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

COMMENTS OF THE UNITED STATES POSTAL SERVICE
IN RESPONSE TO ORDER NO. 4742

In Order No. 4402, the Commission proposed a complete overhaul of its approach to determining the institutional cost contribution requirement for competitive products. In place of the current rule, which requires competitive products collectively to contribute at least 5.5 percent of the Postal Service's total institutional costs, the Commission proposed an entirely new, formula-based approach that would change the requirement every year based on a calculation of the percentage changes in certain market factors.[1] Various industry stakeholders submitted comments in response to Order No. 4402, representing a broad spectrum of viewpoints on competitive product pricing principles.[2] Although the commenters expressed differing opinions as to

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[1] Order No. 4402, Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Feb. 8, 2018).

[2] Specifically, the following comments and declarations were submitted in this docket on April 16, 2018: Comments of Amazon Services, Inc. on Order No. 4402 [hereinafter "ASI Comments"]; Comments of American Consumer Institute Center for Citizen Research Regarding Docket No. RM2017-1; Comments of the Greeting Card Association; Comments of the Parcel Shippers Association [hereinafter "PSA Comments"]; Comments of Pitney Bowes Inc. [hereinafter "Pitney Bowes Comments"]; Public Representative Comments in Response to Notice of Proposed Rulemaking [hereinafter "PR Comments"]; Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products [hereinafter "UPS Comments"]; Comments of the United States Postal Service in Response to Order No. 4402 [hereinafter "Postal Service Comments"]; Declaration of Soiliou Daw Namoro for the Public Representative [hereinafter

whether the minimum contribution requirement should be retained in its current form, eliminated, or increased, there was widespread agreement on one point: the quantitative formula the Commission proposed to set the minimum contribution level was flawed, and could lead to inaccurate results that would be inconsistent with the purpose of the appropriate share requirement.[3]

The Postal Service appreciates the Commission's effort to address some of these concerns in Order No. 4742.[4] The changes to the originally proposed formula set forth in the Revised Notice of Proposed Rulemaking do offer some improvements over the approach first proposed in Order No. 4402. Unfortunately, the revised proposal does not resolve the underlying concerns that would accompany any rigidly quantified, formula-based approach to setting the appropriate share requirement. Instead, as many commenters have asserted, the statutory factors (along with the Commission's own findings) support the conclusion that the Commission should eliminate the requirement entirely, as the statute plainly authorizes it to do.[5] Imposing a new rule that would have the effect of raising a contribution floor that is no longer necessary would benefit only the Postal Service's private competitors – who are already thriving in the current competitive market without such regulatory tinkering – to the detriment of rate-

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"Namoro Declaration"]; Declaration of Robert J. Shapiro [hereinafter "Shapiro Declaration"]; Declaration of J. Gregory Sidak on Behalf of United Parcel Service [hereinafter "Sidak Declaration"].

[3] *See, e.g.,* ASI Comments at 38 (asserting that the proposed formula-based approach "does not overcome the inherent defects of minimum contribution requirements and may inadvertently introduce additional risks"); Pitney Bowes Comments at 12-13 (describing several risks inherent in the proposed formula-based approach); PR Comments at 4-7 (arguing that the proposed approach "is potentially inaccurate in several circumstances and therefore arbitrary").

[4] Order No. 4742, Revised Notice of Proposed Rulemaking, PRC Docket No. RM2017-1 (Aug. 7, 2018).

[5] *See, e.g.,* ASI Comments at 31; PSA Comments at 2-3; Postal Service Comments at 1-2, 24.

paying customers, the general public, and the market as a whole. Should the Commission adopt the revised rule, the Postal Service repeats its recommendation that the starting point for calculations of the formula should be the 5.5 percent requirement that applied in Fiscal Year (FY) 2017.

I. ANY FORMULA-BASED APPROACH TO SETTING THE MINIMUM CONTRIBUTION REQUIREMENT IS LIKELY TO BE FLAWED IN APPLICATION, PARTICULARLY WHERE, AS HERE, THE REQUIREMENT IS NO LONGER NECESSARY TO PROTECT COMPETITION

Under the Postal Accountability and Enhancement Act (PAEA), competitive products are collectively required to cover "what the Commission determines to be an appropriate share of the institutional costs of the Postal Service."[6] The purpose of the appropriate share requirement is to complement the other two provisions of Section 3633 in protecting fair competition, essentially by serving as a mechanism by which the Commission may correct a market imbalance in favor of the Postal Service if such an imbalance is found to exist.[7] Every five years, the Commission must review the institutional cost contribution requirement based on "all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products." Based on this review – in other words, based on its determination as to whether a market imbalance exists in favor of the Postal Service that needs to be

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[6] 39 U.S.C. § 3633(a)(3).

[7] *See* Initial Comments of the United States Postal Service, PRC Docket No. RM2017-1 (Jan. 23, 2017), at 2-6.

corrected – the Commission must decide whether the requirement "should be retained in its current form, modified, or eliminated."[8]

In past reviews of the appropriate share requirement, the Commission first established, and then maintained, the current fixed 5.5 percent minimum.[9] After beginning its latest periodic review in this docket in late 2016, and reviewing the first two rounds of comments submitted by various stakeholders in the earlier stages of this rulemaking proceeding, the Commission ultimately decided not to adopt any of the suggestions put forth by the commenters. Instead, under the proposed rule announced in Order No. 4402, the Commission proposed to set the minimum share for competitive products on an annual basis as part of its Annual Compliance Determination (ACD), based on a formula combining the results of two components: the Postal Service's "Lerner Index" and the "Competitive Market Output" (CMO).[10]

Several parties objected to the proposed use of a formula-based, fully quantitative approach to setting the appropriate share, and raised specific critiques of the Lerner Index, the CMO, or the combination of these two components.[11] The Postal

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[8] 39 U.S.C. § 3633(b).

[9] Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, PRC Docket No. RM2007-1 (Oct. 29, 2007), at 91-92; Order No. 1449, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, PRC Docket No. RM2012-3 (Aug. 23, 2012), at 1-2.

[10] Order No. 4402 at 29-30.

[11] *See, e.g.,* PR Comments at 4-7 (expressing concerns that a lack of relevant data "has led to formulation of a model that could generate counter-intuitive results in several circumstances of future industry growth"); Pitney Bowes Comments at 4 (noting that "the formula runs the risk of becoming unduly rigid and missing key, potentially unpredictable or unknown, factors"); ASI Comments at 38 ("The formula-based approach does not overcome the inherent defects of minimum contribution requirements and may inadvertently introduce additional risks. [It] may be heavily affected by extraneous factors, for example, changes in demand elasticities for competitive parcel products, entry of new competitors, pricing

Service agrees with many of those concerns. Specifically, although the Commission's revised proposal improves upon the original formula set forth in Order No. 4402, as explained below, the Postal Service believes questions remain as to the accuracy of the results that it will generate. Indeed, no mathematical formula could fully reflect the market conditions under which competitive products' potential to contribute to institutional costs might change.[12] Hence, it is questionable whether the appropriate share should be determined solely by reference to a formula.

More fundamentally, the appropriate share requirement is no longer necessary as a regulatory tool to level the competitive playing field, which is robustly competitive and does not need to be leveled; indeed, as the Commission found, far from enjoying a market imbalance in its favor, the Postal Service continues to operate at a net competitive disadvantage.[13] As explained by the Postal Service and many other

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strategies of private carriers, volume increases in segments where the Postal Service has only minimal share, or decreases in the total revenues of the Postal Service's competitors").

[12] *See* Postal Service Comments at 16.

[13] Order No. 4742 at 57-58; Order No. 4402 at 68. If anything, the Commission's update of the Federal Trade Commission's (FTC's) 2008 findings significantly understates the Postal Service's disadvantage. The FTC did not include or quantify the impact of a host of mandates and burdens that apply uniquely to the Postal Service, such as key elements of its universal service obligation, its inability to set the terms of post-retirement benefits and to manage their assets, and the application of numerous federal employment, contracting, and administrative laws. *Compare* FTC, Accounting for Laws That Apply Differently to the United States Postal Service and Its Private Competitors 56-59 (2007), *with* Postal Regulatory Comm'n, Annual Report to the President and Congress, Fiscal Year 2017 (2018), at 46-53, *and* U.S. Postal Serv., Analysis of Additional Postal Service Activities That Could Qualify for Reporting Under 39 U.S.C. § 3651(b)(1)(C), *attached to* Order No. 2163, Notice Establishing Docket Concerning the Scope of Public Service or Activity Cost Reporting Under 39 U.S.C. § 3651(b)(1)(C), PRC Docket No. PI2014-1 (Aug. 20, 2014). The cost impact of these burdens would far outweigh the one-sided, inflated "subsidy" figures that certain UPS-affiliated parties have asserted, even leaving aside the patent flaws in their methodology. *See generally* Shapiro Declaration; *see also* Sidak Declaration at 13-14. Needless to say, the FTC's overall finding of a net disadvantage would remain valid even if a fuller revision were undertaken.

commenters throughout the course of this proceeding, the most reasonable course of action would be reduction or elimination of the minimum contribution requirement.[14]

Nevertheless, the Commission's proposed formula is clearly superior to the alternative appropriate share calculations proposed by UPS in this proceeding as a means of effectuating the Commission's responsibility under Section 3633(b).[15] Therefore, if the Commission declines to reduce or eliminate the appropriate share requirement, the Commission can improve its proposed formula to make it more suitable. To address the Postal Service's fundamental concern that this fully quantitative, formula-based approach might not fully capture the prevailing competitive conditions in the market (and the Postal Service's position within that market), the Commission should recognize the possibility that future developments might render the approach inappropriate as the sole basis for making its Section 3633(a)(3) determination, even in advance of the next Section 3633(b) review.

II. SUBSTITUTION OF THE COMPETITIVE CONTRIBUTION MARGIN FOR THE LERNER INDEX

The Commission's initial proposed formula for calculating the minimum contribution relied on an annual measurement of two variables: (1) the percent change in the Postal Service's Lerner Index relating to competitive products; and (2) the percent change in Competitive Market Output.[16] The Lerner Index was a proposed proxy for the

[14] *See* Postal Service Comments at 3-8.

[15] *See generally* Postal Service Comments at 9-13 (explaining that the Commission properly rejected alternative approaches that fail to address Section 3633(b)'s required factors).

[16] Order No. 4402 at 29.

Postal Service's market (pricing) power, and CMO was a proposed measure of the total size, by revenue, of the domestic package delivery market in which the Postal Service's competitive products compete.[17] According to the Commission, the further a firm's Lerner Index shifts away from zero and towards one, the more market power that firm possesses. The Commission proposed to create a Lerner Index for the Postal Service's competitive products as a whole by dividing the sum of all competitive product volume-variable costs by the sum of all competitive product volume. Because the Postal Service Lerner Index (as calculated in this fashion) has grown over time, the Commission concluded in Order No. 4402 that the Postal Service's market power has grown since the initial adoption of the 5.5 percent appropriate share requirement.[18]

As the Postal Service pointed out in its comments addressing Order No. 4402, a Lerner Index does not consider the need of a firm to cover fixed costs, operate at efficient scale, or price to market; for those reasons, it can be misleading to attribute a firm's above-marginal-cost pricing, as measured by a Lerner Index, to the exercise of monopoly power.[19] Other parties identified additional shortcomings. UPS, for example, described a Lerner Index as a tool used to ensure that a firm is not exploiting its market power by charging inflated prices to consumers; as such, it does not measure (nor is it intended to measure) whether the firm's pricing behavior is harming competition or competitors.[20] In explaining their concerns about use of the Lerner Index, the Public

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

[18] *Id.* at 19-21.

[19] Postal Service Comments at 17-18.

[20] UPS Comments at 29.

Representative and his expert declarant Dr. Soiliou Daw Namoro demonstrated that changes in the Lerner Index could increase the minimum contribution requirement even when the actual contribution generated by competitive products is unchanged or goes down (e.g., if both revenue and volume-variable cost decreased by the same dollar amount).[21]

The Commission now proposes to replace the Lerner Index with the Competitive Contribution Margin (CCM). While the Lerner Index had relied on calculations of unit volume-variable costs and average revenue-per-piece, the CCM is based on total attributable costs and total competitive product values, specifically:

$$\frac{\text{Total Competitive Product Revenue} - \text{Total Competitive Product Attributable Cost}}{\text{Total Competitive Product Revenue}}$$

According to the Commission, the CCM approach will provide a more complete view of the Postal Service's market power for competitive products by more accurately measuring the relationship between cost and price.[22]

The Postal Service has no objection to the Commission's proposal to substitute total revenue across all competitive products for average revenue per piece. However, the changes to this component of the formula do not address the concerns raised in the Postal Service's Comments on Order No. 4402, that a Lerner Index is an imperfect indicator of Postal Service market power and could produce inaccurate results. The CCM, like the Lerner Index, assumes (a) that a larger delta between competitive

[21] PR Comments at 5; Namoro Declaration at 8 & n. 4.

[22] Order No. 4742 at 13-15.

product revenue and competitive product costs necessarily means that the Postal Service is exercising market power, and (b) that exercise of this “market power” harms competition, such that it needs to be addressed through an adjustment to the appropriate share requirement. Neither assumption is correct, as explained above.[23]

Finally, the Postal Service notes that the Commission’s substitution of attributable costs for unit volume-variable costs in its calculation of the CCM makes this component more consistent with the way the Postal Service measures contribution in its reporting (following the methodological changes put in place by the Commission for FY 2017). However, because the measure used in calculating the appropriate share requirement is the <u>growth</u> in either the Lerner Index or the CCM, not its absolute level, substituting CCM for the Lerner Index only impacts the appropriate share requirement if the growth rate for CCM differs from the Lerner Index growth rate. In short, this revision does not solve the underlying problem with using a Lerner Index or CCM as an indicator of Postal Service market power, and it is not entirely clear why the substitution is necessarily an improvement in that context.

III. SUBSTITUTION OF THE COMPETITIVE GROWTH DIFFERENTIAL FOR THE COMPETITIVE MARKET OUTPUT

The second component of the Commission’s initially proposed formula, the “Competitive Market Output,” was designed to measure the overall size of the competitive market, in order to place the Postal Service’s market power in context relative to the market as a whole.[24] Included within the Commission’s definition of the

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[23] In addition, the same issue identified by Dr. Namoro with respect to the Lerner Index, discussed above, could also occur in applying the CCM.

[24] Order No. 4402 at 22.

relevant market are the Postal Service's competitive products, as well as "similar products" offered by competitors with which the Postal Service competes. Thus, the competitive market includes both last-mile and end-to-end deliveries of mail pieces outside the market dominant system, but excludes products the Postal Service does not offer, such as delivery of parcels weighing more than 70 pounds.[25]

To prepare its proposed annual Competitive Market Output calculation, the Commission proposed to use the Product Finances Analysis (PFA) that it produces every year as part of the ACD. PFA data, representing revenues generated by the Postal Service, would be combined with survey data produced by the United States Census Bureau that purportedly estimate operating revenues for competitors within the industry subsector classified as North American Industry Classification System (NAICS) Code 492 – "Couriers and Messengers."[26] According to the Commission, the resulting CMO values showed that, while the Postal Service's revenue-based market share has grown since 2007, its overall market share in 2017 remained relatively low, given the growth in the overall market and firms entering or exiting the market.

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[25] *Id.*

[26] Notwithstanding the market precision issues discussed later in this section, the Postal Service's competitive products correspond far more closely, on the main, to NAICS Code 492 than to any other industry classification. Even Dr. Robert Shapiro agrees, which makes it mystifying that he excludes the industry from his labor-productivity-growth analysis in favor of irrelevant comparisons to warehouses, airlines, railroads, and long-haul trucking. *Compare* Shapiro Declaration at 11 fn.22 *with id.* at 11. *But see id.* at 33 (misrepresenting his comparison as being with "private delivery companies"). Had he instead focused on the far more comparable courier/messenger industry, Dr. Shapiro would have had to admit that the Postal Service's 25-year average annual labor productivity growth rate (+0.5 percent) significantly outstrips that of its private counterparts (-1.9 percent). *See* News Release, Bureau of Labor Statistics, Productivity & Costs by Industry: Selected Service-Providing Industries – 2016 (2017), at 9, https://go.usa.gov/xPxXR. Dr. Shapiro's conclusion that the Postal Service is a productivity laggard relying on "subsidies" is utterly off-base for this reason and many others.

The Commission now plans to replace the Competitive Market Output with the Competitive Growth Differential (CGD).[27] Most of the inputs for this component, including PFA and Census Bureau data, would remain the same under the revised proposal. But while the CMO was intended to capture changes in the competitive market as a whole, the CGD is designed to assess, more specifically, the growth or decline of the Postal Service's market position within that overall competitive market, by taking into consideration the Postal Service's market share. Specifically, CGD = USPS market share * (USPS %∆ in revenue – competitors' %∆ in revenue).[28] Incorporating a suggestion made by the Postal Service, the Commission plans to adjust this component of the formula for inflation.[29]

Incorporating Postal Service market share into the calculation of this component represents an improvement over the previously described approach, as it more accurately reflects the Postal Service's position within the market. The Postal Service also supports the use of real, inflation-adjusted dollars rather than nominal dollars for calculating this component of the formula. The Postal Service observes, further, that removal of the unweighted percent change in competitors' revenue as a variable within the CGD – as initially proposed in the Declaration of Dr. Namoro, and adopted by the Commission with little commentary[30] – does not appear to have much of a quantitative effect based on historical numbers.

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[27] Order No. 4742 at 23.

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

[29] *Id.* at 24-25. *See also* Postal Service Comments at 21-22 (recommending that, if the Commission decided to move forward with the proposed formula, then measurement of the CMO should be adjusted for inflation).

[30] *See* Order No. 4742 at 26-27; Namoro Declaration at 17 & n. 12.

Other aspects of the CGD component continue to raise concerns. As explained in the Postal Service's comments addressing Order No. 4402, the Census Bureau data that would be used to calculate total market revenue are both over-inclusive and under-inclusive, because they include certain types of local carriers that do not compete directly with the Postal Service (e.g., local restaurant delivery), while excluding self-delivery by large retailers. Accurate assessment of the Postal Service's position within the competitive market presupposes, of course, that the market is properly defined. If retailers increasingly move toward self-delivery of ecommerce packages, but those shipping transactions are not reflected in the Census Bureau data used to calculate the CGD, it could appear that the Postal Service is gaining market share in a shrinking market (potentially increasing the appropriate share requirement), when in fact, the Postal Service is losing volume as retailers move their logistics and shipping operations in-house. In addition, the CGD calculation may double-count revenue resulting from intra-industry transactions if both entities record revenue from the same shipment (i.e., if the Postal Service reports revenue from the last-mile delivery of a piece on which FedEx or UPS has reported end-to-end delivery revenue) – further increasing the possibility for errors in application of the formula.

IV. ANCHOR YEAR FOR CALCULATION OF THE FORMULA

In Order No. 4402, the Commission proposed to use the 5.5 percent requirement set in Fiscal Year 2007 as the beginning value for calculations of the appropriate share requirement in future years.[31] This aspect of the Commission's proposal remains unchanged.[32] Because each year's minimum contribution requirement is calculated as the product of the previous year's requirement multiplied by the application of the formula ($1 + \%\Delta CCM_{t-1} + \%\Delta CGD_{t-1}$), the choice of 2007 as the beginning "t" value results in the Commission's proposed formula being applied recursively, reflecting the cumulative effect of retroactively calculated adjustments over more than a ten-year period prior to its proposed effective date.

This proposal is inconsistent with the express statutory language that the appropriate share be reviewed on a recurring basis, once every five years. The Commission claims that recursive application of the formula throughout the entire PAEA era is necessary to reflect "the cumulative effect of developments in competitive market conditions since the PAEA's enactment."[33] However, Section 3633(b) provides for a review of the institutional cost contribution requirement *every five years*, based on the Commission's consideration of "all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products."[34] In its most recent previous review initiated in Fiscal Year 2012, the Commission considered "all relevant circumstances" at that time, and determined that the 5.5 percent requirement should remain in effect until its next review,[35] which began in Fiscal Year 2017. The

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[31] Order No. 4402 at 32.

[32] Oder No. 4742 at 40.

[33] *Id.* at 42.

[34] 39 U.S.C. § 3633(b).

[35] Order No. 1449 at 24-25.

Commission now believes that the appropriate share requirement should be adjusted on a going-forward basis for future years (at least until its next review), but that conclusion does not nullify the findings from Docket No. RM2012-3 that the 5.5 percent requirement was the correct "appropriate share" level for FY 2013 to FY 2017. Hence, FY 2017, the last year in which the Commission's determination in Docket No. RM2012-3 was intended to apply, would be a more appropriate beginning "t" value for calculation of the new formula in future years.[36]

V. CONCLUSION

The Postal Service appreciates the efforts undertaken by the Commission to improve its proposed formula-based approach to calculating the institutional cost contribution requirement. Although the revised formula achieves modest improvements over the proposal described in Order No. 4402, concerns remain as to the formula's accuracy and usefulness for its intended purpose. Nor is adoption of a complex new appropriate share requirement necessary as a regulatory tool to level a competitive playing field that is already healthy and thriving. The Commission should instead reduce or eliminate the requirement.

[36] Even if the Commission intends the going-forward formula calculations to reflect the market changes it believes have occurred since its last review of the appropriate share requirement (i.e., between FY 2013 and FY 2017), by determining in Docket No. RM2012-3 that 5.5 percent should continue to be the requirement for the five-year period following its review in that docket, the Commission effectively foreclosed retroactive reconsideration of what the requirement could or should have been for earlier years. FY 2012 is therefore the earliest beginning "t" value the Commission should consider as the starting point for future calculations of the new formula-based requirement.

Respectfully submitted,

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