RM2017-1 (Jan. 23, 2017), at 1; Comments of Stamps.com, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 5; Reply Comments of eBay Inc., PRC Docket No. RM2017-1 (Mar. 9, 2017), at 2 [hereinafter *eBay Reply Comments*].

[19] *eBay Reply Comments* at 2.

[20] Order No. 4402 at 67-68.

predatory pricing;[21] and (3) the market is competitive and "has grown through increased demand and new entrants."[22] In rejecting arguments put forth by United Parcel Service, Inc. (UPS) that the playing field somehow is "not level," the Commission concluded further that "there is no evidence that the Postal Service has attempted to expand its scale at the expense of profit. Instead, the record shows the Postal Service actively competing."[23] In analyzing the risks involved in setting the appropriate share level too low, the Commission also found that "little incentive exists for the Postal Service to significantly discount its prices."[24]

The Commission was correct in reaching these conclusions. However, in light of these conclusions, the Commission should reconsider its decision to abandon the current 5.5 percent requirement in favor of an annually adjusted, formula-based requirement. The statutory considerations continue to weigh heavily in favor of reducing or eliminating the minimum contribution requirement, and the proposed approach is inconsistent with the consensus view expressed by many Postal Service customers that the requirement could be maintained, reduced, or eliminated, and is likewise inconsistent with the Commission's own conclusions.

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[21] *Id.* at 36-37.

[22] *Id.* at 97-98. *See, e.g.,* Andrew Tipping and Peter Kauschke, *Shifting Patterns: The Future of the Logistics Industry*, PWC (2016), *available at* https://www.pwc.com/sg/en/publications/assets/future-of-the-logistics-industry.pdf (describing the "increasingly competitive" logistics environment in which customers are setting up their own logistics operations and new entrants are disrupting traditional delivery methods).

[23] Order No. 4402 at 74-75.

[24] *Id.* at 50-51.

II. THE COMMISSION PROPERLY REJECTED ALTERNATIVE APPROACHES THAT FAILED TO ADDRESS SECTION 3633(b)'S REQUIREMENTS

In reviewing the minimum contribution level under Section 3633(b), the Commission must "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."[25] Although the Postal Service disagrees with the result the Commission reached and maintains that the minimum contribution requirement should be reduced or eliminated, the Postal Service appreciates that the Commission dismissed several alternative proposals that failed to address the required statutory considerations.

A. If a Minimum Contribution Requirement Is Retained, It Must Account for "Prevailing Competitive Conditions in the Market"

In explaining why it chose to include CMO in its proposed formula, the Commission stated that "[e]valuating the overall size of the market provides context for assessing prevailing competitive conditions."[26] While the Commission's Lerner Index analysis leads it to infer that the Postal Service's market power has grown since 2007, this growth "did not necessarily occur at the expense of the Postal Service's competitors."[27] Competitors likely have experienced similar growth "due to the fact that

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[25] 39 U.S.C. § 3633(b).

[26] Order No. 4402 at 22.

[27] *Id.* at 21. In fact, a significant portion of the growth in competitive product volume has been the result of transfers from the market dominant product list to the competitive product list. *See, e.g.,* Order No. 689, PRC Docket No. MC2010-36 (Mar. 2, 2011) (regarding the transfer of Commercial Standard Mail Parcels); Order No. 710, PRC Docket No. MC2011-22 (Apr. 6, 2011) (regarding the transfer of Commercial First-Class Mail Parcels); Order No. 1411, PRC Docket No. MC2012-13 (Jul. 20, 2012) (regarding the transfer of Parcel Post). Such "growth" does not represent new volume, but simply a shift of existing Postal Service volume from the market dominant side to the competitive side.

overall demand for competitive delivery has increased dramatically over the last 10 years."[28]

The Commission appropriately rejected the approach advocated by the Greeting Card Association (GCA), which would have relied solely on historic contribution levels to set the required minimum contribution.[29] Computing an average of actual historical contribution levels would not address the prevailing competitive conditions in the market, nor would such a computation be responsive to changes in market conditions that could affect competitive products' capacity to contribute to institutional costs.[30] In addition, as the Postal Service explained in its 2017 Reply comments in this docket, the fact that competitive products have historically contributed more than the existing 5.5 percent appropriate share requirement is entirely consistent with the requirement's nature as a floor that the Commission expects the Postal Service to exceed, and does not provide a sufficient basis for raising that floor.[31]

The Commission also properly rejected arguments advanced by UPS that the minimum contribution requirement should be based on stand-alone costs, attributable-cost shares, or revenue shares. As the Commission found, stand-alone costs are used to develop price ceilings, not floors, whereas the statutory task at hand is the

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[28] Order No. 4402 at 21, 88.

[29] *Id.* at 83; Initial Comments of the Greeting Card Association, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 6.

[30] Order No. 4402 at 83.

[31] Reply Comments of the United States Postal Service, PRC Docket No. RM2017-1 (Mar. 9, 2017), at 35-36 [hereinafter *Postal Service Reply Comments*].

development of a price floor, not a ceiling.[32] Additionally, the Postal Service's attributable-cost shares "do not provide any insight into its market power, the size of the overall competitive market, or any other prevailing competitive conditions."[33] Considering Postal Service revenue alone similarly "does not take into account the statutory criteria and Commission precedent."[34] As the Commission correctly noted, these types of proposals are "tantamount to fully-allocated costing," which "has long been rejected by the Commission and by economists in general as being inherently arbitrary" and contrary to statutory requirements.[35]

B. The Commission Has Considered "the Degree to Which Any Costs Are Uniquely or Disproportionately Associated with Any Competitive Products"

1. There are no costs uniquely or disproportionately associated with competitive products that are not already attributed to competitive products

In reviewing the minimum contribution requirement, Section 3633(b) requires the Commission to consider "the degree to which any costs are uniquely or disproportionately associated with any competitive products." A small number of comments submitted in this proceeding raised concerns with the Commission's existing costing methodologies, particularly as they relate to cost attribution.[36] The Commission

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[32] Order No. 4402 at 80-81.

[33] *Id.* at 30 n. 55 & 81-82.

[34] *Id.* at 82.

[35] *Id.* at 81-82.

[36] Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 11-13 [hereinafter *Initial UPS Comments*]; Comments of Former Utility Regulators, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 11-12 [hereinafter *FUR Comments*].

properly rejected these arguments in concluding that there are no costs uniquely or disproportionately associated with competitive products that are not already attributed to competitive products.[37]

First, as previously noted by the Postal Service, existing costing methodologies have been developed and approved by the Commission through public, adversarial proceedings.[38] Second, the PAEA explicitly requires that cost attribution methods must be based on "reliably identified causal relationships."[39] Under the costing methodologies applied in the FY 2017 ACD, the Commission already classifies any costs that are uniquely associated with a competitive product as attributable to that product. These attributable costs, by definition, are not included in the institutional costs of the Postal Service.[40]

In its initial comments in this docket, UPS misconstrued the intent of the "uniquely or disproportionately" clause of the statute by attempting to focus the relevant inquiry on whether any <u>institutional</u> costs are uniquely or disproportionately associated with competitive products.[41] In reality, the intent of the clause was to explore the potential ramifications of any <u>attributable</u> costs that might be uniquely or disproportionately associated with competitive products. During the period in which the

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[37] Order No. 4402 at 43-45.

[38] *Postal Service Reply Comments* at 30.

[39] 39 U.S.C. § 3622(c)(2); Order No. 4402 at 43.

[40] Order No. 4402 at 43-45.

[41] *See, e.g., Initial UPS Comments* at 28. As the discussion in Order No. 4402 underscores, such an inquiry is virtually self-defeating, because if such an association with competitive products existed, the costs in question would not be treated as institutional. Therefore, the interpretation of this statutory language upon which the UPS argument is premised is fundamentally flawed.

PAEA was being contemplated, the Postal Service was employing dedicated facilities for handling mail subsequently classified as competitive.[42] Because the accrued costs for those facilities were fully attributed to competitive mail, none of their accrued costs added to the overall pool of institutional costs.[43] This created a concern that, if the Postal Service expanded deployment of resources dedicated to competitive products, and assuming that the entire costs of those resources were likewise directly attributed to competitive products, the result could be subsets of attributable costs for competitive products that were indicative of the extent to which competitive products might be bypassing the broader postal operational networks within which many institutional costs are generated. In that case, taking account of these attributable costs "uniquely or disproportionately associated with competitive products" might be a clear instance in which it would be appropriate for competitive products to be required to recover a smaller share of institutional costs than if they were piggybacking on the existence of the established common networks to the same extent as market dominant products.

As things turned out, the PMPCs were discontinued. Nonetheless, the potential for such a scenario was the basis for inclusion in current Section 3633(b) of the

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[42] These were the Priority Mail Processing Centers (PMPCs). *See* Opinion and Recommended Decision, PRC Docket No. R2000-1 (Nov. 13, 2000), vol. 1 at 298, 300; *see also Annual Report of the Postmaster General: Hearing Before the Senate Subcomm. on Int'l Security, Proliferation, & Fed. Servs.*, 105th Cong. at 17-18 (1998) (colloquy between Senator Thad Cochran and Postmaster General William Henderson); *Annual Report of the Postmaster General: Hearing Before the Senate Subcomm. on Int'l Security, Proliferation, & Fed. Servs.*, 105th Cong. at 4, 24 (1997) (testimony of Postmaster General Marvin Runyon). The "uniquely or disproportionately" clause first appeared in a PAEA-precursor bill during the same timeframe as the cited Senate committee hearings. *See* H.R. 22, 106th Cong. § 201(a) (1999) (proposed 39 U.S.C. § 3744(b)).

[43] Opinion and Recommended Decision, Docket No. R2000-1 (Nov. 13, 2000), vol. 1 at 298, 300.

"uniquely or disproportionately associated with competitive products" clause.[44] The costs that are the subject of that clause are attributable costs, not institutional costs, and arguments by UPS and others based on a contrary interpretation are simply inapposite.

2. Changes to costing methodologies are unnecessary and would be outside the scope of this proceeding

As noted above in Section I.A, the minimum contribution requirement is one of three separate statutory provisions applicable to competitive products, and it need not serve the same purposes that are already served by Sections 3633(a)(1) or (2). In their 2017 comments in this docket, a group of former regulators from other regulated industries expressed a concern that the lack of a specific connection between the minimum contribution requirement and actual Postal Service costs or revenues somehow creates a risk of cross-subsidization.[45] The Commission properly found that this argument lacked merit, because the Commission's incremental cost test already provides a safeguard against cross-subsidization.[46]

In addition, as the Commission noted in Order No. 4402, UPS filed a Motion to Supplement the Record, seeking to introduce into this proceeding a portion of an informal transcript from a separate case in which UPS is seeking appellate review of a

[44] Moreover, an instance in which application of that provision may continue to be viable was presented in the Postal Service reply comments in this docket last year, with the observation that purchased transportation costs are disproportionately associated with competitive products. *Postal Service Reply Comments* at 14-15. Although not specifically placing it in the context of the "unique or disproportional" discussion, Order No. 4402 recognized this observation by the Postal Service in its review of the alternative approach proposed by UPS based on attributable cost shares. Order No. 4402 at 78-79.

[45] *FUR Comments* at 2-3.

[46] Order No. 4402 at 75.

Commission Order related to cost attribution methods.[47] While the Postal Service does not contest the accuracy of the transcript or take serious issue with the Commission's reviewing it, the transcript is not relevant to this proceeding. The Commission should reject any attempts by UPS to relitigate previously addressed arguments concerning cost attribution under Section 3633(a)(2) in the context of this Section 3633(b) review.

III. THE COMMISSION SHOULD CONSIDER THE RISKS INHERENT IN THE PROPOSED FORMULA-BASED APPROACH AND MAKE CERTAIN REFINEMENTS IF IT DECIDES TO APPLY THE FORMULA IN FUTURE YEARS

The Commission's proposed new formula for calculating the minimum contribution relies on an annual measurement of two variables: (1) the percent change in the Postal Service's Lerner Index relating to competitive products; and (2) the percent change in CMO.[48] The two variables are summed in the following formula:

$$AS_{t+1} = AS_t * (1 + \%\Delta LI_{t-1} + \%\Delta CMO_{t-1}),$$

Where:

AS = Appropriate Share;

t = Fiscal Year;

LI = Postal Service Lerner Index; and

CMO = Competitive Market Output

[47] *Id.* at 4 & n.11.

[48] *Id.* at 29.

Thus, the Lerner Index is a proposed proxy for the Postal Service's market (pricing) power, and CMO is a proposed measure of the total size, by revenue, of the domestic package delivery market in which the Postal Service's competitive products compete.[49]

As a general matter, the Commission's proposed formula is aimed at measuring the potential for competitive products to contribute to institutional costs. Both an increase in any possible pricing power and a growing market (within which the Postal Service already has ample incentive to maintain or grow its share) might be expected to translate into an increase in the potential for competitive products to contribute to institutional costs. However, the Commission's selected variables do not conclusively predict the ability of the Postal Service's competitive products to contribute to institutional costs. Neither the Lerner Index nor CMO captures factors such as the competitive structure of the relevant market(s), the Postal Service's market share(s), or differentiation of the Postal Service's and competitors' product offerings, all of which may have an impact on actual contribution.

Ultimately, no simple formula will be able to fully reflect the market conditions under which competitive products' potential to contribute to institutional costs might change.[50] The following sections discuss considerations the Commission should take into account if it decides to pursue the proposed formula-based approach.

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[49] *See* Order No. 4402 at 17, 22.

[50] *See, e.g.,* KENNETH E. ELZINGA & DAVID E. MILLS, THE LERNER INDEX OF MONOPOLY POWER: ORIGINS AND USES, 101 AM. ECON. REV. 558 (2011), at 559 (noting that "[e]conomists' acceptance of the Lerner Index has been qualified," and that "no single simple measure. . . [of monopoly] will serve adequately to distinguish situations that may differ in many ways") (citations & internal quotation marks omitted) [hereinafter *Elzinga & Mills*].

A. Application of the Lerner Index Could Produce Inaccurate Results

The Commission proposes to calculate a Lerner Index for the Postal Service using marginal cost and revenue-per-piece data from the Product Finances Analyses (PFA) produced by the Commission every year as part of its Annual Compliance Determination (ACD).[51] Specifically, the Commission intends to apply the following formula to determine the Postal Service Lerner Index:

$$\frac{\text{Revenue-per-Piece} - \text{Unit Volume-Variable Cost}}{\text{Revenue-per-Piece}}$$

According to the Commission, a Lerner Index is designed to assess a firm's market power by measuring the relationship between the firm's price and its marginal cost, providing a measure of profitability.[52] However, the Lerner Index does not consider the need of a firm to cover fixed costs, operate at efficient scale, or price to market, thus it can be "misleading to attribute the entire departure [from marginal cost pricing] to the exercise of monopoly power."[53] Courts have specifically refused to rely on a Lerner Index as a sole indicator of market power for those very reasons.[54] A

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[51] Order No. 4402 at 17-19.

[52] Order No. 4402 at 17.

[53] Elzinga & Mills at 559.

[54] *See, e.g., United States v. Eastman Kodak Co.*, 63 F.3d 95, 109 (2d Cir. 1995) ("[E]ven if we were to accept the government's contention that Kodak's short-run marginal costs equal one-half of the product's sales price, we do not think that it necessarily follows that Kodak is earning monopolistic profits. Certain deviations between marginal cost and price, such as those resulting from high fixed costs, are not evidence of market power.") (citing William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 939 (1981)); *accord In re Asacol Antitrust Litigation*, No. 15-cv-12730-DJC, 2017 WL 5196381, at *28 (D. Mass. Nov. 9, 2017); Guttman Energy, Inc., 161 F.E.R.C. ¶ 61,180, at 116 (2017); Second Annual Report & Analysis of Competitive Market Conditions with Respect to Domestic & International Satellite Communications Services, 23 F.C.C.R. 15,170, at ¶¶ 80-81, 90 (2008); Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, 9 F.C.C.R. 7,442, at ¶ 206 n.534 (1994).

significant price increase above marginal cost could also reflect an attempt to bring prices in line with competitors' price levels, which may be substantially above the Postal Service's – or even the competitors' own – marginal costs.[55] While the Commission acknowledges that "sudden large increases in the Postal Service Lerner Index <u>may</u> indicate a competitive advantage <u>under certain circumstances</u>," it is far from clear why, given the prospect of other possible implications, such increases should automatically translate into increases in the minimum contribution requirement (CMO remaining equal).[56]

The Lerner Index, as proposed, is closely related to the percent cost coverage (over volume-variable cost). As the Commission should be well aware, increased cost coverage does not necessarily imply increased capacity for generating contribution.[57] For example, if the Postal Service's competitive product mix were to shift from products

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[55] *See, e.g.,* Enterprise Prods. Partners L.P. & Enbridge Inc., 146 F.E.R.C. ¶ 61,115, at 51 (2014) ("[I]n a market with multiple sellers, the competitive price is determined by the marginal costs of the marginal supplier, the supplier with the highest marginal costs . . . . A fully depreciated pipeline, such as Pegasus, could have significantly lower marginal costs than other alternatives in the market, and could therefore raise its rates above its own marginal costs. While certain commenters would label this price increase above the applicant's marginal costs an exercise of market power, it is merely a pipeline utilizing its lower costs while increasing price to the competitive level."); *see also Mobil Pipe Line Co. v. FERC*, 676 F.3d 1098, 1103 (D.C. Cir. 2012) ("[The potential for a 15-percent price increase] demonstrates only that Pegasus's [cost-based] regulated rate is below the competitive rate."). As to the possibility that competitors' prices are themselves substantially above marginal costs, see *In re Solodyn (Minocycline Hydrochloride) Antitrust Litigation*, No. 14-md-02503, 2018 WL 563144, at *11 (D. Mass. Jan. 25, 2018). It should be noted that CMO is not designed to fill this explanatory gap, as it is agnostic as to unit price levels among competitors or in relation to marginal costs.

[56] Order No. 4402 at 35, 97 (emphasis added).

[57] For instance, changes in the product mix within the market dominant group of products have created downward pressure on market dominant contribution that has reinforced the effects of demand declines. Market dominant cost coverage has not declined even as market dominant contribution has eroded. Compare the contribution and cost coverage for market dominant mail as shown in the FY 2017 Financial Analysis Report ($18.5 billion and 169.5 percent) with the same figures shown on page 24 of the FY 2007 ACD ($25.6 billion and 168.4 percent).

with high unit contribution but low cost coverage to products with low unit contribution but high cost coverage, the measured Lerner Index may increase even as the total contribution decreases. If that scenario occurred, the Lerner Index component of the appropriate share formula would increase competitive products' minimum obligation to contribute to institutional costs when in fact both the ability to generate contribution and total contribution would be decreasing. If the Commission implements a formula based on the observed Lerner Index, it should periodically assess whether the indicated changes to the Postal Service's pricing power actually translate to corresponding changes in contribution.

B. CMO Does Not Precisely Track the Relevant Market, But, If It Is Used, It Should Be Adjusted for Inflation

As measured by the Commission, CMO relies on revenue data obtained from certain surveys (the QSS and SAS[58]), conducted by the United States Census Bureau, which are classified by industry subsector. The subsector the Commission proposes to use is North American Industry Classification System (NAICS) code 492, "Couriers and Messengers."[59] This subsector comprises "Couriers and Express Delivery Services" (NAICS code 4921)[60] and "Local Messengers and Local Delivery" (NAICS code 4922).[61]

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[58] *I.e.,* the Quarterly Services Survey (QSS) and Services Annual Survey (SAS).

[59] Order No. 4402 at 23-24.

[60] "Couriers and Express Delivery Services" includes "establishments primarily engaged in providing air, surface, or combined mode courier and express delivery services of parcels, but not operating under a universal service obligation . . . . These services are generally between metropolitan areas, urban centers, or international, but the establishments of this industry form a network that includes local pick-up and delivery to serve their customers' needs." *See* https://www.naics.com/naics-code-description/?code=492110.

[61] "Local Messengers and Local Delivery" includes "establishments primarily engaged in providing local messenger and delivery services of small items within a single metropolitan area or within an urban

The latter classification appears to include services performed by local couriers and messengers, such as alcoholic beverage and restaurant meal delivery, which do not directly compete with the Postal Service's competitive products.[62] As such, CMO as measured by NAICS code 492 may overstate the market in which the Postal Service competes. On the other hand, the QSS and SAS data for NAICS code 492 may understate the market in which the Postal Service competes in another respect, because it is not clear to what extent the data include delivery services provided by companies for which package delivery is an incidental line of business, such as Amazon.com, brick-and-mortar retailers, and peer-to-peer ridesharing services.[63]

The Commission observes that the formula would decrease the minimum contribution requirement "if the Postal Service were to lose market share and the competitive market were to retract."[64] However, the formula would not decrease the required contribution if the Postal Service lost market share but measured CMO did not also decrease. Among other possibilities, the Postal Service's traditional competitors could compete more aggressively, or customers and non-traditional competitors could expand their delivery operations. In either case, CMO, as proposed, could lose its relevance as an indicator of the Postal Service's ability to generate contribution from

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center. These establishments generally provide point-to-point pick-up and delivery and do not operate as part of an intercity courier network." *See* https://www.naics.com/naics-code-description/?code=492210,

[62] *Id.; see also* https://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=492210&search=2017%20NAICS%20Search.

[63] For example, e-retailers such as Amazon may be classified under NAICS code 454100, while ridesharing services such as Uber and Lyft may be classified under NAICS code 485320. For descriptions of these NAICS codes, *see* https://siccode.com/en/naicscodes/454110/electronic-shopping-and-mail-order-houses-3; https://classcodes.com/lookup/naics-code-485320/.

[64] Order No. 4402 at 88.

competitive products. Similarly, CMO (and, in turn, the calculated minimum contribution requirement) may increase without necessarily reflecting additional market opportunities for the Postal Service or even its direct competitors. Indeed, such a market change towards greater self-delivery may come largely at the expense of the Postal Service and other traditional package shipping companies and be detrimental to competitive products' contribution.[65]

The above issues are endemic in the use of CMO as proposed, and therefore are not amenable to any simple resolution. As such, the Commission should take these issues into account when deciding on the final rule. If the Commission decides to include CMO in the final rule, however, there is a straightforward adjustment that should be made to address a different type of problem. Unlike the Lerner Index, CMO is an absolute measure of market size denominated in current dollars.[66] The Commission, without elaboration, presents growth rates of CMO based on revenues expressed in nominal dollars, rather than constant dollars adjusted for inflation.[67] Thus, CMO growth in the proposed formula would include purely inflationary increases in both the Postal Service's competitive product revenue and the revenue of competitors in NAICS code 492, in addition to growth from increased demand and from increased market power. If CMO were to grow more slowly than inflation, CMO growth may be inadequate to support an increased minimum contribution requirement, given that the institutional

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[65] *See Initial Postal Service Comments* at 15; Order No. 4402 at 49-50.

[66] See https://www.census.gov/services/qss/how_the_data_are_collected.html (accessed April 6, 2018).

[67] *See* Order No. 4402 at 28.

costs to be covered are themselves subject to inflationary pressures.[68] If the Commission decides to adopt its proposed formula using CMO, then the Postal Service recommends that the Commission consider the latter approach by applying a deflator such as CPI-U to it. An illustrative example is provided in Appendix A.

C. FY 2017's Actual Minimum Contribution Requirement of 5.5 Percent Would Provide the Most Appropriate Anchor for Future Calculations of the Formula

The Commission's proposed rules anchor application of the formula at the start of the PAEA era, setting the initial "t" value for the formula as FY 2007.[69] This approach, according to the Commission, "would allow the appropriate share to reflect the prevailing market conditions as they have developed over time since the PAEA's enactment."[70] In Table IV-6, the Commission provides an illustration showing what the minimum contribution requirement would have been for every year during the PAEA era, if the proposed formula had been applied through the entire period.[71] If the Commission were to start the calculation with FY 2007, then the cumulative results of applying the formula through all of the intervening years would result in an appropriate

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[68] In a world with no inflation, the opportunity for competitive products to contribute to defraying institutional costs would be enhanced by either an increase in the volumes transacted in those markets or an increase in the market price, both arising from an increase in demand. But when inflation exists, an increase in market price can arise even without an increase in demand, solely because of inflation. Such price increases just allow competitive products' prices to keep up with the general, economy-wide increase in input prices, but do not enhance their ability to earn true contribution. An increase in that ability occurs only if competitive products' prices rise faster than inflation, and using inflation adjusted dollars would capture that exact condition.

[69] *See* Order No. 4402, Attachment A (providing that "If t = 0 = FY 2007, AS = 5.5 percent"); *id.* at 32-33.

[70] *Id.* at 32.

[71] *Id.* at 33.

share requirement of 7.8 percent for FY 2017, as shown in Table IV-6.[72] The results for FY 2018 and subsequent years, then, would continue to build on the values identified in Table IV-6.

The actual minimum contribution requirement, however, has been exactly 5.5 percent for every year since FY 2007, not the higher illustrative value shown for each year listed in Table IV-6.[73] As recently as March 2018, the Commission confirmed the existing 5.5 percent requirement when it concluded that the Postal Service's competitive products collectively contributed $6.806 billion toward institutional costs in FY 2017, and thereby "satisfied the requirement that they provide a minimum contribution of 5.5 percent of institutional costs" in FY 2017.[74]

The Postal Service submits that the initial "t" value used in Proposed Rule 3015.7(c)(1) should be FY 2017, the most recent year in which the appropriate share requirement was a fixed 5.5 percent, rather than FY 2007, when the existing 5.5 percent requirement was first instituted (or even FY 2012, when it was last considered and retained for the ensuing five-year period).[75] There is simply no basis for applying the new formula beginning in FY 2007 and continuing forward on a cumulative basis. Under the Commission's proposed formula, prevailing competitive conditions are

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[72] *Id.*

[73] *See* 39 C.F.R. § 3015.7(c) (stating the currently applicable requirement that "on a fiscal year basis, the appropriate share of institutional costs to be recovered from competitive products collectively is, at a minimum, 5.5 percent of the Postal Service's total institutional costs").

[74] FY 2017 ACD at 81 & 92.

[75] The earliest date the Commission should consider beginning its calculations would be FY 2012, which is the most recent year in which it explicitly affirmed the continuing applicability of the 5.5 percent requirement under Section 3633(b). Order No. 1449, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, PRC Docket No. RM2012-3 (Aug. 23, 2012), at 1-2.

already reflected in the Lerner Index and CMO. If the Commission had concluded that the 5.5 percent requirement was insufficient at some point after its determinations in FY 2007 or FY 2012, then it could have instituted proceedings at any time to change the requirement. Of course, it declined to do so until it instituted this docket pursuant to Section 3633(b)'s requirement that it review the minimum contribution requirement every five years. It would be inappropriate, and arbitrary, to assign a hypothetical value representing AS_t for purposes of the appropriate share calculation when actual contribution requirements for FY 2007 through FY 2017 already exist.

The Postal Service recognizes that calculation of the formula, $AS_{t+1} = AS_t * (1 + \%\Delta LI_{t-1} + \%\Delta CMO_{t-1})$, where t = FY 2017 and AS_t = 5.5 percent, is likely to result in different minimum contribution requirements for FY 2018 and subsequent years than the hypothetical values that are shown in Table IV-6. The Postal Service nevertheless urges the Commission to modify Proposed Rule 3015.7(c)(1) to reflect a starting "t" value of 5.5 percent for FY 2017, and calculate the resulting minimum contribution levels for future fiscal years using the actual 5.5 percent requirement for FY 2017 as the baseline value.

IV. CONCLUSION

Based on its analysis of all relevant circumstances, including the prevailing competitive conditions in the market and the fact that no costs are uniquely or disproportionately associated with competitive products that are not already attributed to competitive products, the Postal Service continues to believe that the minimum contribution requirement should be reduced or eliminated. If the Commission decides instead to adopt the formula-based approach proposed in Order No. 4402, the Postal Service recommends that the Commission incorporate two refinements, namely, measuring CMO in real, inflation-adjusted dollars and using FY 2017 as the baseline year to begin calculations under the new formula, as discussed above in Section III.

APPENDIX A

In order to illustrate the effects of using a nominal approach to the measurement of Competitive Market Output (rather than inflation-adjusted real changes in the variable), the following stylized model examines the change in competitive products' contribution share of institutional costs, from one year to the next, under a set of realistic assumptions for inflation and revenue growth. Inflation is assumed to be +2 percent. Hence price, unit attributable costs and institutional costs are all inflated by 2 percent. Volume is increased by 3.5 percent because this produces a revenue increase, 5.57 percent, in line with the average annual compound increase in CMO since it bottomed out, pursuant to the Great Recession, in FY 2010 (5.60 percent). It is assumed that revenue from competitive products, row c, keeps pace with the change in CMO—i.e., there is no change in market share. Thus, the percent change in row c is the value by which the CMO variable in the Commission's proposed formula would change going from Year 1 to Year 2. The first three columns in the following table show the impact of using inputs that <u>are not</u> adjusted for inflation, rather than inputs that <u>are</u> adjusted for inflation.

		Year 1	Non-inflation Adjusted Year 2	Percent Change	Inflation Adjusted Year 2	Percent Change
a	Volume	100	103.5	3.5%	103.5	3.5%
b	Price	$1.00	$1.02	2.0%	$1.00	0.0%
c	Revenue (a x b)	$100	$105.57	5.57%	$103.50	3.5%
d	Unit Attributable Costs	$0.75	$0.765	2.0%	$0.75	0.0%
e	Total Attributable Costs (a x d)	$75	$79.1775	5.57%	$77.6250	3.5%
f	Contribution (c - e)	$25	$26.39	5.57%	$25.88	3.5%
g	Institutional Costs	$100	$102	2.0%	$100	0.0%
h	Contr. Share of Inst. Costs (f ÷ g)	25%	25.875%	3.5%	25.875%	3.5%

The highlighted figures indicate that using unadjusted inputs results in a percent change in revenue in row c that overstates the capacity of competitive products to contribute to institutional costs. The key finding is that, because of the inflation that is implicitly driving all dollar-based inputs in the first three columns (but is not recognized explicitly), the contribution share of institutional costs (row h) increases by only 3.5 percent, not the 5.57 percent that would be signaled by row c when CMO, as a variable in the appropriate share formula, is expressed in nominal dollars. However, as shown in the last two columns, if Year 2 nominal revenue, $105.57, is deflated by 2 percent, it can be restated in constant Year 1 dollars as $105.57/(1 + 2%) = $103.50. The row c increase over $100 in Year 1 is now 3.5 percent—the same as the increase in the contribution share in row h. This analysis suggests strongly that an inflation-adjusted rather than nominal CMO variable should be specified in the appropriate share formula.