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BEFORE THE
POSTAL REGULATORY COMMISSION

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

COMMENTS OF UNITED PARCEL SERVICE, INC. ON REVISED NOTICE OF PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS

(September 12, 2018)

United Parcel Service, Inc. ("UPS") respectfully submits these comments in response to the Postal Regulatory Commission's Revised Notice of Proposed Rulemaking, Dkt. No. RM2017-1 (Aug. 7, 2018) ("Order No. 4742").

INTRODUCTION

This statutorily mandated review of the "appropriate share" requirement has been going on for nearly two years.[1] All the while, the requirement has been stuck at 5.5%, a level set over a decade ago. This 5.5% level is so low in light of current market realities that virtually everyone who has participated in this docket agrees it is effectively meaningless—the equivalent of having no requirement at all.[2]

The Commission's prior proposal to revise the requirement, made in February of this year, would have employed a complex formula involving a series of variables—not one of which, to UPS's knowledge, anyone other than the Commission has ever suggested is relevant to the appropriate share determination. All parties filing

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[1] This docket was opened on November 22, 2016, to "facilitate the Commission's examination of the appropriate minimum contribution to the Postal Service's institutional costs that competitive products must provide, pursuant to 39 U.S.C. 3633(b)." Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Nov. 22, 2016) ("Order No. 3624") at 1.

[2] *See, e.g.*, Comments of Amazon Fulfillment Services, Inc., Dkt. No. RM2017-1 (Jan. 23, 2017) at 54 (calling the 5.5% appropriate share "illusory and non-binding"); Declaration of John C. Panzar on Behalf of Amazon Fulfillment Servs., Dkt. No. RM2017-1 (Jan. 23, 2017) at 3 (calling 5.5% a "nonbinding level"); Initial Comments of the United States Postal Service, Dkt. No. RM2017-1 (Jan. 23, 2017) at 18–19 (concluding "there is no apparent regulatory purpose for keeping the current appropriate share level" and it should be "set at zero"); Initial Comments of the Market Dominant Mailers and Competitive Shippers, Dkt. No. RM2017-1 (Jan. 23, 2017) at 1; Reply Comments of Amazon Fulfillment Services, Inc., Dkt. No. RM2017-1 (Mar. 9, 2017) at 9; Reply Declaration of John C. Panzar on Behalf of Amazon Fulfillment Servs., Dkt. No. RM2017-1 (Mar. 9, 2017) at 14; Comments of American Consumer Institute Center for Citizen Research, Dkt. No. RM2017-1 (Apr. 16, 2018) at 1–2.

comments criticized and opposed the proposed formula, including the Public Representative,[3] UPS,[4] Amazon,[5] and even the Postal Service itself.[6]

Nonetheless, the Commission has declined to address the fundamental problems with its formulaic approach and now proposes only a minor rework of its original formula. Nowhere does the Commission explain what, exactly, its formula seeks to measure overall or how it advances the Commission's regulatory objectives. Nor does the Commission explain how its formula ensures, as a practical or theoretical matter, that the Postal Service will in fact cover an "appropriate share" of institutional costs with revenues from its competitive products business. And the Commission certainly does not defend the output that would result from its formula—the formula would generate an appropriate share requirement of just 8.8% for FY2019,[7] a figure that is just as trivial and divorced from reality as is 5.5%.

Competitive products today generate *over 30%* of total revenues for the Postal Service, and, similarly, are responsible for *over 30%* of the total costs that the Postal

[3] *See* Comments of Public Representative Comments on Order No. 4402, Dkt. No. RM2017-1 (Apr. 16, 2018) at 2 (summarizing that the "proposed formulaic methodology, under certain conditions . . . would yield results opposite to its intended purpose and is therefore arbitrary").

[4] *See* Comments of United Parcel Service, Inc. on Order No. 4402, Dkt. No. RM2017-1 (Apr. 16, 2018) at 6–7.

[5] *See* Comments of Amazon.com Services, Inc. on Order No. 4402, Dkt. No. RM2017-1 (Apr. 16, 2018) at 6 (arguing the Commission should not use a formula as a "limit on the Commission's sound judgment").

[6] *See* Comments of the United States Postal Service on Order No. 4402, Dkt. No. ACR2017-1 (Apr. 16, 2018) at 8 (arguing that the Commission should not adopt "an annually adjusted, formula-based requirement").

[7] Order No. 4742 at Table IV-3.

Service attributes to products.[8] The notion that, despite these facts, competitive products should be held responsible for just 8.8% of institutional costs defies logic.

The Commission's approach to the appropriate share requirement, and the Commission's convoluted formula, do nothing to advance the statutory objectives of the Postal Accountability and Enhancement Act ("PAEA"). This Commission once acknowledged that the "appropriate share" requirement was "intended to ensure that the Postal Service competes fairly in the provision of competitive products" by ensuring that competitive products are held responsible for *all* of the costs, common and attributable, with which they are associated.[9] The Commission now appears to have abandoned that goal altogether.

On a practical level, the result will be that the Postal Service's competitive products will *not* bear an "appropriate" share of the institutional costs of the Postal Service. They will bear only a trivial share. The proposed formula allows the Postal Service to cover over 90% of its common costs with revenues from market-dominant products, with competitive products required only to cover a minuscule portion. The

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[8] According to data filed by the Commission, total attributable costs in FY2017 were $42.7B, of which $13.9B (or 32.45%) were attributed to competitive products. Fiscal Year 2017 Volume, Revenue, Incremental Cost and Cost Coverage by Class, Library Reference PRC-LR-ACR2017-1 Appendix A ("FY2017 ACD Summary"), Dkt. No. ACR2017 (Mar. 29, 2018). From the same source, competitive product revenues were $20.7 billion in FY2017, or 29.7% of the $69.7 billion in total revenue for mail and services. *Id.* The Commission has recently redefined institutional costs to exclude both product- and class-level inframarginal costs. FY2017 POSTAL REGULATORY COMM'N ANNUAL COMPLIANCE DETERMINATION REP. ("FY2017 ACD") 8–10 (Mar. 29, 2018). This change has resulted in the removal of approximately $1 billion in costs from the institutional cost category to a new third category of costs that are neither institutional nor caused by any single product. *See* FY2017 ACD Summary. We note that the Commission had not implemented this change in definition when it introduced the formula-based approach to Appropriate Share in Order No. 4402.

[9] Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies, Dkt. No. RM2016-2 (Sept. 9, 2016) ("Order No. 3506") at 121 (quoting S. REP. NO. 108-318, at 19 (2004)).

private companies against whom the Postal Service competes, like UPS and FedEx, have no such luxury—they do not have "market-dominant" products upon which they can foist their common costs. Allowing the Postal Service to do so is fundamentally unfair to those private competitors. It is also unfair to the customers of market-dominant products, who have no alternative suppliers to whom they can turn when their prices go up.

Moreover, allowing the Postal Service's competitive products business to avoid covering all of the costs associated with that business will do nothing to reverse the Postal Service's growing losses. Even as the Postal Service projects an image of package deliveries as a bright spot for its otherwise struggling enterprise, its own financial disclosures tell a very different story. As detailed in Section II.A below, the Postal Service's most recent 10-Q indicates that the Postal Service's delivery of greater volumes of competitive products actually causes the Postal Service to suffer more *losses*. The Postal Service experienced a *$1.1 billion increase* in what it deems "controllable" losses for just the nine months ended June 30, 2018,[10] compared to the same period last year, and its explanation reveals that *competitive products* are largely responsible for these growing losses. Setting the "appropriate share" requirement at a low level will not reverse this trend or promote the financial health of the Postal Service.

Simply put, the Postal Service's package-delivery business should bear all of the costs associated with that business. That includes both the costs attributed to competitive products, under the Postal Service's narrow cost attribution standards, *and*

[10] U.S. Postal Serv., Quarterly Report (Form 10-Q) (Aug. 8, 2018) ("USPS 10-Q Aug. 2018") at 20.

the common costs with which competitive products are associated, through the appropriate share requirement. As demonstrated below, and as UPS has shown before, the Postal Service is not attributing to competitive products many of the costs that even the Postal Service itself acknowledges are driven by its package-delivery business. Rather, the Postal Service classifies these costs as "institutional." And none of the variables in the Commission's proposed formula even attempt to require the Postal Service's package-delivery business to cover all of the institutional costs with which it is associated.

There is a simple solution: the Postal Service reports that competitive products are responsible for roughly 30% of the costs attributed to products (attributable costs), and they should be required to cover roughly that same portion of common costs (institutional costs). As detailed below, UPS has specifically proposed that the appropriate share should be a three-year trailing average of the competitive products' share of attributable costs.[11] This approach uses the best available proxy for the extent to which competitive products are responsible for overall costs, which is why the European Commission adopted it when faced with a similar regulatory landscape. This solution would also promote financial responsibility and basic competitive fairness on the part of the Postal Service.

The Commission should adopt this proposal instead of its proposed formula, which suffers from many flaws, as detailed herein, and does nothing to ensure that competitive products bear the costs they actually cause.

[11] *See infra* Part IV.

I. BASIC FACTS ABOUT THE POSTAL SERVICE'S COST STRUCTURE SHOULD INFORM THE APPROPRIATE SHARE DETERMINATION

Some basic facts about the Postal Service's cost structure should underlie the analysis of the appropriate share requirement. *First*, the Postal Service is a firm that sells many products and services and has significant scale and scope economies, yielding marginal costs for individual products below the Postal Service's total average cost per unit. The Postal Service has taken the position that, as a result of this structure, there is a large volume and portion of costs that it is unable to attribute to products. The Postal Service classifies these costs as the "institutional" costs of the enterprise—and they can be thought of as "common" costs.[12]

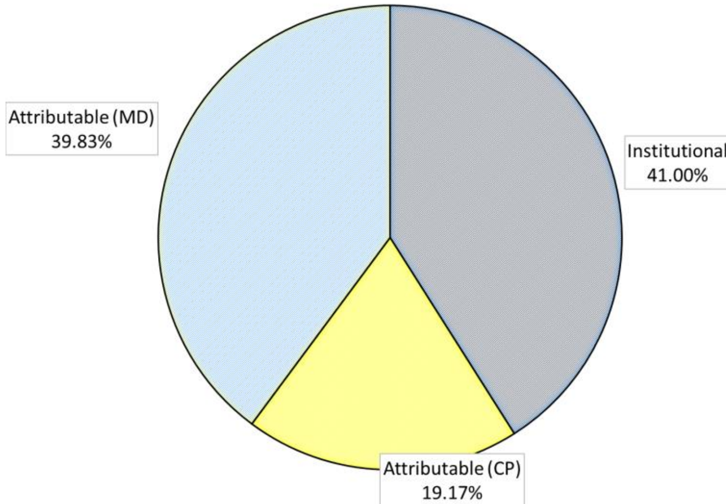
At least as measured under Postal Service cost-attribution practices, these "institutional" costs are massive both in absolute terms ($29.7 billion)[13] and as a percentage of overall costs (roughly 41%).[14] They can be visualized as follows:

[12] At one time, the Postal Service and the Commission spoke of these institutional costs solely as "fixed" costs, but it is now clear that they include costs that are "fixed" (or "sunk") in some sense, along with *variable* costs that are incurred in a way that is common to more than one class of products. *See* Order No. 3506 at 10 ("[T]he residual costs are classified as institutional costs, which generally have two elements: common fixed costs and inframarginal costs."); FY2017 ACD at 8–10. These common costs are found everywhere across the Postal Service's cost pools. UPS contests that "institutional" is necessarily synonymous with "common." Under UPS's cost attribution proposal, which the Commission rejected, institutional costs would essentially be fixed or sunk costs, with all variable costs (common or otherwise) attributed to products.

[13] FY2017 ACD at 92.

[14] *See* FY2017 ACD Summary.

Figure 1: Institutional and Attributable Costs[15]



Second, because it has so many "institutional" costs, the Postal Service cannot earn a profit by setting prices for its individual products that are sufficient only to recover those products' attributable costs. Rather, the Postal Service must set prices that are sufficient to recover both the attributable costs of products *and* the substantial portion of costs classified as institutional—that is, the gray portion of the pie chart above. The question then becomes how much each product, or set of products, should be responsible for recovering those common costs.

Third, while many firms face the problem of having to set prices at a level sufficient to recover common costs in addition to individual costs, the Postal Service is unusual in that it sells one set of products under a statutory monopoly, and another set of products in competitive markets. This gives rise to the concern that the Postal Service might exploit its statutory monopoly by foisting all or nearly all of its common

15 *See* Library Reference PRC-LR-ACR2017-1FY17-CP-1, Dkt. No. ACR2017 (Dec. 29, 2018) at "17 Summary_LR1.xlsx".

costs onto market-dominant products. This practice would be especially problematic given that some costs classified as “institutional” are, in fact, largely driven by the Postal Service’s package-delivery business, even though, the Postal Service claims, these costs cannot be strictly attributed to competitive products. For example, as discussed further in Section II.A. *infra*, the Postal Service has itself acknowledged that it experiences increases in its labor expenses when it grows package volumes, because packages are more labor intensive to deliver. But many of the labor costs driven by package volumes are not attributed to competitive products. Instead they are classified as institutional, because, the Postal Service claims, they are not caused exclusively by competitive products.

Without a meaningful appropriate share requirement, the Postal Service has a natural incentive to load up its market-dominant products with its common costs—including those that are mainly associated with competitive products. This allows the Postal Service to place a disproportionate burden on the customers of market-dominant products. Such a practice is unfair to those customers, who have nowhere to turn for alternative sources of supply. Nor is it a financially sound practice for the Postal Service to rely on market-dominant products to recover a disproportionate share of common costs when those products are on a steady decline.

This practice also distorts competition in markets for competitive products by giving the Postal Service an artificial cost advantage over the private sector. Private firms, like UPS, do not have a set of captive monopoly customers upon whom they can thrust common costs. Private firms must recover *all* of their own common costs through the products they sell in competitive markets. If the Postal Service is not held to a similar standard, it gains an advantage that arises purely from its statutory monopoly. That is not fair, and it is not good for competition, as Congress recognized.[16] Such a distortion of competition is not in the long-term interests of consumers, who value product quality, variety, and innovation—factors which tend to suffer when private enterprise is displaced by government monopolies.[17] This is the primary reason why Congress enacted section 3633 and included an "appropriate share" requirement.

In a report filed in another docket, a long-time postal economist demonstrated that the long-run outcome of giving the Postal Service this advantage, as a theoretical matter, is that it would eventually gain another monopoly—this time over the package business.[18] And while that result might seem purely theoretical, it is striking how quickly the Postal Service has grown its share of package markets. When Congress passed PAEA, the Postal Service's package-delivery business was largely an afterthought. Today, the Postal Service delivers more e-commerce packages to American homes than any other business—eclipsing all private competitors in just a few short years.[19]

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[16] H.R. Rep. No. 109-66 at 44 (2005), available at https://www.congress.gov/109/crpt/hrpt66/CRPT-109hrpt66-pt1.pdf ("[T]he Postal Service *will 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.") (emphasis added)).

[17] *See, e.g.*, Acs, Zoltan J., and David B. Audretsch, *Innovation in Large and Small Firms: An Empirical Analysis*. THE AMERICAN ECONOMIC REVIEW 78.4 (1988): 678–690; Geroski, P. A., *Innovation, Technological Opportunity, and Market Structure*. OXFORD ECONOMIC PAPERS 42.3 (1990): 586–602; Gilbert, Richard J., and Steven C. Sunshine, *Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets*. ANTITRUST LAW JOURNAL 63 (1995): 569–601.

[18] *See* Declaration of John C. Panzar on Behalf of Amazon Fulfillment Services, Inc., Dkt. No. RM2016-2 (Jan. 27, 2016) at 27–28 (discussing long-term "monopoly industry configuration").

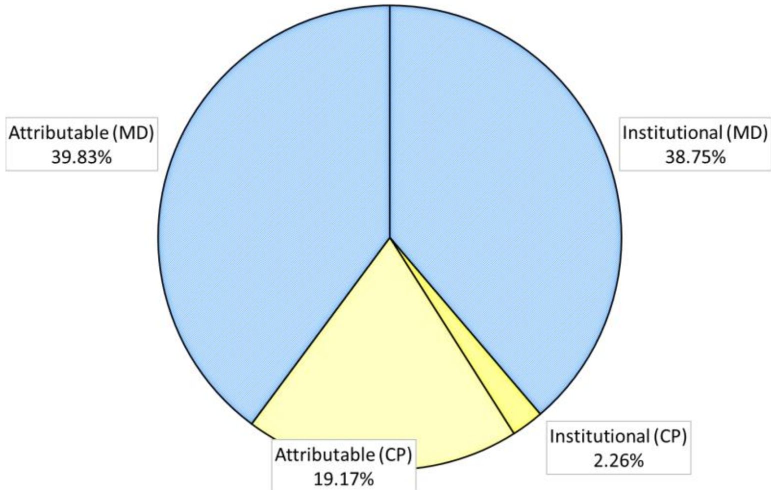
[19] U.S. POSTAL SERV., UNITED STATES POSTAL SERVICE DELIVERS THE FACTS (May 2018), https://about.usps.com/news/delivers-facts/usps-delivers-the-facts.pdf ("We deliver more e-commerce packages to American homes than any other shipper.").

To address these issues, the "appropriate share" requirement must be set at a level that ensures, at a minimum, that the Postal Service's package-delivery business is paying for all of the costs associated with that business. As the Commission has itself observed in the past: "In effect, the appropriate share assigns a portion of the Postal Service's fixed costs to competitive products directly, so that the Postal Service, like its competitors, must set prices to produce sufficient revenues to cover both variable and fixed costs in their entirety."[20]

Basic facts show that the appropriate share requirement is not doing its job today. While competitive products are responsible for 32% of *attributable costs*, using the very narrow attribution standards utilized by the Postal Service, they are required to cover only 5.5% of *institutional costs*. The result is the following pie chart:

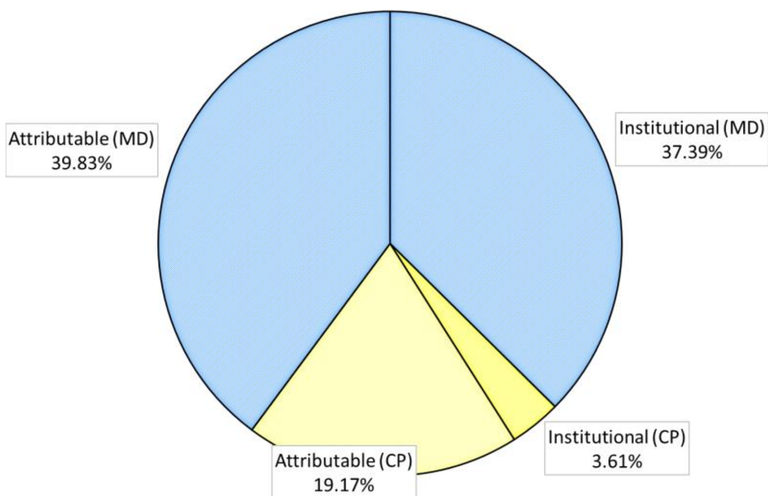
[20] Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, Dkt. No. RM2012-3 (Aug. 23, 2012) ("Order No. 1449"), at 15. Although the Commission spoke in terms of "fixed" costs alone, it is now clear following Order No. 3506 that the Postal Service's institutional costs also include a significant amount of *variable* costs as well, including those that are driven by competitive products. *See* Order No. 3506 at 85 ("The Postal Service also confirms that institutional costs are a mix of fixed and variable costs.").

Figure 2: Cost Attribution Under 5.5% Appropriate Share[21]



The Commission's proposed formula would raise this only slightly, to 8.8% in FY2019, resulting in the following pie chart.

Figure 3: Cost Attribution Under 8.8% Appropriate Share[22]



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[21] *See* Library Reverence PRC-LR-ACR2017-1FY17-CP-1, Dkt. No. ACR2017 (Dec. 29, 2018) at "17 Summary_LR1.xlsx".

[22] *See* Library Reference PRC-LR-ACR2017-1FY17-CP-1, Dkt. No. ACR2017 (Dec. 29, 2018) at "17 Summary_LR1.xlsx".

The result is a striking divergence in the degree to which competitive products are recognized to contribute to *attributable costs*—that is, those costs known to be caused by specific products—(32%), and the degree to which they are held responsible for common costs under the Commission's proposal (just 8.8%).[23] This divergent result makes little sense. If competitive products are known to cause 32% of the costs driven by specific products, common sense provides that they are associated with more than 8.8% of costs associated with the enterprise more generally. As discussed in the next section, economic theory and the Postal Service's own statements confirm this conclusion.

II. COMPETITIVE PRODUCTS ARE ASSOCIATED WITH A SIGNIFICANT PORTION OF INSTITUTIONAL COSTS

A. Some Institutional Costs Are Directly Caused by Competitive Products

UPS previously submitted the declaration of Professor Dennis Carlton, a distinguished economist, who explained that under current practices, some costs that are directly caused by the Postal Service's competitive products business are classified as institutional today.[24] Professor Carlton explained that, although the Postal Service and the Commission refer to the costs attributed to competitive products under 39 U.S.C. § 3633(a)(2) as the "incremental" costs caused by those products,[25] the

[23] Order No. 4742 at Table IV-3.

[24] *See* Declaration of Dennis W. Carlton on Behalf of United Parcel Service, Inc., Dkt. No. RM2017-1 (Mar. 3, 2017) ("Carlton Decl.") at 19–30.

[25] As indicated above, *see supra* note 8, the Commission recently redefined institutional costs to no longer include costs caused by a "class" of products, which it now considers "attributed" to that class of products. FY2017 ACD at 8–10. For purposes of these comments, UPS refers to the concept of "attributable cost" at the product *class* level consistent with the Commission's new definition of institutional cost.

employed methodology does not identify all of the institutional costs that are, from an economic perspective, caused by the Postal Service's delivery of 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."[26] This approach focuses on how costs change at the margins in response to relatively small changes in volumes. But the approach does *not* "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," and thus it "does not appear to account for all costs that would be avoided if USPS did not provide competitive products."[27]

As Professor Carlton explains, "[b]y 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."[28] Put differently, the existing cost attribution approach under sections 3633(a)(2) and 3633(a)(1) does *not* attempt to capture all costs that would go away if the Postal Service stopped delivering packages. 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

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[26] Carlton Decl. ¶ 49.

[27] *Id.*

[28] *Id.*

> 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.[29]

Basic economic theory provides that a portion of institutional costs could be eliminated if the Postal Service stopped selling competitive products, even though the Postal Service claims it cannot attribute these costs to specific competitive products. No one in this docket has effectively disputed the economic points made by Dr. Carlton, and the Commission has never addressed them head on.

Professor Carlton applied these economic points to concrete examples of costs classified by the Postal Service as institutional. For example, if the Postal Service quit the competitive products business, it could undoubtedly "reduce certain headquarters expenses relating to administration and management."[30] These costs totaled $767 million in 2015—but the Postal Service does not attribute them to competitive products; instead, the Postal Service considers them almost entirely institutional.[31] Exit from the competitive products business would also undoubtedly decrease expenses for data processing supplies and services.[32] These costs totaled $680 million in 2015—but again, the Postal Service does not attribute them to competitive products and instead

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[29] *Id.* ¶ 53.

[30] *Id.* ¶ 50.

[31] *Id.* (noting that only $12 million of headquarters expenses was attributed to "International Mail and Services"). In FY2017, headquarters expenses totaled $839 million, of which $824 million were classified as institutional. Public Cost Segments and Components Report, Library Reference USPS-FY2017-2, Dkt. No. ACR2017 (Dec. 29, 2017).

[32] *Id.*

are all considered to be institutional.[33] These are just some examples of the broader phenomenon. These points, too, stand effectively unrebutted.

Notably, the Postal Service's own recent financial statements effectively confirm the points made by Professor Carlton. In fact, these statements show that not just that competitive products are contributing to overall cost increases, but they are causing increases in overall *losses*. The Postal Service's latest 10-Q reports a net loss of $1.49 billion for the third quarter of FY2018 alone.[34] While the Postal Service has long suggested that the losses it suffers are due to factors beyond its control, the 10-Q actually acknowledges that this loss included over a 50% *increase* in what the Postal Service classifies as "*controllable losses*"—that is, losses arising from costs that it should be able to control—over the same period last year.[35] The Postal Service experienced a *$1.1 billion increase* in these controllable losses for just the nine months ended June 30, 2018, compared to the same period last year.[36]

Scratching beneath the surface, it becomes apparent that these losses are caused, at least in part, by delivering packages—that is, competitive products. For example, the Postal Service attributes the largest portion of its increase in controllable losses for the quarter to "higher compensation and benefits expenses of $331 million,"[37] while acknowledging (in a different section of the filing) that these higher costs were

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[33] *Id*. In FY2017, expenses for data processing supplies and services totaled $811 million, of which $793 million were classified as institutional.

[34] USPS 10-Q Aug. 2018, at 3.

[35] *See id.* at 20.

[36] *See id.*

[37] *Id.*

"due to *additional hours incurred to support growth in the labor-intensive package business* as well as contractual wage adjustments."[38]

Under the Commission's proposal, competitive products would be responsible for less than 20% of these increased labor costs, despite the Postal Service's admission that they were partly "due to . . . the labor-intensive package business."[39] In other words, the Postal Service's effort to grow its package business is causing labor costs (and overall losses) to increase, because packages are more labor intensive to deliver than mail. But the Postal Service attributes only 13% of the increased labor costs to competitive products and treats the rest as "institutional" or attributable to market dominant products.[40] When UPS's own labor costs increase due to delivering more packages, it must recover *100%* of those increased costs through revenues from its own products sold in competitive markets. Why is the Postal Service not held to the same standard?

Indeed, under the Postal Service's current costing methodology, increased costs in labor, transportation, and other operational expenses—the very costs the Postal

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[38] *Id*. at 19 (emphasis added). *See also id.* at 25 (noting that certain compensation increases "are the result of supporting continuous volume growth in our labor-intensive Shipping and Packages business").

[39] The costs the Postal Service calls "compensation and benefits" in its financial statements correspond to cost segments that in aggregate are treated as 44% institutional and only 13% are attributed to competitive products. *See* Library Reference UPS-RM2017-1/2, Dkt. No. RM2017-1 (Sept. 12, 2018) at "Labor Cost Attribution.xlsx"; *compare* Library Reference USPS-FY17-5, Dkt. No. ACR2017 (Dec. 29, 2017) ("Cost Segment and Components Reconciliation to Financial Statements"), *with* Library Reference USPS-FY17-2, Dkt. No. ACR2017 (Dec. 29, 2017) ("FY2017 Public Cost Segments and Components Report") at "FY17Public Cost Segs and Comps.xlsx". Under the Commission's proposal, the appropriate share requirement would have been 8.6% in FY2018. Therefore, all things equal, the competitive products business would cover approximately (13% + (8.6% * 44%)), or only 16.8% of these personnel/labor cost increases.

[40] *See* Library Reference UPS-RM2017-1/2, Dkt. No. RM2017-1 (Sept. 12, 2018) at "Labor Cost Attribution.xlsx".

Service acknowledges are driven by its package-delivery services—are generally not attributed to competitive products but are instead treated in large part as "institutional" costs of the enterprise as a whole. If the appropriate share requirement is not set so as to ensure that competitive products are held responsible for at least these types of institutional costs, then the appropriate share cannot be doing its job. The Commission's Order, however, does not even acknowledge the existence of institutional costs that are associated with competitive products. Unsurprisingly, then, its proposed formula does nothing to account for them.

B. The Commission Erroneously Declines to Consider Costs that Are "Disproportionately Associated with Competitive Products"

39 U.S.C. § 3633(b) directs the Commission in setting the appropriate share to consider, among other things, "the degree to which any costs are uniquely or disproportionately associated with any competitive products."[41] As shown above, as a matter of economic logic and by the Postal Service's own admission, a substantial portion of institutional costs are associated with competitive products. The Commission's "proposed formula-based approach," however, *expressly* does *not* consider this factor, and apparently reserves consideration of this factor for a "subsequent order."[42]

It is impermissible for the Commission to decline to consider *mandatory* factors that Congress expressly provided the Commission "shall consider" "[i]n making its

[41] *See* 39 U.S.C. § 3633(b).

[42] Order No. 4742 at 52–53.

determination" regarding the appropriate share. 39 U.S.C. § 3933(b).[43] While the Commission has declared that it will issue a separate order on that determination, it is not clear whether the Commission intends to modify its formula based on its subsequent consideration of this statutory factor. In any case, the Commission's division of its analysis under section 3633(b) into multiple orders causes unnecessary complication and difficulty. The Commission's formula is necessarily incomplete prior to consideration of all mandatory statutory factors. Interested parties cannot know what, exactly, the Commission is proposing and why before that occurs.

The Commission does refer back to a prior order,[44] where it made the very surprising assertion "that there were *no costs* uniquely associated or disproportionately associated with any competitive products that were not already attributed to competitive products under the Commission's methodology."[45] It is unclear whether the Commission is still maintaining this position, notwithstanding its refusal to address comments on this issue.[46] To the extent the Commission is maintaining its position that there are no such costs, the Commission errs.

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[43] *See, e.g.*, Pub. Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1216 (D.C. Cir. 2004) (explaining that a rule is arbitrary and capricious if agency does not consider factor that the statute says it shall consider).

[44] Order No. 4742 (citing Notice of Proposed Rulemaking to Evaluate The Institutional Cost Contribution Requirement for Competitive Products (Order No. 4402), Dkt. No. RM2017-1 (Feb. 8, 2018) ("Order No. 4402") at 43–45).

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

[46] The refusal to address comments itself constitutes a violation of the APA. *See, e.g.*, Genuine Parts Co. v. Envtl. Prot. Agency, 890 F.3d 304, 313 (D.C. Cir. 2018) (citing La. Fed. Land Bank Ass'n, FLCA v. Farm Credit Admin., 336 F.3d 1075, 1080 (D.C. Cir. 2003)) (finding that agency "must respond to those comments which, if true, would require a change in the proposed rule"); Portland Cement Ass'n v. Ruckelshaus, 486 F.2d 375, 393–94 (D.C. Cir. 1973) (remanding to the agency for further proceedings because agency did not address a "significant" and "material" issue raised in comments).

The Commission justified this remarkable assertion by stating that, under the Commission's methodology for attributing costs to individual products, "any cost that is uniquely or disproportionately associated with any competitive product is identified as an attributable cost because it exhibits a reliably identifiable causal relationship with a specific competitive product."[47] But costs with a reliably identifiable causal relationship are those costs that are *uniquely caused* by a specific product. The statute requires more—the Commission is to consider not only costs "uniquely" caused by competitive products *but also* those costs that are "disproportionately" associated with competitive products.[48]

Costs that are "disproportionately" associated with competitive products are not costs that are caused uniquely or exclusively by competitive products. By definition, a cost can only be "disproportionately associated" with "competitive products" if it is at least partially associated with some other products as well. Proper construction of this statutory language requires the Commission to investigate what costs, currently classified as institutional, are "disproportionately associated" with competitive products.[49]

But the Commission has conducted no such investigation. Instead, with regard to "disproportionately associated" costs, the Commission states:

> [T]he Commission's cost attribution methodology identifies relationships between costs and cost drivers, which include mail characteristics such as weight and shape (*e.g.*, letters or parcels). The costs associated with a cost driver are distributed to products in proportion to the prevalence of the driver within each product. For example, heavier products (*e.g.*, parcels) have

[47] Order No. 4402 at 43.

[48] *See* 39 U.S.C. § 3633(b).

[49] 39 U.S.C. § 3633(b).

> more weight-driven costs attributed to them than lighter products (*e.g.*, letters). In this way, the costs attributed to products reflect any disproportionate association of those costs with any specific products (including any competitive products).[50]

The Commission in substance is asserting that disproportionate costs are already attributed to products according to current methodology. But the Commission has previously allowed the Postal Service to take an extremely stringent model for cost causation that does not attribute costs to products unless they are clearly caused by the products.[51] The Commission has also explained to the D.C. Circuit that it is only attributing the *minimum cost* that could be reliably assigned to a product.[52] The Commission cannot have it both ways—the Commission cannot allow the Postal Service to limit cost attribution to very stringent (minimum) reliable causal relationships while at the same time asserting that its cost attribution principles encompass "disproportionately associated" costs. 39 U.S.C. § 3633(b).[53]

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[50] Order No. 4402 at 43.

[51] *See* Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), Docket No. RM2016-2 (Sept. 9, 2016) at 9-10.

[52] United Parcel Serv., Inc. v. Postal Regulatory Comm'n, 890 F.3d 1053, 1068 (D.C. Cir. 2018) ("[T]he Commission simply declined to assume that any given product incurred more than the minimum cost that could reliably be assigned to it. Attributing *more* than this amount, after all, necessitates guesswork, and the Commission sensibly concluded that such guesswork was inconsistent with its statutory obligation to base attribution on only "reliably identified causal relationships"). The Commission itself stated in its brief submitted to the D.C. Circuit that its approach "almost certainly underestimates the inframarginal costs a product actually incurred." Postal Regulatory Commission Final Br. at 39, *United Parcel Serv.*, 890 F.3d 1053 (D.C. Cir. 2018) (No. 16-1354).

[53] Ironically, in a prior docket, UPS had proposed that the Postal Service expand cost attribution beyond those costs that are uniquely or exclusively caused by a single product to encompass a broader set of costs associated with products. But the Postal Service said this type of broader cost attribution was impossible, and the Commission agreed. *See* Order No. 3506 at 59-60. Now, in this proceeding, the Commission is arguing that the Postal Service is already attributing to individual products the very types of costs that it held the Postal Service

The phrase "associated with" in 39 U.S.C. § 3633(b) is plainly broader than the "caused by" standard used for individual product attribution, and it necessarily constitutes 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.

Ultimately, the Commission's approach would render the "uniquely or disproportionately associated" clause of section 3633(a)(3) meaningless. The "disproportionately associated" standard of section 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 section 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 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).

Indeed, while the Commission cites the D.C. Circuit's decision upholding the Commission's implementation of incremental cost attribution in those prior proceedings,[54] that decision strongly implies that the D.C. Circuit expects the appropriate share requirement to address the competitive concerns at the heart of the PAEA—by requiring competitive products to bear costs above and beyond the narrow

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did *not* have to attribute to individual products when UPS made its proposal. That is fundamentally unreasonable.

[54] *See* Order No. 4742 at 7 n.8, 52.

set that are attributed to competitive products.[55] The Commission's proposal would not meet this goal.

C. The Commission's Proposal Allows for Price-Gouging of Market-Dominant Customers

As noted, under the current methodology, the institutional costs of the Postal Service are essentially costs that it considers "common" in that they cannot be clearly linked to any specific individual product or class of products.[56] An entity with substantial common costs and economies of scale must recover its common costs somehow. If these costs are not covered by competitive products, then (to the extent they are covered at all) they will be imposed upon market-dominant products—products and services where customers have no alternatives.

In another context, when one is not dealing with a government monopolist, it arguably makes sense to force customers with fewer alternatives to pay higher prices.[57] But that is not consistent with the regulatory scheme envisioned by the PAEA, which includes a rate cap for market dominant products linked to annual rates of inflation, along with the appropriate share requirement for competitive products.[58] Because the

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[55] *See United Parcel Serv.*, 890 F.3d at 1067 (finding "no reason to doubt that the Accountability Act's . . . requirement that competitive products cover a share of institutional costs will adequately ameliorate any competitive deficit left by the Commission's approach to cost attribution[.]") (internal citations omitted).

[56] To be precise, under the current methodology, institutional costs are those that cannot reliability be attributed to individual products or classes of products, and UPS expressly preserves the argument that the Commission's interpretation of reliability as near certainty leaves many costs caused by individual products or classes of products unattributed.

[57] *See* MICHAEL LEVINE, PRICE DISCRIMINATION WITHOUT MARKET POWER 9 (2002); *see also* W. KIP VISCUSI *et al*., ECONOMICS OF REGULATION AND ANTITRUST 415–17 (4th ed. 2005) (describing Ramsey pricing, which "raise[s] prices in inverse proportion to demand elasticities").

[58] 39 U.S.C. § 3622(d)(1)(A).

competitive products business has not been bearing its share of common costs, the Postal Service has made several requests to deviate from the rate-cap scheme, leading to market-dominant customers facing a series of significant rate increases over the past few years—and there is the potential for more in the future, as well as the possibility of legislative relief.[59]

Market-dominant customers should not be forced to pay more than their fair share of the common costs of the Postal Service. Instead, the Commission should ensure that competitive products are contributing a pro-rata proportion of common costs, and that market-dominant customers are not forced to fund the Postal Service's unprecedented expansion into competitive product markets.

D. The Commission's Proposal Does Not Promote Financial Responsibility

It is also economically irrational to thrust these costs onto market-dominant consumers given long term trends. Market-dominant mail volumes are in a sustained decline.[60] It makes no sense for products that are in such a decline to pay for the substantial re-vamping of the Postal Service towards competitive products that is occurring today.

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[59] *See, e.g.*, Order on Price Adjustments for First-Class Mail, USPS Marketing Mail, Periodicals, Package Services, and Special Services Products and Related Mail Classification Changes (Order No. 4215), Docket No. R2018-1 (Nov. 9, 2017); Order on Price Adjustments for Special Services Products and Related Mail Classification Changes (Order No. 3670), Docket No. R2017-1 (Dec. 15, 2016); Order on Price Adjustments for First-Class Mail, Standard Mail, Periodicals, and Package Services Products and Related Mail Classification Changes (Order No. 3610), Docket No. R2017-1 (Nov. 15, 2016).

[60] *See, e.g.*, *A Decade of Facts and Figures*, ABOUT USPS, https://about.usps.com/who-we-are/postal-facts/decade-of-facts-and-figures.htm (last visited Sept. 4, 2018) (documenting the general decline in total mail volume, including first class mail volume, standard mail volume, and various subsets thereof).

Nor does it make sense for the Postal Service to set prices for competitive products that fail to generate profits when common costs are considered. But there are increasing indications that is precisely what is happening. As noted above, the Postal Service's most recent 10-Q shows that the Postal Service's "controllable losses" are growing as it delivers more packages. And the 10-Q further shows that package-volume growth is increasingly concentrated in the products that it sells at the lowest prices of all of its products, and which have the lowest margins, even under its own accounting principles which largely ignore institutional costs. The Postal Service acknowledges that package delivery is a "lower-contribution business" than its traditional mail business.[61] Volume growth is largely concentrated in "last-mile" delivery services (Parcel Select and Return), which is one of the Postal Service's "lowest-priced package services, and as a result, produces a lower yield per piece when compared to many of our other services."[62] The Postal Service also alludes to the fact that "inbound" international services are losing money, noting that they "generat[e] two thirds of volume but only a third of the revenue" in the international category, as a result of "lower rates for inbound international e-commerce packages."[63]

The Commission's laissez-faire approach to regulation will allow this trend to continue and will not promote the long-term financial stability of the Postal Service. While private companies have a strong incentive to set prices so as to maximize profits,

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[61] USPS 10-Q Aug. 2018, at 19.

[62] *Id.* at 24.

[63] *Id.*

governmental entities like the Postal Service have different incentives, which include the potential incentive to over-expand for the sake of growth rather than profit.[64]

The Commission makes no effort to consider the effect that an unduly low appropriate share requirement will have on the overall financial health of the enterprise. Instead, the Commission appears simply to *assume* that the Postal Service has a natural incentive to set its prices for packages at a profit-maximizing level—an odd assumption for the regulator of an unprofitable enterprise to make. The Commission argues that "because the PAEA allows the Postal Service to retain earnings, the Postal Service is incentivized to maximize profits on competitive products."[65] And it asserts that, as a result, underpricing is "highly unlikely to occur."[66] These conclusory assertions ignore some basic facts.

First, the Postal Service faces political pressures that differ from profit maximization, and instead encourage it to pursue scale over efficiency. The Postal

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[64] *See* Declaration of J. Gregory Sidak on Behalf of United Parcel Service, Institutional Cost Contribution Requirement for Competitive Products, Postal Regulatory Commission, Dkt. No. RM2017-1 (Jan. 23, 2016) ¶¶ 22–26; Reply Declaration of J. Gregory Sidak on Behalf of United Parcel Service, Institutional Cost Contribution Requirement for Competitive Products, Postal Regulatory Commission, Dkt. No. RM2017-1 (Mar. 9, 2017) ¶¶ 7–10; 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 2, 4, 19; 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), at 26–27; Declaration of Dennis W. Carlton, Dkt. No. RM2017-1 (Mar. 9, 2017) at 7–10; *see also* J. Gregory Sidak, *Maximizing the U.S. Postal Service's Profits from Competitive Products*, 11 J. COMPETITION L. & ECON. 617, 662 (2015); David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 500 (2003); David E.M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. CHI. L. REV. 271, 285–86 (2000) (explaining why a public enterprise has a greater incentive than a private firm to engage in predatory pricing); Andrei Shleifer, *State Versus Private Ownership*, 12 J. OF ECON. PERSPECTIVES 133, 135, 138, 148 (1998).

[65] Order No. 4742 at 16.

[66] *Id.*

Service remains a significant employer in many Congressional districts throughout the U.S. and prides itself on being the "second largest employer in the United States."[67] It faces substantial pressure, internal and external, to maintain its size. Serious concerns that the Postal Service would need to significantly scale back operations would be opposed by many political actors. As Professor Carlton noted, a concrete example is that when the Postal Service proposed to close down 82 mail-processing facilities to right-size its network, it was rebuffed by 50 U.S. senators.[68]

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."[69] 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.[70] These are all facts that the Commission has failed to consider.

Second, the Postal Service has never retained competitive product profits, as it uses what it considers to be profits to pay institutional costs.[71] To be sure, PAEA provides for retained earnings from competitive products in the Competitive Products Fund, and even permits the Postal Service to request the Secretary of the Treasury to

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

[68] Carlton Decl. at 9.

[69] *Id.* at 10.

[70] *Id*. at 11.

[71] *See, e.g.*, Responses Of The United States Postal Service To Question 1-6 And 8-13 Of Chairman's Information Request No. 8, Dkt. No. ACR2012 (Feb. 15, 2013), at response to Question 8.c.

invest these surplus retained earnings in any Federal Reserve Bank or in other depositories.[72] But there is no evidence of such investments in the record, and indeed the funds in the Competitive Products Fund are transferred out of the Fund annually. And it is not clear what the Postal Service would do if it ever did generate total contribution that more than covered its institutional costs. It has no shareholders or owners to whom to pay dividends or profits.

Third, the Postal Service is significantly in arrears to the federal government after years of failing to make its PSRHBF payments. If the Postal Service were to retain earnings for a proverbial "rainy day" or begin to pay higher salaries or bonuses to its managers or employees, it would undoubtedly face political pressure to instead pay down its debt. At the same time, the Postal Service faces a softer budget constraint than does any private company, and has less need to save for a rainy day. The Postal Service's public filings continue to express expectations that it would receive a bailout in the event of continued shortfalls.[73] This expectation that the American taxpayers may be required to rescue the Postal Service if its problems continue to grow further undermines the Postal Service's incentives to maximize efficiency and profits.

A robust appropriate share is necessary to promote financial responsibility and to make sure that competitive products are not contributing to the Postal Service's overall losses. The formula proposed by the Commission, and the trivial share level that results, does nothing to advance these objectives.

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[72] *See* 39 U.S.C. § 2011(c) and (d).

[73] *See, e.g.*, USPS 10-Q Aug. 2018, at 9 ("[I]n the event of a cash shortfall, the U.S. government would likely prevent the Postal Service from significantly curtailing or ceasing operations."); U.S. Postal Serv., Quarterly Report (Form 10-Q) (May 10, 2018) (same); U.S. Postal Serv., Quarterly Report (Form 10-Q) (Feb. 8, 2018) (same).

E. The Commission's Analysis Ignores the Acknowledged Statutory Purpose of Ensuring Fair Competition

The Commission at one time recognized that "[a] primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace."[74] The congressional record confirms that 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."[75] 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."[76]

The D.C. Circuit, in affirming the Commission's incremental cost test for attribution, likewise noted that "Congress wished to 'ensure that the Postal Service competes fairly,' that is, without using revenues from market-dominant products subject to its monopoly power to defray costs competitive products would otherwise have to be priced to cover." *United Parcel Serv., Inc. v. Postal Regulatory Comm'n*, 890 F.3d 1053, 1055 (quoting S. Rep. No. 108-318, at 15 (2004)). The Court acknowledged that

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[74] Order No. 1449, Dkt. No. RM2012-3 (Aug. 23, 2012), at 13. The Commission also acknowledged that the appropriate share requirement should address the fact that "[t]he Postal Service's competitors incur certain fixed operating costs . . . and [i]f the Postal Service's competitive products were provided by a stand-alone enterprise, it too would incur fixed operating costs." *Id.*

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

[76] *Id*. at 46.

"the Accountability Act subjects each competitive product to a 'price floor,' *. . .* which must be set high enough to cover both that product's 'costs attributable,' 39 U.S.C. § 3633(a)(2), and a portion of the Postal Service's 'institutional costs,' *id.* § 3633(a)(3), which the Commission construes to mean 'residual costs,' *i.e.*, all costs that are not costs attributable." *Id.* at 1055–56.[77] The D.C. Circuit was convinced to affirm the Commission's narrow interpretation of attributable costs under 39 U.S.C. § 3633(a)(2) because the "requirement that competitive products cover a share of institutional costs, *id.* § 3633(a)(3), will adequately ameliorate any competitive deficit left by the Commission's approach to cost attribution[.]" *Id.* at 1067.

At oral argument before the D.C. Circuit earlier this year, the Commission assured the Court that the under-attribution of incremental costs to competitive products would not result in competitive distortions because those unattributed costs

> 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 . . . . [I]t'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 factors *to ensure that the statutorily mandated price floor is not too low as to promote undue competitive behavior*.[78]

Despite the Commission's representations to the D.C. Circuit, the Commission's proposals in this docket would do *nothing* to assure that the "statutorily mandated price

[77] As noted above, the Commission has *sua sponte* modified the definition of institutional costs it previously explained to the D.C. Circuit. FY2017 ACD at 8–10.

[78] Oral Argument at 39:11–40:22, *United Parcel Serv.*, 890 F.3d 1053 (D.C. Cir. 2018) (No. 16-1354), https://www.cadc.uscourts.gov/recordings/recordings2018.nsf/17447E2027F980FA8525821D005CB8C0/$file/16-1354.mp3 (emphasis added).

floor is not too low as to promote undue competitive behavior."[79] Nowhere in the Order does the Commission identify any concern, even a hypothetical one, about how the Postal Service could possibly enjoy an artificial competitive advantage over the private sector. Seeing no risk of unfair competition, it is unsurprising the Commission has done nothing to prevent it.

Instead, the Commission claims that it is *the private sector* that enjoys a competitive advantage over the Postal Service.[80] The only basis for the Commission's surprising assertion that the *private sector* enjoys a competitive advantage over the Postal Service, notwithstanding the letter and mailbox monopolies, is a single, limited decade-old study conducted by the Federal Trade Commission ("FTC"). The Commission maintains that the "FTC's conclusion that the Postal Service operates at a net economic disadvantage continues to be valid."[81] As previously explained by UPS, however, the 2007 FTC Report *explicitly* excluded consideration of the significance on competition of the Postal Service's letter and mailbox monopolies.[82] The FTC Report concluded the potential benefits flowing from these monopolies constituted an "empirical question" that the FTC was unable to answer.[83] The FTC expressly stated that it had

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[79] *Id.*

[80] *See* Order No. 4402 at 65, 68, 74–76.

[81] Order No. 4742 at 58.

[82] *See* 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 (Apr. 16, 2018) at 23.

[83] FEDERAL TRADE COMMISSION, ACCOUNTING FOR LAWS THAT APPLY DIFFERENTLY TO THE UNITED STATES POSTAL SERVICE AND ITS PRIVATE COMPETITORS 48 (Dec. 2007) ("FTC Report") available at https://www.ftc.gov/sites/default/files/documents/reports/accounting-laws-apply-differently-united-states-postal-service-and-its-private-competitors-report/080116postal.pdf.

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.”[84] The Commission *itself* has recently quantified these benefits for the President and Congress, estimating they range in the billions of dollars.[85]

In the Order at issue, the Commission declined to address UPS’s comments regarding the Commission’s misuse of the FTC Report, instead stating that it would address these comments, too, “in a subsequent order.”[86] But the Commission should no longer ignore fair competition concerns by hiding behind a study written eleven years ago that has obvious flaws. This is not an appropriate way to handle the “primary function” of the appropriate share requirement.[87] The Commission should instead rigorously consider the billions of dollars in cost advantages bestowed by the letter and postal monopolies—which it has already quantified—in setting an appropriate share requirement for the Postal Service.

The Commission’s refusal to accept even the possibility of unfair competition—notwithstanding that this is the very concern animating sections 3633(a)(2) and (3)—is erroneous as a matter of law.

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[84] FTC Report at 64 (“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.”).

[85] *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.

[86] Order No. 4742 at 58 n.69.

[87] Order No. 1449 at 13.

III. THE PROPOSED FORMULA IS UNTETHERED FROM ANY STATUTORY PURPOSE

In addition to these fundamental flaws, the formula proposed by the Commission is itself plagued with errors. As a result of these errors, the formula does not measure anything coherently overall or advance any regulatory objective.

At the outset, the Commission once more inappropriately proposes to seed its formula with the same low 5.5% value set at the outset of PAEA in 2007[88]—a decision that would artificially depress the output of the formula. The Commission also once again proposes to tie its floating appropriate share measure to two irrelevant indices: (1) The Postal Service's Competitive Contribution Margin ("CCM"), which measures the "price-cost margin"[89] of the postal service, considering only attributable costs, in an attempt to detect the degree to which the Postal Service is abusing its "market power" in the competitive marketplace to extract excessive profits,[90] and (2) the Postal Service's Competitive Growth Differential ("CGD"). CGD compares revenue growth rate of the competitive products business to that of its private sector competitors in an attempt to measure whether the competitive products business is growing faster than the market as a whole and displacing private competitors.[91]

As discussed below, neither of these components is designed to address the ongoing problems that section 3633(a)(3) and (b) were enacted to prevent. Neither component attempts to hold the Postal Service to a meaningful "price floor" even though

[88] Order No. 4742 at 37–38.

[89] Order No. 4742 at 15.

[90] *Id.* at 14, 49.

[91] *Id.* at 23.

the D.C. Circuit has identified that as a central purpose of section 3633.[92] As discussed above, it is trivial for the Postal Service's competitive pricing to "pass" the statutory tests embodied in sections 3633(a)(1) and (2), even if they were functioning perfectly, since those tests largely ignore the substantial volumes of common costs the Postal Service reports. It is therefore necessary that the appropriate share requirement implement a meaningful "price floor" or there will be none at all. But the formula components in no way promote this goal.

A. The Commission's Seed Value for Its Proposed Formula Is Arbitrary

Despite UPS's criticisms, and absence of support from any interested party, the Commission has maintained its proposal to seed its formula at 5.5%, and to run it retroactively from 2007.[93] The Commission justifies its disregard of the comments submitted on this issue by stating "[t]hose beginning values allow the resulting appropriate share to capture the impact of market fluctuations on the appropriate share over time and moving forward."[94] Because the formula takes history into account through the CCM and CGD components, the Commission reasons, it might as well keep the starting point where it was in 2007. On this flimsy basis, the Commission proposes to require the Postal Service to cover only a small fraction of its institutional costs with competitive revenues in perpetuity.

Given the minimal possibilities for change introduced by the CCM and CGD components even in response to large growth in competitive products,[95] this seed value

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92 *United Parcel Serv*., 890 F.3d at 1055–56.

93 Order No. 4742 at 38.

94 *Id.* at 40.

95 *Id.* at 17 (table indicating a range in "percentage change in competitive contribution margin" between 2007 and 2017 of negative 5.9% to positive 18.1%); *id.* at 31 (table indicating

will guarantee that the competitive products business will *never* be required to cover the share of institutional costs associated with its operations. The Commission also ignores and does not even attempt to justify the fact that its new formulaic components result in much lower appropriate share outputs than its original formula, and a much stronger tie to the initial seed value.[96]

In 2007, the Commission, "mindful of the risks of setting it too high,"[97] ordered the appropriate share set at what the Postal Service itself characterized as a "relatively low"[98] level in order to give the Postal Service "some flexibility to compete" given that "the Postal Service's market share is relatively small."[99] The "flexibility to compete" the Commission sought to grant the Postal Service in 2007 has turned into an unfair competitive advantage: The competitive products business can charge rock bottom prices because the competitive products business does not need to consider the overwhelming majority of the institutional costs it generates or benefits from. As should be no surprise, this *de minimis* appropriate share requirement opened the way for the Postal Service's vast success in displacing private competitors in the package delivery sector over the past decade.

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a range in "Competitive Growth Differential" between 2007 and 2017 of negative 0.2% to positive 2.7%).

[96] *See, e.g.*, *id.* at 40–47.

[97] Order Proposing Regulations to Establish a System of Ratemaking, Dkt. No. RM2007-1 (Aug. 15, 2007) at 73.

[98] Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking, Dkt. No. RM2007-1 (Jun. 18, 2007) at 25.

[99] Order Proposing Regulations to Establish a System of Ratemaking, Dkt. No. RM2007-1 (Aug. 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.").

The Commission now tells a different story, arguing that 5.5% was not "too low or inadequate" in 2007 because it was "based on historical contribution" before PAEA was enacted.[100] Contribution rates from before section 3633(a)(3) and (b) were enacted are irrelevant to the proper rate under that provision, given the substantial changes to the competitive products business brought about through PAEA. The Commission itself has admitted that the 5.5% appropriate share set in 2007 must be raised because "[r]elevant circumstances have changed" since 2007.[101] Specifically, the Commission determined it must change the 5.5% appropriate share to "better reflect the modern competitive market."[102]

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 competitive products business will soon surpass its market dominant business in terms of revenue, yet the appropriate share requirement will barely change.

Competitive product revenues have grown by a cumulative annual growth rate of 10.6% over the past three years (FY2014 to FY2017),[103] while competitor revenue (as defined by the Commission)[104] has grown by 5.5% per year over the same time period,[105] with market dominant revenue shrinking by 2.3% per year over the same time

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[100] Order No. 4742 at 41.

[101] Order No. 4402 at 12.

[102] *Id.*

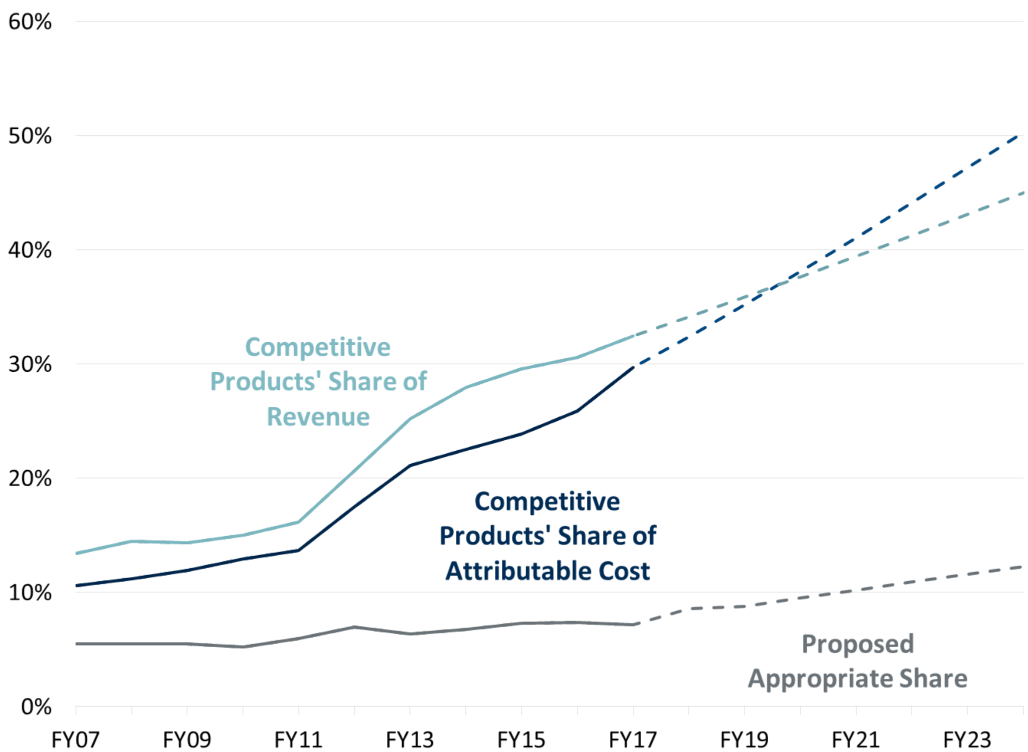
[103] *See* United States Postal Service, Revenue, Pieces, and Weight by Classes of Mail and Special Services (2015–2017).

[104] *See* Order No. 4742 at 20 (defining the "competitor revenue" variable to be the revenue of "Couriers and Messengers" as reported in a Census Bureau dataset).

[105] *See id.* at 46.

period.[106] Extrapolating these trends forward, competitive product revenue would surpass that of market dominant revenue in FY2024. As the following chart shows, when that happens, under the Commission's proposed formula and seed value, making even generous assumptions for the CCM and CGD components, the appropriate share requirement will be less than 15%.

Figure 4: Proposed Appropriate Share Measure and Competitive Products' Growing Importance[107]



[106] *See* United States Postal Service, Revenue, Pieces, and Weight by Classes of Mail and Special Services (2015–2017).

[107] Analysis based on Library References PRC-LR-ACR/1 for FY 2007 - FY 2012, PRC-FinRpt13-LR1, PRC-LR-ACR/1 for FY 2014 - FY 2017, as well as Appropriate Share Formula proposed in Order No. 4742 at 38. *See* Library Reference UPS-RM2017-1/2, Dkt. No. RM2017-1 (Sept. 12, 2018) at "Appropriate Share Figures." Projections are based on extrapolating average growth rates, over FY2014 to FY2017, in revenues and volume variable plus product-specific costs at the product group level. *See id.*

The appropriate share will thus be perpetually low if the Commission seeds the formula at 5.5%. 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. UPS proposes an alternative methodology that involves averaging competitive products' share of Postal Service attributable costs. The average computed value of competitive products' attributable costs as a share of total attributable costs for the last three fiscal years—30.9%—should be considered a seed value in the Commission's formula starting in FY2018.[108]

If the Commission refuses to seed its formula at a meaningful level given the competitive products business' prominence today, and begin the calculation from FY2018, the only other solution that respects the statutory purpose is to design formulaic components that will actually measure the degree to which the competitive products business has grown within the Postal Service's overall operations since 2007. For the reasons explained below, however, CCM and CGD utterly fail to do so.

B. The Competitive Contribution Margin Component Serves No Statutory Purpose and Measures Nothing Meaningful

The Commission has only slightly modified its previously proposed Lerner Index to construct the Competitive Contribution Margin ("CCM"). Both the Lerner Index and the CCM purport to measure the Postal Service's exploitation of its market power by raising prices above competitive levels.[109] Both thus focus only on whether the Postal Service is setting competitive prices *too high*, and do nothing to prevent the setting of prices too low. Both act to offset the financial impact of reclassifying institutional costs

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108 *See infra* Part IV.

109 Order No. 4742 at 19.

as attributable. UPS raised all these issues when the Commission proposed to use the Lerner Index,[110] and the Commission has declined to address any of them. The Commission ignored the conceptual criticisms with this component, addressed only UPS's most minor, technical critiques,[111] and slapped a new label on essentially the same component.

Fundamentally, the problem with the Commission's CCM component is that it seeks to solve a problem that does not exist. No interested party has argued that the Postal Service is abusing its market power to set competitive prices too high, nor that this is even a possibility. Competition against the private sector provides the strongest safeguard against this concern, and the Commission has not cited any evidence that this is a danger. Moreover, the danger that PAEA sought to address with Section 3633(a)(1)–(3), as repeatedly recognized by the Commission and the D.C. Circuit, is underpricing by the Postal Service.[112] In Order No. 4742, the Commission has abandoned any attempt to police the Postal Service's underpricing of competitive products.

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[110] *See* 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 (Apr. 16, 2018) at 29–33.

[111] Order No. 4742 at 11–12 (discussing only UPS's criticisms of the "averaging" of revenue, and distortions caused by "reclassification of market dominant products as competitive").

[112] *See, e.g.*, *United Parcel Serv.*, 890 F.3d 1053, 1055 (D.C. Cir. 2018) ("Congress wished to 'ensure that the Postal Service competes fairly'—that is, without using revenues from market-dominant products subject to its monopoly power to defray costs competitive products would otherwise have to be priced to cover." (quoting " S. Rep. No. 108-318, at 15 (2004))); Order No. 1449 at 13 ("A primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace. . . . If the Postal Service's competitive products were not required to contribute an appropriate share towards the institutional costs of the enterprise, this could result in the market dominant products cross-subsidizing the fixed costs of the stand-alone competitive enterprise.").

There is strong evidence that the Postal Service has undertaken a systematic strategy of *underpricing* its competitive products in violation of these statutory goals. As noted above, it is now clear that volume growth in competitive products is largely focused on the lowest-contribution products sold by the Postal Service, even under its own accounting practices, which do not require these products to cover a reasonable share of common costs.[113] And that is when those products are not sold for a loss—such as was the case with sixteen competitive products in FY16 and seven competitive products in FY17.[114] This is the very strategy that sections 3633(a)(3) and (b) were intended to prevent by securing a statutory "*price floor*" for competitive products.[115] (emphasis added). Indeed, it should be noted that Congress set a statutory price cap for market dominant products,[116] but only a price *floor* for competitive products. There is no price floor for market-dominant products because Congress saw no danger of the Postal Service underpricing market-dominant products. Conversely, PAEA contains no price cap for competitive products because Congress saw no danger of the Postal Service *overpricing* competitive products.

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113 *See supra* p. 24 & note 61.

114 FY2017 ACD at 81; FY2016 POSTAL REGULATORY COMM'N ANNUAL COMPLIANCE DETERMINATION REP. 78 (Mar. 28, 2017).

115 *United Parcel Serv*., 890 F.3d at 1055–56.

116 *See, e.g.*, Order on the Findings and Determination of the 39 U.S.C. § 3622 Review, Dkt. No. RM2017-3 (Dec. 1, 2017) at 3 (explaining that, with PAEA, "Congress anticipated that the . . . [market dominant] price cap would enable the Postal Service to achieve sufficient revenues to cover all of its operating costs and statutorily mandated obligations while at the same time motivate the Postal Service to cut costs and become more efficient"); 39 U.S.C. § 3622 (d)(1)(A) (requiring that the "system for regulating rates and classes for market-dominant products shall . . . include an annual limitation on the percentage changes in rates to be set by the Postal Regulatory Commission that will be equal to the change in the Consumer Price Index").

As noted above, this underpricing is made possible by the problem that the Commission has refused to acknowledge in this docket and elsewhere for years: Competitive products are currently required to cover only a small fraction of their true share of institutional costs. No private competitor would be able to survive by covering only costs analogous to the Postal Service's "attributable costs," while ignoring the costs analogous to the Postal Service's "institutional costs." The reason is obvious: no private competitor has a statutory monopoly from which to extract revenue in order to cover the overall business's common costs.

Indeed, the CCM component would reward and facilitate the very behavior that motivated Congress to impose the requirement that competitive products cover an appropriate share of institutional costs. If the Postal Service were to decrease competitive product prices toward attributable costs in an effort to expand its share of the market, the CCM would call for a reduction in the share of institutional costs that those products were required to cover.

Worse still, even if CCM reliably measured Postal Service market power, the CCM component of the Commission's proposed formula would only meaningfully increase the appropriate share *after* the Postal Service succeeds in driving its private competitors out of business. Only then would the Postal Service have the market power to increase revenues without analogous growth in competitive product attributable costs—after going out of business, competitors would be wary to attempt re-entry knowing the Postal Service could simply repeat its strategy. While the Postal Service still has meaningful private competition, that competition itself is a much more effective check against overpricing than the Commission's proposed formula. The Commission's insistence on including this component implies only that the Commission expects the Postal Service to *succeed* in driving its private competition from the market.[117]

1. The Competitive Contribution Margin Assumes the Postal Service Is a Profit-Maximizing Entity

The relationship between price-cost margin and market power that underlies the theoretical validity of the competitive contribution margin ("CCM") as an indicator of market power only holds for a profit-maximizing entity. If a firm sets prices below their profit-maximizing level, the Lerner Index (or equivalently, the CCM) understates the degree of market power held by that firm. Consider a single-product firm that possesses market power in all relevant markets whose attributable cost is \$1.00 per unit at all levels of production. Suppose market conditions were such that the firm could maximize its profit by setting price at \$2.00 per unit (a price at which it would sell q units), but for whatever reason, the firm decides to set price at \$1.50 (where it would sell $q' > q$ units). Its CCM is then $(1.50q - 1q)/1.50q = 0.33$. Had it set the price at \$2.00, the CCM would be $(2.00q' - 1q')/2.00q' = 0.50$, substantially higher than the realized level of the CCM.

Thus far, the Commission has failed to consider the possibility that the Postal Service would do anything other than set prices for its competitive products at profit-

[117] As, it should be noted, does Amazon's expert in this docket, Professor Panzar. *See* Declaration of John C. Panzar on Behalf of Amazon Fulfillment Services, Inc., Dkt. No. RM2016-2 (Jan. 29, 2016) at 27–28 (arguing that a "monopoly industry configuration" with the Postal Service as the "sole provider in both [mail and package] markets" may be the most efficient outcome if the Postal Service's costs, including benefits derived from its monopoly business, are lower than UPS's). This is precisely the outcome that Congress sought to foreclose through PAEA.

maximizing (*i.e.*, contribution-maximizing) levels.[118] The only alternative discussed by the Commission is that of predatory pricing, or the practice of setting price below marginal cost.[119] The Commission has correctly noted that the anti-cross-subsidy provisions in section 3633 prohibit pricing below attributable costs, and it has used this fact to downplay concerns that the Postal Service would do anything other than maximize its contribution. It also notes that the CCM has always been positive, and thus predatory pricing has never been a concern.[120]

But this misses the point. The fact that the Postal Service has not, at least according to the Commission's restrictive measurement of attributable costing,[121] ever engaged in predatory pricing is *not* equivalent to a finding that it is maximizing profit on competitive products. As with the hypothetical example outlined above, there is a wide range of plausible behavior between profit-maximizing pricing and predatory pricing.

Moreover, as discussed *supra* at Section II.D, the Commission has failed even to consider the possibility that the Postal Service's pricing behavior departs from that of a profit-maximizing enterprise. As a result, the validity of CCM as an indicator of market power collapses. This is true not only in terms of measuring market power at any given point in time, but also in terms of measuring changes in market power over time, as required by the Commission's formula.

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118 The Postal Service has at times emphasized the upward trend in its "voluntary" contribution from competitive products. But, absent meaningful regulation, the Postal Service could abandon this "voluntary" contribution whenever it became convenient to do so.

119 Order No. 4742 at 48–50; Order No. 4402 at 36–37.

120 Order No. 4742 at 50 ("As shown in Figure IV-1, the Competitive Contribution Margin has never been negative. As a result, the Commission continues to find no evidence of Postal Service predatory pricing.").

121 *See supra* Section II.A.

2. The Attributable Cost Component of the Competitive Contribution Margin Measure Is Prone to Measurement Error

A second key concern with the CCM is that, even if one could reliably assume that the Postal Service acts as a profit-maximizing enterprise, the second key input to the CCM—attributable cost—is itself prone to measurement error and changes in definition which render the CCM unreliable as an indicator of changes to market power over time.

The prevailing measure of attributable costs used by the Commission is a target that never stops moving. Several petitions to change analytical principles used in costing have been filed in recent years, and upon Commission approval have had significant effects on the attributable costs of Competitive Products.[122] The measurement of attributable cost is intended to approximate the true cost to the Postal Service of providing an additional unit of a given product. As such, many recent changes in "attributable costs" do not actually reflect changes in cost, but rather changes to an administrative construct whose definition has shifted. This definition can be expected to continue to shift in the coming years.

The results of the most notable recent change to the definition of attributable costs underline the problems with the CCM. The CCM and Lerner Index moved in virtual lockstep from FY2007–2016.[123] The average difference between the percentage

[122] *See, e.g.*, Order Approving Analytical Principles Used in Periodic Reporting (Order No. 2792), Dkt. No. RM2015-7 (Oct. 29, 2015); Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (Order No. 3506), Dkt. No. RM2016-2 (Sept. 9, 2016); Order on Analytical Principles Used in Periodic Reporting (Order No. 3973), Dkt. No. RM2016-12 (June 22, 2017); Order on Analytical Principles Used in Periodic Reporting (Order No. 4259), Dkt. No. RM2017-8 (Dec. 1, 2017).

[123] Order No. 4742 at 17 (Table IV-1).

change in CCM and the percentage change in the Lerner Index was 0.2 percentage points during that period.[124] In FY2017, the difference was 6.2 percentage points—the Lerner Index increased by 7.5%, indicating an above-average increase in market power, whereas the CCM increased by 1.3%, suggesting the market power was essentially unchanged.

The reason for this divergence is simple: the definition of attributable costs changed. In FY2016, attributable costs were equal to the sum of volume variable and product-specific costs, while in FY2017 attributable costs included product- and class-level inframarginal costs in addition to volume variable and product-specific costs. The Lerner Index suffers from many of the same flaws as the CCM; UPS does not think that the Lerner Index should play any role in setting appropriate share either.[125] But the CCM introduces yet another flaw—changes to the definition of attributable costs have *nothing* to do with market power, but have large effects on the CCM component.

Relatedly, the CCM component blunts the effect of changes in cost attribution analytical principles, and it would exacerbate the Postal Service's incentive to under-report competitive costs. Any increase in the attributable costs of competitive products results in, all other things being equal, an offsetting decrease in the CCM that severely mitigates changes that should increase 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. Assume that all other factors

[124] *See id.* The average absolute difference was 1.4 percentage points. *See id.*

[125] *See* UPS Initial Comments, Dkt. No. RM2017-1, at 29–34.

(competitive product revenues, competitive market output, and institutional costs) remain unchanged in real (inflation-adjusted) terms. Given current levels of competitive product revenues and attributable costs, the \$200 million increase in competitive product attributable costs would decrease the CCM by 3%, 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.[126]

Accordingly, the long-run net effect of any change in analytical principles—whether it increases or decreases the attributable costs of competitive products—is roughly cut in half by the countervailing changes to the CCM. The CCM serves as a sort of shock absorber to blunt the impact on the Postal Service of increased cost attribution to competitive products.

The Commission's proposal thus inexplicably sets sections 3633(a)(2) and (3) at odds, each undermining the other. The tension that the Commission's interpretation would create between these two provisions demonstrates the interpretation's weakness. The Commission's interpretation of the statute embodied in the formula implies that the Commission does not believe that sections 3633(a)(2) and (3) are meant to work in harmony to require the Postal Service to cover *all* costs associated with competitive products with competitive revenues.

C. The Competitive Growth Differential Component Serves No Statutory Purpose and Measures Nothing Meaningful

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[126] The CCM is currently (20,690 – 13,884)/20,690 = 0.329. The hypothetical \$200M increase in competitive product attributable costs would lower the CCM to (20,690 – 14,084)/20,690 = 0.319, a 3% decrease (0.319/0.329 – 1 ≈ -0.029). Given an FY2019 appropriate share of 8.8% under the Commission's proposal, and assuming no other changes, this would lower the formula-based appropriate share by 0.3% points (8.8% * (1 – 0.029) = 8.5%, using the Commission's rounding convention). As institutional costs were \$29,700 million in FY2017, this would lower the required contribution by 0.3% x (29,700 – 200) = \$89 million.

Finally, the Commission proposes to peg the appropriate share to the difference between the Postal Service's competitive revenue growth rate and the average revenue growth rate of its competitors, weighted by the Postal Service's market share.[127] If the Postal Service's competitive revenue grows faster than the revenue of its private competitors in a given year, then the appropriate share will be adjusted upwards. For example, if the Postal Service's competitive revenues increase 5% in 2018, and the revenue of the remainder of the competitive marketplace grows by 3%, and the Postal Service has 25% market share, then the appropriate share will be multiplied by a factor of 1.005.[128] The Commission reasons that this component will track the degree to which the competitive products business is expanding into the competitive marketplace.

The difference between the Postal Service's revenue growth and that of its competition has nothing to do with the "appropriate share" of institutional costs that should be covered by competitive revenues. Whether the Postal Service's revenue is growing faster or slower than that of its competition says absolutely nothing about the extent to which the competitive products business is benefitted by, and relies upon, and *is causing* institutional costs for which it bears no financial responsibility.

Worse, this component of the Commission's proposed formula does nothing to protect fair competition in the competitive marketplace. By measuring market share by revenue, rather than volume, the CGD component incentivizes the Postal Service to underprice competitive products. So long as *revenue* growth is no greater than its

[127] *See* Order No. 4742 at 26–27.

[128] This hypothetical assumes that the Competitive Contribution Margin is unchanged.

private competitors, the CGD will have no effect on the appropriate share no matter how much the Postal Service's actual market share by *volume* grows.

Perversely, while its private competitors are still experiencing revenue growth, the Postal Service will not be required to cover a meaningful share of institutional costs with competitive revenues, no matter how large its competitive products business grows. It is only if the Postal Service is successful in displacing private competitors with its underpriced products, driving down its rivals' revenues, that the appropriate share will meaningfully rise due to the CGD component.

Finally, there is no reason to weight the CGD measure by the Postal Service's overall market share. This adjustment has no apparent conceptual justification, and has the practical effect of reducing the effect of the CGD component on the appropriate share across the board. This adjustment does nothing but bias the Commission's formula toward its seed value of 5.5% regardless of other market conditions.

D. The Commission's Equal Weighting of the Competitive Contribution Margin and the Competitive Growth Differential Is Arbitrary

The Commission has proposed to weight the CCM and CGD components equally.[129] The Commission noted that arbitrary weighting of the components would be problematic,[130] but then goes ahead and sets arbitrarily equal weights.[131] The Commission justified these equal weights "from a legal perspective" because the two components measure two different market conditions.[132] CCM measures "market

[129] *See* Order No. 4742 at 43.

[130] *See id.* at 44 ("[T]he assignment of weights at the component level, without unique economic justification, is inconsistent with economic practice.").

[131] *See id.* at 43.

[132] *See id.*

power with respect to consumers and [the CGD] measures the Postal Service's market position with respect to competitors"[133] and "from an economic perspective" because, apparently, there is no reason not to,[134] both components incorporate a measure of revenue.[135] This is insufficient. The weighting of the formulaic components will have a significant effect on the appropriate share measure, and it deserves serious consideration. The following chart shows the difference in the output of the formula assuming three different weightings, starting from the Commission's proposed 5.5% seed value: (1) 10% CCM and 90% CGD, (2) 50% CCM and 50% CGD, and (3) 90% CCM and 10% CGD.[136]

[133] *Id.* at 43.

[134] *Id*. at 44–45 ("Without an economic rationale or justification, the application of unique weights to each variable would be artificial and thus inappropriate.").

[135] *Id.* at 45–46 (asserting that assigning unique weights at the component level "would be inconsistent with statistical practice and would diminish the accuracy of the formula by changing how the components interact with each other").

[136] The Commission's proposed formula gives each of the two components equal weights, which is equivalent to multiplying each captured in the "50% CCM and 50% CGD" scenario. The other two hypothetical scenarios vary the relative importance of each measure in alternative formulations of the Commission's revised formula-based approach, while keeping the aggregate "weights" the same. UPS does not endorse either of the alternative formulations presented here, and also notes that there is no economic or statistical principle preventing the Commission from having aggregate weights that exceed one.

Figure 5: Proposed Appropriate Share Under Various Weighting Scenarios[137]

Moving from the scenario that weights CGD more heavily to one that weights CCM more heavily increases competitive products' FY2019 responsibility by $900M.[138] This disparity will only grow, if has been the pattern since FY2007, the CCM growth rate continues to exceed the CGD.[139]

Because of these effects on the ultimate appropriate share determination, the formula's components should be weighted to the extent one is more connected to the

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[137] Analysis based on PRC-LR-ACR2007-2017, as well as Appropriate Share Formula proposed in Order No. 4742 at 38. *See* Library Reference UPS-RM2017-1/2, Dkt. No. RM2017-1 (Sept. 12, 2018) at "Appropriate Share Figures.xlsx."

[138] This assumes Institutional Costs will be $30B. The appropriate share under the hypothetical scenario that weights CGD more heavily would be 7.5%, while under the scenario that weights CCM more heavily, the appropriate share would be 10.5%.

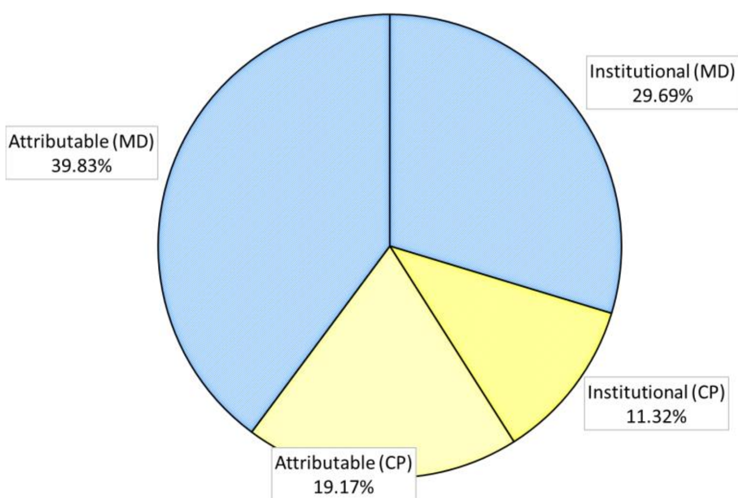
[139] The average percent change in the CCM over the last ten years was 4.2%, ranging as high as 18.1%. The CGD has averaged 1.2% over the past ten years, never exceeding 2.7%.

statutory purposes embodied in section 3633. The Commission has entirely declined to consider the relative extent to which its proposed measures are tied to the statutory purpose. As such, UPS suggests that the Commission's weighting is necessarily arbitrary unless and until the Commission performs such analysis.

IV. <u>THE COMMISSION SHOULD SET THE APPROPRIATE SHARE PERCENTAGE AS A THREE-YEAR AVERAGE OF ATTRIBUTABLE COST SHARES</u>

There is a simple solution, which is what UPS has proposed from the outset of this docket: *Competitive products should be required to generate revenues sufficient to cover a share of common costs that is commensurate with their contribution to overall attributable costs*. This would look like the following:

Figure 6: Cost Attribution Under UPS Proposal[140]



[140] *See* Library Reference PRC-LR-ACR2017-1FY17-CP-1, Dkt. No. ACR2017 (Dec. 29, 2018) at "17 Summary_LR1.xlsx." Assuming 27.6% appropriate share, based on an average of competitive products' share of attributable cost in years FY2013 to FY2015.

As in this graph, the share of institutional costs borne by competitive products should be roughly identical to their share of attributable costs.[141] The best proxy for estimating "the degree to which any costs are uniquely or disproportionately associated with any competitive products" pursuant to the PAEA[142] is to use the share of total attributable costs for which competitive products are responsible. This approach utilizes the most robust processes that exist today for estimating the cost impact of competitive products on the Postal Service's business. This approach would serve the statutory objectives of the appropriate share requirement. It would promote fair competition and financial responsibility while also preventing the price gouging of market-dominant customers.[143] It should be adopted.[144]

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[141] Moreover, to the extent products are re-classified from market-dominant to competitive, of course these shares should be changed. This is a significant concern given that many market-dominant products have been transferred to competitive products in recent years. *See, e.g.*, Order Conditionally Granting Request to Transfer Commercial Standard Mail Parcels to the Competitive Products List, Dkt. No. MC2010-36 (Mar. 2, 2011) at 1–2 (explaining proposed re-classification of Standard Mail Fulfillment Parcels from market-dominant to a sub-category of competitive Parcel Select); Order Approving Price Adjustment for First-Class Package Service Product, Dkt. No. CP2017-230 (Aug. 9, 2017) at 4 (approving re-classification of First-Class Mail Retail (Single-Piece) to competitive products).

[142] 39 U.S.C. § 3633(b).

[143] Notably, it would still not entirely *ensure* fair competition. Due to the natural economies of scale and scope in the delivery industry, truly fair competition would require the Postal Service to ensure competitive products cover stand-alone cost—which would, as an economic matter, be higher than the pro-rata proposal described here.

[144] UPS specifically proposes that the appropriate share be a three-year "trailing average" of the competitive cost attribution percentage. For example, in 2018, the appropriate share should have been 29.4%—the average of the competitive attributable cost shares for the three most recent years for which data would have been available at the time the FY2018 appropriate share would have been set. *See* FY2014–16 U.S. POSTAL SERV. PUBLIC COST & REVENUE ANALYSIS REP. 3 (stating that competitive products' share of attributable costs was 28.0% in 2014, 29.6% in 2015, and 30.7% in 2016).

Critics of this approach have asserted that it amounts to fully distributed costing (also known as fully allocated costing), which they assert is a "discredited" practice.[145] UPS's proposal, however, does not amount to fully distributed costing. Under fully allocated costing, every cost is assigned to a specific product or service, and each product or service must fully cover its "allocated" costs.[146] By analogy, if *all* Postal Service costs were attributed to individual products, then the Postal Service would have fully allocated its costs in this way.

But UPS does not propose that the Postal Service allocate all of its costs to specific products. UPS's proposal would, rather, require the competitive products business *as a whole* to cover the relevant share of costs. The Postal Service would retain the freedom to cover the competitive product business' share of institutional costs however it wishes. Higher-margin competitive products could contribute a greater share. Lower-margin products would not be required to contribute more than possible, given market conditions, as might be the case in a system of fully allocated costs. The result would be no different from what UPS and other private competitors must do—they must decide which competitive products can recover which volume of common costs—and would thus promote fair competition.

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[145] Panzar Reply Declaration, Dkt. No. RM2017-1 (Mar. 9, 2017) at 2. Neither authority cited by Panzar supports his assertion that fully allocated pricing is "discredited." In *NAGCP*, the Supreme Court merely held that the Postal Rate Commission "reasonably construed" its governing statute by selecting a "two-tier" ratesetting structure. Nat'l Ass'n of Greeting Card Publishers v. U.S. Postal Serv., 462 U.S. 810, 833 (1983). Moreover, the Postal Service itself believed all variable costs should be attributed at that time. *Id.* at 829 ("The Postal Service contends that Congress intended long-term and short-term variable costs to be attributed . . . .").

[146] *See, e.g.*, URBAN MASS TRANSP. ADMIN., U.S. DEP'T OF TRANSP., FULLY ALLOCATED COST ANALYSIS: GUIDELINES FOR PUBLIC TRANSIT PROVIDERS 1 (1987), available at https://rosap.ntl.bts.gov/view/dot/474/dot_474_DS1.pdf.

If the Postal Service stopped delivering market dominant products at all, competitive products would by necessity cover all institutional costs. Under the Commission's proposal, however, if competitive products accounted for 90% of the Postal Service's attributable costs, market dominant products would still have responsibility for a majority of institutional costs. Common sense argues that as competitive products account for a larger and larger share of the Postal Service's operations, those products should have a correspondingly greater responsibility to cover institutional costs. The Commission's proposal makes no effort to adjust the appropriate share to this reality.

Moreover, increasing the "appropriate share" to reflect attributable cost shares will encourage the Postal Service to be more disciplined and rational when making future investment decisions. Increasing the contribution percentage does not in any way increase the *total costs* the Postal Service must recover. These costs already exist today, but they are disproportionately placed on the market-dominant side of the ledger. In the last decade, much of the Postal Service's growth in package delivery was made possible by exploiting excess capacity. But the Postal Service is at or near an inflection point where future growth will require major investments. These investments are going to be geared toward competitive products, and they should be paid for by competitive products.[147] These investments are well underway, as can be seen in the recent growth in institutional costs.[148]

UPS has shown that this was the solution adopted by the European Commission when it faced a similar regulatory landscape. Both Congress and the European Commission enacted similar goals and methods of ensuring fair competition despite the presence of a dominant postal operator: (1) both require extensive monitoring and regulation of the dominant operator to prevent private competition from being impaired or distorted;[149] (2) both require cost-based pricing;[150] and (3) both mandate separate accounting treatment for "reserved" or market-dominant products and competitive products to ensure that competition is not distorted.[151]

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[147] In the absence of a robust appropriate share requirement, the Postal Service has an incentive to structure its investments (and costs) to be more institutional than attributable. For instance, the Postal Service might prioritize investments that would be easier to classify as fixed or "common" costs, as opposed to investments that are more likely to be traceable to specific products. If left unchecked, this incentive will lead to an inefficient cost structure that is weighted towards fixed costs and excess capacity. A significant appropriate share requirement also serves as a check on potential cross-subsidization of competitive products by market-dominant products. *See* 39 U.S.C. § 3633(a)(1).

[148] *See infra* Section II.A.

[149] *Compare* H.R. REP. NO. 109-66 at 44 (2005) ("Highlights of the Postal Accountability and Enhancement Act include: . . . Ensuring Fair Competition and Accountability: Under the legislation, the Postal Service will 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."), *with* CMM'N OF THE EUROPEAN CMTYS., DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL AMENDING DIRECTIVE 97/67/EC, CONCERNING THE FULL ACCOMPLISHMENT OF THE INTERNAL MARKET OF COMMUNITY POSTAL SERVICES 7 (2006) ("European Postal Directive") ("Member States must . . . ensure adequate monitoring of the behaviour of the likely dominant operator in order to safeguard effective competition.").

[150] *Compare* S. REP. NO. 108-318 at 9–10 (2004) ("Identifying costs which can reliably be found to have been caused by each specific subclass and service is essential to maintaining economically efficient rates and avoiding inequitable cross-subsidization, which occurs when rates from one product are used to pay costs associated with another."), *with* European Postal Directive at 22 ("[P]rices must be cost-oriented . . . .").

[151] *Compare* S. Rep. No. 108-318 (2004) at 50 ("The intent of [the Competitive Products Fund] section is to level the playing field for the Postal Service and its competitors in

The European Commission follows a cost-allocation procedure similar to that mandated by 39 U.S.C. § 3633. First, the European Commission attributes costs to particular products according to direct and indirect causal relationships, which resembles PAEA's mandate regarding attributable costs.[152] Second, the European Commission mandates that the remaining unattributed costs (which it calls "common costs"), which resemble institutional costs, be allocated according to the share of each product's causally allocated costs:

> [W]hen neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated on the basis of a general allocator computed by using the ratio of all expenses directly or indirectly assigned or allocated, on the one hand, to each of the universal services and, on the other hand, to the other services.[153]

Thus, if the reserved products' share of causally allocated costs were 57%, then reserved products would also be required to cover 57% of common costs.

Postal regulators in the EU and in the U.S. face similar problems in allocating fixed costs between competitive and reserved/market-dominant products. The solution to this problem is important on both continents because the large amount of unattributed costs "gives significant leeway for anti-competitive conduct," a result contrary to the

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the competitive product market by requiring the Postal Service to keep separate financial accounts for market-dominant and competitive products. Separation of accounts also protects taxpayers and the interests of postal consumers in the market-dominant category."), *with* European Postal Directive at 23 ("The universal service providers shall keep separate accounts within their internal accounting systems to clearly distinguish between services and products which receive or contribute to the financial compensation for the net costs of the universal service and those services and products which do not.").

[152] *See* European Postal Directive at 23.

[153] *Id*.

purposes of postal law in both places.[154] In light of these similarities, it is significant that the EU resolves this issue by using attributable cost share as a proxy to allocate institutional costs. The Commission has provided no persuasive reason not to follow this path.

Finally, if the Commission declines to use attributable cost as the relevant metric, the appropriate share requirement should be set to equal the revenues from competitive products as a percentage of total revenues. Like attributable cost shares, this measure reflects the growing importance of competitive products to Postal Service income. On a product-by-product basis, revenues generally equal or exceed attributable costs, and so revenue shares are correlated to some degree with competitive products' increasing role as a driver of growth in institutional costs. Because revenues reflect markups over attributable cost, they reflect to some degree differences across products in willingness to pay.

The Commission asserts that "competitive products' share of revenue is driven in large part by market dominant revenue, which has been declining due to a decline in demand for market dominant products. . . . [T]his increase in revenue share has little [to] do with the criteria of 39 U.S.C. 3633(b) . . . ."[155] This is plainly incorrect. From FY2008 to FY2017, competitive products' share of revenue has grown from 11% to 30%. However, even if market dominant revenues had stayed at FY2008 levels,

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[154] John Hearn, *The Accounting Implications of the EU's Third Postal Directive*, COMPETITION AND REGULATION IN THE POSTAL AND DELIVERY SECTOR 336, 339 (Michael A. Crew & Paul R. Kleindorfer eds., 2008).

[155] Order No. 4742 at 41.

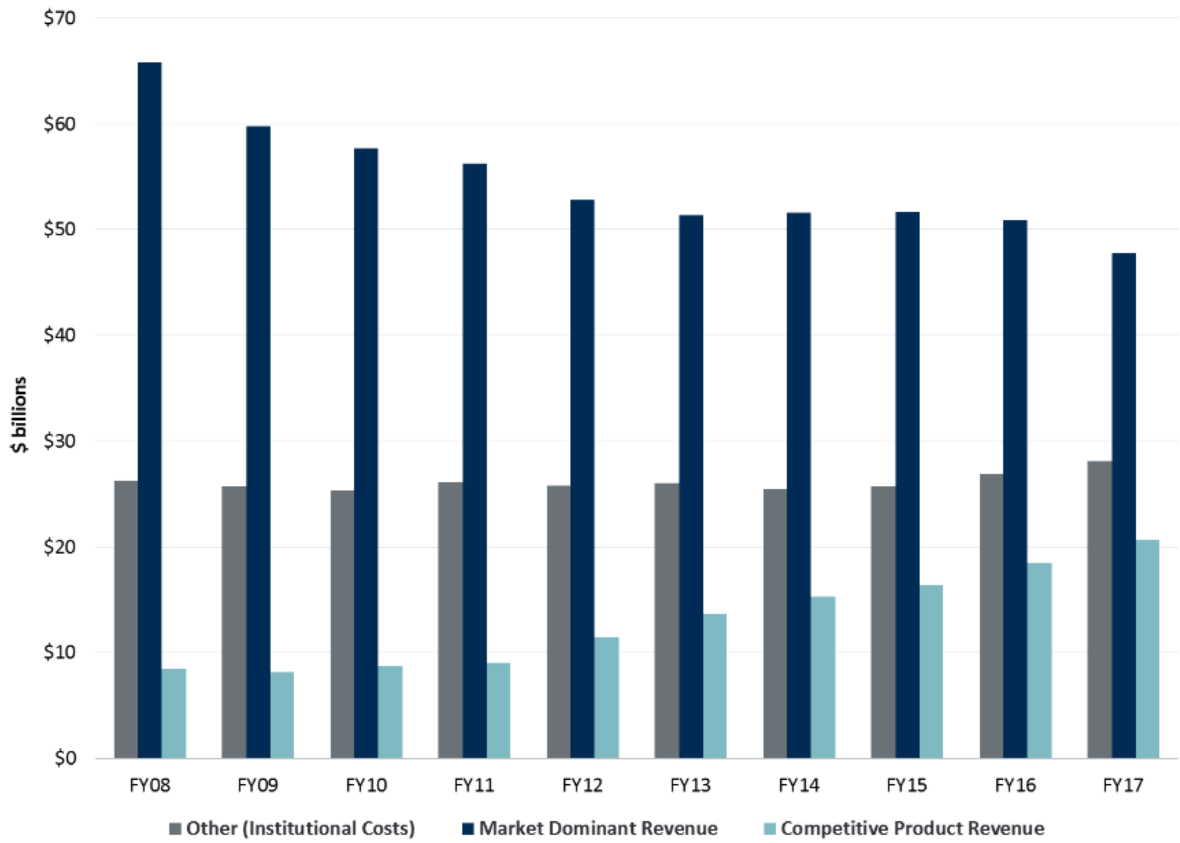
competitive products' share would have grown from 11% to 24%.[156] The idea that the growth of competitive products' importance is driven primarily or "in large part" by the woes of the market dominant business is clearly incorrect.[157] This argument applies equally for competitive products' share of total attributable costs.

Furthermore, as the market dominant business has declined, and the competitive products business has risen, total institutional costs have grown in recent years. Figure 7 below shows the relative changes of total institutional costs, and revenues of the two businesses:

[156] In FY2008, market dominant revenues were \$65.8B while competitive product revenues were \$8.4B. By FY2017, market dominant revenues had decreased to \$47.8B while competitive product revenues had grown to \$20.7B. 8.4/(8.4 + 65.8) ≈ 11%. 20.7/(20.7 + 47.8) ≈ 30%. 20.7/(20.7 + 65.8) ≈ 24%. *See* FY2008 U.S. Postal Serv. Cost & Revenue Analysis Rep.; FY2017 U.S. Postal Serv. Cost & Revenue Analysis Rep.; FY2008 U.S Postal Serv. Cost Segments & Components Rep.; FY2017 U.S. Postal Serv. Cost Segments & Components Rep.

[157] *See* Order No. 4742 at 41.

Figure 7: Market Dominant and Competitive Product Revenues[158]



As can be seen in this figure, despite the dramatic decline of the market dominant business, the Postal Service's total institutional costs have remained roughly steady for the last decade, and have recently grown along with the competitive products business. The growth of the competitive products business has displaced the decline of the market dominant business. As a result, the competitive products business is

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[158] Sources & Notes: FY2008–2017 U.S. POSTAL SERV. COST & REVENUE ANALYSIS REPS., FY2008–2017 U.S. POSTAL SERV. COST SEGMENTS & COMPONENTS REPS. Institutional Costs ("Other Costs") as reported in the Cost Segments and Components Reports are equal to Total Costs – (Total Volume Variable Costs + Total Product Specific Costs). In this figure, Institutional Costs do not include Cost Segments 18.3.3, 18.3.4, 18.3.6, and 18.3.7, which all constitute large portions of costs that the Postal Service considers "uncontrollable." In this figure, Market Dominant Revenue is the revenue reported for "Total Market Dominant Mail and Services" as reported in the annual CRA. Competitive Product Revenue is the revenue reported for "Total Competitive Mail and Services" as reported in the annual CRA.

necessarily relying upon, benefitting from, and causing a greater and greater share of total institutional costs.

Finally, if it is deemed necessary, the Commission could phase in the increase of the appropriate-share percentage. If the Commission chooses this approach, the Commission could adopt a rule that would set a new requirement for the next fiscal year that is a weighted average of (i) the newly calculated three-year moving average of attributable cost shares and (ii) the current appropriate share level. For example, with the current 5.5% requirement and a three-year moving average attributable cost share for 2015–2017 at 30.9%, the Commission could set the 2019 requirement at 18.2% (*i.e.*, 5.5 + 30.9)/2.[159]

CONCLUSION

UPS respectfully requests that the Commission set the FY2019 appropriate share at 30.9%, and adjust that share annually based on the competitive products business's three-year running average share of total attributable costs.

[159] Competitive Products' share of attributable cost was 29.6% in FY15, 30.6% in FY16, and 32.5% in FY17. *See* Library Reference PRC-LR-ACR2017-1, Dkt. No. ACR2017 (Mar. 29, 2018) at "17 Summary_LR1.xlsx"; Library Reference PRC-LR-ACR2016/1, Dkt. No. ACR2016 (Mar. 28, 2017) at "16 Summary_LR1_.xlsx"; Library Reference PRC-LR-ACR2015/1, Dkt No. ACR2015 (Mar. 28, 2016). For purposes of illustration, assume then that the FY2018 share of attributable cost for competitive products comes in at 34%. The 2016–2018 average of attributable cost shares would then be equal to 32.4%. The 2020 appropriate share requirement would then be (18.2 + 32.4)/2 = 25.3%.

Respectfully submitted,

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