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BEFORE THE
POSTAL REGULATORY COMMISSION

Institutional Cost Contribution Requirement for Competitive Products	: : :	**Docket No. RM2017-1**

INITIAL COMMENTS OF UNITED PARCEL SERVICE, INC. ON NOTICE OF PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS
(April 16, 2018)

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United Parcel Service, Inc. ("UPS") respectfully submits these comments in response to the Postal Regulatory Commission's Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Feb. 8, 2018) ("Order No. 4402").

INTRODUCTION

The Postal Service claims it is unable to attribute over *$30 billion* in annual costs to its products, amounting to nearly half of its costs overall, so it classifies these costs as "institutional." The effect of this is that, when the Postal Service sets prices for the individual products it sells in competition with private-sector firms (so-called "competitive" products), it can largely ignore these costs. This is not because these costs are not real costs, but simply because they have been placed in this "institutional" category. This practice gives the Postal Service a massive advantage over private-sector firms. No private firm can ignore nearly half of its costs when setting prices. To keep the lights on, a private company must set prices for its products at levels sufficient to recover all of its costs.

Moreover, this advantage is entirely unearned. It does not arise because the Postal Service is uniquely efficient or has some novel pricing strategy. Rather, it results from the Postal Service's stated inability to attribute these costs to the products it sells. Notably, the Postal Service professes this inability even as it has conceded, in other dockets, that these unattributed costs include *variable* costs—that is, costs it incurs because of how many products it sells.[1] These unattributed variable costs that the

[1] UPS has proposed a methodology for attributing all of these variable costs, but the Postal Service has maintained the methodology is not sufficiently reliable. *See* Petition of United Parcel Service, Inc. For The Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies, Dkt. No. RM2016-2 (Oct. 8, 2015), at 9-10 (summary of UPS Proposal

Postal Service classifies as "institutional" include, for example, costs involved in buying a new fleet of "UPS-sized" trucks[2] for the express purpose of delivering *packages* in competition against UPS (and others). These unattributed, "institutional" costs also include most of the delivery costs associated with the Postal Service's peak-season, when it delivers *packages* for Christmas at what the Postal Service brags are record-setting volumes.[3]

The only protection against the Postal Service using this classification scheme to sell packages at artificially low prices—prices that are low only because they ignore large volumes of costs of the type a private-sector firm could never ignore—is the "appropriate share" requirement that is the subject of this docket.[4] Congress anticipated that if the Postal Service were able to ignore costs associated with its competitive products business when setting prices for those products, it would enjoy a massive, artificial advantage over the private sector. And that is why Congress directed this Commission to ensure that the Postal Service's competitive products business recovers an "appropriate share" of any costs classified as institutional.

In the Order at issue, however, the Commission has abandoned that responsibility. Perhaps most surprisingly, the Commission proclaims in its Order that

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One); Initial Comments of the United States Postal Service on Proposals One and Two, Dkt. No. RM2016-2 (Jan. 27, 2016), at 13-27. So it simply does not attribute them at all.

[2] Mike Colgan, *Familiar White Postal Service Trucks Too Small for Increasing Amount of Parcels Being Mailed*, CBS SF BAY AREA (Jan. 19, 2015), available at http://sanfrancisco.cbslocal.com/2015/01/19/familiar-white-postal-service-trucks-too-small-for-increasing-amount-of-parcels-being-mailed/.

[3] *See* Paul Ziobro, *Delivery Companies Brace for the Pre-Christmas Crush*, WALL STREET JOURNAL (Dec. 17, 2017), *available at* https://www.wsj.com/articles/delivery-companies-brace-for-the-pre-christmas-crush-1513515610.

[4] 39 U.S.C. § 3633(a)(3).

none of the more than $30 billion in costs the Postal Service classifies as institutional are associated, uniquely or disproportionately, with its competitive products business.[5] Respectfully, that conclusion cannot be true. As UPS showed in its opening comments, institutional costs have *grown* by over $1.3 billion in recent years, even as mail volumes continue to plummet.[6] The obvious explanation for this growth is that the Postal Service is devoting more of its resources to delivering competitive products, the volumes of which are rapidly increasing. That is why, for example, the Postal Service bought a new fleet of trucks expressly designed for delivering packages—and it should be clear that at least some of the costs of doing so are associated with the competitive products business. Simply put, the Postal Service would not have bought more expensive, large trucks designed to carry packages *if it was not delivering packages*.

Looked another way, if the Postal Service exited the competitive products business, it would be able to slash costs across the board. The Commission itself has recognized that competitive products' "share of total Postal Service revenue, attributable cost, and contribution to institutional cost has nearly tripled since FY 2007."[7] All of those costs that could be saved if the Postal Service stopped delivering competitive products, including packages, should be considered "incremental" costs of the competitive products business. The Postal Service's competitive products business should be required to cover at least those costs as part of the "appropriate share"

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5 Order No. 4402 at 43.

6 Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Jan. 23, 2017) ("UPS Initial Comments"), at 3.

7 Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Dkt. No. ACR2017 (Apr. 5, 2018), at 6.

requirement. If that does not occur, the Postal Service is not competing on a level playing field.

But the Commission proposes to do no such thing. Instead, the Commission has proposed a complex, novel formula for setting the institutional cost contribution (or "appropriate share") required of competitive products that does nothing to protect fair competition or advance Congress's statutory goals. The Commission proposes to base its formula on two variables for which not a single commenter in this docket advocated—and which have not been addressed in any of the prior proceedings involving 39 U.S.C. §§ 3633(a)(3) and (b) in the decade since Congress enacted the Postal Accountability and Enhancement Act ("PAEA").

These two new proposed variables are a "Lerner Index" and a variable representing "Competitive Market Output." The former measures the gap between average price and attributable cost per piece, with the appropriate share requirement generally rising if prices increase relative to costs. The latter essentially measures how much overall competitive product revenue market is changing. If the overall market revenue grows, the appropriate share requirement will also rise.

The Commission tethers neither of these two variables to the statutory objectives of the appropriate share requirement of 39 U.S.C. § 3633(a)(3).[8] The use of the "Lerner Index," for example, would have the appropriate share requirement increase if the Postal Service's prices were set too high. But the "appropriate share" is not a safeguard against the Postal Service setting prices too *high*. Competition will prevent that from

[8] The Commission has therefore not adequately justified its new approach, which it acknowledges it must do. Order No. 4402 at 11.

occurring. Rather, the requirement is meant to prevent the Postal Service from setting prices artificially low by ignoring costs associated with its competitive products business. Competition cannot prevent that from happening—only regulation can. Meanwhile, the Competitive Market Output variable has nothing to do with covering costs at all. Because neither of these variables address the core statutory goals of 39 U.S.C. § 3633(a)(3), the proposed formula that cobbles them together is the very definition of arbitrary and capricious.

The Commission's proposal to use 5.5% as a starting point makes matters even worse.[9] The Commission set the appropriate share at an admittedly low 5.5% level in 2007 using a completely unrelated methodology, because the Commission was "mindful of the risks of setting it too high" at the outset of regulation and wanted to give the Postal Service "some flexibility to compete" given that "the Postal Service's market share [was] relatively small."[10] That transitional, artificially low measure should play no role in setting today's appropriate share, especially considering the Postal Service's market share can no longer be considered small. Today, just a decade after PAEA, the Postal Service now delivers more packages to American homes than any other enterprise. It is irrational to bake the Commission's prior, intentionally low, transitional rate into a new formula to determine present and future rates.

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[9] *See* Order No. 4402 at 29, 32 ("The Commission sets the beginning appropriate share level for the formula at 5.5 percent because that was the initial appropriate share set in FY 2007").

[10] Order Proposing Regulations to Establish a System of Ratemaking, Dkt. No. RM2007-1 (August 15, 2007) at 73; *see* Order No. 4402 at 7 ("The Commission set the minimum contribution level lower due to differences between the old ratemaking system and the new one being implemented pursuant to PAEA").

Through its proposed formula, the Commission would be giving the Postal Service permission to use the "institutional costs" bucket as a place to tuck away costs associated with competitive products without accountability. With such a low appropriate share requirement, the Postal Service will essentially be able to ignore these costs. That is the very definition of an artificial competitive advantage—no private-sector firm has such a luxury.

UPS respectfully urges the Commission to reconsider its approach and adopt an appropriate share requirement that ensures the Postal Service's competitive products business does not enjoy an artificial advantage over the private sector.

ARGUMENT

I. THE COMMISSION'S ANALYSIS DISREGARDS THE STATUTORY PURPOSE OF PAEA

In the past, the Commission has recognized that "section 3633 and its required regulations are 'intended to ensure that the Postal Service competes fairly in the provision of competitive products.'"[11] The Commission has specifically recognized that "[a] primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace."[12] The Commission observed that the "appropriate share requirement could be said to represent the fixed costs of the competitive enterprise and should reflect the ways in which institutional resources are spent on the competitive enterprise."[13] The Commission has also acknowledged that "[t]he Postal Service's competitors incur certain fixed operating costs . . . and [i]f the Postal Service's

[11] Order No. 3506 at 121 (quoting S. REP. NO. 108-318, at 19 (2004)).

[12] Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs ("Order No. 1449"), Dkt. RM2012-3 (Aug. 23, 2012), at 13.

[13] *Id.*

competitive products were provided by a stand-alone enterprise, it too would incur fixed operating costs."[14]

The congressional record confirms this interpretation of PAEA's statutory purpose. Congress intended that, under PAEA, the Postal Service would "compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors, albeit with stronger controls, oversight, and limitations in recognition of its governmental status."[15] Congress also contemplated that "[o]nce the Commission has issued its regulations, the Postal Service is given pricing flexibility somewhat comparable to that exercised by private competitors. The changes regarding competitive products will be complemented by title III, which provides for a level playing field for such products in several important respects."[16]

Order No. 4402, however, represents an abrupt shift in the Commission's interpretation of its mandate, and the Commission's proposed formula does nothing to advance the statute's regulatory purpose at all. Indeed, the Commission's analysis indicates that the Commission simply does not share Congress's concern embodied in 39 U.S.C. § 3633.[17] Nowhere in the Order does the Commission identify any concern, even a hypothetical one, about how the Postal Service could possibly enjoy an artificial advantage over the private sector. To the contrary, based on a single, limited decade-old study, which on its face did not consider the question in full even at that time, the Commission concludes that it is *the private sector* that enjoys the competitive

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[14] *Id*.

[15] H.R. REP. NO. 109-66 at 44 (2005).

[16] *Id*. at 46.

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

advantage over the Postal Service.[18] On this basis, the Commission uses an elaborate justification to set an appropriate share at what is in practice a low level.

At this point, it is unclear what facts could convince the Commission that the Postal Service might enjoy an artificial advantage over its private sector rivals. This raises the question: What regulatory purpose does the Commission believe the appropriate share requirement serves? If the Commission does not believe that the Postal Service, by virtue of its status as a government monopoly, could possibly enjoy an artificial competitive advantage over the private sector, absent regulation, then what is the point of *any* of the various proceedings the Commission conducts under 39 U.S.C. §§ 3633(a)(2) and (3)?

A. The Order Fails to Acknowledge that Some Institutional Costs are Incremental to Competitive Products.

The failure to hold the Postal Service's competitive products business responsible for *at least* the economic incremental costs of that business provides the Postal Service with a blatant competitive advantage over the private sector. Private companies delivering competitive products, like UPS, FedEx, and others, must eventually recover *all* of the costs caused by their business to stay in business. If the Postal Service's competitive products business is not required to do the same, but instead can effectively ignore costs by classifying them as "institutional," then that business will enjoy a competitive advantage in a manner that defies PAEA and Congress's intent.[19]

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[18] *See* Order No. 4402 at 65, 58, 74 ("The Commission concludes that the FTC's finding that the Postal Service operates at a net competitive disadvantage relative to its competitors remains valid."). *See also infra* I.C.

[19] *See* H.R. REP. NO. 109-66 at 44, 46 (2005).

In its initial filings in this docket, UPS demonstrated that the Postal Service does not attribute all of the costs caused by the Postal Service's competitive products business *as a whole* to individual competitive products. UPS submitted the declaration of Professor Dennis Carlton, a distinguished economist, who explained this point at length.[20] Professor Carlton explained that, although the Postal Service and the Commission refer to the costs attributed to individual competitive products under 39 U.S.C. § 3633(a)(2) as the "incremental" costs caused by those products, the employed methodology misses many costs that are in fact incremental to competitive products.

This is because "[c]osts that USPS classifies as being incremental to competitive products are . . . determined based on an extrapolation of estimated marginal costs (using a constant elasticity assumption) along with information on the underlying volume of competitive products."[21] Consequently:

> The resulting set of costs that USPS defines as incremental are distinct from (and generally understate) incremental costs as defined by economists. As noted above, the economic literature defines incremental costs to include *all* additional costs incurred by a multiproduct firm in providing a given product or service. In the USPS context, the incremental costs of providing competitive services should reflect the difference between all costs incurred due to USPS' provision of both competitive and market dominant products, less the costs USPS would face [if it] only provided market dominant products. USPS' incremental cost framework does not appear to account for all costs that would be avoided if USPS did not provide competitive products. By failing to account for all costs incurred as the result of USPS' decision to provide competitive products, USPS' estimates will systematically understate true incremental costs, as defined in the economic literature.[22]

[20] *See* Declaration of Dennis W. Carlton, Dkt. No. RM2017-1 (Mar. 9, 2017) ("Carlton Decl.") at 19-30.

[21] *Id*. at 21.

[22] *Id*. (emphasis in original).

Put differently, the existing cost attribution approach under 39 U.S.C. § 3633(a)(2) does not attempt to capture all costs that would go away if the competitive products business went away. Again, as Professor Carlton explains:

> [T]his methodology does not fully attempt to evaluate how costs would change if USPS modified the structure of its network in response to dropping provision of competitive products, as is necessary for estimating incremental costs. In such circumstances, an efficient firm would be likely to reconfigure its network—perhaps by, among other things, modifying delivery carriers' routes and/or by changing the number and location of processing facilities. In fact, if USPS stopped providing competitive products it would be expected to make significant changes to its network that would be likely to result in significant reductions in cost. USPS' incremental cost test, however, would fail to fully account for the extent of savings due to changes in network structure and thus understate incremental costs.[23]

The significance of Professor Carlton's points are that the $30 billion or more of unattributed Postal Service costs labeled "institutional" today include costs that are incremental to the competitive products business as a whole. Many of these costs would go away if the Postal Service stopped providing competitive products.

Professor Carlton provided specific examples of costs classified by the Postal Service as institutional that are properly considered incremental to the competitive products business because economic theory dictates these costs could be efficiently eliminated or reduced if the Postal Service stopped providing competitive products. For example, if the Postal Service quit the competitive products business, it could "reduce certain headquarters expenses relating to administration and management."[24] These costs totaled $767 million in 2015—but the Postal Service does not attribute them to individual domestic competitive products; instead they are considered almost entirely

[23] *Id*. at 23.

[24] *Id*. at 21-22.

institutional.[25] Exit from the competitive products business would also undoubtedly decrease expenses for data processing supplies and services.[26] These costs totaled $680 million in 2015—but again, the Postal Service does not attribute them to individual competitive products and instead are all considered to be institutional.[27] These are just some examples of the broader phenomenon.

In Order No. 4402, however, the Commission fails to substantively address Professor Carlton's arguments about how institutional costs include those that are incremental to competitive products. The Commission makes no effort to determine the proportion or amount of institutional costs the Postal Service could eliminate under an efficient reorganization if it stopped providing competitive products.

Instead, the Commission makes a number of superficial critiques. For example, the Commission reasons that, because the Postal Service purportedly attributes all costs that can be reliably attributed to a specific competitive product to that product under 39 U.S.C. § 3633(a)(2), then by definition "there are no costs uniquely or disproportionately associated with competitive products that are not already attributed to competitive products."[28] Elsewhere, the Commission observes that the "incremental cost test" it employs under 39 U.S.C. § 3633(a)(1) necessarily "ensures that competitive products cover their incremental costs."[29]

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[25] *Id*. at 22 (noting that only $12 million of headquarters expenses was attributed to "International Mail and Services.").

[26] *Id*.

[27] *Id*.

[28] Order No. 4402 at 43.

[29] *Id*. at 75 n.121.

These are ultimately tautological arguments that rely on conclusory labels. The Commission may refer to its current approach as attributing the "incremental cost" of a product to that product but, as Professor Carlton explained, applying that label does not guarantee that the Commission is ensuring that competitive products are being held responsible for all of their incremental costs as that term is actually used and understood by economists. In this case, Professor Carlton has explained why the existing approaches are not, in fact, accounting for all costs that are truly incremental to competitive products.[30] Many institutional costs, which are by definition not attributed to specific products under the current methodology, would disappear if the Postal Service stopped delivering competitive products.

Does the Commission really maintain that the Postal Service could not significantly reduce headquarters and administration expenses, data processing supplies and services, vehicle expenditures, building project expenses, and various other costs classified as institutional today if it got out of the business of delivering packages? Does the Commission really believe the Postal Service would need as many large and expensive, package-sized trucks with an increased capacity of three to six times, as much data processing, as many buildings and facilities, and as many peak-season workers if it was no longer delivering packages? Does the Commission really dispute that, if the Postal Service stopped delivering competitive products, it would incur significantly fewer inframarginal costs, including those classified as institutional today?

UPS submits that it is clear—and should be beyond dispute—that the Postal Service could significantly reduce its institutional costs if it exited the competitive

[30] *See* Carlton Decl. at 19-30.

products business. Faced with such a significant decline in volume, and the absence of the only product lines that are growing, a rational business would cut costs classified as institutional today. The Postal Service could, for example, modify the structure of its delivery network, such as by "modifying delivery carriers' routes and/or by changing the number and location of processing facilities."[31] That would save institutional costs. If it stopped delivering packages, the Postal Service could also buy smaller vehicles, rather than larger, and more expensive, "UPS-sized" vehicles.[32] And it could buy fewer of those cheaper vehicles as well. That would save institutional costs too. The examples go on and on. So *of course* competitive products are responsible for a significant portion of institutional costs.

That is the only apparent explanation for why the Postal Service *added* at least $1.3 billion institutional costs in the last couple years, even as mail volumes continue a rapid downward trend.[33] The Postal Service acknowledged that in 2017, "mail volumes declined by approximately 5.0 billion pieces, or 3.6 percent, while package volumes grew by 589 million pieces, or 11.4 percent, continuing a multi-year trend of declining mail volumes and increasing package volume."[34] The Postal Service states that it

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[31] *Id*. at 23-24.

[32] Mike Colgan, *Familiar White Postal Service Trucks Too Small for Increasing Amount of Parcels Being Mailed*, CBS SF BAY AREA (Jan. 19, 2015), available at http://sanfrancisco.cbslocal.com/2015/01/19/familiar-white-postal-service-trucks-too-small-for-increasing-amount-of-parcels-being-mailed/.

[33] This $1.3 billion is conservatively derived by taking the $2.2 billion difference in institutional cost numbers from FY2016 ($36.4 billion) and FY2014 ($34.2 billion) and excluding the amounts for which prefunded annuitant health benefits ("component 203") and workers' compensation calculations from the prior year ("component 205") are responsible.

[34] United States Postal Service, *U.S. Postal Service Reports Fiscal Year 2017 Results*, NATIONAL NEWS (Nov. 14, 2017), https://about.usps.com/news/national-releases/2017/pr17_069.htm.

delivers "more e-commerce packages to the home than any other shipper,"[35] has been delivering "one-third of all domestic packages in the United States,"[36] and has enjoyed competitive volume growth of over 200% since 2007.[37] These are the trends that have driven a $1.3 billion increase in institutional costs over the last couple years.

Order No. 4402 does nothing to explain why the Postal Service would be unable to reduce institutional costs if it got out of the package business. It does nothing to explain why its assertion that there are no institutional costs "uniquely or disproportionately associated with competitive products" can be consistent with the fact that the Postal Service's institutional costs have increased by over $1.3 billion, when competitive products are the driving the vast majority of volume growth. The Order does not analyze the specific points made by UPS and Professor Carlton about why economic theory would predict that, in fact, many institutional costs would go away if competitive products went away—and thus those costs are properly understood as incremental to competitive products.

At most, the Order suggests that *UPS* is at fault for not identifying with sufficient rigor or specificity those portions of institutional costs that could disappear if the Postal Service stopped providing specific competitive products.[38] In fact, UPS has specifically

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[35] United States Postal Service, *U.S. Postal Service Reports Fiscal Year 2016 Results*, NATIONAL NEWS (Nov. 15, 2016), https://es-about.usps.com/news/national-releases/2016/pr16_092.htm.

[36] *Reforming the Postal Service: Finding a Viable Solution: Hearing Before the House Oversight and Government Reform Committee*, 114th Cong. 10 (May 11, 2016) (statement of Megan J. Brennan, CEO of United States Postal Service) (emphasis added).

[37] *Compare* POSTAL REGULATORY COMMISSION, ANNUAL COMPLIANCE DETERMINATION: U.S. POSTAL SERVICE PERFORMANCE (FISCAL YEAR 2007) 24 (2007) ("Total Competitive Mail" of 1.63 billion pieces), *with* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2017) 5 (2017) ("Total Competitive Mail" of 5.10 billion pieces).

[38] Order No. 4402 at 44.

identified numerous such costs, as discussed above. Moreover, the Commission should not confer a blatant competitive advantage to the Postal Service simply because UPS, an outside party, with limited access to the relevant data, is unable to identify every single cost the Postal Service should attribute to competitive products. It is the Commission, not UPS, that is responsible for ensuring that the Postal Service is complying with PAEA.

Whatever formula or methodology the Commission uses to set the appropriate share level must at a minimum account for the fact that a significant amount of institutional costs are associated with competitive products. The Commission itself has previously appeared to acknowledge that such costs must be "parceled out" to products in a "reasonable way."[39] In January 2018, the Commission's appellate counsel explained the following to the United States Court of Appeals for the D.C. Circuit through counsel for the Commission:

> [I]f the court's concern is what's going to happen to all of the inframarginal costs that aren't deemed cost-attributable, well, those are going to be considered "institutional costs," and ***institutional costs are allocated according to a reasonable and appropriate sum to the various competitive products***, expressly taking market considerations into account. . . . And the upshot of that argument is that—you know, it's not the case as UPS suggests that, if you rule for the Commission, inframarginal costs are just going to vanish to the ether never to be allocated or assigned again. Rather, ***they are going to be put into the institutional cost bucket, and the total in that bucket is going to be parceled out according to the Commission in a reasonable way*** to account for market

[39] UPS offered this transcript in a motion to supplement the record on January 26, 2018. *See* United Parcel Service, Inc.'s Motion to Supplement Record, Dkt. No. RM2017-1 (Jan. 26, 2018), at 1. The Commission rejected the Motion, but in Order No. 4402 the Commission invited UPS or anyone else to raise it in response to the Order. *See* Order No. 4402 at 4 n.11.

> factors to ensure that the statutorily mandated price floor is not too low as to promote undue competitive behavior.[40]

In other words, the Commission itself recognized that institutional costs were meant to be allocated in a "reasonable" manner that would reflect the contributions of competitive products to costs that cannot be easily attributed to individual products. But nothing in the Commission's proposed formula has anything to do with parceling out costs to products at all.

B. The Order Fails to Address the Conceptual Limitations of the Incremental Cost Test

The Commission also dismissed concerns about the impact of artificially low Postal Service pricing on economic efficiency. As Professor Carlton explained, the logic of the incremental cost test (as reflected, for example, in the cross-subsidization literature) breaks down when applied to an *inefficient* enterprise.[41] Government entities like the Postal Service—through no fault of their own—are subject, for example, to political pressures that might lead to the enterprise prioritizing size over efficiency. As explained by Professor Carlton, for example, the Postal Service made a proposal to close down 82 mail-processing facilities to right-size its network, but its attempts to do so were rebuffed by 50 U.S. senators.[42] As another example, the Postal Service often prides itself on being the "second largest employer in the United States."[43] The Postal

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[40] Oral Argument at 39:11-40:22, *United Parcel Service, Inc. v. Postal Regulatory Commission* (D.C. Cir. Jan 22, 2018) (No. 16-1354) (emphasis added), available at https://www.cadc.uscourts.gov/recordings/recordings2018.nsf/17447E2027F980FA8525821D005CB8C0/$file/16-1354.mp3.

[41] Carlton Decl. at 16-17.

[42] *Id*. at 9.

[43] United States Postal Service, *Working at USPS*, https://about.usps.com/careers/working-usps /welcome.htm (last accessed Apr. 16, 2018).

Service has also admitted it does not take physical shape of the mailed item into account in their costing models for inbound "letter post," which is comprised of letters, flats, and parcels weighing up to 4.4 pounds.[44]

Together, these incentives lead to the Postal Service "operating an inefficiently large number of post offices, distribution units and processing facilities, creating excess capacity in USPS' network."[45] These incentives contributed to the Postal Service's unprecedented expansion into competitive product markets. And the Postal Service's tendency to operate at high levels of excess capacity leads to economically inefficient reductions in calculated attributable costs. As explained by Professor Carlton:

> As noted above, the economic logic of the incremental cost test breaks down when firms do not operate efficiently. Due to the inefficiency-related distortion of incremental costs, the price charged by USPS for competitive products may exceed the (distorted) measure of incremental cost. However, USPS' provision of competitive products will nonetheless harm economic efficiency because products provided by a firm (USPS) that operates inefficiently as a whole displaces activities by efficient rivals and this can lead to the continual expansion of USPS and displacement of more efficient firms. For example, if USPS has excess facilities then capacity in these facilities can be used to expand the provision of competitive products at an incremental cost lower than it would face if USPS operated efficiently.[46]

As a result of these points, even if the Postal Service were ensuring that its competitive products business covers its incremental costs as calculated by the Postal Service and accepted by the Commission, there would still be economic inefficiency. The theoretical justification of the incremental cost test—that the "competitive process

[44] *See* Responses of the United States Postal Service to Questions 1-2 of Chairman's Information Request No. 18, Dkt. No. ACR2017 (Feb. 20, 2018), at 1-2.

[45] Carlton Decl. at 10.

[46] *Id*. at 11.

will lead to the efficient outcome as long as the price floor is set using the incremental cost test"[47]—thus breaks down.

Order No. 4402 says that this argument "conflate[s] fixed costs with institutional costs and variable costs with attributable costs."[48] The Order also says Carlton "understates the extent to which fixed costs are attributed to individual products under the Commission's costing methodology due to the methodology's use of cost drivers."[49] To support these assertions, the Commission provides an example whereby the use of an inefficient mail processing machine results in additional cost attribution because "the economic fixed costs of facility space and depreciation would be attributed to the products utilizing the inefficient machine in the same proportion as workhours" and the machine "would require additional workhours in order to process the same amount of mail."[50] But the Commission's example ignores the fact that a large portion of fixed costs remain unattributed. For example, 70% of vehicle depreciation costs and 45% of equipment depreciation costs are treated as institutional.[51]

Moreover, even if the Postal Service hypothetically has some incentive to efficiently manage fixed costs, it also has uniquely powerful incentives (unlike those faced by private companies) in the other direction as well. And sometimes those cannot be resisted, like in the above instance where the Postal Service tried to shut down 82

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[47] Declaration of John C. Panzar on Behalf of Amazon Fulfillment Services, Inc., Dkt. No. RM2016-2 (Jan. 29, 2016) ("Panzar Decl."), at 28.

[48] Order No. 4402 at 44.

[49] *Id*.

[50] *Id*. at 44-45.

[51] *See* USPS-FY17-2 (ACR2017) (noting that $78 of $112 million in Vehicle Depreciation Costs (Segment 20.2) and $312 of $692 million in Equipment Depreciation costs (Segment 20.1) are classified as Institutional).

mail-processing facilities. The Commission fails to grapple with this point and thereby misses the dangers of allowing a government enterprise to compete against the private sector without appropriate safeguards.

Carlton also explained that the incremental cost test for cross-subsidy does not consider dynamic efficiency—the impact of innovation and technical progress on economic activity.[52]

Regarding dynamic efficiency, the Commission writes:

> With regard to Sidak's and Carlton's comments concerning dynamic efficiency, the Commission finds that the market itself does not appear to be lacking innovation. The delivery industry since the enactment of the PAEA has been defined by innovation and entry, including the introduction of more efficient vehicles, improved dynamic routing algorithms, Sunday delivery by the Postal Service, and the growth of Amazon as both a customer of, and competitor to, other delivery services.[53]

But this is a non sequitur. The concern about dynamic efficiency is that, if the private sector is pushed to the margins, innovation will suffer in the *future*. For instance, Carlton emphasized "the risk that USPS's competitive products will displace those provided by more efficient and innovative private firms, and *adversely affect the long-term dynamic efficiency of the sector*."[54] It is no response to point to innovation driven by the private sector *in the past*.

It is well-established that government entities like the Postal Service may create a drag on dynamic efficiency.[55] While private companies have a strong profit incentive, government entities have the incentive and ability to over-expand with growth as the

[52] Carlton Decl. at 16.

[53] Order No. 4402 at 76.

[54] Carlton Decl. at 6 (emphasis added).

[55] *Id*. at 17.

primary motivator rather than profit.[56] Only a robust appropriate share requirement can guard against this outcome. The Commission's new proposed methodology fails to address this concern at all.

C. The Order's Conclusion that the Postal Service Suffers From a Net Economic Disadvantage to the Private Sector is Fundamentally Flawed.

In Order No. 4402, the Commission relies upon a report issued by the Federal Trade Commission in 2007[57] as a basis for its conclusion that the Postal Service does not enjoy any competitive advantages over the private sector:

> *As discussed in section V, supra, the Commission concludes that the FTC's finding that the Postal Service operates with a net economic disadvantage in offering competitive products continues to be valid*. However, the Commission does not find that the appropriate share should be eliminated as a result. Instead, the Commission contends that the proposed formula-based approach best captures the statutory criteria of 39 U.S.C. 3633(b) and balances the concerns of all groups—customers, competitors, market dominant mailers, shippers, and the general public.[58]

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[56] *Id*.

[57] *See* FEDERAL TRADE COMMISSION, ACCOUNTING FOR LAWS THAT APPLY DIFFERENTLY TO THE UNITED STATES POSTAL SERVICE AND ITS PRIVATE COMPETITORS (2007) ("FTC Report").

[58] Order No. 4402 at 97 (emphasis added); *see also id*. at 8 (Commission relying on the FTC Report to conclude that "[w]ith regard to competitive advantage . . . the Postal Service operated at a net competitive disadvantage relative to its competitors"); *id*. at 62 ("Section 703(d) is clear that the Commission's review is limited only to those subsequent events that affect the continuing validity of the FTC's net economic effect estimate. As discussed above, the FTC was tasked with identifying federal and state laws that apply differently to the Postal Service with respect to competitive products and using that information to estimate the laws' net economic effect on the Postal Service. The FTC's net economic effect finding was based on the implicit subsidies and legal constraints that the FTC could quantify, each of which was linked to specific federal or state laws. Therefore, the Commission determines 'subsequent event' in section 703(d) refers to changes to federal or state laws quantified in the FTC's estimate of the net economic effect. *As a result, the Commission finds the scope of its review under section 703(d) is limited to considering whether the laws behind the implicit subsidies and legal constraints quantified by the FTC have changed since the FTC Report's issuance, and if so, whether those changes affect the continuing validity of the FTC's estimate of the net economic effect of those laws.*") (emphasis added).

The Commission's initial reliance on the FTC Report was erroneous for the simple reason that the FTC Report explicitly excluded any consideration of the advantages flowing from the Postal Service's letter and mailbox monopoly. Even though the FTC recognized that the Postal Service enjoyed an artificial advantage over private firms to the extent "it benefitted from economies of scope by producing both market-dominant and competitive products" and that "[t]he consensus appears to be that the postal monopoly provides the Postal Service with some economies of scope in the provision of competitive products,"[59] the FTC ultimately concluded that the extent of these economies of scale was "ultimately . . . an empirical question" that the FTC was unable to answer.[60]

Similarly, the FTC acknowledged that the Postal Service's exclusive access to mailboxes also generated cost advantages over the private sector that "may be substantial" because of the cost the lack of mailbox access "imposes on private carriers."[61] But the FTC was unable to quantify the magnitude of those cost advantages.[62]

Accordingly, when the FTC summarized its overall conclusions about the benefits and burdens experienced by the Postal Service as compared to private carriers, the

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[59] FTC Report at 47-48 ("The ability to share the network established to deliver products covered by the postal monopoly may reduce the USPS's cost of providing competitive products. . . . If delivering monopoly products lowers the USPS's costs of producing competitive products, then it enjoys an advantage over its private competitors that the [Private Express Statutes] prevent them from duplicating.").

[60] *Id.* at 48.

[61] *Id.* at 52-53. Prof. Carlton agrees that the mailbox monopoly also provides an artificial cost advantage over the private sector, without an apparent efficiency justification. Carlton Decl. at 18-19.

[62] *See* FTC Report at 52 (noting that "no commenters provided estimates of the costs of the mailbox monopoly").

FTC expressly stated that it had made "*no estimate of the benefits [the Postal Service] derives from its postal and mailbox monopolies*," because those benefits fell into the category of those that were "more difficult to quantify."[63] This limitation nullifies the findings of the FTC Report. UPS has previously explained the inordinate benefits flowing from the letter and postal monopolies, which enable the Postal Service to tack its competitive products business onto its expansive market-dominant business at very low cost.[64] The letter and postal monopolies prevent private-sector competitors from competing in market-dominant products, and therefore private-sector competitors cannot compete for the same economies of scale and scope. The Postal Service therefore holds a strong and unassailable advantage because it can price its competitive products at levels an equally efficient private sector competitor could never match by exploiting the economies of scale built for the market-dominant enterprise.

While the FTC Report has failed to quantify or estimate these benefits, others have done so—in a recent paper, Dr. Robert Shapiro estimated the value of the Postal Service's monopolies to be $12.9 billion in FY2016.[65] The Commission itself in five of

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[63] *Id.* at 64 (emphasis added) ("Further, there is no estimate of the benefits it derives from its postal and mailbox monopolies. These benefits, if possible to estimate, would further reduce net income for competitive products which in turn would require additional revenue increases or cost reductions.").

[64] UPS Initial Comments at 14 (citing sources and noting that "[t]he Postal Service delivered 149.8 billion pieces of market-dominant mail in 2016, which amounts to about 410.5 million pieces of market-dominant mail per calendar day. It delivered that market-dominant mail to approximately 156 million delivery points. Given its vast assets funded largely by revenues from its postal monopoly, the Postal Service derives a tremendous advantage when it is able to piggyback competitive products and services on that infrastructure at a very low marginal and incremental cost, which the accepted cost methodologies allow it to do today.").

[65] *See* Robert J. Shapiro, *A New Accounting of the United States Postal Service: The Special Rights and Subsidies that Support Its Monopoly Operations and Cross Subsidize Its Competitive Business*, SONECON (Apr. 16, 2018), at 3.

their successive Annual Reports to Congress has estimated the benefits of these monopolies for the years FY2008 to FY2016, and they all range in the billions of dollars.[66] This advantage is perhaps the *most* important one the Postal Service enjoys from a competition perspective, and any competitive analysis disregarding it is severely flawed, especially when the Commission fails to acknowledge its own estimates of the value of these postal monopolies.

Since the FTC's analysis was incomplete, it was erroneous for the Commission to conclude from the FTC Report that the Postal Service operated at a net competitive disadvantage to the private sector in 2007.[67] Eleven years later, the Commission's reliance on this report is even more erroneous—the competitive landscape has changed for the worse and the Postal Service's rapid expansion into competitive product markets continues year after year. At a minimum, these changes constitute "subsequent events" that should cause the Commission to initiate a fresh study on these issues.[68] The Commission's continued reliance on the FTC Report for the fundamental premise that the Postal Service does not have a competitive advantage renders all conclusions flowing from that premise arbitrary and capricious.

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[66] *See, e.g.*, Annual Report to the President and Congress, Dkt. No. ACR2017 (Jan. 26, 2018), at 54; Annual Report to the President and Congress, Dkt. No. ACR2012 (Jan. 3, 2013), at 40.

[67] *See also* Declaration of J. Gregory Sidak on Behalf of United Parcel Service, RM2017-1 (Jan. 23, 2017), at 6 (explaining that the FTC Report "excluded key Postal Service benefits that the FTC had been unable to quantify" which included benefits flowing from the "postal and mailbox monopolies").

[68] *See* Postal Accountability and Enhancement Act, Pub. L. No. 109-435, 120 Stat. 3198 (2006) § 703. Section 703 was not codified, but is reproduced in the notes to 39 U.S.C. § 3633.

In its Order, the Commission also observed that "no antitrust-related action had been taken against the Postal Service,"[69] which it took as evidence that there were no concerns about the Postal Service competing unfairly. But even if it were true that there are no antitrust cases against the Postal Service, a private company's decision whether or not to file an antitrust suit involves weighing a number of considerations. Nothing should be inferred from the absence of such a filing. UPS should be able to see the statutory goals of PAEA—including the protection of fair competition—vindicated in *this administrative forum*.

D. The Order Renders the "Disproportionately Associated" Language in 39 U.S.C. § 3633(b) a Nullity

The governing statutory text directs the Commission to "consider . . . the degree to which any costs are uniquely or *disproportionately associated with* competitive products" (emphasis added). The "disproportionately associated" standard of 39 U.S.C. § 3633(b) must be broader than the "reliably identified causal relationships" standard of 39 U.S.C. § 3622(c)(2) or it would serve no purpose. If the language of 39 U.S.C. § 3633(b) is to have any function at all, it is to ensure that the competitive products business is covering costs that go beyond those where reliably identified causal relationships with individual competitive products exist—otherwise the "appropriate share" requirement would merely duplicate the analysis conducted under 39 U.S.C. § 3633(a)(1) and 39 U.S.C. § 3633(a)(2).

Notwithstanding this, the Commission concludes in Order No. 4402 that "there are *no costs* uniquely or disproportionately associated with competitive products that

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[69] Order No. 4402 at 8.

are not already attributed to competitive products."[70] It reasons this is so because any cost that is "uniquely associated" with a product is already attributed as a "product-specific" cost."[71] This conclusion violates basic principles of statutory analysis, and is also highly problematic given the concerns discussed above.

In theory, the Postal Service should be attributing costs that are "uniquely . . . associated with" specific products to those products under 39 U.S.C. § 3633(a)(2). As detailed above, there are reasons to doubt this is occurring. But even if 39 U.S.C. § 3633(a)(2) were functioning perfectly by identifying all "uniquely associated" costs, that says nothing about costs that are "*disproportionately associated with* any competitive products."[72] The statutory language is disjunctive. PAEA requires that the Commission "consider" whether there are costs that are "uniquely ***or*** disproportionately associated with competitive products[.]"[73] It is illogical for the Commission to point to the fact that no institutional costs are "uniquely associated" with competitive products as proof that no such costs are "disproportionately associated" with competitive products. But that is exactly what it has done.

The phrase "associated with" in 39 U.S.C. § 3633(b) is plainly broader than "caused by[,]" and necessarily a broader category than those costs with "reliably identified causal relationship[s]" to specific products in 39 U.S.C. § 3631(b). But the Commission's Order has rendered the phrase "associated with" devoid of meaning. "[A]ssociated with" implies that an associative relationship may exist even if a tight

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[70] Order No. 4402 at 43 (emphasis added).

[71] *Id.*

[72] 39 U.S.C. § 3633(b) (emphasis added).

[73] *Id.* (emphasis added).

causal relationship is lacking. The word "disproportionately" implies that the relevant costs might be "associated with" more than one kind of product. A cost can only be "disproportionately associated with any competitive products" if it is at least partially "associated with" something other than "any competitive products" as well. Otherwise, that cost is "uniquely . . . associated with"—not "disproportionately associated with"—competitive products. The Commission's proposed interpretation would impermissibly render the statutory language ("disproportionately associated with") to be mere surplusage.[74]

Proper construction of this statutory language requires the Commission to investigate costs, currently classified as institutional, that are "disproportionately associated" with competitive products.[75] It is arbitrary and capricious for the Commission to abdicate its responsibility to consider whether there are any institutional costs "disproportionately associated with any competitive products" with conclusory statements to the effect that there are no such costs, and there could be no such costs.[76] The Commission's position is also in tension with its prior statements regarding how institutional costs would be "parceled out" to products, including competitive products.[77]

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[74] *See Marx v. Gen. Revenue Corp.*, 568 U.S. 371, 386 (2013) ("[T]he canon against surplusage is strongest when an interpretation would render superfluous another part of the same statutory scheme. . . . 'As our cases have noted in the past, we are hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law[.]'") (quoting *United States v. Jicarilla Apache Nation,* 564 U.S. 162, 185 (2011)).

[75] 39 U.S.C. § 3633(b).

[76] *See* Order No. 4402 at 39, 73.

[77] Oral Argument at 39:11-40:22, *United Parcel Service, Inc. v. Postal Regulatory Commission* (D.C. Cir. Jan 22, 2018) (No. 16-1354) (emphasis added), available at https://www.cadc.uscourts.gov/recordings/recordings2018.nsf/17447E2027F980FA8525821D005CB8C0/$file/16-1354.mp3.

II. THE PROPOSED FORMULA DISREGARDS THE STATUTORY PURPOSE OF PAEA

For the foregoing reasons, the Commission should set the appropriate share requirement in a manner that ensures that the Postal Service's competitive products business is responsible for all costs that are associated with competitive products, thus making the Postal Service compete on a level playing field. The Commission's proposed new formula does nothing to address these goals and it appears the Commission does not agree with these objectives.

A. The Lerner Index Component

The Lerner Index has traditionally been used as a market power screen in merger analysis and is meant to estimate a firm's pricing power. It is a tool used to ensure a current or future business is not exploiting or will not exploit market power by charging inflated prices. The intent is to protect consumers. Such an index does nothing to protect fair competition and was never intended to do so.

The Lerner Index has nothing to do with the statutory policies underlying the appropriate share requirement. It makes no attempt to measure which institutional costs are associated with competitive products, uniquely or disproportionately. It does not attempt to model whether the Postal Service may be displacing more efficient rivals. It does not address the Postal Service's tendency to pursue irrational growth. And it does nothing to ensure a level playing field. Again, that is because it is not even trying to do these things.

The Lerner Index's focus on whether prices are *too high* makes little sense when the concern is whether the Postal Service's prices for competitive products are set at artificially *low* levels because those prices do not reflect all of the costs associated with (or caused by) competitive products. In fact, rather than serving the regulatory purpose, the Commission's approach would facilitate the Postal Service's ability to underprice its products in order to increase its scale while marginalizing private sector competition.

Under the proposed formula, the Postal Service would be well-positioned to engage in a predation strategy. The Postal Service could first lower competitive product prices drastically, by ignoring many of the costs caused by the business, in order to take business away from its competitors and increase its market share. This strategy would result in a very low Lerner Index, because the Lerner Index will decrease as revenue per piece decreases. This would in turn lead to a *decrease* of the appropriate share requirement.[78] Free of any meaningful "appropriate share" requirement, the Postal Service could inhibit the ability of private market participants to invest and expand capacity.

As competition is eliminated and a "monopoly industry configuration" takes hold,[79] where the Postal Service comes to dominate the package market, the Postal Service would then be well positioned to raise prices on competitive products. Only then would the Commission's formula impose a meaningful appropriate share—after the Postal Service begins pricing competitive products significantly above cost.

The Lerner Index also blunts the effect of changes in cost attribution analytical principles, and would exacerbate the Postal Service's incentive to under-report competitive costs. Any increase in the attributable costs of competitive products results

[78] This effect may be partially offset by competitive market growth caused by artificially low prices, which would increase the "Competitive Market Output" variable.

[79] *See* Panzar Decl. at 27-28 (hypothesizing where the "market equilibrium result is the monopoly industry configuration").

in, all other things being equal, an offsetting decrease in the Lerner Index that lowers the price floor for competitive products. To see why this is the case, suppose there is a change in analytical principles that results in an increase of $200 million in competitive products' attributable costs, and that these costs were previously classified as institutional costs, such that institutional costs undergo a corresponding decrease.[80] Assume that all other factors (competitive product revenues, competitive market output, and institutional costs) remain unchanged. Given current levels of competitive product revenues and attributable costs, the $200 million increase in competitive product attributable costs would decrease the Postal Service Lerner Index by 3%,[81] which would in turn decrease the appropriate share and thus competitive products' responsibility for institutional costs by nearly $100 million at current levels of institutional costs.[82] Accordingly, the long-run net effect of any change in analytical principles—whether it

[80] Recent years have seen several changes in analytical principles with cost implications of this magnitude: Docket RM2015-7 resulted in an increase in Competitive Product cost attribution of roughly $108 million (see USPS-RM2015-7/1/Cost Impacts/Cost_Impacts_ Proposal_13.xlsx); Docket RM2016-12 resulted in a decrease in Competitive Product cost attribution of roughly $255 million (see USPS-RM2016-12/1/Cost.Impacts.Capacity.Volume. Variabilities/Impact.Proposed.Variabilities.FY2015.CRA.Costs.Public.xlsx); Docket RM2017-8 resulted in an increase in Competitive Product cost attribution of roughly $198 million (see USPS-RM2017-8/1/Cost Impacts/USPS.RM2017.8.1.Prop.Four.Public.CostImpacts.FY16.xlsx); Docket RM2017-9 resulted in an increase in Competitive Product cost attribution of roughly $62 million (see USPS-RM2017-9/ Cost_Impact_RM2017-9.Prop.5.xlsx).

[81] The Lerner Index would decrease from its FY2017 value of 0.356 to 0.346, a decrease of roughly 3%. (20,690 – (13,324 + 200))/20,690 = 0.346, while (20,690 – 13,324)/20,690 = 0.356.

[82] Specifically, competitive products' responsibility for institutional costs would decrease by $92 million. Institutional costs were $30,872 million in FY2017. 0.3% x (30,872-200) = 92.

increases or decreases the attributable costs of competitive products—is very nearly cut in half by the countervailing changes to the Lerner Index.[83]

Beyond the theoretical limitations of the Lerner Index, there are practical limitations as well. The Commission plans to calculate "competitive product unit volume-variable cost"[84] by computing a weighted average of the marginal costs calculated for each of the Postal Service's competitive products. But as the U.S. Postal Service Office of Inspector General ("OIG") has correctly recognized, the Postal Service is a multiproduct firm with "different cost characteristics" for *each* of its products, such that an "average" measure of costs across different products "does not provide a meaningful number."[85] For this reason, it is improper to average or group together disjointed products, and doing so will lead to absurd consequences, including instability caused by a shifting Postal Service mail mix.

The table below illustrates the potential for changes in product mix to introduce distortions and errors into the Commission's proposed Lerner Index measure. It presents product-level Lerner Indices over the period from 2012 through 2017. These index values differ consistently and substantially by product, leading to a situation in which changes in product mix that are unrelated to market conditions can cause

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[83] The implications are nearly identical if the increase in competitive product attributable costs is offset by a decrease in market dominant attributable costs rather than a decrease in institutional costs.

[84] Order No. 4402 at 18.

[85] U.S. POSTAL SERVICE OFFICE OF INSPECTOR GENERAL, A PRIMER ON POSTAL COSTING ISSUES, WHITE PAPER (REPORT NO. RARC-WP-12-008) ("Primer on Postal Costing") 2 (Mar. 20, 2012) ("The Postal Service is a multiproduct firm—This characteristic is important because average cost . . . has no meaning in a multiproduct firm. . . . Each of [the Postal Service's] products has different cost characteristics, so dividing total cost by number of total pieces of mail does not provide a meaningful number.").

substantial swings in the Commission's composite measures. Future reclassifications of currently market dominant products as competitive could easily introduce further shifts that are, again, unrelated to changes in market conditions.

Lerner Index by Product, FY2012 to FY2017

	2012	2013	2014	2015	2016	2017
Total Priority Mail Express	0.425	0.491	0.525	0.536	0.563	0.576
Total Ground	0.241	0.161	0.218	0.291	0.415	0.440
Total First-Class Package Service	0.124	0.230	0.211	0.190	0.293	0.308
Total Priority Mail	0.243	0.256	0.254	0.223	0.220	0.259
Total Competitive International	0.341	0.432	0.408	0.391	0.418	0.414

Sources:
Order No. 4402, FY12-FY17 Public CRA.

The Commission makes a related error when it purports to calculate a single "price variable" for all competitive products.[86] The Commission purports to measure a single "price" for competitive products by dividing the "sum of all competitive product revenue" by "the sum of all competitive product volume."[87] It is arbitrary as an economic matter to group competitive prices in this manner for the same reasons it is arbitrary to do so for competitive costs.

Other factors also cast doubt on the reliability of the proposed Lerner Index value. For example, there is strong seasonal variation in the Postal Service's mail volumes over the course of a year. A single measure of the marginal cost or revenue (the key inputs to the Lerner Index) is misleading if the firm in question faces high levels of peak demand but lower levels of baseline demand—as is certainly the case for the Postal Service. Moreover, the opaque and complex nature of the Postal Service's

[86] Order No. 4402 at 18-19.

[87] *Id*. at 19.

costing methodologies creates additional potential for error.[88] If the Postal Service is not accurately measuring its costs, any formula based on those costs will also be flawed.

B. The Competitive Market Output Component

The Commission includes a measure of Competitive Market Output as part of its proposed formula because "evaluating the overall size of the market provides context for assessing prevailing competitive conditions."[89] The Commission reasons that the Postal Service will better be able to increase contribution from competitive products if the overall market grows.[90]

But the overall market's size has nothing to do with the "appropriate share" of institutional costs the Postal Service should cover with competitive product revenue. This factor fails to address concerns that the Postal Service is not fully capturing incremental costs or that the Postal Service is displacing more efficient rivals. It fails to address the Postal Service's tendency to pursue irrational growth. And it fails to address fair competition concerns. Again, it simply has nothing to do with the statutory purpose that, until the Order, the Commission has acknowledged it is obliged to serve.

There is no economic basis for tying the appropriate share requirement to the overall revenue of the entire competitive market. Neither the Commission nor the Postal Service have the ability to control what prices are charged by other participants

[88] Primer on Postal Costing at 1-5, 11 (noting that postal costing system is over 40 years old, designed to capture the "complexity associated with costing products in a multiproduct network industry," and often relying on a hodgepodge of audits, studies, and reviews).

[89] Order No. 4402 at 22.

[90] *Id*.

in the market. Moreover, the proposed variable does not account for the possibility of customers making in-house deliveries, which would not impact overall market volume but would decrease the Commission's proposed variable nonetheless.

The Commission's reliance on the Census Bureau's Services Survey for data on the competitive market is also flawed.[91] While that Survey captures large competitors like UPS or FedEx, it does not capture all relevant players. There are small regional delivery companies that are not likely to be well-captured by that Survey. There is also a constant stream of market disruptors that similarly are not captured.

The Commission's decision to measure output based on revenue rather than volume may also lead to irrational results.[92] Currently, the competitive market output variable will implicate the pricing behavior of the Postal Service and its competitors. For example, if the broader industry cuts prices because of improved technology but volumes do not significantly change, the Competitive Market Output will decrease even though actual volume remains constant. The Competitive Market Output component of the proposed formula is thus untethered from any identifiable statutory purpose, and will lead to perverse outcomes.

If any market share data is relevant, it is an examination of how much the *Postal Service* in particular is growing within the context of the overall market. The

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[91] Furthermore, the Census Bureau notes on their website, https://www.census.gov/services/qss/qsstechdoc.html (last visited Apr. 16, 2018), that published estimates of QSS data "may differ from the actual, but unknown, population values," due to the presence of both sampling and nonsampling error. The Census Bureau further recommends that any use of the published estimates incorporate sampling variability into their analyses, as sampling error could affect the conclusions drawn from these estimates. There is no evidence that the Commission has done that here.

[92] Order No. 4402 at 23 ("The Commission determines that revenue, rather than volume, is the better measure of the overall size of the competitive market").

Commission recognized this when it last evaluated the appropriate share.[93] Applied here, the Commission itself has recognized that competitive products' "share of total Postal Service revenue, attributable cost, and contribution to institutional cost has nearly tripled since FY 2007."[94] Under the Commission's own logic, this indicates that the appropriate share must be increased significantly.

C. The Commission's Seed Value for its Proposed Formula is Arbitrary

The Commission proposes to use the level set in 2007, 5.5%, as a seed value for its formula.[95] It is irrational to use the Commission's prior determination, based on a completely different analysis, and intentionally set at what the Postal Service itself called a "relatively low institutional cost contribution"[96] in 2007, as the basis for the appropriate share going into the future from 2018.

In 2007, the Commission, "mindful of the risks of setting it too high," ordered the appropriate share set at an intentionally low level in order to give the Postal Service "some flexibility to compete" given that "the Postal Service's market share is relatively small."[97] These concerns have no bearing today, given the Postal Service's dramatic successes in the competitive market. The Commission itself has admitted that the 5.5%

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[93] *See* Order No. 1449 at 18.

[94] Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Dkt. No. ACR2017 (Apr. 5, 2018), at 6.

[95] *See* Order No. 4402 at 32 ("The Commission sets the beginning appropriate share level for the formula at 5.5 percent because that was the initial appropriate share set in FY 2007").

[96] Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking, Dkt. No. RM2007-1 (Jun. 18, 2007).

[97] Order Proposing Regulations to Establish a System of Ratemaking, Dkt. No. RM2007-1 (August 15, 2007) at 73; *see* Order No. 4402 at 7 ("The Commission set the minimum contribution level lower due to the differences between the old ratemaking system and the new one being implemented pursuant to PAEA").

appropriate share set in 2007 must be raised because "[r]elevant circumstances have changed" since 2007.[98] Specifically, the Commission determined it must change the 5.5% appropriate share to "better reflect the modern competitive market."[99]

Despite recognizing the legacy 5.5% appropriate share level was inadequate, the Commission decided to nonetheless use it as the starting point in its formula.[100] The Commission did so because "that was the initial appropriate share set in FY 2007" and "was based on historical contribution levels, as well as the consideration that setting the appropriate share too high would create risks for the Postal Service."[101] After setting that value for FY 2007, the Commission applies its formula on a yearly basis through the present to arrive at an appropriate share value, based on the formula, of 10.8% for FY18.[102]

But if the Commission knows that 5.5% is too low given current market conditions, it should not use 5.5% as a seed value in calculating the appropriate share today.[103] This is because the seed value in the proposed formula will have persistent, lingering effects on future appropriate share values. The Commission recognizes this when it explained it will multiply the percent changes associated with the factors in the

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[98] Order No. 4402 at 12.

[99] *Id.*

[100] *Id.* at 31-32.

[101] *Id.* at 32.

[102] *Id.* at 33.

[103] The Commission also explains why it kept the 5.5% level in 2012, stating "Without any evidence that the Postal Service was benefitting from a competitive advantage or that the market was not competitive, the Commission determined that maintaining the appropriate share at 5.5% was the correct course." Order No. 4402 at 12. The Commission's 5.5% appropriate share figure was tainted, not once, but twice, by the erroneous conclusion that the Postal Service was not benefitting from a competitive advantage. To peg the entire formula on such a twice-tainted seed value is completely unjustified.

formula “by the current fiscal year’s appropriate share.”[104] In fact, if the Postal Service were pricing at cost (resulting in a Lerner Index of zero) and the competitive market conditions stayed the same, the appropriate share for the upcoming year would be *identical* to the appropriate share of the current year.

Applying simple trend analysis to Commission’s proposed formula demonstrates the shortcomings of using 5.5% as the seed value. If current trends continue, the Postal Service’s competitive products business will surpass its market dominant business in terms of revenue. But when that happens, under the Commission’s proposed formula and seed value, the appropriate share requirement will be less than 15%.

Specifically, note that competitive product revenues have grown by a cumulative annual growth rate of 10.6% over the past three years (FY2014 to FY2017), while competitor revenue (as defined by the Commission) has grown by 5.0% per year over the same time period, with market dominant revenue shrinking by 2.4% a year over the same time period. Extrapolating these trends forward, competitive product revenue would surpass that of market dominant revenue in FY2024. If the Lerner Index stays at its current level, the appropriate share in that year would be 14.5%.[105] In other words, it is plausible that, under the Commission’s proposed formula, even when competitive

[104] Order No. 4402 at 30.

[105] The assumption of a flat Lerner Index appears reasonable, at least in the near term. While the Lerner Index grew significantly from FY2015 to FY2017, it actually shrunk from FY2010 TO FY2012 and was stagnant from FY2013 to FY2015. *See* Order No. 4402 at 37 (Table IV-1). Furthermore, there are limits to how high the Lerner Index can go, because values of 0.5 already indicate a high degree of market power. If the Lerner Index grew by 5% per year, it would equal 0.5 in FY2024, but even then, the appropriate share would have only grown to 18.2%, under the assumptions outlined here.

products account for more than 50% of Postal Service revenue, they would bear responsibility for less than 15% of institutional costs.

Finally, like the 5.5% requirement in place before, the new 10.8% requirement is economically meaningless. Because competitive products generate about 29.9% of Postal Service revenue,[106] the Postal Service readily passes the 10.8% requirement. If the Commission does not raise the appropriate share requirement significantly, it might as well set it to 0% since that would have virtually the same impact on the Postal Service's business.

The Postal Service and other advocates of a zero percent appropriate share argue that the Postal Service is contributing substantial revenues from competitive products each year to the operation of the enterprise, regardless of the required appropriate share.[107] This is a voluntary contribution, not an assigned cost. The Postal Service cannot operate without these revenues, but they want the amount they contribute treated as voluntary and entirely within their discretion.

Competition will suffer in the market for years to come if the Commission seeds the formula with a 5.5% appropriate share value. At a minimum, the Commission should seed its proposed formula with a meaningful appropriate share value based on today's market conditions and apply the formula on a prospective basis. Below, UPS proposes an alternative methodology that involves averaging competitive share of Postal Service revenue. The average computed value of competitive revenues as a

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[106] *See* UNITED STATES POSTAL SERVICE, REVENUE, PIECES, AND WEIGHT BY CLASSES OF MAIL AND SPECIAL SERVICES FOR FISCAL YEAR 4-5 (2017) (dividing "Total Competitive Revenue" by "Total All Revenue").

[107] *See, e.g.*, Initial Comments of the United States Postal Service, Dkt. No. RM2017-1 (Jan. 23, 2017), at 18.

share of total revenues for the last three fiscal years—26.6%—should be considered as a potential "seed value" in the Commission's formula for 2018 and onwards.

III. THE COMMISSION SHOULD SET THE APPROPRIATE SHARE BASED ON COMPETITIVE PRODUCTS' REVENUE

Even if the Commission declines to use attributable costs as the relevant proxy for the appropriate share, the formula could still be set to equal competitive products' revenues as a percentage of total revenues. For instance, this share was 24.0% in 2015, 25.9% in 2016, and 29.9% in 2017.[108] The average of these numbers is about 26.6%.

Revenue shares are correlated with competitive products' increasing role as a driver of growing institutional costs. Although a revenue-based formula might incentivize the Postal Service to charge lower prices than it otherwise would, it would at least reflect the growing importance of competitive products to the Postal Service's bottom line.

CONCLUSION

The Commission should adopt a metric that meets the recognized statutory purpose of the appropriate share requirement. The Commission has specifically recognized that "[a] primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace."[109] The proposed formula has no connection whatsoever to this "primary function." The Commission should instead adopt an approach based on a three-year trailing average of the share of Postal Service

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[108] UNITED STATES POSTAL SERVICE, REVENUE, PIECES AND WEIGHT BY CLASSES OF MAIL AND SPECIAL SERVICES FOR FISCAL YEAR 4-5 (2015-17) ("Total Competitive Revenue" divided by "Total All Revenue").

[109] Order No. 1449 at 13.

revenue obtained from competitive products, which would set the appropriate share at 26.6%. Alternatively, the Commission should at a minimum use 26.6% as the seed value in its own formula on a prospective basis.

Respectfully submitted,

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