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POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Institutional Cost Contribution
Requirement for Competitive Products

Docket No. RM2017-1

PUBLIC REPRESENTATIVE COMMENTS IN RESPONSE TO
REVISED NOTICE OF PROPOSED RULEMAKING

(September 12, 2018)

I. INTRODUCTION

Pursuant to the Revised Notice of Proposed Rulemaking issued on August 7, 2018, the Public Representative hereby offers Comments including the Additional Declaration of Dr. Soiliou Daw Namoro on the Commission's proposed revised formula for calculating the minimum appropriate share of contribution by Postal Service competitive products towards its institutional costs.[1] The appropriate share currently specified in the Commission's rules is 5.5 percent. 39 CFR § 3015.7(c).[2]

II. SUMMARY OF PUBLIC REPRESETATIVE COMMENTS

The comments below discuss the impact of the modifications proposed in the Order No. 4742 revised notice. Dr. Namoro submits a new Declaration[3] in addition to his Declaration filed with the Public Representative's previous Comments on Order No.

[1] Revised Notice of Proposed Rulemaking, August 7, 2018 (Order No. 4742).

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

[3] Additional Declaration of Dr. Soiliou Daw Namoro, September 12, 2018 (Additional Namoro Decl.).

4402.[4] In his Declaration, he thoroughly examines the mathematical implications of the revised formula. Despite the modifications proposed to the Commission's formula, the Public Representative continues to believe that a strictly formulaic approach *should not* be adopted at this time.

II. PROCEDURAL HISTORY OF THE APPROPRIATE SHARE REQUIREMENT

The Commission established the initial appropriate share requirement pursuant to 39 U.S.C. § 3633(a), enacted on December 20, 2006, as part of the Postal Accountability and Enhancement Act, to "ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service." 39 U.S.C. § 3633(a)(3). In 2007, the Commission set the first appropriate share at 5.5 percent by relying principally on the historic contribution of competitive products at that time.[5]

Every five years, 39 U.S.C. § 3633(b) requires the Commission to review whether the institutional costs contribution requirement under § 3633(a)(3) "should be retained in its current form, modified, or eliminated." In that review, the Commission shall consider "all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products." 39 U.S.C. § 3633(b). At the conclusion of the first five-year review in 2012, the Commission decided to retain the 5.5 percent appropriate share requirement.[6] In Order No. 1449, the Commission expressed the view that the appropriate share represents a "minimum" requirement. Order No. 1449 at 1, 4, 38, 38 note 47, 39 note 48, and Attachment A, proposed rule 3015.7(c)(1). In that order, the Commission examined the requirements of 39 U.S.C.

[4] Declaration of Dr. Soiliou Daw Namoro, September 12, 2018, April 16, 2018 (Namoro Decl.).

[5] Docket No. RM2007-1 Order Proposing Regulations to Establishing a System of Ratemaking, August 15, 2007, at 71, 124 (Order No. 26), Order Establishing Ratemaking Regulations for Market dominant and competitive Products, October 29, 2007, at 91, 138 (Order No. 43).

[6] Docket No. RM2012-3, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, August 23, 2012 (Order No. 1449).

§ 3633(b) with an analysis that blended qualitative and quantitative factors, the result of which led the Commission to maintain the appropriate share at 5.5 percent.

This second five-year review commenced on November 22, 2016, with the Commission's Advance Notice of Proposed Rulemaking.[7] Following comments and reply comments, the Commission issued a Notice of Proposed Rulemaking in Order No. 4402 prescribing a novel formula-based approach for setting the appropriate share, relying upon a dynamic model.[8] The Commission received comments on Order No. 4402 and issued the Revised Notice of Proposed Rulemaking in Order No. 4742, on August 7, 2018, to which these Comments are directed.[9]

In order to adequately comment upon the revisions being proposed by Order No. 4742, the Comments below begin with a discussion of the dynamic formula presented in Order No. 4402.

III. COMMENTS

A. Order No. 4402

In Order No. 4402, the new formula-based approach proposed to set the appropriate share through a dynamic formula, which would annually update the appropriate share percentage based on market conditions. Order No. 4402 at 11-33.

The proposed formula-based approach used two components to annually capture changes in the Postal Service's market power and in the overall size of the competitive market: the Postal Service Lerner Index and the Competitive Market Output. *Id.* at 15.

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[7] Advance Notice of Proposed Rulemaking, November 22, 2016 (Order No.3624).

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

[9] Revised Notice of Proposed Rulemaking, August 7, 2018 (Order No. 4742).

The purpose of the Postal Service Lerner Index was to measure the Postal Service's market power within the competitive market.[10] *Id.* at 16 The Commission determined that evaluating the Postal Service's market power allowed it to assess whether competition was being preserved and whether the Postal Service possessed any competitive advantage. *Id.*

The purpose of the second component of the proposed formula, the Competitive Market Output, was to measure the overall size of the competitive market. *Id.* at 22. The Commission proposed evaluating the overall size of the market because doing so enabled the Postal Service's market power to be placed into context relative to the market as a whole. *Id*.

With the two components discussed above, the Commission proposed calculating the appropriate share using the following formula:[11]

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

$$If\ t = 0 = FY\ 2007,\ AS = 5.5\%$$

The Commission proposed measuring the year-over-year percentage change in the Postal Service Lerner Index and Competitive Market Output, weighting both components equally. *Id.* at 29-31. As proposed in Order No. 4402, the formula's calculation was recursive with the Commission proposing to begin the calculation in FY 2007, using an initial appropriate share value of 5.5 percent. *Id.* at 31-32. The Commission proposed adjusting the appropriate share annually by using the formula to calculate the appropriate share for the upcoming fiscal year. *Id.* at 34. The appropriate share for each upcoming fiscal year would be reported in the Commission's Annual Compliance Determination (ACD). *Id.*

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[10] In Order No. 4402, the Commission noted that market power is a competitor's ability to profitably set prices well above costs with little chance that entry or expansion by other competitors would erode such profits.

[11] *Id.* at 29.

In comments filed on April 16, 2018, the Public Representative sponsored the Declaration of Dr. Soiliou D. Namoro who stated that it appeared that the Commission's formula as proposed did not correctly incorporate the elements of market structure into the calculation of the appropriate share. As a result of his analysis, Dr. Namoro concluded that the proposed formula did not improve on the current 5.5 percent minimum share and recommended retaining the 5.5 percent minimum. Namoro Decl. at 26.

The Public Representative expressed the opinion that in view of Dr. Namoro's analysis and recommendation and the arbitrary nature of the methodology proposed in Order No. 4402, he believed that when taking into account the conditions existing in the Parcel Shipping Industry, the Postal Service's precarious financial situation, and the trends expected during the next five-year period, particularly when balanced with other factors previously considered relevant by the Commission, it would be unwise at this time for the Commission to take any action to raise the minimum contribution level currently in effect for competitive products.[12]

B. Order No. 4742

1. Commission Analysis in Order No. 4742

In Order No. 4742, the Commission is proposing modifications to both the Postal Service Lerner Index and the Competitive Market Output previously presented in Order No. 4402. The Commission proposes modifications to the Postal Service Lerner Index in order to address concerns addressed in the public comments related to the aggregation of data used in its calculation, to provide a better measure of Postal Service market power, and more clearly distinguish the Commission's market power component from a traditional Lerner Index. The Commission proposes modifications to the Competitive Market Output in order to more explicitly incorporate Postal Service market share. Order No. 4742 at 8.

[12] Public Representative Comments in Response to Notice of Proposed Rulemaking, Docket No. RM2017-1, April 16, 2018, at 14.

The Commission notes that the modified components measure two discrete concepts. The Competitive Contribution Margin measures the Postal Service's absolute market power; that is, its own ability to raise prices above costs, whereas the Competitive Growth Differential measures the Postal Service's market position relative to its competitors. These concepts measure different aspects of the competitive market, as the Competitive Contribution Margin considers the Postal Service's market power with respect to consumers and the Competitive Growth Differential measures the Postal Service's market position with respect to competitors.

The Commission asserts that both modified components play critical and equal roles in supporting the formula's ability to capture the criteria set forth in 39 U.S.C. § 3633(b). For example—as it relates to capturing prevailing competitive conditions in the market—the Competitive Contribution Margin provides insight into potential Postal Service competitive advantage; the Competitive Growth Differential reflects any changes in Postal Service market share; and both are equally necessary in order to capture various changes to the market and competitors. Additionally, both modified components are deemed to play a role in capturing each of the other relevant circumstances the Commission considers. In the Commission's judgement, neither component is more significant than the other in capturing the criteria set forth in 39 U.S.C. § 3633(b), and thus the Commission found it is appropriate to weight the components equally.

Therefore, the revised formula proposed by the Commission in Order No. 4742 is:

$$AS_{t+1} = AS_t * (1 + \%\Delta CCM_{t-1} + CGD_{t-1})$$

$$If\ t = 0 = FY\ 2007,\ AS = 5.5\%$$

Where,

AS = Appropriate Share[13]

[13] This figure continues to be expressed as a percentage and rounded to one decimal place for simplicity and consistency with the Commission's past practice of expressing an appropriate share using one decimal place.

CCM = Competitive Contribution Margin
CGD = Competitive Growth Differential
t = Fiscal Year

The table below illustrates the calculation using the Commission's revised proposed formula starting with an appropriate share of 5.5 percent in FY 2007. Order No. 4742 at 46.

Calculation of Appropriate Share
FY 2007 – FY 2019[14]

Fiscal Year	**Appropriate Share for the Current Year** (AS_t)	**Percentage Change in Competitive Contribution Margin for the Prior Year** $(\%\Delta CCM_{t-1})$	**Competitive Growth Differential for the Prior Year** (CGD_{t-1})	**Appropriate Share for the Following Year** (AS_{t+1})
FY 2007	5.5%	N/A	N/A	5.5%
FY 2008	5.5%	0.0%	0.0%	5.5%
FY 2009	5.5%	-5.9%	0.7%	5.2%
FY 2010	5.2%	13.4%	1.2%	6.0%
FY 2011	6.0%	15.7%	0.9%	7.0%
FY 2012	7.0%	-7.9%	-0.2%	6.4%
FY 2013	6.4%	3.7%	2.7%	6.8%
FY 2014	6.8%	5.5%	2.5%	7.3%
FY 2015	7.3%	0.4%	1.2%	7.4%
FY 2016	7.4%	-2.6%	0.2%	7.2%
FY 2017	7.2%	18.1%	1.4%	8.6%
FY 2018	8.6%	1.3%	1.1%	8.8%

As a result, the appropriate share for FY 2019 (as indicated in the bottom-right cell in the table would be 8.8 percent under the Commission's modified formula. Order No. 4742 at 47. The comparable appropriate share for FY 2019 under the

[14] *See* Library Reference PRC-LR-RM2017-1/2.

Commission's original Order No. 4402 methodology was 10.8 percent. Order No. 4402 at 33.

2. Characteristics of Order No. 4742

In Order No. 4742, the Commission asserts the modified formula captures the prevailing competitive conditions in the market. First, similar to the Postal Service Lerner Index, the Competitive Contribution Margin provides insight into whether the Postal Service possesses a competitive advantage.[15] The higher the Competitive Contribution Margin, the more market power the Postal Service possesses. *Id. at 49*

Second, the change in the Postal Service's market share by revenue would be reflected in the Competitive Growth Differential even more so than the Competitive Market Output component of the previously proposed formula. Unlike the Competitive Market Output, which reflected market share in its composition, the Competitive Growth Differential directly incorporates Postal Service market share into the calculation of the appropriate share. *Id. at 51*

Finally, changes in the market and to competitors, such as overall market growth, firm entry or exit from the market and innovation, are reflected by both of the modified components. For example,[16] if a firm enters the market and generates new business, competitor revenue relative to the Postal Service's revenue would increase, thereby decreasing the Competitive Growth Differential. Order No. 4742 at 52.

The Commission asserts that the modified formula captures other relevant circumstances. First, the modified formula continues to capture changes caused by Postal Service product transfers to the competitive product list. When a product is

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[15] As discussed in Order No. 4402, the Commission also uses its analysis required by section 703(d) to assess whether Postal Service competitive products have a competitive advantage. *See* Order No. 4402 at 35, 54-68. The Commission clarifies that a section 703(d) analysis is the primary way the Commission assesses whether Postal Service competitive products have a competitive advantage due to differences in the application of federal and state laws to the Postal Service compared to competitors. The Commission notes that it also uses other factors (*e.g.*, large increases in market power or evidence of Postal Service predatory pricing) to assess whether the Postal Service has a competitive advantage.

[16] Each example assumes all other factors remain constant.

transferred from the market dominant to the competitive product list, the modified formula continues to incorporate it directly through the Competitive Growth Differential because the modified component continues to include the transferred product's revenue as part of the Postal Service's revenue. The effect of product transfers would also be reflected in changes in Postal Service market share because market share is calculated using, in part, Postal Service revenue, which would include the revenue of any transferred product.

Second, the modified formula captures mail mix changes as the Competitive Growth Differential reflects the revenue the Postal Service receives from any increase in competitive product volume. The Competitive Contribution Margin, similar to the Postal Service Lerner Index, would reflect the growth or decline of very profitable or less profitable competitive products. *See id.* at 48-49.

Third, regarding market uncertainties, the modified formula captures changes in market demand or other macroeconomic conditions through changes in either of the modified components.

The Commission also found that its modified formula should capture efforts to innovate or changes in e-commerce, accomplishing the same objective as the previously proposed formula. The Competitive Growth Differential captures these changes as they affect the Postal Service's position in the market.

Finally, in terms of the risk involved with setting the appropriate share too high, the Commission finds that this risk is addressed by the modified formula, just as it was by the previously proposed formula. The modified formula continues to limit increases in the appropriate share to no higher than appropriate to account for Postal Service growth in market power and for growth in Postal Service market position. In terms of the risks involved in setting the appropriate share too low and allowing the Postal Service to gain market share by discounting prices, the Commission continues to find that this risk is minimal.

C. Dr. Namoro's Analysis of Order No. 4742 Formula

1. The Revised Formula Fails to Consider the Correct Factor

As noted above, the Commission, in Order No. 4742 has made numerous modifications to its proposed formula. As in the prior round of comments submitted by the Public Representative in this docket, Declarant Namoro has evaluated the Commission's modified formula which would be utilized to annually set the minimum contribution required from Competitive products.

In his Additional Declaration, Dr. Namoro concludes that much understanding can be gained about the new formula if one takes the Commission's *Competitive Contribution Margin* (CCM) for what it effectively is: the percentage of gross sales revenue available to cover (or contribute to) institutional costs. Hence, changes in this ratio, or in its absolute counterpart, the numerator of the CCM, measure in relative and absolute terms, possibly imperfectly, *the joint ability of the Postal Service's competitive products to contribute to the coverage of institutional costs.* This capability is the *Postal Service's ability to pay*. Additional Namoro Decl. at 4.

He notes that the new formula compares the changes in the Postal Service's ability to pay to appropriate referential baselines. The changes in the Postal Service's *absolute* ability to pay is compared to changes in the industry average revenue, which is also an *absolute* measure. The changes in the Postal Service's *relative* ability to pay is compared to changes in the competitors' share of total market revenue, which is also a relative measure. *Id*. at 14.

Dr. Namoro concludes that since the apparent purpose of the new formula is to index the change in the appropriate share to the change in the Postal Service's ability to pay, its underlying modeling strategy and the associated decision rule are, in his view, logically sound. *Id*.

2. Stability of the Order No. 4742 Formula

In response to a criticism that Order No. 4742 fails to demonstrate the stability of its proposed recursive formula, Dr. Namoro also considered the stability of the revised formula's projected outcomes. Dr. Namoro studied the Lyapunov-stability of the proposed formula.[17] The *Lyapunov*-stability of the equilibrium share may be a desirable property, because it implies the long-term convergence of the computed shares to a limit, which depends on the magnitude of the initial share. However, as it pertains to the Commission's formula, he concludes that it cannot be proved or disproved theoretically without making questionable assumptions on the dynamics of the Postal Service's ability to pay. Additional Namoro Decl. at 5 and 22. However, Dr. Namoro did make certain extreme assumptions to perform simulations of potential outcomes and concludes that based on actual experience over a ten year period, the stability of the formula is within reason. *Id*. at 29.

3. Additional Issues Indicate a Formula is Not the Best Resolution

However, despite the modifications proposed to the Commission's formula, and the limited additional value added by the modifications to the formula, the Public Representative continues to believe that a rigid formulaic approach *should not* be adopted at this time. In this regard, Dr. Namoro in his Additional Declaration raises the following issues concerning the principles guiding the Commission's minimum-share updating policy:

> *Should any relative increase (or any relative decrease) in the Postal Service's ability to pay be automatically construed as an increase (respectively, a decrease) in its obligation to pay? Id*. at 15.

[17] Lyapunov-stability in the present context, is the property of the computed shares to remain close to zero, if the initial share is set close to zero. *See* Slotine J-J. E., and W. Li, *Applied Nonlinear Control*, Prentice Hall, 1991, at 48-50.

On this issue, Dr. Namoro makes the following observations:

- This question essentially concerns the degree of flexibility that the Postal Service has, or ought to have, in conducting its business within its statutory scope. *Id*. at 4 Specifically, the flexibility that it ought to have in allocating the CCM should be a factor to consider by the Commission in deciding the minimum share. *Id*. at 15. The precept that the Commission is seeking to determine the appropriate share as a *minimum,* should lead it to take into consideration in its decision to increase or lower the appropriate share, the existence of other financial needs that the Postal Service's contribution margin could cover. The complexity of the judgments required by this consideration is less amenable to a simple mathematical updating rule as the one implied by the new formula. *Id*.
- The content of the informational materials, specifically, the data and the statutory guidelines, that underlie the new formula, is not substantially different from the materials that were used by the Commission to develop and support the Order No. 4402 formula. Consequently, although, as is discussed in the Additional Declaration, the new formula is, in many respects, an improved version of the Order No. 4402 formula, the realized improvement remains short of demonstrating that the ongoing appropriate share has become inappropriate and, therefore, needs to be changed. *Id*. at 3.
- Recent developments in the delivery industry suggest that a careful review of the Commission's appropriate share regulation involves judgments which may not be accurately depicted in a mathematical formula. *Id*.

D. Arguments for a Higher Appropriate Share Are Misplaced

Below, the Public Representative reviews several of the factors supporting his conclusion that the current statutory minimum should remain unchanged.

First, an argument has been advanced that it is incorrect to assume that any increase in the appropriate share requirement will necessarily suppress price competition because it would force the Postal Service to raise its prices of competitive products to “uncompetitive levels”, thus creating a price “umbrella” that would encourage the Postal Service’s competitors to raise their own prices for similar products. Rather, this line of argument goes, that even if an increased appropriate share requirement were to compel the Postal Service to raise the prices of its competitive products, it does not necessarily follow that the competitors would also raise their prices of similar products. An example cited, for an industry characterized by economies of scale, is that a price increase by the Postal Service would presumably shift demand to the Postal Service’s competitors on the margin, thereby increasing competitors’ sales, and could lead to a unit cost decrease for them, thus mitigating their incentive to raise prices in response to the Postal Service’s price increase.[18]

This is a convenient argument, but it ignores the fact that the final consumer, who ultimately pays (in one form or other) for shipping will probably come out worse off. This argument, like the one it attempts to rebut, also typically seems to end up benefiting the Postal Service’s competitors; primarily, it appears, UPS. In addition, it is hard to recall any instance where the Postal Service’s competitors have actually not increased their prices annually. There is no assurance that an increase in competitive prices will benefit anyone other than the current Postal Service competitors whose own rates are likely to track any upward movement in Postal Service rates, and who are very profitable.

There is too little margin for error in the Postal Service’s pricing of competitive products to risk a minimum-contribution rule level that might cause a loss of otherwise profitable volumes of competitive products. Also, as the Commission noted in Order No. 4402, the Postal Service has little incentive to discount prices in order to gain

[18] J. Gregory Sidak, “*Making the Postal Service Great Again*”, The Criterion Journal of Innovation, Vol. 3, 2018, at 150.

market share because discounting prices to gain market share would decrease the Postal Service's profitability at a time when it continues to face financial challenges.[19]

UPS has proposed, on multiple occasions, basing the appropriate share on the revenue share of the Postal Service's Competitive Products which for FY 2017 would be approximately 30.2 percent.[20] The Postal Service's current 23.2 percent contribution to institutional costs in FY 2017 is characterized as a "choice"' made by the Postal Service.[21] However, the Postal Service's choice is one of prices for its competitive products, which, in turn, results in a certain level of contribution. In all likelihood, given the Postal Service's financial condition, the Postal Service has sufficient incentive to choose a set of competitive prices that maintain a high level of contribution subject to the fact that the true "market price" is basically unobservable except in the unlucky event that it is exceeded in which case a second chance, a "mulligan" so to speak, is highly unlikely to be an option. In addition, a considerable portion of the Postal Service's competitive volumes originate with its competitors which would tend to indicate that if the economy were to decline, the Postal Service's volumes could be affected quite rapidly. Thus, what appears to be a comfortable interval between the mandated appropriate share and what is actually achieved could shrink rapidly just like driving on an interstate highway, where a safe following distance between cars on a clear day, will quickly become quite unsafe in the event it begins to snow.

UPS's recommended revenue-based appropriate share is simply a thinly disguised maximum. UPS is free to challenge in Court the Commission's interpretation of the appropriate share as a minimum, but if the Commission were to seriously consider UPS's revenue–based allocation methodology, it would amount to a *de facto*

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[19] *See* Order No. 4402 at 50-51. The modified formula continues to be calculated with a time lag that further discourages price discounting by the Postal Service because the negative consequences would appear before the benefits. *See id.* at 51.

[20] The term 'minimum' never appears in conjunction with UPS's proposal to increase the appropriate share.

[21] *Id.* at 104.

abandoning of its interpretation of the appropriate share requirement as a minimum, which the Public Representative opposes.

Basing the appropriate share [minimum] on a purely volumetric basis would yield an appropriate share of 3.4 percent.[22] The Public Representative believes that a volumetric allocation has the advantage of removing the influence of pricing considerations from the process. Fortunately, the Commission has failed to endorse either a pure revenue or volumetric-based formulaic approach. It should not do so here.

IV. CONCLUSION

The Commission has neither the statutory mandate nor the necessary facts and data to regulate the entire last-mile segment of the parcel shipping market, even if it desired to do so. The industry's rapidly evolving roster of participants and constantly changing demand patterns would make such regulation, particularly through limited, indirect regulation of the Postal Service alone, through determination of the appropriate share, an exercise in futility.

The Commission put it best in Docket No. R2006-1 saying, "[T]he Commission is mindful of the need to *strike a balance* between the needs of shippers and competitors."[23] The Commission should adopt a similar posture in the instant proceeding. In the absence of evidence that the Postal Service is or will be competing unfairly, the Commission should avoid establishing a requirement that the Postal Service must price its competitive products ever higher in a way that favors the Postal Service's competitors to the detriment of mailers. Rather, the Commission should allow the market to strike a balance between retail shippers and competitors.

For all of the factors discussed above, considering conditions in the Parcel Shipping Industry, the Postal Service's precarious financial situation, and the trends expected during the next few years when balanced with other factors previously

[22] Based on the Postal Service's FY 2017 total volume and competitive product volume.

[23] PRC Docket No. R2006-1, Opinion and Recommended Decision, February 26, 2007 at 387.

considered relevant by the Commission, the Public Representative continues to recommend that the Commission take no action at this time to modify the 5.5 percent requirement.

Respectfully submitted,

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