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ORDER NO. 4963

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners:

Robert G. Taub, Chairman;
Nanci E. Langley, Vice Chairman;
Mark Acton; and
Tony Hammond

Institutional Cost Contribution
Requirement for Competitive Products

Docket No. RM2017-1

ORDER ADOPTING FINAL RULES RELATING TO THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS

Washington, DC 20268-0001
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(Issued January 3, 2019)

I. INTRODUCTION

In this Order, the Commission completes its second 39 U.S.C. § 3633(b) review of the appropriate share that competitive products[1] contribute to the Postal Service's institutional costs.[2] All Postal Service costs are classified as either attributable or

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[1] All Postal Service products are characterized as either market dominant or competitive. 39 U.S.C. § 3642(b)(1). Market dominant products are those products over which the Postal Service exercises sufficient market power to effectively set prices substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products. *Id.* Competitive products consist of all other Postal Service products. *Id.* Examples of market dominant products include products in the First-Class Mail, USPS Marketing Mail, and Periodicals classes. Examples of competitive products include Priority Mail, Priority Mail Express, and First-Class Package Service.

[2] *See* 39 U.S.C. § 3633(b). This review was mandated by the Postal Accountability and Enhancement Act (PAEA) of 2006, Pub. L. 109-435, 120 Stat. 3198 (2006).

institutional. Attributable costs are costs that are assigned to specific products on the basis of reliably identified causal relationships.[3] Institutional costs are residual costs that cannot be specifically attributed to products through reliably identified causal relationships.[4]

Section 3633(a)(3) of title 39 of the United States Code requires that competitive products collectively cover what the Commission determines to be an appropriate share of the Postal Service's institutional costs. 39 U.S.C. § 3633(a)(3). Section 3633(b) requires that the Commission revisit the appropriate share regulation at least every 5 years to determine if the minimum contribution requirement should be "retained in its current form, modified, or eliminated." 39 U.S.C. § 3633(b). In making such a determination, the Commission is required to consider "all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products." *Id.* Thus, by its terms, section 3633(b) provides three separate elements that the Commission must consider during each review: (1) the prevailing competitive conditions in the market; (2) the degree to which any costs are uniquely or disproportionately associated with competitive products; and (3) all other relevant circumstances. *Id.*

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[3] Attributable costing was most recently considered in Docket No. RM2016-2, which examined the concept of reliably identifiable causally related costs and expanded the scope of Postal Service cost attribution. *See generally* Docket No. RM2016-2, Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), September 9, 2016 (Order No. 3506); *see also United Parcel Serv., Inc. v. Postal Reg. Comm'n*, 890 F.3d 1053 (D.C. Cir. 2018) (*UPS*); Petition for Rehearing *En Banc*, *United Parcel Serv., Inc. v. Postal Reg. Comm'n*, No. 16-1354 (D.C. Cir. filed July 6, 2018), *denied per curiam*, No. 16-1354 (D.C. Cir. filed July 27, 2018); Petition for a Writ of Certiorari, *United Parcel Serv., Inc. v. Postal Reg. Comm'n,* No. 18A398 (U.S. Dec. 26, 2018).

[4] Examples of institutional costs include the Postmaster General's salary, building project expenses, and area administration expenses. *See* Order No. 3506 at 10 n.16.

Pursuant to 39 U.S.C. § 3633(b), the Commission issued an Advance Notice of Proposed Rulemaking, which established this docket as the Commission's second review of the appropriate share requirement on November 22, 2016.[5] On February 8, 2018, after considering initial and reply comments received, the Commission issued Order No. 4402, which proposed a new formula-based approach to setting the appropriate share and provided an opportunity for interested persons to submit comments.[6] Several comments received in response to Order No. 4402's proposed formula-based approach suggested modifications to the formula. On August 7, 2018, the Commission issued Order No. 4742, a Revised Notice of Proposed Rulemaking, proposing modifications to its formula-based approach.[7] Appendix A contains the full list of relevant comments, related citations, and related filings received in response to Order Nos. 4402 and 4742.[8] For the reasons discussed below, the Commission

[5] Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, November 22, 2016 (Order No. 3624). The Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products was published in the *Federal Register* on November 29, 2016. *See* 81 Fed. Reg. 85,906 (Nov. 29, 2016).

[6] *See generally* Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, February 8, 2018 (Order No. 4402). The Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products was published in the *Federal Register* on February 14, 2018. *See* 83 Fed. Reg. 6758 (Feb. 14, 2018).

[7] Revised Notice of Proposed Rulemaking, August 7, 2018 (Order No. 4742). The Revised Notice of Proposed Rulemaking was published in the *Federal Register* on August 13, 2018. *See* 83 Fed. Reg. 39,939 (Aug. 13, 2018).

[8] On December 17, 2018, UPS filed a motion to supplement the record of this proceeding. *See generally* Motion to Supplement the Record. In its Motion to Supplement the Record, UPS requests that the record be supplemented to include a report titled "United States Postal Service: A Sustainable Path Forward, Report from the Task Force on the United States Postal System" (Task Force Report) as "relevant to the ongoing proceedings." Motion to Supplement the Record at 1; *see also id.* Exhibit A. Both the Postal Service and PSA, *et al.* filed oppositions to UPS's Motion to Supplement the Record. *See generally* Postal Service Answer to Motion; PSA *et al.* Answer to Motion. The Commission denies the Motion to Supplement the Record. UPS's Motion to Supplement the Record cites no new evidence provided in the Task Force Report that necessitates supplementing the record, and instead selects non-contextual excerpts from the report that UPS attempts to link to prior comments that it has made in this proceeding. UPS's contentions re-raised in its Motion to Supplement the Record are addressed in relation to prior comments from UPS and other commenters on these topics in this Order. *See* sections VIII.B.1 and VIII.C.4, *infra* (responding to concerns that the current costing methodology distorts competition and creates an advantage for the Postal Service); sections V.C and VIII.C.4, *infra* (responding to UPS's proposal that the costing methodology be changed such that institutional costs are fully allocated to products based on proportions of either revenue or attributable costs by explaining that the attribution of costs to specific products or groups of products must be based on reliably identified causal relationships pursuant to 39 U.S.C. §§ 3622(c)(2) and 3631(b), and that cost allocation without a

implements the formula-based approach described in Order No. 4742 to calculate the appropriate share and adopts related final rules.

II. BACKGROUND

Prior to discussing the formula-based approach adopted by this Order, the Commission addresses two general topics that provide necessary background. First, the Commission describes developments in the parcel delivery market and discusses how both the market and the Postal Service's position in the market have changed since the Commission first set the appropriate share in 2007 and since the Commission last reviewed the appropriate share in 2012. Second, the Commission discusses the appropriate share requirement and its purpose in the context of the statutory scheme for regulating competitive products.

A. Parcel Delivery Market Since 2007

At the time the appropriate share requirement was initially set in Docket No. RM2007-1, the postal regulatory system was undergoing substantial changes as a result of the enactment of the PAEA. The distinction between market dominant and competitive products, and the differing regulatory schemes to be applied to each, were new with the PAEA's enactment.

In promulgating its initial competitive product rules in Docket No. RM2007-1, the Commission set the appropriate share at 5.5 percent of total institutional costs.[9] In doing so, the Commission considered various proposals for how best to quantify the appropriate share, including "equal unit contribution," "equal percentage markup,"

causal link would be tantamount to fully-allocated costing, which would be inconsistent with existing statute); section VIII.B.1, *infra* (explaining that no evidence exists indicating that the Postal Service is competing unfairly and that any advantages the Postal Service receives due to its government status are outweighed by the burdens imposed upon it); sections VII.A.3.a and VIII.B.1, *infra* (responding to UPS's assertions concerning the Postal Service's alleged underpricing and alleged focus on growth rather than profit); section VII.A.3.a, *infra* (explaining that the current structure of the Postal Service and its financial condition create the incentive to maximize profits from its competitive products and that UPS has failed to provide any empirical evidence to the contrary).

[9] *See* Docket No. RM2007-1, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, October 29, 2007, at 91, 138 (Order No. 43).

"markup of competitive products' attributable costs," and "percentage of revenues."[10] In setting the appropriate share at 5.5 percent, the Commission selected an "easily understood" percentage of total institutional costs based on competitive products' historical contribution to institutional costs during the previous 2 fiscal years. *Id.* at 70, 73. The Commission was also "mindful of the risks of setting [the appropriate share] too high, particularly at the outset of the new system of regulation." *Id.* at 73.

Five years later, in Docket No. RM2012-3, the Commission maintained the appropriate share at 5.5 percent of total institutional costs.[11] At that time, the Postal Service had only offered products in the competitive mail category for 5 years. In making its determination, the Commission noted that there had been a lack of significant increase in the Postal Service's market share between Fiscal Year (FY) 2007 and FY 2011. Order No. 1449 at 16-18. The Commission also noted several market uncertainties that had "the potential to alter the relationship of attributable costs to institutional costs," and stated that "[t]hese uncertainties could affect the appropriate share contribution requirement in the future." *Id.* at 23, 24. Without any evidence that the Postal Service was benefiting from a competitive advantage or that the market was not competitive, the Commission determined that maintaining the appropriate share at 5.5 percent was the correct course. *Id.* at 16-19.

Since the Commission's last review of the appropriate share, a clearer picture of the parcel delivery market[12] and the Postal Service's position in that market has emerged. One of the key developments that has played a major role in shaping the picture of the parcel delivery market is growing demand, driven in large part by the substantial increase in e-commerce sales. Over the past 10 years, e-commerce sales have grown significantly, as demonstrated in Table II-1 below.

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[10] *See* Docket No. RM2007-1, Order Proposing Regulations to Establish a System of Ratemaking, August 15, 2007, at 70 (Order No. 26).

[11] *See* Docket No. RM2012-3, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, August 23, 2012, at 26 (Order No. 1449).

[12] The Commission uses the term "parcel delivery market" because it best reflects the market in which the Postal Service's competitive products compete.

Table II-1

E-commerce Sales

CY 2007 – CY 2017[13]

Calendar Year	E-commerce Sales (Millions)	Year-over-Year Growth
2007	$135,877	
2008	$141,895	4.43%
2009	$144,900	2.12%
2010	$169,110	16.71%
2011	$198,556	17.41%
2012	$229,295	15.48%
2013	$259,817	13.31%
2014	$297,406	14.47%
2015	$339,062	14.01%
2016	$388,049	14.45%
2017	$448,441	15.56%

Table II-1 demonstrates that e-commerce sales have more than tripled since Calendar Year (CY) 2007. Table II-1 also shows that annual growth rates have steadied over the past 5 years, fluctuating between 13.31 percent and 15.56 percent. During the first 5 years after the PAEA's enactment, the annual growth rates exhibited more extreme fluctuations, ranging from 2.12 percent to 17.41 percent. The continuous growth in demand, fueled by e-commerce sales, has also led to growth in revenue for those firms responsible for delivering e-commerce goods, as demonstrated below.

Between FY 2007 and FY 2017, the parcel delivery market in the United States as measured by revenue expanded by 24.62 percent.[14] Table II-2 demonstrates that growth has been concentrated over the past 5 fiscal years.

[13] Source: Library Reference PRC-LR-RM2017-1/3.

[14] Library Reference PRC-LR-RM2017-1/3.

Table II-2

Parcel Delivery Market Growth by Revenue

FY 2007 – FY 2017[15]

Fiscal Year	Postal Service Competitive Product Revenue (Millions)	Competitor Revenue (Millions)	Total Revenue (Millions)
2007	$7,909	$77,895	$85,804
2008	$8,382	$76,136	$84,518
2009	$8,132	$64,621	$72,753
2010	$8,677	$63,359	$72,036
2011	$8,990	$66,871	$75,861
2012	$11,426	$69,270	$80,696
2013	$13,741	$70,955	$84,696
2014	$15,280	$73,376	$88,656
2015	$16,428	$77,922	$94,350
2016	$18,495	$81,529	$100,024
2017	$20,690	$86,191	$106,881

As Table II-2 shows, the Postal Service and its competitors experienced steady increases in revenue over the past 5 fiscal years, indicating that growth in the market benefited all market competitors.

Table II-2 also indicates that the Postal Service has captured market share since FY 2007, particularly in the years since FY 2011. Table II-3 shows the market share by revenue for the Postal Service and competitors for FY 2007 through FY 2017.

[15] Source: Library Reference PRC-LR-RM2017-1/3. The Commission notes that throughout this Order it frequently uses FY 2017 data as the most recent data because in those cases, FY 2018 data are either not available or have not yet been finalized.

Table II-3

Market Share by Revenue

FY 2007 – FY 2017[16]

Fiscal Year	Postal Service Market Share	Competitor Market Share
2007	9.22%	90.78%
2008	9.92%	90.08%
2009	11.18%	88.82%
2010	12.05%	87.95%
2011	11.85%	88.15%
2012	14.16%	85.84%
2013	16.22%	83.78%
2014	17.24%	82.76%
2015	17.41%	82.59%
2016	18.49%	81.51%
2017	19.36%	80.64%

As shown in Table II-3, the Postal Service's market share as measured by revenue was 9.22 percent in FY 2007. By FY 2017, the Postal Service's market share as measured by revenue grew to 19.36 percent. Although this demonstrates that there has been growth in the Postal Service's market share as measured by revenue, the Postal Service maintains a relatively modest share of the overall market. This is especially true when one considers that the parcel delivery market has three primary competitors that make up the majority of the market: United Parcel Service, Inc. (UPS), Federal Express Corporation (FedEx), and the Postal Service.

One of the primary ways these three competitors have competed with one another for customers is through firm specialization and product differentiation. Each of these firms has developed specialties in certain types of delivery: FedEx specializes in international and express delivery; UPS specializes in business-to-business delivery; and the Postal Service specializes in last-mile business-to-consumer delivery of

[16] Source: Library Reference PRC-LR-RM2017-1/3.

lightweight parcels.[17] As a result, each of these competitors offers products with differences in a range of features, including price, service, reliability, tracking features, and the availability of ancillary services such as insurance and return options.

In addition to this firm specialization and product differentiation, these three primary competitors also engage in unique strategies to minimize their costs and lure higher-volume commercial customers. Although each of the competitors offers published prices available to all customers, each also attempts to gain business through agreements involving non-published prices.[18] These agreements offer lower, non-published rates, often in exchange for volume commitments.[19] This results in a two-tiered pricing structure for the parcel delivery market, consisting of published rates for retail customers and lower, non-published rates for higher-volume commercial mailers.

Competitors in the parcel delivery market also cooperate with each other, utilizing each other’s specializations to minimize their own delivery costs. This is known as “co-opetition.”[20] The market comprises various components, including an upstream portion that features collection, processing, and transportation functions and a downstream

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[17] *See, e.g.,* Public Representative Reply Comments in Response to Advance Notice of Rulemaking, March 9, 2017, at 2-3, 7-8; Comments of Amazon Fulfillment Services, Inc., January 23, 2017, at 40, 42 (Amazon Order No. 3624 Comments); FedEx Corporation, 2017 Report on Form 10-K, July 17, 2017, at 8-12, available at: *http://d18rn0p25nwr6d.cloudfront.net/CIK-0001048911/7fba0d15-1c88-4aeb-a941-4b86fb1163af.pdf*; Reuters, “UPS plan to boost business shipping falls short with investors” (Sept. 13, 2018), available at: *https://www.reuters.com/article/us-ups-outlook/ups-plan-to-boost-business-shipping-falls-short-with-investors-idUSKCN1LT26Q*; Yahoo! Finance, Edited Transcript of UPS FY 2018 Q1 Earnings Conference Call, Statement of David P. Abney, United Parcel Service, Inc., Chairman and Chief Executive Officer (Apr. 27, 2018), available at: *https://finance.yahoo.com/news/edited-transcript-ups-earnings-conference-174713606.html* (“And when it comes to the [business-to-business] side of the business, we can talk about [business-to-consumer] so much that we sometimes just don't mention the fact that we are the largest shipper of [business-to-business].”); United States Postal Service, 2018 Report on Form 10-K, November 16, 2018, at 9, available at*:* *https://about.usps.com/who-we-are/financials/10k-reports/fy2018.pdf*; Order No. 4402 at 22 (“For example, the Postal Service does not accept parcels weighing more than 70 pounds….”).

[18] The Postal Service refers to these agreements as negotiated service agreements (NSAs).

[19] *See, e.g.,* Initial Comments of the American Catalog Mailers Association (ACMA), January 23, 2017, at 2; *see also* 39 C.F.R. § 3001.5(r) (defining an NSA as “a written contract, to be in effect for a defined period of time, between the Postal Service and a mailer, that provides for customer-specific rates or fees and/or terms of service in accordance with the terms and conditions of the contract.”).

[20] *See, e.g.,* Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, January 23, 2017, at 11 (PR Order No. 3624 Comments); Amazon Order No. 3624 Comments at 42.

portion that features last-mile delivery. *See* PR Order No. 3624 Comments at 11. As an example of "co-opetition" in the upstream portion of the market, the Postal Service has contracted with FedEx for FedEx to provide the Postal Service with airport-to-airport transportation of Priority Mail Express and Priority Mail within the United States through September 29, 2024.[21] In the downstream portion of the market, UPS and FedEx use the Postal Service to complete last-mile delivery of many of their parcels.[22] Similarly, the Postal Service also provides last-mile delivery for customers such as Amazon.com Services, Inc. (Amazon), with Amazon's own transportation and distribution network performing the upstream work. Amazon Order No. 3624 Comments at 3. This "co-opetition" results in lower costs for each of the three competitors, which in turn lowers the overall cost of delivering parcels and improves the productive efficiency of the market.[23]

The health of the market is demonstrated in part by the competitors' prices. UPS, FedEx, and the Postal Service all steadily increased prices over the past 11 years. Table II-4 shows the average annual price increases for all three competitors from CY 2008 to CY 2019.

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[21] FedEx Corporation, 2018 Report on Form 10-K, July 16, 2018, at 10, available at: *http://d18rn0p25nwr6d.cloudfront.net/CIK-0001048911/84c1e483-852c-424c-8303-ea8ba4ff841b.pdf*.

[22] *See* Amazon Order No. 3624 Comments at 42; PR Order No. 3624 Comments at 11.

[23] The Organisation for Economic Co-operation and Development defines productive (or technical) efficiency as "the ability of a firm to produce a given quantity at a particular point in time using a combination of the necessary inputs" (*e.g.*, labor, capital, raw material). *See* Organisation for Economic Co-operation and Development, *The Role of Efficiency Claims in Antitrust Proceedings* 13 (2012), available at: *http://www.oecd.org/competition/EfficiencyClaims2012.pdf* (OECD Paper). An improvement in productive efficiency indicates a decrease in production costs. *See id.*

Table II-4

Average Annual Price Increases

CY 2008 – CY 2019[24]

Calendar Year	Average Postal Service Price Increase	Average UPS Price Increase	Average FedEx Price Increase
2008	5.79%	5.81%	5.81%
2009	5.00%	6.38%	6.38%
2010	3.30%	5.81%	5.38%
2011	3.60%	6.38%	5.90%
2012	4.60%	6.38%	5.90%
2013	8.10%	6.19%	5.90%
2014	2.40%	4.90%	4.37%
2015	3.50%	4.90%	4.90%
2016	9.50%	5.05%	4.90%
2017	3.90%	4.90%	4.37%
2018	4.10%	4.90%	4.90%
2019	7.40%	4.90%	4.90%

As Table II-4 indicates, all three competitors have utilized annual price increases as the market has expanded. Table II-5 shows the cumulative price increases for the three competitors for CY 2008 through CY 2013 and for CY 2014 through CY 2019.

Table II-5

Cumulative Price Increases

CY 2008 – CY 2013 and CY 2014 – CY 2019[25]

Calendar Years	Postal Service Cumulative Increase	UPS Cumulative Increase	FedEx Cumulative Increase
2008-2013	34.42%	43.14%	40.88%
2014-2019	34.81%	33.43%	31.91%

Although Table II-4 demonstrates some variation in the annual percentage increases among the three competitors, Table II-5 shows that the cumulative price increases have

[24] Source: Lojistic, 2018 Annual Carrier General Price Increase, available at: *https://www.lojistic.com/pdf/UPS-Fedex-General-Price-Increase-History-2018.pdf*; Library Reference PRC-LR-RM2017-1/3. Geometric means were used to develop average increases for the Postal Service in CY 2008, and for UPS and FedEx in all calendar years. The Commission also presents arithmetic averages for comparison in Library Reference PRC-LR-RM2017-1/3, but the method for calculating the averages does not alter the discussed conclusions.

[25] Source: *Id.*

converged. This is particularly true over the past 6 years, when the Postal Service, UPS, and FedEx had cumulative price increases of 34.81 percent, 33.43 percent, and 31.91 percent, respectively.

As would be expected in an expanding market that features annual price increases, the profits of UPS and FedEx grew between FY 2007 and FY 2017. In FY 2017, UPS's annual profit was 20 percent higher than it was in FY 2007.[26] In FY 2017, FedEx's annual profit was 49 percent higher than it was in FY 2007.[27] Although not directly comparable to UPS's and FedEx's profit growth, the Postal Service's contribution of its competitive products to institutional costs has also increased over the same time period. *See* Order No. 4402 at 52.

The parcel delivery market has undergone substantial expansion since the enactment of the PAEA, with growth that has been particularly concentrated over the past 5 fiscal years. This growth has largely been due to a substantial increase in e-commerce, which has, in turn, substantially increased demand in the parcel delivery market. All indications are that the rising tide has lifted all boats, with all competitors experiencing increased revenues, the ability to raise prices annually, and increased profits.

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[26] UPS Annual Report, Fiscal Year 2007, at 8, available at: *http://www.investors.ups.com/static-files/d5c044a5-97c0-43ab-9c15-8e8df21ddae0*; UPS Annual Report, FY 2017, at 2, available at: *http://www.investors.ups.com/static-files/469f785d-5c5d-4c95-9b2e-3151de31a8c6*; Library Reference PRC-LR-RM2017-1/3.

[27] FedEx Annual Report, Fiscal Year 2007, at 14, available at: *http://images.fedex.com/us/investorrelations/financialinfo/2007annualreport/online/fedex_annual07_editorial.pdf*; FedEx Annual Report, FY 2017, at 9, available at: *http://s1.q4cdn.com/714383399/files/oar/2017/AnnualReport2017/AnnualReport2017flat/docs/FedEx_2017_Annual_Report.pdf*; Library Reference PRC-LR-RM2017-1/3.

B. The Appropriate Share and Statutory Scheme for Regulation of Competitive Products

In this section, the Commission provides a more detailed discussion of the legislative intent underlying section 3633 of the PAEA, as well as the specific provisions concerning the appropriate share (sections 3633(a)(3) and (b)). With regard to the appropriate share specifically, the Commission focuses on the purpose of the PAEA and its appropriate share provisions, the authority provided to the Commission by those provisions, and the significance of the appropriate share as a minimum contribution level, or floor.

In 2006, Congress enacted the PAEA[28] in order to establish an overall regulatory structure for the Postal Service that balanced the need for increased pricing flexibility with the need for effective oversight and accountability.[29] As mentioned above, the PAEA significantly changed how the Postal Service operates by bifurcating Postal Service products into market dominant and competitive categories, each governed by a distinct regulatory scheme.[30]

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[28] No committee or conference report was issued for the bill enacted into law. The Commission reviews the PAEA's legislative history and examines committee reports accompanying previous versions of the bill, such as H.R. Rep. No. 109-66, pt. 1 (2005) (House Report) accompanying H.R. 22, 109th Cong. (2005), and S. Rep. No. 108-318 (2004) (Senate Report) accompanying S. 2468, 108th Cong. (2004).

[29] *See, e.g.,* S. Rep. No. 108-318 at 6 ("This legislation makes that long overdue revision by establishing a regulatory structure that balances the Postal Service's need for increased pricing and product flexibility with the need for effective oversight and accountability."); H.R. Rep. No. 109-66, pt. 1, at 44 (listing the main highlights of the PAEA as: (1) the preservation of universal service; (2) the promotion of efficiency and flexibility; and (3) ensuring fair competition and accountability).

[30] *Compare* 39 U.S.C. § 3622 *with* 39 U.S.C. § 3633; *see* Order No. 26 at 71; S. Rep. No. 108-318 at 6 ("…the Postal Service's current products are divided into two categories: market-dominant products for which there is little or no competition and competitive products for which private sector alternatives exist."); H.R. Rep. No. 109-66, pt. 1, at 46 ("In the new regulatory regime proposed in the bill, the classes of mail and services are classified as either Market Dominant or Competitive products.").

For competitive products, the PAEA focused on providing the Postal Service with greater pricing flexibility that permitted more customer- and market-responsive pricing, subject to minimal Commission oversight.[31] This oversight is designed to ensure that the Postal Service competes fairly.[32] More specifically, the Senate Report indicated that the PAEA "establishes a flexible system of pricing," while also "establishing appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete." S. Rep. No. 108-318 at 14. Indeed, the Commission has continuously recognized that, with the enactment of the PAEA and particularly the changes relevant to competitive products, Congress intended to provide the Postal Service with pricing flexibility while also ensuring that the Postal Service competes fairly within the parcel delivery market.[33]

Congress's effort to permit pricing flexibility and ensure fair competition is mainly encompassed in the scheme for the regulation of competitive products, which consists of the three provisions of section 3633(a). Section 3633(a)(1) prohibits the subsidization of competitive products by market dominant products. *See* 39 U.S.C. § 3633(a)(1). Section 3633(a)(2) requires each Postal Service competitive product to cover its attributable costs. *See* 39 U.S.C. § 3633(a)(2). Section 3633(a)(3) requires competitive products to collectively cover what the Commission determines to be an

[31] In contrast, for market dominant products, the PAEA focused on a streamlined rate-making process with enhanced Commission oversight. *See* H.R. Rep. No. 109-66, pt. 1, at 46; S. Rep. No. 108-318 at 7-8.

[32] S. Rep. No. 108-318 at 7, 14; H.R. Rep. No. 109-66, pt. 1, at 44; *see, e.g.,* S. Rep. No. 108-318 at 7 ("[T]he Postal Service Board of Governors is permitted to more directly manage and price the Postal Service's competitive products; subject to minimal Regulatory Commission oversight to ensure that the Postal Service competes fairly with the private sector delivery services."); S. Rep. No. 108-318 at 14 ("This bill establishes a flexible system of pricing the Postal Service's competitive products which reduces regulatory burdens and permits more customer- and market-responsive pricing. It does this while establishing appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete."); *see also* S. Rep. No. 108-318 at 15 ("[T]he Committee feels that the regulation of competitive products should be constructed to result in the minimum possible regulatory burden….").

[33] Order No. 26 at 72 ("[U]nder the PAEA, the concept of rate levels for competitive products largely disappears, with the Postal Service given the flexibility to price competitive products however it wishes, provided its rates satisfy the statutory standards of lawfulness."); Order No. 4402 at 16 ("With the enactment of the PAEA, Congress sought to ensure a 'level playing field' between the Postal Service and its competitors as a means of preserving competition.").

appropriate share of institutional costs. *See* 39 U.S.C. § 3633(a)(3). As the Commission noted in Order No. 26, these provisions "are designed to act in concert to ensure that competitive rates are lawful." Order No. 26 at 64.

However, each provision of section 3633 also serves its own purpose within the overall scheme for regulation of competitive products. As noted in Order No. 26, under the PAEA, prices for competitive products are no longer predicated on explicit consideration of non-cost related factors. *Id.* at 72. To that end, section 3633(a)(1) and (a)(2) represent the limits on the Postal Service's pricing flexibility. As the House Report stated, "[t]he Postal Service will be given flexibility to price competitive products, but competitive products and services will have to pay their own costs without subsidy from market-dominant mail revenues." H.R. Rep. No. 109-66, pt. 1, at 44. To accomplish this, section 3633(a)(1) and (a)(2) work to ensure that the Postal Service's competitive product prices are set such that each individual competitive product covers the costs that it causes and competitive products as a whole cover the costs that they cause as a whole. These two requirements necessitate that the Postal Service's competitive products cover all of the costs caused by the competitive product business.

On the other hand, the primary function of section 3633(a)(3), the appropriate share requirement, is to ensure a level playing field and to act as a safeguard to ensure fair competition on the part of the Postal Service.[34] Put differently, "[t]he appropriate share requirement is one of the PAEA's principal protections against the Postal Service engaging in unfair or anticompetitive pricing." *Id.* at 25. This is supported by the statutory language of section 3633(b) and the requirement that the Commission review the appropriate share at least every 5 years after considering the prevailing competitive conditions in the market, the degree to which any costs are uniquely or disproportionately associated with any competitive products, and all other relevant

[34] *See* Order No. 1449 at 15 ("The appropriate share can also be viewed as imposing another level of protection against unfair or anti[]competitive pricing on the part of the Postal Service."); *id.* at 13 ("A primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace."); *id.* ("[T]he appropriate share requirement is an important safeguard to ensure fair competition on the part of the Postal Service.").

circumstances. *See* 39 U.S.C. § 3633(b). The three considerations of section 3633(b) are focused on the assessment of market conditions and fair competition concerns. As noted previously, Congress intended to provide the Commission with oversight over whether the Postal Service is competing fairly. Sections 3633(a)(3) and (b) give the Commission the authority to do so. *See generally* 39 U.S.C. §§ 3633(a)(3) and (b). As the D.C. Circuit recently recognized, the Commission's role under section 3633 "is to carry out the particulars of the scheme Congress created, not to engineer specific market outcomes." *See UPS*, 890 F.3d at 1067.

Although the provisions related to the appropriate share demonstrate the type of safeguard against unfair competition intended by Congress, the exact meaning of the term "appropriate share" is less evident. As noted in Order No. 4402, the plain language of section 3633 reflects an express delegation of authority to the Commission, by Congress, to determine what share of institutional costs is appropriate for competitive products to cover. Order No. 4402 at 13. However, Congress did not define the term "appropriate share," and thus "its meaning is left for the Commission to determine based on consideration of all relevant factors." Order No. 26 at 69.

The PAEA was the product of blending different versions of postal reform legislation authored by the House of Representatives and the Senate. As a result, drafts between 2000 and 2005 all included the same conflicting language with respect to defining the appropriate share: House versions of the bill would have required competitive products to make "a reasonable contribution" to institutional costs, while Senate versions of the bill would have required competitive products to cover "their share" of institutional costs.[35] The House Report noted that "the requirement that competitive products collectively make a reasonable contribution to overhead" was a "broad standard," which contained "inherent flexibility," and that the standard was "not intended to dictate a particular approach that the [Commission] should follow." H.R. Rep. No. 109-66, pt. 1, at 49. Although the Senate's 2004 postal reform bill used the

[35] *See, e.g.,* H.R. 4341, 108th Cong. at 15 (2004); S. 2468, 108th Cong. at 121 (2004); S. 662, 109th Cong. at 145 (2005).

phrase "their share," the Senate Report explained that for the attribution of competitive product costs, including institutional costs, "the technical decision of what cost analysis methodologies are sufficiently reliable at any given time to form the basis for attribution should be left to the [Commission]." S. Rep. No. 108-318 at 9.

Both committee reports imply that the House and the Senate intended to provide the Commission with broad decision-making flexibility with regard to the chosen approach. The final law that was passed reflects the common view of substantial Commission discretion, with the PAEA's requirement that "all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service." *See* 39 U.S.C. § 3633(a)(3). The Commission's determination is limited by consideration of the three elements of section 3633(b): (1) the prevailing competitive conditions in the market; (2) the degree to which any costs are uniquely or disproportionately associated with any competitive products; and (3) all other relevant circumstances. *See* 39 U.S.C. § 3633(b); *see also* Order No. 4402 at 13.

Along with the above considerations, Congress indicated that the appropriate share should constitute a minimum contribution level.[36] Therefore, the Commission previously found that the "appropriate share is a floor for all competitive products," that it "represents a minimum (not a maximum) contribution level," and that "the hope (and expectation) is that competitive products will generate contributions in excess of the floor."[37] Notably, the use of "minimum contribution" in section 3633(b)'s heading, as well as the requirement that the Commission review the appropriate share at least every 5 years after considering market-related factors, did not appear in previous versions of the PAEA. Thus, along with Congress's decision to use the more flexible "appropriate

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[36] *See* the heading of 39 U.S.C. § 3633(b), which reads, "Review of minimum contribution." Although section headings cannot limit the plain meaning of a statutory text, they supply cues as to what Congress intended. *See Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S.Ct. 883, 893 (2018) (citing *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008); *Yates v. United States*, 135 S.Ct. 1074, 1083 (2015)); *see also* 2A Sutherland Statutory Construction § 47:14 (7th ed.).

[37] Order No. 26 at 72; *see also, e.g.,* Order No. 4742 at 38 n.47; Order No. 4402 at 81; Order No. 1449 at 12.

share" terminology, the use of "minimum contribution" in section 3633(b)'s heading and the required reviews also arose from the process of blending the different versions of postal reform legislation authored by the House and Senate. Despite Congress's opportunity to require a more precise or higher level of coverage, it did not do so. This indicates that Congress intended for the appropriate share to represent the minimum amount that the Postal Service's competitive products must contribute to institutional costs.

Establishing the appropriate share requirement as a floor, or minimum, is also significant because setting a floor does not require the same high level of precision that setting an exact appropriate share would require.[38] In promulgating its initial competitive product rules, the Commission determined that basing competitive products' contribution on a percentage of total institutional costs mirrored the directive of section 3633(a)(3).[39] Thus, the appropriate share represents the minimum percentage level of contribution that competitive products are required to collectively contribute toward the Postal Service's total institutional costs. In other words, in order to satisfy section 3633(a)(3), competitive products' contribution to institutional costs must be equal to or higher than the minimum contribution level, or floor.[40] In this way, the appropriate share can also be viewed as a markup, because competitive products' prices must be "marked up" sufficiently to cover the minimum appropriate share requirement. When determining such a markup, there are risks in setting the markup either too low, potentially creating an artificial competitive advantage, or too high and unreasonably

[38] The limited application of the appropriate share is also relevant to understanding why a high degree of precision is unnecessary. Because the appropriate share is a minimum, compliance is determined by calculating the minimum contribution requirement for a given fiscal year and considering whether the actual contribution of the Postal Service's competitive products equals or exceeds that contribution requirement. *See, e.g.,* Docket No. ACR2017, Postal Regulatory Commission, Annual Compliance Determination, March 29, 2017, at 92 (FY 2017 ACD). If the actual contribution equals or exceeds the minimum contribution requirement, then competitive products satisfy 39 U.S.C. § 3633(a)(3) for that fiscal year. Further, neither the Commission nor the Postal Service uses the appropriate share in any other calculations or methodology.

[39] *See* Order No. 4402 at 6; Order No. 26 at 70.

[40] *See* Order No. 26 at 72; Order No. 4402 at 81; Order No. 4742 at 38 n.47.

limiting the Postal Service's ability to compete.[41] Therefore, the Commission's goal is to maintain a "delicate balance" when determining the appropriate share. Order No. 26 at 73.

III. THE FORMULA-BASED APPROACH

As discussed in Order No. 4402 and above, relevant circumstances have changed since the Commission's last review and over the 11 years since the enactment of the PAEA. *See* Order No. 4402 at 12. The data of the past 11 years have allowed for a clearer picture of the market to emerge. As described above, the parcel delivery market is one where competition is healthy and no one competitor has gained the lion's share of the increased demand and increased revenues and profits that the surge in e-commerce has provided. The Postal Service has joined its competitors in reaping the benefits of this growth. The Postal Service's market share, competitive volumes, and competitive contribution as a percentage of institutional costs have increased steadily since FY 2007. *Id.* For these reasons, the Commission has determined that it is appropriate to replace the minimum 5.5 percent appropriate share with a formula-based approach that will be used to annually update the appropriate share based on prevailing competitive conditions in the market and other relevant circumstances.

In section A below, the Commission briefly describes its formula-based approach. The Commission discusses the conceptual basis for the formula and what its output represents. In section B, the Commission discusses the two components of the formula—the Competitive Contribution Margin and the Competitive Growth Differential. In section C, the Commission discusses the resulting formula's operation and its connection to the criteria outlined in section 3633(b).

A. Conceptual Basis

Since the PAEA was enacted, the appropriate share has been set as a static percentage of institutional costs. While this was appropriate for the past 11 years, it has

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[41] *See* Order No. 26 at 73; Order No. 4402 at 50-51; Order No. 4742 at 54-55.

become increasingly clear that significant changes in the market have occurred in the intervening years. These changes have included recovery from the global financial crisis, surging demand, "co-opetition," steady increases in revenue and profit for all competitors, and growth in market share and competitive volume for the Postal Service. *See* section II.A, *supra*; Order No. 4402 at 12. Because of these changes, the Commission finds it suitable at this time to implement a more dynamic approach to setting the appropriate share. This approach more clearly and transparently ties the appropriate share requirement to the prevailing competitive conditions in the market and other relevant circumstances.

The Commission's formula-based approach provides an objective basis on which to quantify the statutory considerations that the Commission has previously evaluated qualitatively. This basis is the Postal Service's market power, which implicitly captures the vast majority of the qualitative considerations that the Commission has previously looked to in assessing the prevailing competitive conditions in the market and other relevant circumstances.[42]

Market power is a firm's ability to price an individual product or service higher than the marginal cost of producing it. Order No. 4402 at 16-17. The higher a firm is able to price its products above costs, the more market power that firm possesses. *Id.* However, market power is constrained in two primary ways. First, even if a firm faces no competition (*i.e.*, it has a monopoly), its market power will be limited by the elasticity of demand for its products.[43] That is to say, the firm will only be able to increase its prices up to the point at which consumers are no longer willing to pay for the product.[44] Second, when a firm does face competition in providing a product, its exercise of market power is also constrained by the firm's market share and the conduct and performance of other competitors, who can underprice the firm, better advertise their products, or

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[42] *See* section VIII, *infra*, for a discussion of prevailing competitive conditions and other relevant circumstances considered by the Commission and captured by the formula.

[43] Jeffrey Church & Roger Ware, *Industrial Organization: A Strategic Approach* 36 (2000), available at: *https://works.bepress.com/jeffrey_church/23/*.

[44] Steven E. Landsburg, *Price Theory & Applications* 319 (8th ed. 2011).

otherwise compete with the firm.[45] As a result, market power as a concept embodies both absolute and relative aspects. A firm's absolute market power is its ability to raise prices with regard to its own consumers. A firm's relative market power, which can also be described as its market position, is its capacity to exercise market power relative to its competitors. A firm's absolute market power in a competitive market will necessarily be limited by its market position.

Through its exercise of market power, the Postal Service has the capacity to generate revenue from its competitive products in excess of the amount necessary merely to cover those products' attributable costs (*i.e.*, the Postal Service has the capacity to generate profit). The Postal Service could conceivably abuse its market power if it were able to charge its customers unreasonably high prices without being underpriced by a competitor. At the same time, however, if the Postal Service were to forego exercising its market power by failing to generate profit from competitive products, even where it had enough market power to enable it to obtain a reasonable profit, then the Postal Service might conceivably be said to be failing to maximize profit from its competitive products. Under certain circumstances, this could constitute a form of unfair competition.[46]

Because the Postal Service's absolute market power is limited by its market position, the Postal Service's absolute market power and its market position must be assessed in conjunction. If the Postal Service had a monopoly over the delivery of parcels, its market power would be limited only by the elasticity of demand for parcel delivery. However, the Postal Service does not have a monopoly over parcel delivery; it competes with other firms in providing this service. Hence, the Postal Service's market power is constrained not only by the elasticity of demand for parcel delivery in general, but by the Postal Service's share of the overall parcel delivery market and the conduct

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[45] *See* Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 283 (4th ed. 2005); Landsburg, *supra* n.44, at 387-389.

[46] *See* Church & Ware, *supra* n.43, at 660. As the Commission discusses in section VII.A.3.a, *infra*, there is evidence to suggest that the Postal Service has been maximizing profit from competitive products.

and performance of the Postal Service's competitors. Therefore, failing to consider the Postal Service's market position, including its market share, would result in a misleadingly high measure of its market power.

Given the Postal Service's absolute market power and its market position, a key piece of information can be ascertained—competitive products' joint minimal capacity to contribute to the coverage of institutional costs. This capacity can be thought of as "the percentage of gross sales revenue [from competitive products collectively] available to cover (or contribute to) institutional costs." *See* Namoro Order No. 4742 Decl. at 4. As discussed below, each of the two components of the Commission's formula provides the Commission with key information that is interrelated with the information provided by the other component. Taking these components together and applying them through the operation of the formula allows the Commission to determine the year-over-year change in the capacity of competitive products to collectively generate profit based on the Postal Service's market power and market position. As discussed in Order Nos. 4402 and 4742, 5.5 percent was the proper level for the appropriate share to have been set at in 2007, because it was based on historic contribution levels at that time.[47] The formula is designed to adjust the appropriate share upwards or downwards based on changes in the capacity of competitive products to contribute to institutional costs since that time.

B. The Components of the Formula

1. Competitive Contribution Margin

The first component of the formula is the Competitive Contribution Margin. This component is designed to measure the Postal Service's absolute market power—*i.e.*, its ability with respect to its own customers to charge prices for its competitive products that are higher than the marginal cost of producing those products. The formula then

[47] *See* Order No. 4402 at 6-7, 12, 32; Order No. 4742 at 4, 6, 34, 40-42.

assesses the change in the Competitive Contribution Margin from year to year to determine how much the Postal Service's absolute market power has changed.

In Order No. 4402, the Commission determined that several of the considerations the Commission previously considered under "prevailing competitive conditions in the market" were directed at ascertaining the Postal Service's market power in the parcel delivery market. Order No. 4402 at 15-16. As the Commission explained, "[m]arket power arises when a competitor in the market: (1) can profitably set prices well above its costs and (2) enjoys some protection against entry or expansion by other competitors that would normally erode such prices and profits."[48] The Commission found that "[e]valuating market power allows the Commission to assess whether competition is being preserved and whether the Postal Service possesses a competitive advantage." Order No. 4402 at 16.

To assess the Postal Service's absolute market power, the Commission used a traditional Lerner index, which measures the difference between the marginal cost of producing a product and the amount of revenue a firm is able to realize from that product, as a starting point. The Commission then made several modifications for reasons specific to the Postal Service's competitive products and in response to comments received.[49] Based on these modifications, the Commission proposed the Competitive Contribution Margin as the first component of the formula and calculated it as follows:[50]

$$Competitive\ Contribution\ Margin = \frac{Total\ Revenue - Total\ Attributable\ Cost}{Total\ Revenue}$$

The Competitive Contribution Margin is used to assess the market power for all Postal Service competitive products collectively for a given fiscal year. It determines this based on the difference between the total attributable costs of producing the Postal

[48] *Id.* at 16 (citing Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law*, Vol. IIB 109 (4th ed. 2014)).

[49] *Id.* at 17-19; Order No. 4742 at 13-17.

[50] Order No. 4742 at 13.

Service's competitive products collectively, and the amount of revenue the Postal Service is able to realize from competitive products collectively.[51] If the Postal Service's competitive product total attributable cost were to increase relative to its competitive product total revenue, this would indicate that the Postal Service possessed less market power. *See* Order No. 4402 at 17. The Competitive Contribution Margin would decline in response to this decrease in market power. If the Postal Service's competitive product total revenue were to increase relative to its competitive product total attributable costs, this would indicate the Postal Service possessed more market power. *See id.* The Competitive Contribution Margin would increase in response to this increase in market power.

Similar to a Lerner index, Competitive Contribution Margin values typically range from 0 to 1.[52] At 0, total revenue equals total attributable cost, which represents a perfectly competitive environment in which a firm makes no profit. *See id.* at 20. Thus, Competitive Contribution Margin values close to 0 are evidence of highly competitive environments. The further the Competitive Contribution Margin shifts away from 0 and toward 1, the more market power the Postal Service's competitive products have. *Id.* The domestic parcel delivery market is a network industry that contains significant barriers to entering the market.[53] These barriers prevent perfect competition, and firms within network industries naturally possess some degree of market power. *See* Order No. 4402 at 20. As a result, Competitive Contribution Margin values in excess of 0 are expected for the Postal Service.

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[51] A traditional Lerner index uses price instead of total revenue and marginal cost instead of total attributable cost. *See* Church & Ware, *supra* n.43, at 29.

[52] *See id.* at 20. As discussed in Order No. 4402, index values less than 0 may indicate a firm is engaging in predatory pricing. *See id.* at 36.

[53] *Id.* Network industries are industries with cost advantages arising from handling products together, whether large amounts of the same product (economies of scale), or several different products (economies of scope). *See* Order No. 3506, Appendix A at 5-6; *see also* Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 35 (3d ed. 1999); David C. Colander, *Microeconomics* 228 (5th ed. 2004); United States Postal Service, Office of Inspector General, Risk Analysis Research Center, Report No. RARC-WP12-008, A Primer on Postal Costing Issues, March 20, 2012, at 2-3, available at: *https://www.uspsoig.gov/sites/default/files/document-library-files/2015/rarc-wp-12-008_0.pdf.*

2. Competitive Growth Differential

The second component of the formula is the Competitive Growth Differential. This component is designed to assess the growth or decline of the Postal Service's market position from year to year, which allows the component to capture the change in the size of the Postal Service's competitive business relative to that of its competitors. Order No. 4742 at 23, 27. The Postal Service's market position is determined by comparing the year-over-year change in the Postal Service's competitive product revenue to the year-over-year change in competitors' collective revenue. This relative growth is then adjusted by the Postal Service's market share.[54] The Competitive Growth Differential is calculated as follows:[55]

$$Competitive\ Growth\ Differential = Market\ Share_{USPS} * (\%\Delta Revenue_{USPS} - \%\Delta Revenue_{C\&M})$$

The market share weight reduces the influence of the Postal Service's relative growth on the appropriate share, in order to reflect the constraints that the Postal Service's competitors and market share place on its capacity to generate contribution. As the Postal Service gains market share, the magnitude of this reduction decreases, because the Postal Service faces fewer constraints on its ability to gain revenue relative to its competitors.

Revenue data for the Postal Service are obtained from the Product Finances Analysis (PFA), which is produced each year by the Commission as part of its Annual Compliance Determination (ACD) made pursuant to 39 U.S.C. § 3653. Revenue data for the Postal Service's competitors are obtained from two surveys conducted by the United States Census Bureau.[56] The revenue data used in the Competitive Growth Differential are adjusted for inflation, using the Consumer Price Index for All Urban

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[54] *Id.* at 23-24. The Postal Service's market share is determined by dividing the Postal Service's total competitive product revenue by the sum of the Postal Service's total competitive product revenue and total competitor revenue, as depicted in the following formula:

$$Market\ Share_{USPS} = \frac{Revenue_{USPS}}{Revenue_{USPS} + Revenue_{C\&M}}$$

[55] Order No. 4742 at 230.

[56] For further description of these data sources, *see* Order No. 4402 at 23-27.

Consumers (CPI-U) as the deflator.[57] In accounting for inflation as part of the Competitive Growth Differential, the Commission found that the accuracy of the component is improved by using real revenue growth instead of nominal revenue growth. Order No. 4742 at 29. In Order No. 4742, the Commission noted that without adjusting for inflation, the formula could interpret inflationary changes in the market as market growth. *Id.* By accounting for inflation, the Competitive Growth Differential more accurately measures actual changes in the Postal Service's market position.

C. Resulting Formula

Using both components, the appropriate share will be calculated using the following formula:[58]

$$AS_{t+1} = AS_t * (1 + \%\Delta CCM_{t-1} + CGD_{t-1})$$
$$If\ t = 0 = FY\ 2007,\ AS = 5.5\%$$

Where,

AS = Appropriate Share[59]

CCM = Competitive Contribution Margin

CGD = Competitive Growth Differential

t = Fiscal Year

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[57] Order No. 4742 at 23-24. The CPI-U is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, and data are obtained from the United States Bureau of Labor Statistics. *See* United States Bureau of Labor Statistics, Consumer Price Index – All Urban Consumers (Series ID CUUR0000SA0), available at: *https://data.bls.gov/timeseries/CUUR0000SA0*; United States Bureau of Labor Statistics, Consumer Price Index, Frequently Asked Questions, available at: *https://www.bls.gov/cpi/questions-and-answers.htm*. The Commission indexes the CPI-U data to FY 2007; that is, FY 2007 constitutes the base year for any inflation adjustment, which aligns the CPI-U data with the beginning year for the Commission's proposed formula. *See* Order No. 4742 at 24-25.

[58] *Id.* at 38.

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

The appropriate share will be adjusted annually by using the formula to calculate the minimum appropriate share for the upcoming fiscal year.[60] The new appropriate share level for the upcoming fiscal year will be reported as part of the Commission's ACD. *Id.* at 38-39.

In order to calculate an upcoming fiscal year's appropriate share percentage (AS_{t+1}), the formula multiplies the sum of the prior fiscal year's Competitive Growth Differential and percentage change in the Competitive Contribution Margin, $(1 + \%\Delta CCM_{t-1} + CGD_{t-1})$, by the current fiscal year's appropriate share (AS_t). *Id.* at 39. Both components of the formula are given equal weight. *Id.* at 43-46.

The formula is recursive in order to incorporate year-over-year changes in the parcel delivery market. *Id.* at 39. As described in Order No. 4742, the formula's calculation begins in FY 2007 with a beginning appropriate share of 5.5 percent. *Id.* at 40. These beginning values allow the resulting appropriate share to capture the impact of market fluctuations on the appropriate share since the PAEA's enactment and moving forward.

Table III-1 below illustrates the calculation of the appropriate share using the Commission's formula starting with an appropriate share of 5.5 percent in FY 2007.

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[60] *Id.* For examples of how the formula functions from year to year, *see id.* at 39-40.

Table III-1

Calculation of Appropriate Share,

FY 2007 – FY 2019[61]

Fiscal Year	**Appropriate Share for the Current Year** (AS_t)	**Percentage Change in Competitive Contribution Margin for the Prior Year** $(\%\Delta CCM_{t-1})$	**Competitive Growth Differential for the Prior Year** (CGD_{t-1})	**Appropriate Share for the Following Year** (AS_{t+1})
FY 2007	5.5%	N/A	N/A	5.5%
FY 2008	5.5%	0.0%	0.0%	5.5%
FY 2009	5.5%	-5.9%	0.7%	5.2%
FY 2010	5.2%	13.4%	1.2%	6.0%
FY 2011	6.0%	15.7%	1.0%	7.0%
FY 2012	7.0%	-7.9%	-0.2%	6.4%
FY 2013	6.4%	3.7%	2.7%	6.8%
FY 2014	6.8%	5.5%	2.5%	7.3%
FY 2015	7.3%	0.4%	1.2%	7.4%
FY 2016	7.4%	-2.6%	0.2%	7.2%
FY 2017	7.2%	18.1%	1.4%	8.6%
FY 2018	8.6%	1.3%	1.1%	8.8%

D. Connection to Section 3633(b) Criteria

As noted by declarant J. Gregory Sidak on behalf of UPS, no single objective solution exists as to what the appropriate share should be. *See* Sidak Order No. 4742 Decl. at 35-36. Rather, the PAEA set forth criteria that any approach to setting the appropriate share must consider. These criteria are the prevailing competitive conditions in the market; the degree to which any costs are uniquely or disproportionately associated with any competitive products; and all other relevant circumstances. 39 U.S.C. § 3633(b). The Commission has repeatedly found that there are no costs uniquely or disproportionately associated with competitive products that are not already attributed to those products under the Commission's current cost attribution methodology. Order No. 4402 at 43-44; Order No. 4742 at 52-53; section VIII.C, *infra*. As a result, the formula-based approach does not separately account for

[61] Source: Library Reference PRC-LR-RM2017-1/3.

such costs.[62] The formula-based approach captures the prevailing competitive conditions in the market and other relevant circumstances of section 3633(b), incorporating factors considered in the Commission's previous reviews of the appropriate share.

The vast majority of the qualitative considerations the Commission has previously looked to in assessing the prevailing competitive conditions in the market and other relevant circumstances are captured by considering the Postal Service's market power and market position. These include evidence of any competitive advantage by the Postal Service; changes in the Postal Service's market share; changes in the parcel delivery market and the competitors in it; product transfers; mail mix changes; and market uncertainties.[63]

In light of the pace of change in the market, the Commission has determined that it is desirable to have an appropriate share requirement that is updated more frequently than once every 5 years. The proposed formula provides the Commission with a means to assess market conditions and other relevant circumstances annually, which will make the appropriate share requirement both more reflective of, and more responsive to, changes in market conditions and other relevant circumstances.

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[62] Order No. 4742 at 52. Competitive product attributable costs are, however, reflected in the Competitive Contribution Margin. *See generally* section III.B.1, *supra*.

[63] *See* Order No. 4402 at 35, 38-40, 46-50; Order No. 4742 at 49-52, 55-56. As the Commission acknowledged in Order No. 4402, some of the qualitative considerations the Commission has historically relied upon, such as the existence of antitrust actions against the Postal Service, cannot be explicitly captured by the formula. *See* Order No. 4402 at 34 n.60. The Commission found, however, that most of these qualitative factors are implicitly captured by the formula. *Id*.

IV. GENERAL POSITIONS OF COMMENTERS

In response to Order No. 3624, the Commission received a variety of comments advocating that the Commission either significantly increase the appropriate share requirement, maintain it at its current level of 5.5 percent, or reduce or eliminate the requirement. These comments were summarized and analyzed in Order No. 4402, in which the Commission first proposed transitioning to a formula-based approach to setting the appropriate share. *See generally* Order No. 4402 at 68-99. The Commission then sought comments on its proposed formula. *Id.* at 100. In response to Order Nos. 4402 and 4742, several commenters, in addition to offering input with regard to the Commission's proposed formula, renew their initial arguments from the comments they filed in response to Order No. 3624. These commenters advocate for their initial policy positions rather than a formula-based approach.

UPS argues that the appropriate share should be increased substantially based on the prevailing competitive conditions in the market, particularly growth in the Postal Service's market share and evidence of the Postal Service having a competitive advantage, and to reflect the unique and disproportionate costs that UPS alleges to be associated with competitive products.[64] The American Consumer Institute Center for Citizen Research (ACI), which did not file comments in response to Order No. 3624, also argues that the appropriate share should be significantly increased. ACI Order No. 4402 Comments at 3; ACI Order No. 4742 Comments at 1.

The Public Representative continues to advocate for maintaining the current appropriate share requirement at 5.5 percent based on the prevailing competitive conditions in the market, future uncertainties in the market, and the risks associated with setting the appropriate share too high.[65]

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[64] UPS Order No. 4402 Comments at 8-28, 35-41; UPS Order No. 4742 Comments at 53-59. UPS is joined in this recommendation by its declarant, Sidak. Sidak Order No. 4742 Decl. at 2.

[65] PR Order No. 4402 Comments at 7-14; PR Order No. 4742 Comments at 11-16. He is joined in this recommendation by his declarant, Soiliou Daw Namoro. Namoro Order No. 4402 Decl. at 26.

The Postal Service, Amazon, Pitney Bowes Inc. (Pitney Bowes), and the Parcel Shippers Association (PSA) continue to advocate for either reducing the appropriate share or eliminating it altogether, based on the relative market positions of the Postal Service and its competitors, the lack of any significant change in the Postal Service's market share, and the lack of any evidence of the Postal Service having a competitive advantage.[66] They also base their positions on future uncertainties in the market and the risks associated with setting the appropriate share too high.[67] Pitney Bowes expresses the view that "[t]here is no need to maintain or increase the minimum contribution requirement[,]" for many of the same reasons cited by the Postal Service, Amazon, and PSA.[68]

To the extent that the Commission responded to these comments in Order No. 4402, the Commission does not address them in detail in this Order. However, the Commission notes these commenters' general positions because they provide useful context for understanding these commenters' more specific views. The Commission has considered all of these commenters' positions and has determined that a formula-based approach is the most appropriate approach at this time. *See* Order No. 4402 at 74-76, 87-88, 96-99. In the remainder of this Order, the Commission addresses those comments that were received in response to Order No. 4402 but were not specifically addressed in Order No. 4742. The Commission also addresses comments received in response to Order No. 4742.

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[66] Postal Service Order No. 4402 Comments at 5-8; Postal Service Order No. 4742 Comments at 2, 5-6; Amazon Order No. 4402 Comments at 6-40; Amazon Order No. 4742 Comments at 5-6; PSA Order No. 4402 Comments at 1-3.

[67] Postal Service Order No. 4402 Comments at 4-6; Amazon Order No. 4402 Comments at 24-25, 26-30; PSA Order No. 4402 Comments at 1-2.

[68] Pitney Bowes Order No. 4402 Comments at 4-13, 16; Pitney Bowes Order No. 4742 Comments at 3-4.

V. COMMENTS PROPOSING ALTERNATIVES AND COMMISSION ANALYSIS

A. Previous Commission Discussion

In Order No. 4402, the Commission considered and rejected proposals by UPS that the appropriate share be based on either competitive products' attributable cost shares (*i.e.*, the proportion of competitive products' attributable costs relative to the Postal Service's total attributable costs), or competitive products' revenue shares (*i.e.*, the proportion of competitive products' revenue relative to the Postal Service's total revenue). The Commission found that relying on attributable cost shares alone would fail to take into account the prevailing competitive conditions in the market and other relevant circumstances as required by section 3633(b). Order No. 4402 at 81. The Commission also found that such an approach would be tantamount to fully-allocated costing, which has long been rejected by the Commission, economists, and the courts. *Id.*

With regard to competitive products' revenue shares, the Commission found that, as with attributable cost shares, such an approach would fail to take into account the prevailing competitive conditions in the market and other relevant circumstances. *Id.* at 82. The Commission also found that competitive products' revenue shares are affected by an exogenous factor: the ongoing decline of volume and revenue for the Postal Service's market dominant products. *Id.* If market dominant revenue continues to decline, competitive product revenue will necessarily make up a larger proportion of the Postal Service's overall revenue. *Id.* However, this fact does not indicate anything with regard to conditions in the parcel delivery market.

The Commission also rejected proposals to maintain the appropriate share at its current level of 5.5 percent, finding that changes in the prevailing competitive conditions in the market and other relevant circumstances—including growth in the Postal Service's market power and market share, as well as growth in the overall market—rendered a change in approach appropriate at this time. *Id.* at 88.

With regard to proposals that the Commission either reduce or eliminate the appropriate share requirement, the Commission found that while the Postal Service continues to operate at a net competitive disadvantage in the market relative to its competitors, the Commission’s formula-based approach would better capture the statutory criteria of section 3633(b) and “balance[] the concerns of all groups—customers, competitors, market dominant mailers, shippers, and the general public.” *Id.* at 97.

B. Comments

UPS continues to argue that the appropriate share should be based on either competitive products’ attributable cost shares or competitive products’ revenue shares.[69] Sidak also advocates basing the appropriate share on competitive products’ attributable cost shares. Sidak Order No. 4742 Decl. at 37-39.

UPS specifically disputes the Commission’s finding from Order No. 4402 that UPS’s attributable cost share proposal would be tantamount to fully-allocated costing.[70] UPS maintains that unlike fully-allocated costing, which would require every cost to be assigned to a specific product or service, its proposal “would, rather, require the competitive products business as a *whole* to cover the relevant share of costs.” UPS Order No. 4742 Comments at 52 (emphasis in original). UPS further defends its attributable cost share proposal on the grounds that it “will encourage the Postal Service to be more disciplined and rational when making future investment decisions,” which “are going to be geared toward competitive products….” *Id.* at 53. UPS asserts that a similar approach has been used by the European Commission. *Id.* at 54-56.

UPS also specifically disputes the Commission’s finding from Order No. 4402 that UPS’s revenue share proposal is infeasible in part because competitive products’ share of total Postal Service revenue is affected by the ongoing decline in market dominant revenue.[71] UPS asserts that competitive products’ share of total Postal Service revenue would have grown substantially even if market dominant revenue had

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[69] UPS Order No. 4402 Comments at 36, 40; UPS Order No. 4742 Comments at 50-53, 56.

[70] UPS Order No. 4742 Comments at 52; *see* Order No. 4402 at 81.

[71] UPS Order No. 4742 Comments at 56; *see* Order No. 4402 at 82.

remained at FY 2008 levels.[72] UPS stipulates that the increase in the appropriate share that it seeks could be phased in over time, if necessary. *Id.* at 59.

ACI asserts that the Commission should adopt an "affiliate transactions rule," which would base the appropriate share on competitive products' revenue shares, until such time as the Commission is able to develop a "full cost accounting model" for competitive products. ACI Order No. 4742 Comments at 1, 3.

The Public Representative specifically criticizes UPS's revenue share proposal, asserting that it is "simply a thinly disguised maximum." PR Order No. 4742 Comments at 14. He and Namoro continue to argue that the appropriate share should be maintained at its current level of 5.5 percent.[73] The Public Representative asserts that the Postal Service's poor financial condition incentivizes it to maximize revenue from its competitive products, and that the risks and uncertainties associated with setting the appropriate share too high render it unwise to increase the requirement at this time. PR Order No. 4402 Comments at 8-9. He asserts that there is no evidence of any competitive advantage by the Postal Service, as the Postal Service's market share has not changed significantly since the Commission's last review, competitive products' share of total Postal Service volume is still relatively minor, and the Postal Service's competitors remain profitable. *Id.* at 12-16.

The Postal Service, Amazon, PSA, and Pitney Bowes all continue to argue that the appropriate share should be reduced or eliminated. The Postal Service asserts that because the PAEA authorized it to retain earnings from competitive products, it is incentivized to exceed the minimum appropriate share requirement when pricing its competitive products. Postal Service Order No. 4402 Comments at 6. It also asserts that competition in the market is healthy, and that raising the appropriate share would

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[72] UPS Order No. 4742 Comments at 56-57. Specifically, UPS asserts that from FY 2008 to FY 2017, "competitive products' share of revenue has grown from 11 [percent] to 30 [percent]…[but] even if market dominant revenues had stayed at FY[]2008 levels, competitive products' share would have grown from 11 [percent] to 24 [percent]." *Id.* (footnote omitted).

[73] PR Order No. 4402 Comments at 7-14; PR Order No. 4742 Comments at 16; Namoro Order No. 4402 Decl. at 26.

"benefit only the Postal Service's private competitors…." Postal Service Order No. 4742 Comments at 2-3. As a result, it argues that the appropriate share requirement is no longer necessary. *Id.* at 2-3, 14.

Amazon likewise asserts that the parcel delivery market is competitive and that the appropriate share requirement is no longer necessary.[74] It argues that none of the section 3633(b) considerations weigh in favor of maintaining the appropriate share requirement. Amazon Order No. 4402 Comments at 5. It contends that the Postal Service is incentivized to price its products competitively, which has been reflected in the Postal Service's actual pricing behavior since the PAEA was enacted. *Id.* at 32-33. It also asserts that "the Postal Service is in a better position as the operator to decide how to price its products…than is a regulatory body," and "the notice-and-comment and decision-making requirements of administrative litigation necessarily prevent regulators from adjusting regulatory rate floors as quickly as competitive conditions can change and competitive prices should change in response." *Id.* at 32, 34.

PSA labels the appropriate share requirement an "irrelevant anachronism," and argues that it should be eliminated. PSA Order No. 4402 Comments at 1.

Pitney Bowes takes the position that "there is no need to maintain or increase the minimum contribution requirement," and appears to be in favor of reducing or eliminating the appropriate share.[75] In Pitney Bowes' view, the evidence shows that an increased contribution requirement is not necessary to preserve competition in the market; that the Postal Service does not have a dominant position in the market; that the Postal Service has pursued contribution to institutional costs from competitive products by implementing price increases on a growing number of competitive products; that the Postal Service's overall market share in the parcel delivery market remains

[74] Amazon Order No. 4402 Comments at 5; Amazon Order No. 4742 Comments at 8.

[75] Pitney Bowes Order No. 4402 Comments at 16; *see also* Pitney Bowes Order No. 4742 Comments at 2-3, 4.

modest; and that the parcel delivery market remains dynamic. Pitney Bowes Order No. 4402 Comments at 8-9.

C. Commission Analysis

As discussed at section VI, *infra*, UPS, Sidak, and ACI all criticize the Commission's formula-based approach as flawed because it purportedly fails to take into consideration all of the relevant circumstances applicable to setting the appropriate share.[76] However, none of these parties suggest an alternative approach that would provide for consideration of any additional factor they identify as lacking in the formula. Rather than reflecting relevant circumstances, these commenters suggest alternatives that would set an appropriate share determined exclusively by the Postal Service's revenues or attributable costs.

Despite UPS's and Sidak's objections, the Commission continues to conclude that the attributable cost share and revenue share proposals would produce an outcome tantamount to fully-allocated costing, because either proposal would result in costs being allocated to specific products or groups of products on a basis other than causal relationships, which is what the PAEA calls for.[77] The fundamental problem with such an approach, as it relates to the appropriate share, is that it would base the appropriate share on considerations different from those of section 3633(b). As the Commission stated in Order No. 4402, the Postal Service's attributable cost shares (or revenue shares) do not provide any insight into its market power, the size of the overall parcel delivery market, or any other prevailing competitive conditions in the market or other relevant circumstances. *See* Order No. 4402 at 81. Notably, UPS does not dispute this in its comments in response to Order Nos. 4402 and 4742. Rather, its argument in favor of using attributable cost shares or revenue shares is based primarily on its

[76] *See* UPS Order No. 4402 Comments at 34-35; Sidak Order No. 4402 Decl. at 40-42; ACI Order No. 4742 Comments at 4, 6-7.

[77] *See* Order No. 4402 at 81-82. Amazon asserts that Sidak's position in this proceeding concerning fully-allocated costing appears to contradict his peer-reviewed publications, wherein he condemns fully-allocated costing as inherently arbitrary. Amazon Order No. 4402 Comments at 28-29.

interpretation of the unique and disproportionate costs element of section 3633(b)—an argument that the Commission has specifically rejected.[78]

With regard to UPS's assertion that its proposals would lead to the Postal Service being more "disciplined and rational" in its investment decisions, the Commission finds this logic to be speculative. Even if it were true, it would be counterweighed by the PAEA's clear requirements regarding cost attribution and the considerations on which to base the appropriate share. *See* section II.B, *supra*, and section VIII.C, *infra*. Furthermore, this approach is likely to force the Postal Service to reduce investment in markets in which it is currently profitable, which would harm the Postal Service's financial stability.

With regard to UPS's assertion that competitive products' share of total Postal Service revenue would have grown even if market dominant revenue had not declined, the fact remains that at least some of the change in competitive products' share of revenue is the result of the decline in market dominant revenue. The decline of market dominant revenue has nothing to do with the prevailing competitive conditions in the parcel delivery market, which further demonstrates why using revenue shares to set the appropriate share is inappropriate.

With regard to ACI's proposal for an "affiliate transactions rule," the Commission concludes that the effect of the proposal would be equivalent to UPS's revenue share proposal, because it proposes imposing the institutional cost burden proportionately to the share of revenue that competitive products generate relative to the Postal Service's

[78] *See, e.g.*, UPS Order No. 4742 Comments at 51 (quoting 39 U.S.C. § 3633(b)) ("The best proxy for estimating 'the degree to which any costs are uniquely or disproportionately associated with any competitive products'…is to use the share of total attributable costs for which competitive products are responsible."); Order No. 4402 at 43-44; *see also* section VIII.C, *infra*.

total revenue.[79] The Commission accordingly rejects it for the same reasons.

With regard to the recommendations of the Public Representative, Namoro, the Postal Service, Amazon, PSA, and Pitney Bowes, the Commission continues to find that the market conditions underlying the original 5.5 percent appropriate share have changed, and that the Commission's formula will better capture the statutory criteria of section 3633(b) than reducing, eliminating, or maintaining the appropriate share would.

VI. COMMENTS ON THE FORMULA GENERALLY AND COMMISSION ANALYSIS

Many of the comments received in response to Order No. 4402 that were specific to the Commission's formula were addressed in Order No. 4742. These included comments concerning data aggregation issues; disproportionate incorporation of competitor revenue; incorporation of the Postal Service's market share; the economic basis for linking market size with the appropriate share amount; the use of revenue as a measure of output; accounting for inflation; accounting for product differentiation; and issues dealing with the formula's beginning appropriate share value, beginning fiscal year, and component weighting.[80]

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[79] *See* ACI Order No. 4742 Comments at 1. The Commission construes ACI's proposal as advocating for a revenue share-based approach to setting the appropriate share. "Affiliated transactions," a term used in other industries, is not applicable to the Postal Service. Specifically, in the regulation of utilities, affiliate transactions rules are intended to prevent a regulated utility from favoring an unregulated affiliate by paying the affiliate above-market prices for goods and/or services. *See, e.g.*, *Boston-Edison Co. Re: Edgar Electr. Energy Co.*, 55 FERC ¶¶ 61,382, 62,168 (1991). Such rules require the regulated utility to charge the unregulated affiliate the higher of either the market price or the fully-allocated cost of a good or service. *See* Docket No. RM2017-3, Comments of the American Consumer Institute Center for Citizen Research, February 23, 2018, at 8-9. However, such rules are unnecessary in the context of the Postal Service because the purpose of such rules, *i.e.*, protecting captive customers from unduly high prices, is achieved by the PAEA's price cap on market dominant products.

[80] *See* Order No. 4742 at 11-12, 20-23, 35-37.

The remaining comments specific to the Commission's formula can be divided into two broad groups: those pertaining to the formula generally and those specific to one of the formula's two components and operation. This section focuses on comments concerning the formula generally.

Comments addressing the formula generally can be further divided into six topics: the use of a formula-based approach; the Commission's choice of variables; the possibility of the formula facilitating underpricing by the Postal Service; uncertainties associated with the formula; the potential for unclear results because of changes in the mail mix; and a catch-all category for other issues related to the formula generally.

A. The Use of a Formula-Based Approach

1. Comments

Both Amazon and Pitney Bowes assert that the use of a formula-based approach will not, as Pitney Bowes states, "cure the inherent limitations of imposing a regulatory price floor where none is actually required."[81] These commenters assert that the use of a formula could also introduce additional risks to the appropriate share determination. Specifically, Amazon asserts that:

> The proposed formula may be heavily affected by extraneous factors…[such as] changes in demand elasticities for competitive parcel products, entry of new competitors, pricing 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.

Amazon Order No. 4402 Comments at 38. In addition, Amazon maintains that "the minimum contribution requirement produced by the formula would be insufficiently responsive to prevailing competitive conditions, and would limit the Postal Service's ability to respond to changes in those conditions." *Id.* Pitney Bowes asserts that "[a]dopting a formula-based approach may create additional risk *because* it is less

[81] Pitney Bowes Order No. 4402 Comments at 12; Amazon Order No. 4402 Comments at 38.

subjective." Pitney Bowes Order No. 4402 Comments at 12 (emphasis in original). This is because such an approach "runs the risk of becoming unduly rigid or missing a key, potentially unpredictable or unknown, variable."[82]

In addition, several commenters express the view that not all considerations relevant to determining the appropriate share are capable of being captured by a formula-based approach. Pitney Bowes argues that certain considerations relevant to determining the appropriate share are not capable of being assessed through a formula because they cannot be directly quantified. Pitney Bowes Order No. 4402 Comments at 15. It offers as examples the section 703(d) analysis[83] and evidence that other competitors in the market have alleged anticompetitive behavior by the Postal Service. Pitney Bowes Order No. 4402 Comments at 15. Similarly, the Postal Service asserts that "no simple formula will be able to fully reflect the market conditions under which competitive products' potential to contribute to institutional costs might change."[84] Namoro states that determining the appropriate share involves judgments which might not be adequately depicted in a mathematical formula. Namoro Order No. 4742 Decl. at 3.

Amazon contends that "[i]f the Commission chooses…to maintain the minimum contribution requirement then it should adopt a flexible methodology that considers both qualitative and quantitative factors, and that uses numerical formulas only as part of a broader exercise of judgment…." Amazon Order No. 4742 Comments at 4. Pitney Bowes likewise asserts that "[t]he final rule should clarify that the Commission will

[82] Pitney Bowes Order No. 4402 Comments at 12-13. Pitney Bowes concedes that a formula-based approach would convey at least some advantage, in that it "provides the Commission with a less subjective assessment of changes in market conditions," and "the Commission's commitment to assess these quantitative factors annually could help smooth out necessary adjustments." *Id.* at 12. Amazon likewise notes that "some of [the risks which Amazon identifies] would likely be attenuated by the minimum contribution requirements likely to be generated by the proposed formula, by the recursive nature of the formula, and by the Commission's commitment to conduct an annual review." Amazon Order No. 4402 Comments at 39. Nevertheless, Amazon maintains that "the risks still significantly outweigh any potential benefits." *Id.*

[83] For a discussion of section 703(d), *see* section IX, *infra.*

[84] Postal Service Order No. 4402 Comments at 16; *see* Postal Service Order No. 4742 Comments at 5.

explicitly consider the qualitative factors the Commission has developed in prior reviews in conjunction with any new quantitative inputs as part of its assessment of changes in the market." Pitney Bowes Order No. 4742 Comments at 4.

2. Commission Analysis

With regard to assertions that the use of a formula would not rectify the limitations inherently associated with the existence of a regulatory price floor, the Commission discussed such alleged limitations in Order No. 4402 and determined that the use of a formula-based approach appropriately balanced them with current market conditions and other relevant circumstances. *See* Order No. 4402 at 74-76, 87-88, 96-99. The fact that the formula will be affected by factors such as those identified by Amazon is by design. Such factors constitute elements of the parcel delivery market, and were the formula not to consider them, directly or indirectly, it would fail to reflect the statutory criteria: the prevailing competitive conditions in the market and other relevant circumstances. Such factors do not influence the formula disproportionately or unreasonably. Rather, they are appropriately reflected through the formula's two components, which jointly reflect changes in the Postal Service's capacity to contribute to institutional costs given its market power and market position.

With regard to concerns that the use of a formula could introduce additional risk into the appropriate share determination and might prove insufficiently responsive to changes in market conditions, the Commission concludes that the risks associated with the formula-based approach are minimal. The formula captures the prevailing competitive conditions in the market, reflects the Postal Service's absolute and relative market power, and, as simulated by Namoro in his declaration in response to Order No. 4742, responds well to changes in the Postal Service's capacity to contribute to institutional costs.[85] The Commission also finds that the formula is more responsive to changes in market conditions than the approach employed by the Commission in the

[85] *See* section III.A and section III.B, *supra* and section VIII.B, *infra*; *see also* Namoro Order No. 4742 Decl. at 28-29.

past, because the formula will be applied annually based on the most recent changes in the Postal Service's market power and market position. Risks due to unforeseen circumstances are mitigated by the Commission's authority to review the appropriate share—and the formula—at any time.[86]

With regard to Pitney Bowes' concern that evidence of anticompetitive behavior by the Postal Service would not be captured by the formula, the Commission explained in Order Nos. 4402 and 4742 that such evidence would be implicitly incorporated into the Competitive Growth Differential to the extent that it would likely cause the component to increase.[87] Specific allegations of anticompetitive behavior by the Postal Service can also be brought to the Commission's attention at any time through the filing of a petition for rulemaking that requests the Commission to re-evaluate the appropriate share requirement in light of such evidence or through the filing of a complaint pursuant to 39 U.S.C. § 404a.

With regard to the analysis required by section 703(d) of the PAEA, the Commission notes that this inquiry is statutorily separate from consideration of the elements under section 3633(b). The formula is designed to address the latter, specifically the prevailing competitive conditions in the market and other relevant circumstances. The Commission is statutorily obligated, pursuant to section 703(d), to separately assess the ongoing validity of the 2007 Federal Trade Commission (FTC) report whenever the Commission promulgates or revises regulations under 39 U.S.C. § 3633.[88] Should the Commission's assessment under section 703(d) necessitate a change to the appropriate share in the future, the Commission retains the flexibility to make such adjustment within the formula-based approach.

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[86] *See* 39 U.S.C. §§ 3633(a) and (b) (stating the Commission *must* review the appropriate share every 5 years, but *may* "from time to time…revise" such regulations).

[87] *See* Order No. 4402 at 35-36; Order No. 4742 at 49 n.59.

[88] PAEA § 703(d); *see* Federal Trade Commission, Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors, December 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*.

With regard to suggestions that the Commission consider quantitative and qualitative factors simultaneously when setting the appropriate share, the Commission finds that the formula is specifically designed to reflect the relevant statutory considerations, both quantitative and qualitative. The Commission is able to revisit the formula at any time in the future if necessary.

B. Choice of Variables

1. Comments

ACI asserts that "the Commission fails to empirically demonstrate that the two components [of the formula]…have any explanatory power in determining an appropriate institutional cost share specifically in the production of competitive products." ACI Order No. 4742 Comments at 6. This is because "there is no evidence that these variables adequately explain the variation in prevailing competitive conditions in the market," and "there are many other variables that may provide more accurate information on prevailing competitive conditions in the market." *Id.* (internal citation and marks omitted). ACI provides a list of what it alleges to be other relevant variables for purposes of assessing prevailing market conditions.[89] ACI specifically focuses on the Postal Service's institutional costs as a missing variable. ACI Order No. 4742 Comments at 4.

Sidak similarly argues that by reducing the relevant analysis to only two components, the formula fails to account for standard economic factors such as "whether there are persistent barriers to entry or high sunk costs associated with entry in the market, as well as the rate of innovation in the market." Sidak Order No. 4402 Decl. at 40-41. Sidak maintains that "one cannot reliably infer the degree of price

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[89] *Id.* at 7. This list includes: ability to shift profits; ability to shift revenues; ability to shift costs; intangible value of the brand; intangible value of the mailbox; number of firms in the market; quality of service; Herfindahl-Hirschman index; innovation; demand for substitute goods; demand for complementary goods; economies of scope; economies of scale; geographic disparities; first to market advantage; rate changes; price elasticity; cross-price elasticity; barriers to entry; economic output; labor market conditions; outsourcing; number of suppliers; and supply chain issue[s]. *Id.* ACI also asserts that the formula fails to incorporate costs uniquely or disproportionately associated with competitive products, as required by the PAEA. *Id.*; *see* section VIII.C, *infra*.

competition in a market solely on the basis of price-cost margins," and "neither economic theory nor empirical evidence indicates a dispositive relationship between profit margins and the possession of market power." *Id.* at 41 (internal citation and marks omitted). As a result, "[a] rigorous analysis of competitive conditions must consider various economic factors simultaneously." *Id.* Sidak asserts that although the Commission mentions some of these factors, the Commission "effectively chooses to give those factors zero weight…." in its formula. *Id.* at 41-42. Sidak also argues that the formula fails to account for entry or exit of firms from the market, because changes in the formula's indices "can be attributed to demand shocks or supply shocks in the package-delivery market which typically occur independently of entry or exit…." *Id.* at 51 (internal marks omitted).

However, Namoro states that the formula's modelling strategy—indexing changes in the appropriate share to changes in the Postal Service's ability to contribute more money to institutional costs—is logically sound. Namoro Order No. 4742 Decl. at 14.

2. Commission Analysis

The appropriate share constitutes the minimum share that competitive products are required to contribute to institutional costs. It functions as a test that the Commission uses to ensure that the Postal Service is competing fairly in the market, given existing market conditions. Taken together, the Competitive Contribution Margin and the Competitive Growth Differential capture the prevailing competitive conditions in the market and other relevant circumstances. *See* Order No. 4742 at 49-52, 55-57. These components are quantifiable, practical, and based on available data. As discussed in section III, *supra*, the Competitive Contribution Margin represents the Postal Service's absolute market power—its ability to charge its customers above the marginal cost of production for its competitive products.[90] This ability is only possible to

[90] *See* section III, *supra*; *see also* Order No. 4742 at 9; Namoro Order No. 4742 Decl. at 4; PR Order No. 4742 Comments at 6.

the extent that prevailing competitive conditions in the market and other relevant circumstances, including the structure of the market and the cost structure of the Postal Service, allow it.

However, the Postal Service's ability to generate revenue from competitive products is also constrained by the conduct and performance of the Postal Service's competitors. Therefore, assessing the prevailing competitive conditions in the market and other relevant circumstances also requires assessing the Postal Service's relative market power—its position in the market relative to other competitors. The Competitive Growth Differential balances the Competitive Contribution Margin by adjusting the measure of the Postal Service's absolute market power based on the amount of market share the Postal Service possesses and the revenue growth of the Postal Service relative to that of its competitors. The Competitive Contribution Margin and the Competitive Growth Differential together reflect both the prevailing competitive conditions in the market and other relevant circumstances as the Commission previously explained in Order No. 4742. *See* Order No. 4742 at 48-52, 53-57.

ACI does not provide any basis for concluding that the variables it proposes are more appropriate than the Competitive Contribution Margin and the Competitive Growth Differential. Each of ACI's proposed variables is either already reflected in the formula, not representative of the criteria of section 3633(b), or not feasibly measured. For example, price changes, price elasticities, outsourcing, barriers to entry, innovation, first-to-market advantage, service quality, substitute and complement demands, and scale and scope economies are all reflected in the formula, primarily through the Competitive Contribution Margin.[91] Output is reflected directly through the Competitive Growth Differential. The ability to shift costs, revenues, and profits, as well as the value of the Postal Service's brand, do not relate to the criteria of section 3633(b). The

[91] In Order Nos. 4402 and 4742, the Commission discussed how the formula incorporates several of these concepts. *See* Order No. 4402 at 34-40; Order No. 4742 at 48-52.

number of firms, associated Herfindahl-Hirshmann indices,[92] number of suppliers, and associated supply chain issues are not feasibly measured.

With regard to the Postal Service's institutional costs, there is no reason for the formula to account for them, as ACI suggests. The PAEA requires competitive products to cover an "appropriate share" of the Postal Service's institutional costs, based on the considerations mandated by section 3633(b) and not the total amount of institutional costs that exist. Moreover, institutional costs are, by definition, not causally related to any competitive products, and as the Commission has determined, there are no institutional costs uniquely or disproportionately associated with competitive products.[93]

With regard to Sidak's argument that the formula fails to account for standard economic factors, the Commission explained in Order Nos. 4402 and 4742 that having a measure of the Postal Service's market power coupled with a measure of the overall market position enables the Commission to capture the prevailing competitive conditions in the market and other relevant circumstances.[94] This includes the economic factors specifically identified by Sidak. A network industry features high barriers to entry and large startup, or sunk, costs. *See* section III.B.1*, supra*. When entry is limited, incumbent firms more easily exercise market power because the threat of being underpriced by a new competitor is limited. These barriers to entry and sunk costs result in the Competitive Contribution Margin having a higher value than would likely be the case in a less concentrated industry. However, the formula's focus is on change—changes to barriers to entry and sunk costs are expected to be reflected in the Competitive Contribution Margin, which rises or falls in response to changes in the Postal Service's market power.

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[92] A Herfindahl-Hirshmann index is a measure of market concentration. *See* United States Department of Justice & Federal Trade Commission, *Horizontal Merger Guidelines* § 5.3 (2010).

[93] *See* section VIII.C, *infra*; *see also* Order No. 4402 at 43-45; Order No. 4742 at 52-53.

[94] *See* Order No. 4402 at 34-40, 45-53; Order No. 4742 at 48-57.

Measuring the rate of innovation in a market is an imprecise exercise, with no standardized definitions or evaluations.[95] Economically, successful implementation of innovation results in the ability to earn greater profits, whether as a result of cost-saving innovations or the development of a new service where no competition exists.[96] In either case, such innovations would be reflected in the Competitive Contribution Margin to the extent that they affect the Postal Service's price markup (either because the Postal Service's marginal costs decrease while prices remain constant or because the Postal Service is able to increase its prices in response to increased demand). Innovations would also be reflected in the Competitive Growth Differential to the extent that they result in either revenue shifting between the Postal Service and its competitors or the Postal Service or any competitor gaining customers from the development of a new, innovative service.

Finally, with regard to Sidak's argument that the formula fails to account for the entry or exit of firms from the market, the formula in fact reflects such activity directly through the Competitive Growth Differential, and indirectly through the Competitive Contribution Margin. The entry and exit of firms would be directly reflected in the Competitive Growth Differential through changes in Postal Service and competitor revenue and the Postal Service's market share. These changes would also likely affect the Postal Service's prices, thereby indirectly affecting the Competitive Contribution Margin.

C. Possibility of the Formula Facilitating Underpricing

1. Comments

UPS and ACI assert that the formula could facilitate predatory pricing by the Postal Service.[97] According to these commenters, the Postal Service could lower its

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[95] *See* Scott D. Anthony, *How to Really Measure a Company's Innovation Prowess*, Harv. Bus. Rev. (Mar. 21, 2013), available at: *https://hbr.org/2013/03/how-to-really-measure-a-compan*.

[96] N. Gregory Mankiw, *Macroeconomics* 241 (7th ed. 2010).

[97] UPS Order No. 4402 Comments at 30; UPS Order No. 4742 Comments at 40, 47; ACI Order No. 4742 Comments at 4-5.

prices in order to underprice its competitors and gain market share, which would bring about a decrease in the value of the Competitive Contribution Margin (because that component is based on the difference between price and marginal cost).[98] As the value of the Competitive Contribution Margin fell, it would lead to a decrease in the appropriate share, further fueling the Postal Service's ability to underprice its competitors.[99]

In addition, UPS alleges that because the Competitive Growth Differential measures the size of the market based on revenue, as opposed to volume, the Postal Service will be incentivized to underprice its competitive products, because as long as the Postal Service's revenue growth is no greater than that of its competitors, the Postal Service will be free to increase competitive product volume without the Competitive Growth Differential having any effect on the appropriate share. UPS Order No. 4742 Comments at 46-47. UPS suggests that only after all of the Postal Service's competition had been eliminated and the Postal Service no longer had any motivation to engage in anticompetitive pricing would the formula begin to impose a meaningful appropriate share requirement under such a scenario.[100]

2. Commission Analysis

The Commission first notes that what UPS characterizes as "predatory pricing" is not in fact equivalent to predatory pricing in an antitrust context, as that term has an established definition of pricing a product below cost.[101] The Postal Service is prohibited from pricing its competitive products below their attributable costs by 39 U.S.C. § 3633(a)(2).

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[98] UPS Order No. 4402 Comments at 30; UPS Order No. 4742 Comments at 40; ACI Order No. 4742 Comments at 4-5.

[99] *See* UPS Order No. 4402 Comments at 30; UPS Order No. 4742 Comments at 40; ACI Order No. 4742 Comments at 4-5.

[100] UPS Order No. 4402 Comments at 30; UPS Order No. 4742 Comments at 40.

[101] *See, e.g., Sprint Nextel Corp. v. AT&T, Inc.*, 821 F.Supp.2d 308, 314 n.6 (D.C. Cir. 2011) (internal citation omitted) ("Predatory pricing may be defined as pricing below an appropriate measure of cost for the purpose of eliminating competitors in the short run and reducing competition in the long run.").

Although there is a wide range of conduct between formal predatory pricing and healthy competition, the Commission concludes that the Postal Service is competing fairly. Specifically, the Postal Service and its major competitors have cumulatively increased their prices by similar amounts over the past 6 years. *See* section II.A, Table II-5, *supra*. Furthermore, both the Postal Service and its competitors make widespread use of non-published rates for select high-volume customers.[102] A market with a small number of competitors, each of which uses both published and non-published rates, is likely to trend towards an equilibrium point approaching competitive prices.[103] At such an equilibrium point, each firm produces its products at the least possible cost, and resources are optimally allocated between the various participants in the market.[104] This appears to be the current state of the parcel delivery market. Published prices alone cannot be dispositive when evaluating competitors' conduct in the parcel delivery market, and the use of both published and non-published rates by all participants in the market suggests that no one firm is capable of pricing in a way that permits it to dominate the market and drive out competitors.

Furthermore, if the Postal Service were to reduce its markup on competitive products in order to lower the Competitive Contribution Margin in an effort to gain volume and eliminate competition, this decrease would be partially offset by growth in the Competitive Growth Differential, because the Postal Service's revenue would grow relative to that of its competitors. Moreover, any attempt by the Postal Service to reduce its markup risks the Postal Service failing to generate enough contribution to comply with the appropriate share prior to that effect appearing in the Competitive Contribution Margin.

It is also worth noting that the Postal Service arguably could have pursued a strategy similar to that alleged by UPS and ACI under the current appropriate share requirement but has not done so. As discussed in section VIII.B.1.e, *infra*, the Postal

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[102] These agreements are known as NSAs. *See* section II.A, *supra*.

[103] *See* Areeda & Hovenkamp, *supra* n.48, § 404(b)(3).

[104] *See id.* § 402(b).

Service has consistently increased competitive product prices above the rate of inflation. For all of these reasons, the Commission finds it highly unlikely that the Postal Service would engage in such a strategy.

D. Uncertainties Associated with the Formula

1. Comments

Sidak, Pitney Bowes, and the Postal Service raise concerns about uncertainties associated with the formula. Sidak first asserts that the use of a recursive formula could cause the appropriate share to enter either a positive feedback loop, in which the appropriate share would become so high that the Postal Service would be unable to compete in the market, or a negative feedback loop, in which the appropriate share would become so low that the Postal Service would be enabled to underprice its competitors. Sidak Order No. 4402 Decl. at 43. The Postal Service and Pitney Bowes both describe the formula as "risky."[105]

Second, Sidak and Pitney Bowes each assert that there is no way to know if the formula would be suitably responsive to unanticipated changes in the market.[106] More specifically, Sidak notes that the time period analyzed by the Commission in Order Nos. 4402 and 4742, spanning from when the PAEA was enacted in 2006 through 2017, was a period of "unique conditions" in the shipping industry. Sidak Order No. 4402 Decl. at 43. These unique conditions included "one of the largest recessions in U.S. history *and*…rapid growth of last mile package delivery." *Id.* (emphasis in original). Sidak posits that it is impossible to know whether the formula would be sustainable outside of these narrow conditions. *Id.* at 43-44.

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[105] Postal Service Order No. 4402 Comments at 2-3; Pitney Bowes Order No. 4402 Comments at 12-13.

[106] Sidak Order No. 4402 Decl. at 43-44; Pitney Bowes Order No. 4402 Comments at 13.

2. Commission Analysis

The possibility of a feedback loop depends entirely on the components of a given formula. If, for example, the formula were to increase the appropriate share by an average of historic contribution, then it could possibly lead to a feedback loop, because in that case the continuously increasing contribution levels since the PAEA's enactment would cause a continuous increase in the average historic contribution, thereby continuously increasing the appropriate share. However, the components of the formula that the Commission adopts reflect the performance of both the Postal Service and its competitors and incorporate changes in demand that inhibit the potential of a feedback loop.

With regard to Sidak's, Pitney Bowes', and the Postal Service's assertions regarding uncertainty, the "narrow conditions" Sidak alludes to over the past 11 years constituted a global financial crisis greater than any in the past half-century, coupled with rapid expansion and innovation in the parcel delivery market. That the formula would have been responsive to these extreme conditions, as discussed in Order Nos. 4402 and 4742, provides confidence that the formula will be suitably responsive to less extreme conditions in the future.[107] Namoro also demonstrates, through a simulation in his declaration, that even if the most extreme circumstances of the past 11 years were to repeat themselves before the Commission's next mandatory review of the appropriate share, the formula's results would not change radically. Namoro Order No. 4742 Decl. at 28-31. The Commission reiterates that if the formula should fail to function as intended, the Commission retains the ability to modify it at any time.

E. Unclear Results Stemming From Changes in the Mail Mix

1. Comments

ACI asserts that any results produced by the formula "are likely to be influenced by mixed effects." ACI Order No. 4742 Comments at 6. By way of example, ACI

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[107] *See* Order No. 4402 at 20-21, 28-29; Order No. 4742 at 46-47.

asserts that whereas a textbook Lerner index would compare unit price to unit marginal cost for individual competitive products, the Commission's formula compares total competitive product revenue to total competitive product attributable costs for competitive products collectively. *Id.* According to ACI, "this comparison lumps all products and costs together," which is problematic because "[w]hile individual prices may or may not change, revenues will change as the mix of products changes." *Id.* Thus, ACI maintains that "[i]t is methodologically incorrect to not account for mixed and substitution effects," which would result from changes in the competitive product mail mix. *Id.*

2. Commission Analysis

The mixed and substitution effects ACI refers to describe changes in the competitive product mail mix. These effects are accounted for in the formula. Specifically, if the Postal Service's product mix were to shift from products over which the Postal Service exercises more market power to products over which the Postal Service exercises less market power *(e.g.*, if the Postal Service were to deliver more Priority Mail and fewer Priority Mail Express pieces), the composition of the Competitive Contribution Margin would change and the component itself would decrease.[108] If the product mix were to shift in the opposite direction, (*e.g.*, if the Postal Service were to deliver more Priority Mail Express pieces and fewer Priority Mail pieces), then the Competitive Contribution Margin would increase.

F. Miscellaneous Issues

1. Comments

The Public Representative and Namoro raise miscellaneous issues pertaining to the formula. First, they assert that the Commission has failed to identify or articulate the mathematical characteristics defining the "minimum" that the appropriate share

[108] *See* Order No. 4402 at 46-49; Order No. 4742 at 55-56. The calculations for the market power of Priority Mail and Priority Mail Express can be found in Library Reference PRC-LR-RM2017-1/3.

represents.[109] Specifically, Namoro posits that "the Commission's optimality criteria, or its evaluation criteria regarding the choice of the updating procedure are unknown to the public." Namoro Order No. 4402 Decl. at 23-24. The Public Representative and Namoro maintain that absent such a definition, it is impossible to define the criteria according to which the Commission's formula should be assessed.[110]

Second, Namoro advises the Commission not to base the appropriate share on an average of historic realized contribution, because to the extent that the appropriate share has been set at 5.5 percent throughout the PAEA era, the use of an average of actual historic contribution levels would preclude the possibility that the appropriate share could ever fall below 5.5 percent. Namoro Order No. 4402 Decl. at 20-21. Namoro warns that this would be contrary to 39 U.S.C. § 3633(b), which places no such bounds on the Commission's discretion, and could result in a "ratchet effect," in which the Postal Service kept competitive products' contribution to institutional costs below the profit-maximizing level in order to keep the appropriate share low. *Id.* at 21-22.

Third, the Public Representative and Namoro identify an "anomaly" with the formula as it was initially proposed in Order No. 4402, where if both price and marginal cost were to increase or decrease by the same dollar amount, the market power component of the formula would decrease or increase correspondingly, although one would expect it to remain unchanged, because the differential between price and cost would be unchanged.[111]

Fourth, Namoro proposes using logarithmic growth to measure the changes in the components of the formula, rather than annual percentage changes. Namoro Order No. 4742 Decl. at 32-34.

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[109] PR Order No. 4402 Comments at 4; Namoro Order No. 4402 Decl. at 18-19.

[110] PR Order No. 4402 Comments at 4; Namoro Order No. 4402 Decl. at 18-19.

[111] PR Order No. 4402 Comments at 5; Namoro Order No. 4402 Decl. at 8-9.

2. Commission Analysis

The Public Representative and Namoro are correct that specific criteria need to be defined to estimate a mathematical minimum, which is what the appropriate share is designed to be. In this case, the criteria for setting the appropriate share are defined by law. They consist of those factors that the Commission has considered in every appropriate share determination—the prevailing competitive conditions in the market; the degree to which any costs are uniquely or disproportionately associated with any competitive products; and all other relevant circumstances. 39 U.S.C. § 3633(b). To the extent that the formula-based approach captures those factors, it satisfies the optimality criteria provided by the PAEA.

The Commission finds the concerns expressed with respect to basing the appropriate share on an average of historic realized contribution to be well-placed, and the Commission notes that it has not proposed such an approach.

The “anomaly” concerning the market power measure identified by the Public Representative and Namoro is in fact an expected outcome, because such changes would reflect changes in the Postal Service’s exercise of market power. The Competitive Contribution Margin is designed to measure profitability, not profit, so if the Postal Service’s competitive revenues and costs were to change in the same degree, then competitive products’ profitability would change, even if their profit did not. Furthermore, as a practical matter, it is extraordinarily unlikely that the Postal Service’s competitive revenue and attributable costs would change by the exact same amount.

With regard to Namoro’s recommendation concerning logarithmic growth, such an approach would have the benefit of obviating the need for inflation adjustments. However, Namoro himself concedes that such an approach would be most accurate when growth rates are close to 100 percent. Namoro Order No. 4742 Decl. at 32-34. However, the growth rates at issue in this proceeding are all well below 100 percent. *See* Library Reference PRC-LR-RM2017-1/3. Therefore, the Commission declines to use this approach.

VII. COMMENTS SPECIFIC TO THE FORMULA'S COMPONENTS, THE FORMULA'S OPERATION, AND COMMISSION ANALYSIS

The second broad grouping of comments are those alleging specific concerns with the formula's components and the formula's operation. As an initial matter, the Commission notes that most of the comments described in this section were initially directed at either the Postal Service Lerner Index or the Competitive Market Output, which were the market power and market position formula components initially proposed by the Commission in Order No. 4402. *See* Order No. 4402 at 15-21. In Order No. 4742, the Commission modified these components and renamed them the Competitive Contribution Margin and the Competitive Growth Differential, respectively. *See* Order No. 4742 at 9-32. As a result, any comments specific to the Postal Service Lerner Index or the Competitive Market Output have technically been rendered moot. Nevertheless, to the extent that many of these comments could be viewed as being equally applicable to the Competitive Contribution Margin and/or the Competitive Growth Differential, the Commission evaluates them as such in this Order.

Comments specific to one of the formula's components that were received in response to Order Nos. 4402 and 4742 (and not already addressed in Order No. 4742), can be divided into those directed at the Competitive Contribution Margin and those directed at the Competitive Growth Differential. Similar to Order No. 4742, comments specific to the formula's operation can be divided by those directed at the beginning year, beginning appropriate share, and weighting of the components.

A. Competitive Contribution Margin

1. Previous Commission Discussion

The formula’s market power component—the Competitive Contribution Margin—measures competitive products’ absolute market power, which is the Postal Service’s ability with respect to its customers to raise competitive product prices relative to those products’ costs. *See* section III.A and section III.B.1, *supra*.

With regard to the formula’s market power component, in Order No. 4402 the Commission initially proposed a measure that the Commission termed the “Postal Service Lerner Index.” Order No. 4402 at 15-21. This measure was modelled on the economic concept of a Lerner index, which measures the market power for a given firm by calculating how far that firm is able to price a given product over the product’s marginal cost of production. *Id.* at 17. A basic Lerner index is typically calculated using the formula:

$$Lerner\ index = \frac{Price - Marginal\ Cost}{Price}$$

Id. The Postal Service Lerner Index, which had to be adjusted to reflect the fact that the Postal Service is a multi-product firm and that each competitive product has its own unique marginal cost and set of prices, was represented by the formula:

$$Postal\ Service\ Lerner\ Index\ = \frac{Revenue\text{-}per\text{-}Piece - Unit\ Volume\text{-}Variable\ Cost}{Revenue\text{-}per\text{-}Piece}$$

Id. at 17-19. Revenue-per-piece, or average unit revenue for all competitive products, was used to represent the “price” variable for competitive products collectively. *Id.* at 18-19. Unit volume-variable cost, or the average unit cost of production for all competitive products, was used to ascertain the “marginal cost” variable for competitive products collectively. *Id.* at 18.

In Order Nos. 4742, the Commission proposed modifications to this component in response to comments received in response to Order No. 4402. Order No. 4742 at 9-19. Specifically, the Commission proposed using total competitive product revenue, rather than average competitive product revenue, and total competitive product costs, rather than average competitive product costs. *Id.* at 13. The Commission also proposed using competitive product attributable costs rather than competitive product volume-variable costs. *Id.* This modified component, which the Commission re-named the Competitive Contribution Margin, is represented by the following formula:

$$Competitive\ Contribution\ Margin = \frac{Total\ Revenue - Total\ Attributable\ Cost}{Total\ Revenue}$$

Id.

Commenters raise two main issues with regard to the Competitive Contribution Margin: they question its relevance, and they question its accuracy.

2. Relevance

a. Comments

UPS, Sidak, and ACI assert that a Lerner index—the economic concept on which the Competitive Contribution Margin is partially based—was designed to evaluate whether a firm has set its prices too high, as in, *e.g.*, an antitrust case.[112] These commenters maintain that such an inquiry is not relevant to the appropriate share determination, because the relevant issue is whether the Postal Service is misattributing the costs of its competitive products in order to set those products' prices at artificially low levels.[113]

[112] UPS Order No. 4402 Comments at 29; UPS Order No. 4742 Comments at 37-38; Sidak Order No. 4742 Decl. at 19-20; ACI Order No. 4742 Comments at 2.

[113] UPS Order No. 4402 Comments at 29-30; UPS Order No. 4742 Comments at 37-38; Sidak Order No. 4742 Decl. at 19-20; ACI Order No. 4742 Comments at 2.

b. Commission Analysis

A Lerner index is designed to assess how far above marginal cost a firm is able to price its products. One application for such a measurement, and the one for which it has primarily been used historically, is in an antitrust context. However, it is equally plausible to use a Lerner index in order to obtain a relative measure of a firm's market power over time, based on that firm's ability to set prices above costs. As the Commission explained in Order Nos. 4402 and 4742, evaluating change in the Postal Service's market power helps the Commission determine whether competition is being preserved and whether the Postal Service has a competitive advantage, and thus it is relevant to the appropriate share determination.[114] With respect to the allegations regarding cost misattribution, the Commission finds them to be baseless, as discussed in section VIII.C, *infra*.

3. Accuracy

With regard to the Competitive Contribution Margin's accuracy, commenters allege three specific deficiencies: that it is inaccurate because the Postal Service is not a profit-maximizing entity; that it is based on inaccurate assumptions regarding the relationship between pricing and market power; and that it suffers from several errors in measurement.

a. Profit Maximization

(1) Comments

Sidak and UPS assert that the Competitive Contribution Margin would only be effective if evaluating a profit-maximizing firm, which, these commenters maintain, the Postal Service is not.[115] Sidak argues that as a government enterprise, the Postal Service is incentivized to sacrifice profit in order to expand the scale of its operations,

[114] *See* Order No. 4402 at 16; Order No. 4742 at 5.

[115] Sidak Order No. 4402 Decl. at 19-22, 55-56; Sidak Order No. 4742 Decl. at 17; UPS Order No. 4742 Comments at 25-26, 41-42.

and thus is less focused on covering its marginal costs than a profit-maximizing firm would be.[116] Sidak posits that the Postal Service sets prices with a lower markup above marginal cost than would be set by a profit-maximizing firm, and as a result the Postal Service's true market power is understated by a traditional Lerner index or a similar measure of market power.[117] Sidak disputes the Commission's finding in Order No. 4402 that given the low volume of competitive products relative to the Postal Service's overall operations, underpricing competitive products would not be effective in expanding scale. Sidak Order No. 4402 Decl. at 55-56; *see* Order No. 4402 at 74. Sidak asserts that this finding is undermined by the fact that competitive product volumes are growing. Sidak Order No. 4402 Decl. at 55-56.

Sidak and UPS maintain that even if the Postal Service is incentivized to maximize profits for its competitive products, evidence suggests that it has not done so.[118] First, Sidak notes that despite the fact that the PAEA authorizes the Postal Service to retain and invest earnings from competitive products, there is no evidence of the Postal Service having ever done so. Sidak Order No. 4742 Decl. at 17. Second, Sidak notes that the Postal Service routinely incurs losses on inbound international parcel delivery. *Id*. at 18. While Sidak acknowledges that international shipping rates for these mailpieces have been set by an international organization—the Universal Postal Union (UPU)—Sidak nevertheless suggests that there is limited evidence of the Postal Service having seriously attempted to have these rates increased. *Id*. Sidak asserts that "[b]ecause the Postal Service does not have shareholders or owners of any

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[116] Sidak Order No. 4402 Decl. at 20-21 (citing J. Gregory Sidak, *Maximizing the U.S. Postal Service's Profits from Competitive Products*, 11 J. Competition L. & Econ. 617, 662 (2015); J. Gregory Sidak, *Why Should the Postal Service Deter Amazon's Competitive Entry into Last-Mile Parcel Delivery?*, 2 Criterion J. on Innovation 101, 111-114 (2017); David E. M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 Antitrust L. J. 479, 499-503 (2003); David E. M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. Chi. L. Rev. 271, 285-286 (1999); William J. Baumol, *Toward a Theory of Public Enterprise*, 12 Atl. Econ. J. 13, 14 (1984)).

[117] Sidak Order No. 4402 Decl. at 20-21. Sidak endeavors to demonstrate his profit maximization argument using a series of equations. *Id.* at 22-24. These equations, like the rest of Sidak's argument, are theoretical in nature. They ostensibly could apply to government enterprises in general, but are not based on any specific data pertaining to the Postal Service.

[118] Sidak Order No. 4742 Decl. at 17; UPS Order No. 4742 Comments at 26-27.

kind (who would benefit from profit maximization), the [Commission] must do more than merely assert that the Postal Service has an incentive to maximize profits to argue plausibly that the Postal Service is a profit-maximizing firm." *Id*.

UPS asserts that just because the Postal Service has not engaged in predatory pricing, as the Commission concluded in Order No. 4402, does not mean that it is profit maximizing. UPS Order No. 4742 Comments at 42.

Amazon and the Postal Service, on the other hand, both argue that the Postal Service is incentivized to maximize profit from competitive products, and that historical evidence shows that the Postal Service has behaved in accordance with this incentive.[119]

(2) Commission Analysis

UPS and Sidak have not provided any empirical evidence that the Postal Service is not maximizing profit from its competitive products. Sidak's theoretical criticisms of government enterprises in general do not consider the PAEA's bifurcation of competitive product pricing from market dominant product pricing.[120] Unlike market dominant products, which are subject to substantial rate regulation, Congress intended for the Postal Service to be able to price its competitive products flexibly in order to generate retained earnings.[121] Due to this difference in pricing regulation, it is not at all apparent that Sidak's arguments regarding the pricing behavior of government enterprises would be equally applicable to the Postal Service's competitive products, which occupy a unique niche in regulatory policy.

[119] Amazon Order No. 4402 Comments at 12-16, 33; Postal Service Order No. 4402 Comments at 6-7.

[120] For a more comprehensive criticism of the research Sidak relies upon, *see* Michael D. Bradley, Jeff Colvin, & Mary Perkins, *Testing for Anti-Competitive Behavior in Public Enterprises*, *in Competitive Transformation of the Postal Delivery Sector* 169-170 (Michael A. Crew & Paul R. Kleindorfer eds. 2004).

[121] This intent is clearly expressed in the PAEA's legislative history. *See, e.g.,* S. Rep. No. 108-318 at 6-7, 14-16; H.R. Rep. No. 109-66(I) at 43-44.

Indeed, the current structure of the Postal Service and its financial condition create the incentive to maximize profits from competitive products. As market dominant product volume has decreased in recent years, contribution to the Postal Service's institutional costs from market dominant products has also decreased, worsening its financial condition.[122] The Postal Service is unable to offset the decline in market dominant products' institutional cost contribution by maximizing profits on those products because market dominant product price increases are constrained by a price cap.[123] Under the price cap, the Postal Service cannot seek to maximize profits on those products in order to limit the decline in their institutional cost contribution. Therefore, the Postal Service must, by necessity, seek to maximize the profits of its competitive products where the greatest pricing flexibility exists. Competitive products' ability to help offset the decline in institutional cost contribution from market dominant products provides a clear incentive for the Postal Service to maximize profits from its competitive product business.

Furthermore, as discussed in greater detail in section II.A, *supra* and section VIII.B.1.e, *infra*, the Postal Service has imposed price increases greater than the rate of inflation and in line with its competitors on competitive products and has also increased the contribution level of competitive products to institutional costs.[124] Such actions are not indicative of a firm that is prioritizing scale to the detriment of profit, and instead are evidence that the Postal Service is maximizing profits from its competitive products.[125]

UPS's and Sidak's observations regarding the Postal Service's operations are not evidence that the Postal Service is not maximizing profit with respect to its competitive products. The lack of retained competitive product earnings is explained by

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[122] Docket No. RM2017-3, Library Reference PRC-LR-RM2017-3/1, December 1, 2017, Excel file "PRC-LR-RM2017-3-1.xlsx," tab "Figure II-26."

[123] *See* 39 U.S.C. § 3622(d)(1)(A). For further discussion of the market dominant price cap, *see* section VIII.B.1.e, *infra*.

[124] *See* section II.A, *supra,* and section VIII.B.1.e, *infra*; *see also* Order No. 4402 at 52, Table IV-7 (Postal Service historical contribution levels to institutional costs).

[125] *See also* Order No. 4402 at 75; Order No. 4742 at 16.

the financial instability the Postal Service's market dominant business has experienced over the last decade.[126] Competitive product profits have been necessary to maintain current operations; hence, the Postal Service has not been able to give consideration to future investment. This fact does not in any way call into question the Postal Service's incentives with regard to profit from its competitive products.

In response to Sidak's assertions concerning international shipping rates, it is unclear which specific "inbound international parcel" products Sidak is referring to. Many international products are classified as market dominant, and thus do not form part of the market at issue in this proceeding. With regard to the Postal Service's competitive international products, the Postal Service has set rates consistent with the Universal Postal Convention and the General Regulations of the UPU.[127]

b. Relationship Between Pricing and Market Power

(1) Comments

The Postal Service maintains that a Lerner index is an imperfect indicator of market power and could produce inaccurate results. This is because, according to the Postal Service, a Lerner index assumes, first, that a larger differential between competitive product revenue and competitive product costs necessarily reflects an exercise of increased market power by the Postal Service; and second, that the exercise of such market power harms competition and thus requires remediation through the mechanism of the appropriate share requirement. Postal Service Order No. 4742 Comments at 8-9. The Postal Service posits that neither of these assumptions is correct, and that the Competitive Contribution Margin does not necessarily reflect the Postal Service's capacity to increase contribution from its competitive products to

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[126] *See* Docket No. RM2017-3, Order on the Findings and Determination of the 39 U.S.C. § 3622 Review, December 1, 2017, at 151-178 (Order No. 4257).

[127] Furthermore, in FY 2018, Competitive International Mail and Services at Universal Postal Union rates comprised only 1.11 percent of the Postal Service's total competitive product revenue. *See* United States Postal Service, Revenue, Pieces and Weight Report, Fiscal Year 2018, November 14, 2018, Excel file "FY2018_RPWsummaryreport_public_eoy.xlsx," quotient of cells D152 and D156.

institutional costs, because departures from marginal cost in terms of pricing may occur for a variety of non-competitive reasons. *Id*.

The Postal Service argues that the Competitive Contribution Margin "does not consider the need of a firm to cover fixed costs, operate at efficient scale, or price to market," and thus "it can be misleading to attribute the entire departure from marginal cost pricing to the exercise of [market] power."[128] The Postal Service asserts that "it is far from clear why, given the prospect of other possible implications, such increases [in the Competitive Contribution Margin] should automatically translate into increases in the minimum contribution requirement…." Postal Service Order No. 4402 Comments at 18. Based on this contention, the Postal Service maintains that the Competitive Contribution Margin is not necessarily an improvement compared to the Postal Service Lerner Index. Postal Service Order No. 4742 Comments at 9.

The Postal Service likens the Competitive Contribution Margin to "cost coverage," a ratio frequently employed by the Commission in other contexts, which expresses unit revenue for a particular product as a percentage of unit cost. The Postal Service asserts that increased cost coverage does not necessarily imply increased capacity for generating contribution, and, in the same vein, that the Competitive Contribution Margin will not necessarily indicate increased ability to generate contribution to institutional costs. Postal Service Order No. 4402 Comments at 18-19. For those reasons, the Postal Service asserts that the Competitive Contribution Margin does not constitute a substantial improvement over the Postal Service Lerner Index that the Commission initially proposed in Order No. 4402. Postal Service Order No. 4742 Comments at 9.

(2) Commission Analysis

The Competitive Contribution Margin evaluates the Postal Service's market power based on the Postal Service's ability to set prices for its competitive products

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[128] Postal Service Order No. 4402 Comments at 17 (internal citations and marks omitted); Postal Service Order No. 4742 Comments at 7.

above costs, regardless of the reason for such a markup. Any price set above marginal cost, by definition, represents an exercise of market power.[129] The Postal Service could not raise its prices, for either competitive or non-competitive reasons (at least not without losing revenue), unless it possessed sufficient market power to permit such a price increase. Such an exercise of market power, in turn, affects the market by forcing competitors and consumers to react, either by changing their prices or by changing their level of output or consumption. The Competitive Contribution Margin is therefore appropriate for inclusion in the formula.[130]

The link the Postal Service attempts to make between cost coverage and the Competitive Contribution Margin is inapposite. The two measures are superficially similar, but the Competitive Contribution Margin conveys more information than cost coverage. Cost coverage represents revenue as a percentage of cost. The Competitive Contribution Margin, on the other hand, constitutes a standardized measure of the profitability the Postal Service earns. Specifically, unlike cost coverage, which is unbounded (meaning that there is no theoretical limit to how high it can go), the Competitive Contribution Margin is bounded between 0 and 1 (assuming competitive products cover their costs). This provides a more meaningful interpretation of the Postal Service's ability to price its competitive products above cost, and thus provides a clear signal of the Postal Service's pricing power in the parcel delivery market. Cost coverage constitutes a comparatively weaker signal of simply how compensatory a product is.

c. Alleged Problems with Measurement of the Postal Service's Market Power

Commenters allege a number of problems with the Competitive Contribution Margin as a measurement of the Postal Service's market power. These allegations can generally be divided into three groups: issues pertaining to price or revenue; issues

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[129] *See* Landsburg, *supra* n.44, at 317.

[130] *See* Order No. 4402 at 34-40; Order No. 4742 at 48-52.

pertaining to costs and costing methodology; and issues pertaining to the overall accuracy of the Competitive Contribution Margin.

(1) Issues Pertaining to Price or Revenue

(a) Comments

Sidak suggests that demand for parcels is elastic and argues that, as a result, the Competitive Contribution Margin would not accurately measure changes in market share if the Postal Service were to lower competitive product prices in order to expand scale. He further contends that in such a situation, the Postal Service's market share would increase while the formula's market power component would decrease, because the Postal Service would gain market share at the expense of competitors but its profit margin would be reduced. Sidak Order No. 4402 Decl. at 50-51.

Sidak also asserts that the modifications made to the market power component in Order No. 4742—in which the Commission switched from using average cost and revenue figures for competitive products to using total cost and revenue figures—did nothing to address what he alleges to be the component's basic problem, which is that revenue can constitute an inaccurate measure of price for a multiproduct firm that engages in price discrimination, as the Postal Service does.[131] This is because for such a firm a marginal unit is typically sold at a price lower than the average price, and thus average revenue will typically overstate price.[132] Sidak alleges that "using total revenue is just as unreliable as using average revenue in informing the Postal Service's market power," because "a Competitive Contribution Margin that uses total revenue (and total attributable cost) is mathematically equivalent to one that uses average revenue (and unit attributable cost)." Sidak Order No. 4742 Decl. at 16.

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[131] Sidak Order No. 4742 Decl. at 15-16; Sidak Order No. 4402 Decl. at 30-31.

[132] Sidak Order No. 4742 Decl. at 15-16; Sidak Order No. 4402 Decl. at 30-31.

UPS argues that the formula's market power component arbitrarily calculates a single price variable for all competitive products by dividing the sum of all competitive product revenue by the sum of all competitive product volume. UPS Order No. 4402 Comments at 33.

(b) Commission Analysis

Sidak is correct that the Competitive Contribution Margin does not directly measure market share. Market share is accounted for by the Competitive Growth Differential, which incorporates market share to weight the relative growth in the Postal Service's revenue, thereby reflecting the Postal Service's market position.

With regard to Sidak's assertion that switching from average cost and revenue data to total cost and revenue data has no effect on the Competitive Contribution Margin, the Commission stated in Order No. 4742 that this change was made primarily to reduce any confusion associated with referring to the market power component as the "Postal Service Lerner Index," given that textbook Lerner indices are typically calculated at the unit, rather than the aggregate, level. Order No. 4742 at 14.

Sidak's criticism of the use of the Competitive Contribution Margin as a measure of market power for the Postal Service due to the Postal Service's use of price discrimination is mitigated by the fact that the Competitive Contribution Margin does not use the absolute level of the Postal Service's market power in a given year as input, but instead the annual growth or decline in market power. Even if the measure does not perfectly reflect the absolute value of the Postal Service's market power, so long as it can accurately track growth or decline, it serves as an accurate measure for purposes of determining the appropriate share.

With regard to UPS's argument related to the calculation of an arbitrary price variable, neither the Postal Service Lerner Index nor the Competitive Contribution

Margin require the use of volume as an input.[133] Therefore, this component does not create a single price for competitive products. *See id.* at 13-14.

(2) Issues Pertaining to Costs and Costing Methodology

(a) Comments

UPS asserts that attributable cost—which constitutes one of the inputs to the Competitive Contribution Margin—is prone to measurement errors and changes in definition by the Commission, and that, as a result, the Competitive Contribution Margin will be unreliable as an indicator of market power. UPS Order No. 4742 Comments at 43-44. UPS asserts that “changes to the definition of attributable costs [by the Commission] have *nothing* to do with market power, but have large effects on the Competitive Contribution Margin component.” *Id.* at 44 (emphasis in original). UPS cites as an example the changes made to the Commission’s costing methodology in Docket No. RM2016-2, in which the Commission expanded its definition of attributable costs (which had previously consisted only of volume-variable costs and product-specific costs) to extend to all incremental costs (including volume-variable costs, product-specific costs, and also certain inframarginal costs).[134] This change in the definition of attributable costs increased the size of the pool of costs attributed to competitive products, and UPS asserts that it caused an increase in the Competitive Contribution Margin for FY 2017, the first fiscal year to which the new definition was applicable. UPS Order No. 4742 Comments at 43-44.

UPS also argues that the Competitive Contribution Margin “blunts the effect of changes in cost attribution analytical principles, and would exacerbate the Postal Service’s incentive to under-report competitive costs,” because even though increases in competitive products’ attributable costs would cause the appropriate share to

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[133] The use of volume in the Postal Service Lerner Index was for presentation. The Commission demonstrated that removing the volume term did not affect the results of the Postal Service Lerner Index or the current market power component, the Competitive Contribution Margin. *See id.*

[134] UPS Order No. 4742 Comments at 43-44 (citing Order No. 3506).

decrease, such a decrease would not be offset by a corresponding increase in attributable costs.[135]

ACI argues that the formula will be inaccurate because it uses attributable costs as a proxy for marginal costs. ACI Order No. 4742 Comments at 4. ACI maintains that attributable costs overstate marginal costs. *Id.*

(b) Commission Analysis

With regard to UPS's argument that attributable costs are prone to measurement error, the Commission has confidence in its costing systems, which have been developed over 45 years during which time they have been subject to public comment and litigation.[136]

With regard to UPS's argument that changes in the costing methodology for calculating attributable costs would have a measurable impact on the Competitive Contribution Margin, the Commission notes that changes in cost attribution methodologies are approved by the Commission after an opportunity for public comment and only if such changes improve the quality, accuracy, or completeness of the data produced.[137] If a change were to be approved for the definition of attributable costs, such a change would affect the Competitive Contribution Margin by improving the accuracy, quality, or completeness of the data underlying the attributable cost input. This would in turn improve the quality, accuracy, or completeness of the market power measure itself.

With regard to UPS's specific discussion of the change in the definition of attributable costs that occurred in Docket No. RM2016-2, the Commission notes that such changes in definition are extraordinarily rare. The change in Docket No. RM2016-2 was the first definitional change since 1984, and it was the only change in the past 10

[135] UPS Order No. 4402 Comments at 30-31; UPS Order No. 4742 Comments at 37-38, 44-45.

[136] *See, e.g.*, Order No. 3506 at 11-14 (discussing development of Commission's costing methodology).

[137] *See* 39 U.S.C. § 3652(e)(2); 39 C.F.R. § 3050.11(a).

years that had a material impact on the Competitive Contribution Margin.[138] Moreover, as noted above, even when such changes have a material impact, they are only approved when they demonstrate an improvement in the quality, accuracy, or completeness of the related data.

UPS is correct that if more costs are attributed to competitive products and revenue remains constant, the Competitive Contribution Margin would decrease. This is because the Competitive Contribution Margin is based on the revenue markup above attributable costs. Holding all else constant, if attributable costs increase but revenue does not, then the differential between cost and revenue would be smaller and the Competitive Contribution Margin would decrease. It is noteworthy, however, that increases in cost attribution indirectly affect the appropriate share even under the current appropriate share requirement, and under the formula, these incentives would be lessened.[139]

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[138] Contrary to UPS's assertion that the change in the definition of attributable costs caused an increase in the Competitive Contribution Margin, this change increased the amount of attributable costs. As UPS acknowledges, all else being equal, increases in attributable costs have the effect of reducing the Competitive Contribution Margin. The Competitive Contribution Margin increased in FY 2017 despite the change in the definition of attributable costs, not because of it.

[139] To provide an example: suppose competitive products incur $100 in attributable costs, and the Postal Service has $200 in institutional costs. Suppose also that the Postal Service's competitive revenue is $150, and competitor revenue is constant. Under the current appropriate share framework, competitive products must recover the following costs:

$$CC_1 = \$100 + (200 * 5.5\%) = \$111$$

If the Postal Service attributed an additional $10 in costs to competitive products, then competitive products would have to recover the following costs:

$$CC_2 = \$110 + (\$190 * 5.5\%) = \$120.45$$

As such, the current appropriate share already provides a theoretical incentive for the Postal Service to underreport costs. Under the formula, the amount of costs competitive products would have to recover would be calculated by the following (again assuming $110 in attributable costs and $190 in institutional costs):

$$CC_3 = \$110 + \left(\$190 * \left(5.5\% * \left(1 + \left(\frac{.27}{.33} - 1\right)\right)\right)\right) = \$118.36$$

Thus, under the formula, the incentive to underreport competitive products' attributable costs is reduced compared to the current appropriate share requirement.

It is also worth noting that an increase in the level of attributable costs the Postal Service's competitive products must recover is an outcome that UPS has consistently sought in this and other dockets.[140] However, as the Commission has explained before, its costing methodology seeks to maximize the accuracy of cost attribution, rather than maximizing the amount of costs attributed.[141] As such, the Commission does not consider the impact of changes to the appropriate share when it evaluates changes in cost attribution. The Commission retains the authority to revisit the appropriate share requirement at any time if a change in the Commission's costing methodology were to have a substantial impact on the operation of the formula.

ACI is correct that attributable costs include more than marginal costs. Specifically, under the Commission's costing methodology attributable costs are equivalent to incremental costs, and incremental costs include volume-variable (or marginal) costs, product-specific costs, and a portion of inframarginal costs. *See* Order No. 3506 at 61-62. However, for a group of products, such as competitive products collectively, marginal costs alone do not represent all of the costs that would be avoided by not providing the group of products. Marginal costs correctly measure the costs avoided by not providing a single mail piece, but for a group of products, incremental costs are the appropriate measure of the marginal costs for a group of products.

(3) Issues Pertaining to Overall Index Accuracy

(a) Comments

ACI asserts that a Lerner index does not accurately measure market power for firms with large economies of scale and scope, such as the Postal Service, because

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[140] *See, e.g.,* Docket No. RM2015-7, United Parcel Service Comments on Postal Service Proposal Thirteen Regarding City Carrier Street Time Costs, March 18, 2015, at 21-23; Docket No. RM2016-2, Petition of United Parcel Service, Inc. for the Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies, October 8, 2015, Proposal One; Docket No. RM2016-12, United Parcel Service Comments on Postal Service Proposal Four Regarding Proposed Changes in Analytical Principles, October 17, 2016, at 9-11; Docket No. RM2018-6, Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking on Analytical Principles Used in Periodic Reporting (Proposal Three), June 29, 2018.

[141] *See, e.g.*, Order No. 3506 at 40 n.60, *aff'd*, 890 F.3d 1053 (D.C. Cir. 2018).

such firms will have higher gross profits than firms not benefitting from such economies, and thus will appear to have more market power. ACI Order No. 4742 Comments at 3. ACI maintains that "[c]ompetitive industries have varying degrees of gross profitability in large part due to higher capital costs, and a positive Lerner [i]ndex could simply reflect the firm's need to earn non-negative profits rather than market power."[142]

Sidak disputes that the Competitive Contribution Margin would approximate an operating profit margin, as the Commission found in Order No. 4742. Sidak Order No. 4742 Decl. at 17-18. Sidak once again asserts that the Postal Service is not a profit-maximizing entity, and he thus argues that it would be inappropriate to try to infer the Postal Service's market power from its operating profit margin. *Id*. Additionally, Sidak asserts that the Commission relied upon an incorrect definition of "operating profit" in Order No. 4742 when the Commission found that the Competitive Contribution Margin "determin[es] the ratio of operating profit to revenue." *Id.* at 19 (citing Order No. 4742 at 15). Sidak maintains that "[t]he definition of operating profit is not standardized in the economic literature; but, at a minimum, it should include operating costs, such as variable costs, even if they are shared with other products." Sidak Order No. 4742 Decl. at 19. Sidak thus once again takes issue with the Commission's costing methodology, arguing that "[o]mitting shared costs will vastly overstate the Postal Service's operating profit from competitive products," and as a result, "the Competitive Contribution Margin does not result in an accurate operating profit-to-revenue ratio." *Id*. In the same vein, Sidak asserts that "market power" should be properly understood as the ability not only to extract a markup higher than the cost of producing a product, but to extract a price higher than the price which would prevail in a competitive market. *Id*.

Sidak also asserts that "[t]here is…no justification for the [Commission] to calculate [the Competitive Contribution Margin] across all competitive products in the

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[142] *Id.* (internal marks omitted) (citing Laura Spierdijka & Michalis Zaourasa, *Measuring Banks' Market Power in the Presence of Economies of Scale: A Scale-Corrected Lerner Index*, J. Banking & Fin. Vol. 87, 40-48 (Feb. 2018)).

aggregate when the Postal Service's product-level cost data are readily available to the Commission." *Id.* at 18.

UPS and Sidak argue that the Competitive Contribution Margin will not measure market power accurately in a market that experiences seasonality, which they assert is the case with regard to the parcel delivery industry.[143] In such an industry, market power component values will be "higher in periods of peak demand than in periods of off-peak demand," and as a result, "an annual [market power component] would exaggerate [the measurement of market power] during periods of off-peak demand and understate [the measurement of market power] during periods of peak demand." Sidak Order No. 4402 Decl. at 26-27. Sidak asserts that "the magnitude of the seasonal spike in demand for the Postal Service's competitive products has increased over time," and "[i]f peak demand…increases relative to off-peak demand, the [formula's market power component] could increase without any corresponding change in market power…." *Id*. at 27-28.

(b) Commission Analysis

In response to ACI's contention that a Lerner index cannot be used for firms with economies of scale and scope, the Commission notes that such indices have been used by economists to estimate the market power of multiproduct firms in other industries.[144] Furthermore, the Competitive Contribution Margin will reflect the properties of a Lerner index to the extent that incremental costs are an appropriate measure of marginal costs for a group of products, which, as the Commission discussed above, they are. *See* section VII.A.3.c.(2), *supra*.

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[143] UPS Order No. 4402 Comments at 33-34; Sidak Order No. 4402 Decl. at 26. "Seasonality" is defined as periodic changes in demand. *See* NIST/SEMATECH e-Handbook of Statistical Methods, June 1, 2003 (as revised October 30, 2013), available at: *http://www.itl.nist.gov/div898/handbook*. The parcel delivery industry generally experiences seasonal fluctuations in demand, with higher volumes experienced during the winter holiday season.

[144] *See* Carlton & Perloff, *supra* n.45, at 276-277.

With regard to Sidak's assertion that the Competitive Contribution Margin would fail to approximate an operating profit margin, the Commission finds that this argument is incorrect. First, as discussed previously in this Order, the Commission rejects Sidak's contention that the Postal Service is not profit-maximizing with respect to its competitive products. *See* section VII.A.3.a, *supra*. Furthermore, contrary to Sidak's assertions, the Competitive Contribution Margin does include shared costs through its use of competitive product attributable costs. By using attributable costs, this measure includes any costs caused by, or shared among, competitive products collectively, as well as any costs caused by individual competitive products.

As to Sidak's argument regarding the definition of the Competitive Contribution Margin as a measure of operating profit, his contention presumes fundamental methodological inaccuracies in the estimation of incremental costs, which the Commission has previously determined do not exist. *See* section VII.A.3.c.(2), *supra*.

With regard to Sidak's criticism that the Competitive Contribution Margin is not calculated at the product level, under the PAEA, compliance with section 3633(a)(3) is determined at the aggregate, not the product, level. The appropriate share is intended to protect competition for the entire parcel delivery market—not for individual products. As such, it is appropriate to calculate the Competitive Contribution Margin across all competitive products.

With regard to UPS's and Sidak's arguments concerning seasonality, the Commission finds them to lack merit. The Postal Service estimates its attributable costs on an annual basis, so any unique seasonal costs (*e.g.*, holiday routes) would be incorporated into the annual costs for competitive products. Furthermore, the formula will be applied on an annual basis, so any seasonality effects on prices or costs will be reflected consistently in the Competitive Contribution Margin. Because the Competitive Contribution Margin is intended to measure the market power of the Postal Service's competitive products on an annual basis, the fact that it may overestimate market power during lower-demand seasons and underestimate it during higher-demand seasons is irrelevant to its accuracy as an annual measure.

B. Competitive Growth Differential

1. Previous Commission Discussion

In Order No. 4402, the Commission initially proposed a measure that it termed the "Competitive Market Output." Order No. 4402 at 22-29. This measure was intended to ascertain the overall size of the parcel delivery market based on revenue. *Id.* at 22-23. The Commission found that evaluating the overall size of the market provided context for assessing prevailing competitive conditions in the market and other relevant circumstances, because it enabled the Commission to view the Postal Service's market power relative to the market as a whole. *Id.* at 21-22.

The Competitive Market Output relied on data from three different sources. For data pertaining to revenue for the Postal Service's competitive products, it relied on the PFA, which the Commission produces every year as part of its ACD made pursuant to 39 U.S.C. § 3653. *Id.* at 18, 23. For data pertaining to revenue for the Postal Service's competitors, it relied on two surveys conducted by the United States Census Bureau: the Quarterly Services Survey (QSS); and the Services Annual Survey (SAS). *Id.* at 23-24.

The QSS is a survey conducted annually by the United States Census Bureau, designed to estimate operating revenues for each service sector of the economy. *Id.* at 24. Revenue data are classified by industry subsector. *Id*. The Commission determined that the relevant subsector for purposes of evaluating the parcel delivery market was North American Industry Classification System (NAICS) Code 492—"Couriers and Messengers."[145] The SAS is a survey conducted annually by the Census Bureau to calculate revenues, expenses, and other economic indicators for industries. *Id.* at 25. The QSS provides data on a quarterly basis, which can be combined to correspond with the Postal Service's fiscal years. *Id.* at 24. However, quarterly data

[145] *Id*. NAICS is the classification system used by the Census Bureau. It was designed to classify business establishments by the type of activity performed for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. NAICS Code 492 encompasses all parcel delivery by firms without a universal service obligation. *Id*. at 24 n.44.

are not available for FY 2007, FY 2008, or part of FY 2009. *Id.* at 24-25. Therefore, the Commission used calendar year data from the SAS as a proxy for those years. *Id.* at 25. The Commission made adjustments to the SAS data to correct for differences from the QSS data due to sampling differences and seasonality adjustments. *Id.* at 25-26.

In response to comments received in response to Order No. 4402, the Commission proposed to replace the Competitive Market Output with an alternate component called the "Competitive Growth Differential." Order No. 4742 at 19-32. This measure is designed to be more robust than the Competitive Market Output. Rather than simply determining the overall size of the parcel delivery market, it seeks to determine the Postal Service's relative market position, based on both the Postal Service's market share and the difference between the year-over-year change in revenue for the Postal Service and the year-over-year change in revenue for the Postal Service's competitors. *Id.* at 26-27. It eliminates a concern raised by some commenters that the Competitive Market Output disproportionately incorporated competitor revenue. *Id.* at 20, 23-27. The Competitive Growth Differential directly incorporates the Postal Service's market share as a weight, in order to "ensure[] that any changes in the appropriate share…are not solely driven by growth in the overall market but are also reflective of whether those changes give the Postal Service greater (or reduced) market share." *Id.* at 28. It adjusts revenue data for inflation, using the CPI-U as a revenue deflator and indexing the CPI-U data to FY 2007. *Id.* at 23-24. The Competitive Growth Differential is defined by the following equation:

$$Competitive\ Growth\ Differential = Market\ Share_{USPS} * \ (\%\Delta Revenue_{USPS} - \ \%\Delta Revenue_{C\&M})$$

Order No. 4742 at 23.

As with the Competitive Market Output, the Competitive Growth Differential measures market output by revenue, rather than by volume. *Id.* at 24. The Commission found that whereas "volume data would need to be adjusted for intra-industry transactions…revenue data can be used directly, without adjustment." *Id*. Moreover, the Commission found that "revenue data are…available for all firms in the relevant market through publicly available sources, whereas volume data for the Postal Service's competitors are not publicly available." *Id*. The Competitive Growth Differential also relies upon the same data sources as the Competitive Market Output—the PFA for data relevant to the Postal Service's competitive products and the Census Bureau's QSS and SAS surveys for data relevant to the Postal Service's competitors. *Id*.

Commenters raise two main issues with regard to the Competitive Growth Differential: they question its relevance; and they question its accuracy.

2. Relevance

a. Comments

In Order Nos. 4402 and 4742, the Commission concluded that evaluating the overall size of the market and the Postal Service's position in the market provides needed context for assessing the prevailing competitive conditions in the market and other relevant circumstances. Order No. 4402 at 22; Order No. 4742 at 28-29. In doing so, the Commission specifically rejected arguments by UPS having to do with the relevance of the market position component. Order No. 4742 at 28-29.

UPS continues to argue that "[t]he difference between the Postal Service's revenue growth and that of its competition has nothing to do with the 'appropriate share'…[because] [w]hether 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." UPS Order No. 4742 Comments at 46 (emphasis in original). Sidak similarly argues that "the revenues of the Postal Service's competitors [are not] a necessary, or even relevant, input for determining the proper contribution that competitive postal products should make to the Postal Service's recovery of its institutional…costs," and "[t]he Postal Service's relative position in the market…is not directly relevant to the Postal Service's need or ability to cover institutional costs…." Sidak Order No. 4742 Decl. at 37. Pitney Bowes states that this component "measures factors that are beyond the control of the Postal Service," and its "values can fluctuate significantly based on new entrants in the market, the pricing or operational strategies of competitive private carriers, or changes in consumer demand." Pitney Bowes Order No. 4402 Comments at 13.

b. Commission Analysis

As the Commission discussed in section III.A, *supra*, the formula is designed to measure both the absolute and the relative market power of the Postal Service. The Competitive Growth Differential's specific role in the formula is to measure the Postal Service's relative power in the market by evaluating the year-over-year change in the Postal Service's market position as compared to its competitors. UPS's and Sidak's criticism of the Competitive Growth Differential's relevance is based on an incorrect interpretation of the appropriate share's statutory purpose and of the Commission's cost attribution methodology.

UPS interprets the appropriate share as a mechanism for allocating institutional costs based on causation, rather than the considerations mandated by section 3633(b) (*i.e.*, the prevailing competitive conditions in the market; whether any costs are uniquely or disproportionately associated with any competitive products; and other relevant circumstances). *See* 39 U.S.C. § 3633(b). As the Commission has previously explained, however, competitive products do not "cause" institutional costs.[146] Institutional costs are those costs that are not caused by any individual product or set of products, but by the entire Postal Service enterprise collectively. All costs that are caused by competitive products are already attributed to those products under the Commission's existing costing methodology. *See* section VIII.C, *infra*.

The Commission disagrees with Sidak's assertion that the Postal Service's market position is not relevant to the appropriate share determination. For the reasons stated in this Order, the Commission finds that a consideration of the Postal Service's

[146] Order No. 4402 at 40-45; Order No. 4742 at 52-53; *see* section VIII.C, *infra.*

market position plays a key role in ascertaining the prevailing competitive conditions in the market and other relevant circumstances as required by 39 U.S.C. § 3633(b).[147]

With regard to Pitney Bowes' observation, the fact that the Competitive Growth Differential measures factors beyond the Postal Service's control is by design. The presence of competitors means that the Postal Service cannot unilaterally define its market position. In other words, the Postal Service cannot set its prices however it pleases, nor may it determine its output, revenue levels, or market share, as these are all affected by the behavior of the Postal Service's competitors. The Competitive Growth Differential captures the exogenous factors affecting the Postal Service's market position, which is necessary when evaluating change in the Postal Service's market position.

3. Accuracy

Comments with regard to the Competitive Growth Differential's accuracy can be divided into five categories: data quality; data completeness; the use of revenue as opposed to volume for purposes of measuring market size; weighting the Competitive Growth Differential by the Postal Service's market share; and inflation adjustments. The Commission discusses the comments received under each category and provides its related analysis in the remainder of this section.

a. Data Quality

(1) Comments

UPS, Sidak, and the Postal Service all express concern that the Census Bureau data on which the Commission relies for the Competitive Growth Differential do not accurately capture the size of the relevant market. UPS asserts that "[w]hile [the Census Bureau data] capture[] large competitors like UPS or FedEx…, [t]here are small regional delivery companies that are not likely to be well-captured…, [and] [t]here is also

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[147] *See* section III.A, *supra*; *see also* Order No. 4742 at 47-52, 53-57.

a constant stream of market disruptors that similarly are not captured." UPS Order No. 4402 Comments at 35.

The Postal Service asserts that the NAICS subsector on which the Competitive Growth Differential is based "appears to include services performed by local couriers and messengers, such as alcoholic beverage and restaurant meal delivery, which do not directly compete with the Postal Service's competitive products." Postal Service Order No. 4402 Comments at 20. Therefore, the Postal Service asserts that the data set relied on by the Commission may overstate the size of the relevant market.[148] At the same time, the Postal Service asserts that the data set relied on by the Commission may understate the size of the relevant market because "it is not clear to what extent the data include delivery services provided by companies for which [parcel] delivery is an incidental line of business…." Postal Service Order No. 4402 Comments at 20. According to the Postal Service, examples of such companies include Amazon, brick-and-mortar retailers, and peer-to-peer ridesharing services. *Id*. The Postal Service also suggests that the Competitive Growth Differential could double-count data from intra-industry transactions if both entities record revenue for the same shipment. Postal Service Order No. 4742 Comments at 12. Despite all of these assertions, the Postal Service concedes that its "competitive products correspond far more closely, on the main, to NAICS Code 492 than to any other industry classification." *Id.* at 10 n.26.

Sidak asserts that the Commission likely misrepresents the size of the parcel delivery market to the extent that it fails to make any adjustment to the relevant data to exclude delivery of parcels weighing more than 70 pounds.[149] Because the Postal Service only delivers parcels weighing 70 pounds or less, Sidak states that anything heavier than 70 pounds is not a "similar product," and should not be included in the same market as the Postal Service's products.[150]

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[148] *Id.*; Postal Service Order No. 4742 Comments at 12.

[149] Sidak Order No. 4402 Decl. at 18 n.72; Sidak Order No. 4742 Decl. at 13 n.48.

[150] Sidak Order No. 4402 Decl. at 18 n.72; Sidak Order No. 4742 Decl. at 13 n.48.

(2) Commission Analysis

The concerns raised by the Postal Service and UPS about the choice of NAICS subsector are overstated. NAICS is designed to classify economic activity by what it terms "establishments."[151] An establishment is a location from which an "enterprise," or an individual firm, conducts business. *Id.* Many enterprises have only one establishment, but large enterprises, including the Postal Service and its major competitors, have many establishments. An establishment that has delivery as its primary activity will be classified in one sector, whereas an establishment that has transportation as its primary activity will be classified in another sector—even if both establishments constitute parts of the same enterprise. *Id.* If multiple activities are being carried out at one physical location, NAICS is able to separate the location into separate "establishments" based on the respective work activities being conducted, as long as: (1) no one industry description in the classification includes such combined activities; (2) separate reports can be prepared on the number of employees, their wages and salaries, sales or receipts, and expenses; and (3) employment and output are significant for both activities. *Id.* If the above conditions are not met, then the location in question will be classified based on the primary activity conducted there. *See id.* at 19-21.

As such, NAICS is designed to classify revenue by specific work activity. For enterprises for which parcel delivery is only an incidental part of their business, the revenue from parcel delivery is incorporated into NAICS Code 492 to the extent that the enterprise can prepare separate reports on delivery and non-delivery activities. It is possible that some retail self-delivery would not be reflected in the Census data, but the amount of such activity is likely to be relatively small, because more substantial enterprises generally use more sophisticated accounting methods that are able to capture the necessary data.

[151] Executive Office of the President, Office of Management & Budget, North American Industry Classification System, at 19 (2017), available at: *https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf* (NAICS 2017 Manual).

Furthermore, the QSS, the primary survey from which data for the Competitive Growth Differential are drawn,[152] is updated quarterly to reflect new market entrants, and is fully redrawn every 5 years.[153] Thus, while NAICS Code 492 may include some firms at the margins that do not form part of the relevant parcel delivery market, and may exclude some firms that do in fact form part of the relevant market, these discrepancies are likely to be small and quickly corrected by the Census Bureau. These small overinclusions and underinclusions may also partially offset each other. On balance, then, the Commission finds that NAICS Code 492 closely reflects the actual composition of the relevant market, as the Postal Service itself concedes.[154]

The Postal Service also voices concern that parcels handled by more than one delivery provider will be double-counted.[155] This issue would only be a problem if revenue were being used as a proxy for volume. However, as the Commission discussed in Order No. 4742, revenue does not serve as a proxy for volume in the Commission's formula.[156] It is precisely because of the existence of intra-industry transactions such as those described by the Postal Service that the Commission found revenue to constitute a superior measure of market output when compared to volume.[157] When multiple competitors handle a single parcel, it is difficult to assign a percentage of the parcel's volume to each respective firm. It is much easier, however, to determine how much of the total revenue for the parcel was realized by each respective firm.

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[152] The Commission used the SAS for FY 2007 through FY 2009 because the QSS did not measure the delivery sector at the time. The SAS is designed to reflect entry of competitors in the same way the QSS is. *See* United States Census Bureau, Service Annual Survey (SAS), available at: *https://www.census.gov/programs-surveys/sas.html.*

[153] *See* United States Census Bureau, Quarterly Services Survey Technical Documentation, available at: *https://www.census.gov/services/qss/qsstechdoc.html.*

[154] *See* Postal Service Order No. 4742 Comments at 10 n.26 (acknowledging that the Postal Service's competitive products correspond more closely with NAICS Code 492 than any other classification).

[155] For a discussion of how this situation arises, *see* section II.A, *supra*, which discusses co-opetition between competitors in the parcel delivery market.

[156] Order No. 4742 at 23-24 (explaining that revenue is used to measure market position).

[157] *See* Order No. 4402 at 23; Order No. 4742 at 24.

Sidak correctly points out that the Postal Service does not deliver any parcel over 70 pounds. However, NAICS defines deliveries in Code 492 as:

> [T]hose that may be handled by one person without using special equipment. This allows the collection, pick-up, and delivery operations to be done with limited labor costs and minimal equipment. Sorting and transportation activities, where necessary, are generally mechanized. The restriction to small parcels partly distinguishes these establishments from those in the transportation industries.[158]

Parcels over 70 pounds cannot be reasonably handled by one person without special equipment. As such, it is reasonable to conclude the NAICS Code 492 data already exclude such parcels.

b. Data Completeness

(1) Comments

Sidak asserts that the Competitive Growth Differential will be unable to account for dynamic growth caused by innovations in the market or vertical entry into the market by large retailers. Sidak Order No. 4402 Decl. at 32-35. With regard to innovations, he argues generally that no existing measure of real output or real income is capable of accounting for changes in the quality and efficiency of goods resulting from major technological innovations.[159] With regard to vertical entry, he argues that revenue from self-delivery by large retailers would likely be integrated into those retailers' end-to-end shipping costs, and thus not available to the Census Bureau. Sidak Order No. 4742 Decl. at 25. Sidak also argues that the Competitive Growth Differential will not reflect market growth from vertical integration by large retailers because it relies on revenue data instead of volume data. *Id*. He claims it will erroneously perceive the effect of vertical entry to be a decrease in revenue for the Postal Service's competitors and artificially increase the appropriate share in response. *Id*.

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[158] NAICS 2017 Manual at 404.

[159] *Id*. at 32 (citing William D. Nordhaus, *The Economics of New Goods* 29 (Timothy F. Bresnahan & Robert J. Gordon eds. 1997)).

UPS likewise asserts that the Competitive Growth Differential would be unable to account for an increase in retailers making in-house deliveries, which would not affect overall market volume but would cause the Competitive Growth Differential to decrease. UPS Order No. 4402 Comments at 35.

(2) Commission Analysis

With regard to Sidak's argument that no existing measure of real output or real income is capable of accounting for changes in the quality or efficiency of goods resulting from major technological innovations, the conclusion of the paper that Sidak cites is not as radical as Sidak represents. Nordhaus argues that many existing measures of real output understate growth in standards of living where the outputs being measured are themselves the result of innovations. Nordhaus, *supra* n.158, at 54-55. Nordhaus argues that the outputs traditionally measured in such circumstances are not final outputs, or final goods, but intermediate goods, which serve as the means to produce the final good. *Id.* at 39. He uses the example of lamps. The quality and quantity of light produced by modern electric lamps is so far advanced when compared to light produced by previous types of lamps (*i.e.*, kerosene lamps, gas lamps, open flames), that it is impossible to capture the true efficiency gains by simply using measures of output from modern lamps and accounting for historical changes in price. *Id.* at 38-54. Instead, Nordhaus develops a price index for light itself, rather than for lamps, because, in Nordhaus's view, lamps are merely an intermediate good used in the production of light, which is the final good. *Id.* at 43-54. Nordhaus compares his price index for light to more modern price indices and finds that modern price indices overstate growth in the price of light because they do not reflect efficiency gains from technological development. *Id.* Nordhaus suggests this approach could be applied to a variety of different outputs. *Id.* at 54-64.

Nordhaus's argument would not apply to parcel delivery, because parcel delivery is not a final good. Consumers and businesses do not purchase deliveries solely as deliveries—they purchase deliveries as an ancillary purchase to the item being delivered. It is the item being delivered, not the delivery itself, which constitutes the final good in such a transaction. As such, the inputs used in the Commission's formula constitute intermediate goods, not final goods, and Nordhaus's reasoning is inapplicable to them.[160]

As stated previously, the Commission's formula reflects the implementation of innovations in the delivery market.[161] To the extent that innovations expand delivery output, these innovations are reflected in the Competitive Growth Differential. To the extent that such innovations reduce costs for the Postal Service, the Competitive Contribution Margin directly captures them. To the extent that innovations reduce costs for competitors, such innovations are likely to change those competitors' pricing and production strategies, which indirectly affect the Competitive Growth Differential.

With regard to Sidak's argument having to do with vertical entry, the QSS—the primary survey on which the Competitive Growth Differential relies—is designed to reflect such entry to the extent that retail firms engage in delivery themselves.[162] As discussed above, if a firm engages in delivery, it will either use its existing retail locations to make the deliveries, open new locations to make the deliveries, or employ a combination of both. If the firm can create separate reports for its delivery activities, then an existing location will be classified as two separate establishments for purposes of NAICS: one for retail and the other for delivery. Otherwise, the primary activity carried out at the location will determine the establishment's classification. Thus, it is possible that some retail self-delivery will not be reflected in the Census data, but the amount of such activity is likely to be low because if the amount of delivery work were substantial, it is highly likely that the firm's accounting procedures would be

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[160] Additionally, the Commission notes that the adjustments described by Nordhaus are intended to address paradigm shifts in standards of living which occur over decades, not the 11-year period that the Commission's formula covers. Over the past 11 years, the parcel delivery industry has not experienced a paradigm shift on the level of electrically generated light. Although e-commerce has significantly expanded the parcel delivery market, and new entrants in the market have pioneered innovations in last-mile delivery, there has not been a revolutionary change on the scale contemplated by Nordhaus.

[161] *See* Order No. 4402 at 39-40; Order No. 4742 at 48-49.

[162] As mentioned previously, the Commission used the SAS for FY 2007 through FY 2009 because the QSS did not measure the delivery sector at the time, but the SAS is designed to reflect entry of new competitors in the same way as the QSS.

sophisticated enough to enable it to be recognized as a delivery establishment by NAICS. If a firm opens dedicated establishments for delivery, those establishments will be classified in NAICS Code 492. Thus, dynamic growth based on vertical entry into the market by and large will be captured by the Competitive Growth Differential.

UPS's assertion that the Competitive Growth Differential fails to account for retailers making in-house deliveries is incorrect. As stated above, the QSS is designed to incorporate such deliveries. Furthermore, to the extent that the QSS fails to incorporate such deliveries, it will not necessarily result in a decrease in the Competitive Growth Differential. The impact of such unincorporated deliveries would depend on the extent to which retailers capture revenue currently earned by the Postal Service and its competitors, as well as the relative amounts of revenue captured from the Postal Service and its competitors.

c. Revenue versus Volume

(1) Comments

In Order No. 4742, the Commission addressed comments concerning the use of revenue, as opposed to volume, as a measure of market output. Order No. 4742 at 19, 22, 29. The Commission reiterated its finding from Order No. 4402 that revenue data for all competitors were available and directly comparable, whereas volume data were not uniformly available and would require frequent adjustments. *Id.* at 19 (citing Order No. 4402 at 23). The Commission acknowledged that theoretical circumstances exist where the use of revenue as a measure of output could be misleading, but the Commission found those circumstances inapplicable to the instant case. Order No. 4742 at 29. The Commission found that as long as revenue is measured in real terms, the Competitive Growth Differential would accurately reflect the Postal Service's relative position in the market. *Id*.

Sidak asserts that if demand for the Postal Service's competitive products is inelastic, then price and total revenue will vary directly (*i.e.*, a decrease in price would lead to a decrease in total revenue, an increase in quantity demanded, and an increase in costs). Sidak Order No. 4742 Decl. at 31. Sidak maintains that even if revenue is adjusted for inflation, as the Commission proposed to do in Order No. 4742,[163] there will remain theoretical circumstances where revenue is less correlated with costs than volume. Sidak Order No. 4742 Decl. at 31. Sidak also asserts that the Competitive Growth Differential will fail to reflect market growth or the Postal Service's market share entirely if the Postal Service and its competitors experience the same percentage increase or decrease in revenue from one fiscal year to another. *Id*. at 25-26.

UPS argues that measuring revenue instead of volume incentivizes the Postal Service to underprice competitive products because no matter how much volume grows, it will have no effect on the appropriate share as long as revenue growth is no greater than that of the Postal Service's competitors from year to year. UPS Order No. 4742 Comments at 46-47.

(2) Commission Analysis

Sidak is correct that if demand is price-inelastic, changes in revenue will not be proportional to changes in volume, and therefore revenue would not accurately approximate volume. The Competitive Growth Differential, however, is not designed to approximate volume, and it does not use revenue for this purpose. Rather, it uses revenue to represent the growth of the market and the position of the participants within the market. This is necessary because of the market's co-opetive nature. The Postal Service performs last-mile delivery for many of its competitors, meaning a mailpiece enters the mailstream via a competitor's network, but is delivered to its final destination by the Postal Service. In such a case, both the competitor and the Postal Service could claim the piece when calculating volume totals. However, because the piece was handled by both the competitor and the Postal Service, it is unclear to whom the volume should be attributed. *See* Order No. 4402 at 6; section II.A, *supra.* Using revenue avoids this problem, because it is possible to discern the amount of revenue realized by the Postal Service and its competitors collectively. For further discussion of the reasons

[163] *See* Order No. 4742 at 29.

for the Commission's use of revenue, *see* Order No. 4402 at 23 and Order No. 4742 at 19.

The fact that the Competitive Growth Differential will not change if the Postal Service's revenue and its competitors' revenue change by the same percentage amount is expected. The Competitive Growth Differential is designed to reflect the Postal Service's market position, *i.e.*, its relative market power. The appropriate share should not change if the Postal Service's market position has not changed, because in that case (assuming change in the Competitive Contribution Margin is constant), the prevailing competitive conditions in the market and other relevant circumstances have not changed.

With regard to UPS's argument that measuring revenue instead of volume incentivizes the Postal Service to underprice its competitive products, if the Postal Service were to attempt to strategically lower its prices in order to prevent the appropriate share from increasing, then competitive products might not generate enough contribution to meet the appropriate share requirement during the interim period between when the Postal Service lowered its prices and when the corresponding reduction in the appropriate share actually occurred. Due to the time lag between changes in market conditions and when the appropriate share is updated, changes in the appropriate share would not be instantaneous, making strategic pricing difficult to implement in practice. *See* Order No. 4402 at 30. Further, as previously discussed, the Postal Service is incentivized to maximize profits on its competitive products. *See* section VII.A.3.a, *supra.* The benefits to the Postal Service of maximizing profits are likely to far outweigh any benefit potentially realized from lowering prices in an attempt to decrease the appropriate share.

d. Weighting by Market Share

(1) Comments

In Order No. 4742, the Commission responded to comments arguing that the formula's market position component should incorporate the Postal Service's market share. Order No. 4742 at 21, 28. As part of the modifications to this component, the Competitive Growth Differential directly incorporates the Postal Service's market share into the appropriate share calculation as a weight. *See id.* at 28. The Commission determined that this would ensure that any change in the appropriate share due to changes in the Competitive Growth Differential would not solely be driven by growth in the overall market but would also be reflective of whether those changes affected the Postal Service's relative position in the market. *Id*.

UPS, Sidak, and the Postal Service all comment on this modification. UPS asserts that "[t]his adjustment has no apparent conceptual justification, and has the practical effect of reducing the effect of the [Competitive Growth Differential] on the appropriate share…." UPS Order No. 4742 Comments at 47.

Sidak asserts that the Competitive Growth Differential, because of the way it is structured, would capture the change in the size of the Postal Service's competitive business relative to that of the Postal Service's competitors even without including an explicit term for the Postal Service's market share. Sidak Order No. 4742 Decl. at 21-22. Moreover, Sidak asserts that the Postal Service's market share, when explicitly incorporated as a weight, functions as a scalar multiple that will always serve to reduce the magnitude of the Competitive Growth Differential. *Id*. at 23. Sidak asserts that as a result of incorporating the Postal Service's market share, the Competitive Growth Differential will have a minimal effect on the appropriate share, even when the Postal Service experiences rapid growth in its competitive business. *Id*. at 24. Hence, Sidak maintains that the Postal Service's market share is an extraneous term that serves no purpose in the formula. *Id*.

The Postal Service asserts that weighting the Competitive Growth Differential by market share is an improvement, but it states that using the Competitive Growth Differential in place of the Competitive Market Output does not appear to have much of an actual effect. Postal Service Order No. 4742 Comments at 11.

(2) Commission Analysis

UPS and Sidak are correct that weighting the Competitive Growth Differential by the Postal Service's market share has the effect of reducing the influence of the component. This is by design. The Competitive Growth Differential reflects the Postal Service's relative market power, which adjusts the Postal Service's absolute market power as represented by the Competitive Contribution Margin. The inclusion of market share as a weight reflects the constraints placed on the Postal Service's absolute market power by its competitors and its market share. As the Postal Service gains market share, the magnitude of this reduction decreases because the Postal Service faces fewer constraints in its exercise of market power, and hence in its ability to gain revenue relative to its competitors. If the Postal Service were a monopoly, then its market share would be 100 percent, and the Competitive Growth Differential would be equivalent to the increase in competitive product revenue. Such a result would be appropriate in that situation because the Postal Service would face no price competition, and no threat of losing volume to competitors so its minimum capacity to contribute to competitive products would not be limited by competitors in any way.

Sidak is also correct that the Competitive Growth Differential would capture the change in size of the Postal Service's competitive business relative to that of the Postal Service's competitors (*i.e.*, the Postal Service's relative growth), even without including an explicit term for the Postal Service's market share. However, this information would not be sufficient to determine the Postal Service's market position. If the Competitive Growth Differential lacked market share as a weight, then the formula would overstate the Postal Service's market power because it would not incorporate the constraint on market power posed by the Postal Service's market share. If the Competitive Growth Differential did not include a term for the relative growth in the Postal Service's revenue compared to that of its competitors, then this component would not adequately account for the change in the Postal Service's capacity to contribute to institutional costs. Rather, it would merely adjust the growth in the Competitive Contribution Margin, which is a measure of profitability, by the Postal Service's market share. This would only represent an adjusted profitability measure, not the capacity to contribute to institutional costs.

e. Inflation

(1) Comments

As part of the modifications to the market position component proposed in Order No. 4742, the Commission proposed using real revenue growth, rather than nominal revenue growth, in order to determine the change in the overall size of the parcel delivery market from year to year. Order No. 4742 at 24, 29. The Commission found that taking into account inflation would prevent the formula from interpreting inflationary changes in the market as market growth. *Id.* at 29. The Commission determined that the appropriate revenue deflator to use would be CPI-U, and the Commission indexed the CPI-U data to FY 2007. *Id.* at 24-25. ACI, Sidak, and the Postal Service all comment on this modification.

ACI argues that "[t]he prices of consumer goods and services…have little bearing on the rate changes of the…products in question." ACI Order No. 4742 Comments at 5. ACI also argues that "the use of the [CPI-U] to deflate revenues assumes that all competitors have the same price changes." *Id*. ACI takes the position that "[t]rying to fix the proposed formula's shortcomings by removing price effects simply introduces new problems." *Id*.

Sidak posits that the actual effect of adjusting the Competitive Growth Differential for inflation will be minimal. Sidak Order No. 4742 Decl. at 27. Sidak asserts that the market share input to the Competitive Growth Differential does not rely on dollar values from different time periods, so adjusting for inflation will have no effect. *Id*. Moreover, Sidak asserts that to the extent that the Competitive Growth Differential simply measures the year-over-year difference between the percentage change in the Postal Service's competitive product revenue and the percentage change in competitors' revenue, adjusting the result for inflation will serve only to decrease the measured difference. *Id*. at 27-29.

Sidak also argues that inflation measured by CPI-U will not fully capture strategic price decreases by the Postal Service's competitors because many components of CPI-U will not vary based on changes in the prices for competitive postal products. *Id*. at 29-30. Moreover, Sidak maintains that adjusting the Competitive Growth Differential for inflation does not address the concern that the cost of providing competitive products correlates more closely with volume than with revenue, and would not necessarily account for the potential of pricing decisions to cause divergence between revenue and volume. *Id*. at 27, 30-31.

The Postal Service supports the inflation adjustment. Postal Service Order No. 4742 Comments at 11.

(2) Commission Analysis

With regard to arguments concerning the propriety of CPI-U as a revenue deflator for competitive postal products, no commenter identified an alternative index as more appropriate. The Commission finds it important that CPI-U is a stable measure of inflation. Furthermore, using CPI-U is consistent with the Commission's practice in other contexts.[164]

With regard to ACI's assertion that using CPI-U as a revenue deflator assumes that all competitors experience similar price increases, the Commission notes that the Postal Service and its competitors have implemented similar price increases in recent years. *See* section II.A, Table II-5, *supra*.

Sidak is correct that adjusting the Competitive Growth Differential for inflation does not significantly affect the component. However, the Commission finds that it improves the component's accuracy by eliminating inflationary effects, however small they may be. With regard to Sidak's assertion that accounting for inflation will not account for the effects of strategic price decreases by the Postal Service's competitors,

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[164] *See, e.g.*, 39 C.F.R. §§ 3010.21-.22 (CPI-U used for inflation adjustment in market dominant rate cases); 39 C.F.R. §§ 3035.15-.16 (CPI-U used for inflation adjustment to the revenue limitation in market tests).

the Commission notes that the inflation adjustment was not intended to account for the effect of strategic pricing by competitors. That issue was addressed by the structural modifications to the market position component in Order No. 4742, which removed unweighted competitor revenue. *See* Order No. 4742 at 25-27.

Sidak's assertion that competitive product costs correlate more closely with volume than with revenue rests on an implicit assumption that the appropriate share should, in some way, correlate to the Postal Service's attributable costs. As the Commission has discussed, the use of cost shares for purposes of setting the appropriate share is methodologically inappropriate.[165]

C. Operation of the Formula

In Order No. 4742, the Commission provided a detailed description of the formula's calculation, explaining, among other things, the structure of the formula, the use of equally weighted components, the formula's recursive nature, and the beginning values used to calculate the appropriate share. Order No. 4742 at 9-47. In response to Order No. 4742, commenters raised concerns regarding the formula's beginning fiscal year and beginning appropriate share as well as the weighting of the components.

1. Beginning Fiscal Year and Beginning Appropriate Share

a. Previous Commission Discussion

In Order No. 4402, the Commission determined that the beginning fiscal year for purposes of the formula should be FY 2007 in order to capture market changes since the PAEA's enactment. The Commission also determined that 5.5 percent should be the beginning appropriate share, as that was the appropriate share initially set in FY 2007. Order No. 4402 at 32.

In Order No. 4742, the Commission addressed comments concerning the beginning fiscal year and the beginning appropriate share, including recommendations

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[165] *See* section V.C, *supra*; *see also* Order No. 4402 at 81.

regarding both beginning values. Order No. 4742 at 40-43. The Commission declined the Postal Service's suggestion to begin the formula's calculation in FY 2017 (or as an alternative, FY 2012) because doing so would disregard the cumulative impact of market changes in the past 11 years.[166] In addition, the Commission explained that using competitive product's revenue share in place of the 5.5 percent as a beginning appropriate share, as suggested by UPS, was inappropriate because competitive product's revenue share is not reflective of market conditions, the considerations of section 3633(b), or Commission precedent.[167]

As explained in Order No. 4742, the formula's beginning values were chosen to allow for incorporation of changes in the market in the years since the PAEA's enactment. Order No. 4742 at 41-42. The Commission ultimately affirmed its findings in Order No. 4402 and concluded its chosen beginning values enable the formula to capture the impact of market fluctuations on the appropriate share since the PAEA's enactment and moving forward. *Id.* at 40-43.

In response to the Commission's findings in Order No. 4742, commenters continue to note concerns with the beginning fiscal year and the beginning appropriate share value.

b. Comments

The Postal Service and Amazon do not comment on the Commission's determination that the calculation of the formula should begin with the value of 5.5 percent. However, both commenters disagree with the Commission's use of FY 2007 as the beginning fiscal year. Amazon states there is "no rational basis" for using FY 2007 as the beginning fiscal year and that doing so creates an "artificial" appropriate share for FY 2017, when the appropriate share was 5.5 percent. Amazon Order No. 4742 Comments at 7. It contends that the plain language of section 3633 requires the Commission to assess the prevailing competitive conditions in the market and not the

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[166] Order No. 4742 at 41-43; *see* Postal Service Order No. 4402 Comments at 22-24.

[167] Order No. 4742 at 41; *see* UPS Order No. 4402 Comments 36-40.

cumulative effects of changes over previous years. *Id.* Furthermore, Amazon states that the use of FY 2007 as the beginning fiscal year is inconsistent with the Commission's prior decision in Docket No. RM2012-3 where the Commission maintained the appropriate share at 5.5 percent even though there were "undoubtedly changes" between FY 2007 and FY 2012. *See id.*

The Postal Service also contends that the use of FY 2007 as the beginning fiscal year is inconsistent with the language of section 3633 because, the Postal Service maintains, the Commission's review of the appropriate share is limited to a 5-year period. Postal Service Order No. 4742 Comments at 13. Additionally, the Postal Service states that the Commission's findings in this proceeding do not nullify the Commission's findings in Docket No. RM2012-3, *i.e.,* that the appropriate share between FY 2013 and FY 2017 was to be 5.5 percent. *Id.* at 13-14. Therefore, the Postal Service concludes that because 5.5 percent was intended to apply until FY 2017, FY 2017 would constitute a more appropriate beginning fiscal year. *Id.* at 14.

ACI and UPS discuss concerns with the beginning appropriate share used in the formula. ACI maintains that using 5.5 percent as the beginning value "incorporates a downward bias in institutional cost recovery."[168] UPS similarly states that the use of 5.5 percent as the beginning value will result in a "perpetually low" appropriate share and "will guarantee that the competitive products business will *never* be required to cover the share of institutional costs associated with its operations." UPS Order No. 4742 Comments at 33-34, 37 (emphasis in original). As a result, UPS suggests that the Commission use a 3-year average of competitive products' attributable costs (30.9 percent), beginning in FY 2018 in order to calculate the appropriate share moving

[168] ACI Order No. 4742 Comments at 3, 4. ACI does not propose an alternative beginning appropriate share, but it does present an alternative to the Commission's formula-based approach (*i.e.,* full cost accounting or the affiliate transactions rule), which is discussed above. *Id.* at 1, 3, 6-8; *see* section V.C, *supra.*

forward. UPS maintains that this beginning value is a "meaningful"[169] representation of "today's market conditions." UPS Order No. 4742 Comments at 37.

c. Commission Analysis

In its current review of the appropriate share, the Commission has analyzed all relevant circumstances, including the prevailing competitive conditions in the market, and has concluded that a modification to the 5.5 percent appropriate share is appropriate at this time because market conditions have changed since the last appropriate share review and since the PAEA's enactment.[170] These changes have caused the Commission to develop a formula that incorporates changes in market conditions and other relevant circumstances, facilitated by the use of seed values (*i.e.,* a beginning fiscal year and a beginning appropriate share). As noted initially in Order No. 4402, the Commission selected FY 2007 as the beginning fiscal year in order to capture market changes since the PAEA's enactment, and the Commission selected 5.5 percent as the beginning value in order to assess the impact those market changes have had on the initial appropriate share. Order No. 4402 at 32.

Amazon contends that by using FY 2007 as the beginning fiscal year, the Commission creates an artificial appropriate share for FY 2017, when the actual appropriate share for that year was 5.5 percent.[171] In Order No. 4742, the Commission explained that its formula-based approach "does not purport to change the actual [appropriate share] values for any prior fiscal year." Order No. 4742 at 42-43. The Commission further explained that applying the formula to calculate appropriate share

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[169] UPS's perception of a "meaningful" beginning appropriate share value is, at least in part, related to its position that the appropriate share should be significantly higher and that competitive products' revenue or attributable costs should be used as a proxy for the appropriate share. *See* UPS Order No. 4402 Comments at 40; UPS Order No. 4742 Comments at 50-59. Were the Commission to take UPS's suggestion and set the beginning appropriate share at over 30 percent, regardless of the beginning fiscal year used, the resulting appropriate share would also be above 30 percent, which is in line with UPS's proposal on the appropriate share. *See* section IV, *supra*.

[170] *See* section II.A, *supra*; *see also* Order No. 4402 at 12.

[171] Amazon Order No. 4742 Comments at 7. This contention is similar to that of the Postal Service's comments in response to Order No. 4402. *See* Postal Service Order No. 4402 Comments at 24.

values between FY 2007 and FY 2017 is necessary to determine the impact that market changes have had on the original 5.5 percent appropriate share. *Id.* at 43.

In response to Amazon's argument that the Commission's consideration of the "prevailing competitive conditions in the market" should be limited to considering only current competitive conditions, the Commission disagrees. "Prevailing" in this context means "predominating" or "persisting."[172] Although "prevailing" includes consideration of current conditions, it is not so limiting as to preclude consideration of anything other than today's competitive conditions in the market. In order to gain understanding of the "predominating" or "persisting" competitive conditions in the market, the Commission must take a broader view. There is nothing in the statute that prevents the Commission from looking back in time to consider how market conditions have evolved. Given that the Commission is statutorily mandated to review the appropriate share every 5 years, and has been regulating competitive products under the current statutory scheme for just over 10 years, it is reasonable that the Commission would consider changes in prevailing competitive conditions in the market in recent years as part of its assessment. In fact, this type of backward-looking approach to assessing the parcel delivery market is consistent with the Commission's previous review of the appropriate share. As Amazon points out, in 2012 the Commission looked back over the previous 5 years[173] and discussed market changes since that time. *See* Amazon Order No. 4742 Comments at 7. In this proceeding, a broader view is also appropriate given that the Commission is changing its approach to setting the appropriate share. The Commission considers incorporation of the period since the enactment of the PAEA a critical part of its formula-based approach because it facilitates the formula's ability to capture both the changes since the PAEA's enactment and changes moving forward.

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[172] *See* Merriam-Webster Dictionary, available at: *https://www.merriam-webster.com/dictionary/prevailing*; *see also* Merriam-Webster Dictionary, available at: *https://www.merriam-webster.com/dictionary/prevailingly* and *https://www.merriam-webster.com/dictionary/prevailingness*.

[173] In the Commission's first review, the previous 5 years was synonymous with the period of time since the PAEA's enactment.

Finally, Amazon maintains the Commission's formula-based approach is inconsistent with the Commission's determination in Docket No. RM2012-3, because in that review the Commission maintained the appropriate share at 5.5 percent despite identifying changes in the market. Amazon Order No. 4742 Comments at 7. However, in Order No. 4402 and in this Order, the Commission explained the extent to which relevant circumstances have changed since 2012, rendering a formula-based approach appropriate at this time.[174]

In response to the Postal Service's contention that choosing FY 2007 as the beginning year is inconsistent with the PAEA because section 3633(b) limits the Commission's review to only a 5-year review period, the Commission finds this contention inaccurate. The Commission notes that the language in section 3633(b) is not related to the period of time that the Commission's review encompasses; it is related to the timing of mandatory Commission reviews of the appropriate share. In accordance with section 3633(b), the Commission's review must occur at least every 5 years. *See* Order No. 4402 at 13 n.21.

As noted above, the Commission also received comments related to the beginning appropriate share. In response to ACI's and UPS's concern regarding the "lowering" effect that using 5.5 percent as the beginning appropriate share has on the formula's results, the Commission reiterates its reasons for selecting 5.5 percent as the beginning appropriate share. As explained in Order No. 4742, the Postal Service, its competitors, and market conditions have changed since the PAEA's enactment and since the Commission's last review. *See* Order No. 4742 at 41. The goal of the formula-based approach is to better capture these changes, both historically and moving forward. *See id.*

The Commission also reiterates its previous discussion of the appropriate share's purpose. *See* section II.B, *supra.* By statute, the appropriate share constitutes a minimum contribution requirement, one that was not intended to be a maximum or to

[174] Order No. 4402 at 12; *see* section II.A, *supra.*

capture an exact appropriate share amount that the Postal Service must contribute.[175] Just as in prior reviews, the Commission is continuously mindful of the risks associated with a mandatory contribution level.[176] The use of 5.5 percent as the beginning appropriate share ensures that the appropriate share encompasses those risks and also reflects the appropriate share's purpose as a minimum contribution level.

UPS's suggestion that the Commission use the 3-year average of competitive products' share of attributable costs (30.9 percent) as the beginning appropriate share is similar to a previous UPS recommendation that was rejected by the Commission. In response to Order No. 4402, UPS recommended that the Commission use the average revenue share of the Postal Service's competitive products over the past 3 fiscal years (26.6 percent) as the beginning value for purposes of the appropriate share. UPS Order No. 4402 Comments at 39-40. The Commission determined that the "use of…revenue share would be inappropriate because it does not…reflect market conditions in FY 2007 and subsequent years." Order No. 4742 at 41. The Commission also noted that changes in competitive products' percentage of revenue are driven largely by changes in market dominant products' percentage of revenue. *Id.* UPS's suggestion that the Commission use the 3-year average of competitive products' attributable costs as the beginning appropriate share is also inappropriate for the same reasons. Despite UPS's assertion to the contrary, competitive products' percentage of overall attributable costs is not reflective of "today's market conditions" because, as previously discussed, competitive products' percentage of the Postal Service's total attributable costs is also affected by declining market dominant mail volume. *See* section V.C, *supra*; UPS Order No. 4742 Comments at 37. In addition, just as with average revenue share, competitive products' share of overall attributable costs is directly affected by changes in market dominant products' attributable costs. Thus, if the Commission accepted UPS's suggestion, factors unrelated to the criteria of section 3633(b) would affect the appropriate share. *See* Order No. 4742 at 41.

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[175] *See id.*; 39 U.S.C. § 3633(b).

[176] Order No. 4402 at 50-51; Order No. 4742 at 56-57.

2. Equal Weighting

a. Previous Commission Discussion

In Order No. 4742, the Commission determined that the two components of the formula should be weighted equally and found it was appropriate from both a legal and an economic perspective.[177] The Commission concluded that it was appropriate to weight the components equally from a legal perspective because the components were both based on the required consideration of the statutory criteria of section 3633(b), including prevailing competitive conditions in the market and other relevant circumstances. Order No. 4742 at 43-44. Because both components play an equal role in capturing the criteria of section 3633(b), the Commission concluded that both were equally necessary as part of the formula calculation. *Id.*

In addition, the Commission concluded that it was appropriate to weight the components equally from an economic perspective. *Id.* at 44-46. The Commission noted that there are situations where weights are typically used (such as in regression or survey analysis), but the reasons for their use are not applicable to the Commission's formula. *Id.* at 44-45. The Commission also found that both components rely on a shared input, the Postal Service's competitive product revenue, making the components related. *Id.* at 45. As a result, the Commission concluded that any attempt to assign unique weights would have a disproportionate effect on the formula's calculation. *Id*. at 45-46.

b. Comments

ACI, UPS, and Sidak all note concerns with the Commission's equal weighting of the components as part of its calculation of the formula. ACI states that "applying equal weights makes the appropriate share indisputably biased" because the Competitive Contribution Margin demonstrates more variance than the Competitive Growth Differential, making the Competitive Contribution Margin more influential on the resulting

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[177] Order No. 4742 at 43. Much of the Commission's analysis was in response to Sidak's declaration in response to Order No. 4402. *See generally* Sidak Order No. 4402 Decl. at 39.

appropriate share. ACI Order No. 4742 Comments at 5. ACI contends that the Commission provides no economic justification for its use of equal weights and that, "[i]n the absence of any empirical evidence to justify equal weights, the Commission should abandon [its]…formula-based approach." *Id.*

UPS maintains that "[t]he weighting of the formulaic components will have a significant effect on the appropriate share measure, and it deserves serious consideration." UPS Order No. 4742 Comments at 48. Similar to ACI, UPS notes a disparity in the growth rate of the Competitive Contribution Margin compared to the Competitive Growth Differential. *Id.* at 48-49. Because of these effects, UPS concludes the components "should be weighted to the extent one is more connected to the statutory purposes embodied in section 3633," and that thus far the Commission has failed to consider such a connection. *Id.* at 49-50.

Sidak continues to challenge the Commission's decision to use equal weights in its calculation of the formula. Similar to his comments in response to Order No. 4402, Sidak contends that the Commission does not analyze: (1) whether the two components are endogenous; (2) whether one component is more highly correlated with competitive products' attributable costs; or (3) how the appropriate share calculation would evolve under different weighting scenarios.[178] Sidak maintains that equal weighting of the components is inappropriate from a legal perspective because it is inconsistent with section 3633(b), seemingly due to the Commission's failure to consider other relevant circumstances as required by section 3633(b). Sidak Order No. 4742 Decl. at 32-33.

From an economic perspective, Sidak describes the Commission's comparison of the weighting used in survey or regression analysis to its formula-based approach as "irrelevant," because the Commission's formula "does not rely on any econometric or statistical analysis." *Id.* at 34 (emphasis omitted). He disagrees with the Commission's concern about diminished accuracy when using weights, and notes that there are other

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[178] Sidak Order No. 4742 Decl. at 31; *see* Sidak Order No. 4402 Decl. at 39.

instances of assigning weights to components, such as those used in Ramsey pricing or in the context of theoretical analysis of cost allocation or multi-product pricing, that the Commission could consider. *Id.* at 35. He specifically states that the Commission's finding that weighting would diminish the accuracy of the formula is not valid because there is not "a single correct measure of the Postal Service's appropriate-share requirement," or "a single objective solution to the appropriate-share inquiry." *Id.* at 35-36. Finally, Sidak contends that there is "no economic justification for the [Commission's] assumption that, if a particular weighting method is unavailable, the next-best alternative is to apply no rigorous weighting method at all."[179]

c. Commission Analysis

UPS and Sidak disagree with the Commission's legal justification for weighting the two components of the formula equally and contest the components' connection to the statutory considerations of section 3633(b).[180] After consideration of these comments, the Commission continues to find that the components capture prevailing competitive conditions in the market and other relevant circumstances to an equal degree, and thus should be weighted equally.

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[179] *Id.* at 34. Sidak does note that by choosing two components for the formula and assigning equal weights to them, the Commission assigns "a weight of *zero* to all other potential input variables ('all other relevant circumstances') to the formula." *Id.* at 36-39 (emphasis in original); *see* section VI.B.1, *supra*. He further suggests assigning a zero weight to the Competitive Growth Differential and using competitive products' attributable costs as an alternative variable to the Competitive Growth Differential. Sidak Order No. 4742 Decl. at 36-37. Although included in his discussion on equal weighting, Sidak's comments relate more to his concerns regarding the relevance of the Competitive Growth Differential, which are addressed in section VII.B.2, *supra*. To the extent that he proposes substituting the Competitive Growth Differential with a variable reflecting competitive products' attributable costs, his proposal suffers from the same shortcomings as using attributable cost shares as the appropriate share, as discussed in section V, *supra*.

[180] UPS Order No. 4742 Comments at 49-50; Sidak Order No. 4742 Decl. at 32-33.

As noted in Order No. 4742, both components equally consider the statutory criteria of section 3633(b).[181] Each component measures different aspects of the market and each captures different considerations within the statutory criteria. For example, in Order No. 4742, the Commission noted that the Competitive Contribution Margin provides insight into potential Postal Service competitive advantage and that the Competitive Growth Differential captures changes in market share. *Id.* at 43-44. Competitive advantage and changes in market share are both considerations of prevailing competitive conditions in the market. *See* Order No. 4402 at 34. In addition, the Commission explained that the Competitive Contribution Margin and the Competitive Growth Differential both capture the effects of products transfers to the competitive product list. Order No. 4742 at 55. The Commission also explained how both components capture market uncertainties that may occur due to changes in market demand or other macroeconomic conditions. *Id.* at 56. Product list transfers and market uncertainties are other relevant circumstances that the Commission considers pursuant to section 3633(b). Order No. 4402 at 45-46.

Although each component captures prevailing competitive conditions in the market and other relevant circumstances to varying degrees, the overall formula provides a balanced reflection of the annual changes in prevailing competitive conditions or other relevant circumstances. As an example of this balance, the Commission notes that although the Competitive Contribution Margin better captures competitive advantage than the Competitive Growth Differential, the Competitive Growth Differential better captures market share than the Competitive Contribution Margin. Thus, while the ability of two components to capture the statutory criteria

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[181] Order No. 4742 at 43. The prevailing competitive conditions considered are: (1) the existence (or nonexistence) of evidence suggesting that the Postal Service has benefitted from a competitive advantage with respect to competitive products; (2) changes to the Postal Service's market share with respect to competitive products since the Commission's last review; and (3) changes to the package delivery market and to the Postal Service's competitors since the Commission's last review. Order No. 4402 at 34. The other relevant circumstances are: (1) transfers to the competitive product list; (2) changes to the mail mix; (3) uncertainties in the marketplace; and (4) risks from setting the appropriate share too high or too low. Order No. 4402 at 45-46. Neither component captures risks; however, the Commission notes the formula as a whole addresses the risks associated with setting the appropriate share. Order No. 4742 at 56-57.

differs, it is also balanced. For these reasons, the Commission continues to find that both components equally capture the statutory criteria of section 3633(b).

In addition, commenters note several economic-related concerns with the Commission's determination that the two formula components should be weighted equally. ACI and UPS note that the Competitive Contribution Margin changes to a greater degree, year-over-year, than the Competitive Growth Differential, and both conclude that this result biases the appropriate share.[182] The Commission agrees that the Competitive Contribution Margin generally changes to a greater degree than the Competitive Growth Differential. However, the Commission does not agree that this necessitates disparate weighting of the formula's components. By capturing relevant circumstances, including prevailing competitive conditions in the market, each component reflects the year-over-year changes in certain aspects of market conditions. That is why the formula employs the year-over-year percentage changes for both the Competitive Contribution Margin and the Competitive Growth Differential. The magnitude of these changes is different because the Competitive Contribution Margin measures growth of the Postal Service's market power, which generally changes to a greater degree than the Postal Service's market position, as measured by the Competitive Growth Differential. *See* Order No. 4742 at 31. As noted above, the two components do not identically capture changes in the different aspects of prevailing competitive conditions in the market or other relevant circumstances, but including both components in the formula ensures a balanced reflection of the market. The different rates of change in the components are expected and result from the design of the formula. The Competitive Growth Differential effectively adjusts the absolute market power measured by the Competitive Contribution Margin in order to determine the minimum that the Postal Service's competitive products must contribute to institutional costs. Therefore, these different rates of change do not indicate any bias that needs to be corrected through disparate weighting of the components as UPS and ACI suggest.

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[182] ACI Order No. 4742 Comments at 5; UPS Order No. 4742 Comments at 48-49.

In response to Sidak's comments that the application of equal weights is arbitrary, the Commission notes that Sidak does not specify how to select weights for the components or what weights to assign. In support of the argument that equal weights should be economically justified, he relies on a non-economic example. Sidak maintains that the Commission should assign weights to the components in the formula similar to how a baker assigns weights to ingredients when baking.[183] However, this analogy between a baking recipe and the formula is inapposite. When determining ingredient proportions of a recipe, a baker works with distinct, separable ingredients, such as flour and sugar. A baker knows that the flour does not include any sugar, and vice versa. If the baker were to change the amount of flour he uses, he would not necessarily need to change the amount of sugar.

However, similar logic cannot be applied to the Commission's formula. Its components are not distinct because they both depend on changes in the Postal Service's competitive product revenue, which makes them economically related. *See* Order No. 4742 at 45. If revenue changes, both components in the formula will change as well. Since both components of the formula are composite measures that are calculated using different types of economic data (*e.g.*, the Postal Service's and competitors' revenue; the Postal Service's attributable costs), changes in these data result in changes in the components. Therefore, the very composition of each component, as well as their balanced reflection of the market, are intentional characteristics of the formula. The Competitive Growth Differential, for example, is calculated as a "weighted difference in revenue growth between the Postal Service and it competitors," and the Postal Service's market share is used as a weight. *Id.* at 27-28. If an additional weight were assigned, it would alter the value of each component and destroy the balance between them.

After criticizing the Commission's economic examples of when weighting is typically used and claiming that those instances are inappropriate in this context, Sidak suggests other examples of when weighting may be used, such as in Ramsey pricing or

[183] Sidak Order No. 4402 Decl. at 39; Sidak Order No. 4742 Decl. at 34.

in the context of theoretical analysis of cost allocation or multi-product pricing. Sidak Order No. 4742 Decl. at 35. He states that the Commission should not liken his proposal to assign weights to the weighting used in survey or regression analysis because the Commission's formula does not use survey or regression analysis. *Id.* However, that same logic holds against using the weighting techniques discussed by Sidak. The Commission's formula does not involve Ramsey pricing, cost allocation, or multi-product pricing. Just as the weighting used in survey or regression analysis is inappropriate in this context, so too is the weighting used in Ramsey pricing, cost allocation, or multi-product pricing.

In addition, Sidak criticizes the Commission for not analyzing whether the two components used in the formula are endogenous.[184] By definition, *"endogenous* variables are those which are explained by the model,"[185] while "*exogenous variables* are variables the values for which are determined outside the model but which influence the model."[186] In the Commission's formula-based approach, the appropriate share formula can be viewed as an algebraic model. In this model, the appropriate share is determined by the model, and is therefore endogenous. The components or variables are determined by either the actual "historically given" data or "some separate mechanism" developed outside the model which, by definition, makes them exogenous and not endogenous. *See id.*

Sidak also alleges that the Commission fails to consider whether one component is more highly correlated with competitive products' attributable costs than the other.[187] The Commission notes that correlation analysis is useful when attempting to identify the relationship between variables.[188] In multivariate regression, for example, high

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[184] Sidak Order No. 4402 Decl. at 39; Sidak Order No. 4742 Decl. at 31.

[185] Michael J. Brennan, *Preface to Econometrics: An Introduction to Quantitative Methods in Economics* 11 (3d ed. 1973) (emphasis in original).

[186] Michael D. Intriligator, *Econometric Models, Techniques, & Applications* 28 (1978) (emphasis in original).

[187] Sidak Order No. 4402 Decl. at 39; Sidak Order No. 4742 Decl. at 31.

[188] *See, e.g.*, Sam Kash Kachigan, *Multivariate Statistical Analysis: A Conceptual Introduction* 118-120 (2d ed. 1991).

correlation between explanatory variables decreases the precision of the estimates.[189] However, correlation analysis does not apply to the Commission's formula-based approach, because the formula does not involve any econometric analysis. Furthermore, Sidak does not explain how any potential findings would affect the validity of the formula or how such findings should be used to derive differential weights. As discussed previously, the appropriate share constitutes a minimum contribution level. As a result, to comply with section 3633(a)(3), competitive products must reach an institutional cost contribution level that is equal to or higher than the appropriate share.[190] Even if one component of the formula were more correlated with competitive products' attributable costs than the other, such a result would not provide any additional information relevant to the selection of the appropriate share. Thus, Sidak's suggestion is not relevant to the Commission's decision to include two components in the formula and assign equal weights to them.

Finally, Sidak contends that the Commission failed to consider how the appropriate share would evolve under different weighting scenarios.[191] However, based on the Commission's analysis, it was unnecessary to do so. The Commission reviewed the components' relatedness to the statutory criteria and determined that equal weighting was appropriate from a legal perspective. Order No. 4742 at 43-44. The Commission also recognized that both components depend on changes in the Postal Service's revenue making the components economically related. *Id.* at 45-46. Any attempt to weight the components differently would alter their balanced reflection of prevailing competitive conditions in the market and other relevant circumstances. As a result, different weights would diminish the accuracy of the intended balance and would have a disproportionate effect on the formula. *Id.* Thus, the Commission determined

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[189] *See, e.g.,* John Fox, *Applied Regression Analysis and Generalized Linear Models* 308-309 (2d ed. 2008).

[190] 39 U.S.C. § 3633(a)(3); Order No. 26 at 70.

[191] Sidak Order No. 4742 Decl. at 31; *see also* Sidak Order No. 4402 Decl. at 39.

that equal weighting was appropriate from an economic perspective. *Id.* These Commission findings eliminated any need to consider other weighting scenarios.

VIII. COMMENTS SPECIFIC TO SECTION 3633(b) AND COMMISSION ANALYSIS

In this section, the Commission first discusses comments received related to the appropriate share's statutory purpose. The Commission then addresses comments received related to the three elements of section 3633(b): (1) the prevailing competitive conditions in the market; (2) the degree to which any costs are uniquely or disproportionately associated with any competitive products; and (3) all other relevant circumstances.[192]

A. Statutory Purpose

1. Previous Commission Discussion

As discussed in section II.B, *supra*, Congress intended to provide the Postal Service with pricing flexibility and ensure fair competition through section 3633(a). Section 3633(a)(1) and (a)(2) represent limits on the Postal Service's pricing flexibility by ensuring prices are set such that individual competitive products, and competitive products collectively, cover the costs that they cause. *See* section II.B, *supra.* Section 3633(a)(3), the appropriate share requirement, is intended to ensure fair competition and protect against the possibility of the Postal Service engaging in unfair competition. *Id*. Although Congress did not define the term "appropriate share," and left its meaning for the Commission to determine, it was intended to be a broad standard that did not dictate any particular approach be used. *Id.* The Commission's determination with regard to the appropriate share is limited by consideration of the three elements of section 3633(b): (1) the prevailing competitive conditions in the market; (2) the degree to which any costs are uniquely or disproportionately associated with any competitive products; and (3) all other relevant circumstances. *Id.*; 39 U.S.C. § 3633(b).

[192] *See* 39 U.S.C. § 3633(b); *see also* Order No. 4402 at 6; Order No. 4742 at 3-4.

2. Comments

Pitney Bowes and Amazon maintain that the plain language of section 3633 gives the Commission express authorization to determine the appropriate share.[193] These commenters discuss the Commission's discretion in determining the approach used to set the appropriate share and note the importance of the Commission maintaining flexibility.[194] However, Pitney Bowes and Amazon contend that implementation of a formula-based approach is at odds with section 3633's promotion of flexibility and discretion.[195] Additionally, both Amazon and Pitney Bowes appear to imply that section 3633(a)(1) and (a)(2) ensure fair competition, because both requirements adequately "protect against any concerns regarding cross-subsidization and anticompetitive pricing practices."[196]

The Postal Service maintains that the purpose of the appropriate share requirement is to "complement the other two provisions of [s]ection 3633[(a)] in protecting fair competition." Postal Service Order No. 4742 Comments at 3. It contends that the appropriate share requirement is a mechanism the Commission may use to correct a market imbalance that favors the Postal Service if one is found to exist. *Id.*

The Public Representative states that Congress "did not intend for the Commission to follow a particular approach" when establishing the appropriate share, and he notes that the Commission previously rejected multiple proposed methodologies for calculating the appropriate share when initially promulgating the Commission's rules. PR Order No. 4402 Comments at 9-10. He appears to conclude that the use of a formula is at odds with the legislative history and previous Commission decisions, which

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[193] Pitney Bowes Order No. 4402 Comments at 13; Amazon Order No. 4402 Comments at 31, 38.

[194] Pitney Bowes Order No. 4402 Comments at 13; Amazon Order No. 4402 Comments at 31, 38.

[195] Pitney Bowes Order No. 4402 Comments at 14-15 ("Exclusive reliance on a formula-based approach would needlessly forfeit the flexibility and discretion that Congress vested in the Commission under section 3633(b)."); Amazon Order No. 4402 Comments at 38 ("[T]he use of a formula-based approach is inconsistent with the express policy direction reflected in the language of the statute and the legislative history to promote the Commission's flexibility and discretion in determining the minimum contribution requirement…."); Amazon Order No. 4742 Comments at 6.

[196] Pitney Bowes Order No. 4402 Comments at 4-6; Amazon Order No. 4742 Comments at 3.

he maintains support his recommendation that the appropriate share be maintained at its current level. *Id.* at 10-11.

In its discussion of the purpose of the appropriate share, ACI considers section 3633 in its totality. First, ACI appears to consider section 3633(a)(1), (a)(2), and (a)(3) together and concludes that the three requirements combined necessitate that the Postal Service's competitive products fully recover joint and overhead costs.[197] Second, ACI states that "Congress was focused on preventing the [Postal Service's] market-dominant products from providing any financial assistance for the benefit of competitive products...." *Id*. ACI maintains that "the objective of the Commission should be to protect market dominant services, not competitive services," and to that end, ACI contends that "[t]he only rational reason to allow the [Postal Service] to offer competitive services" is so that competitive products "can carry an equal or larger share of overheads [*i.e.,* institutional costs] for the benefit of its [market dominant products]." ACI Order No. 4402 Comments at 2. ACI therefore appears to conclude that the appropriate share should be used to protect market dominant products and require competitive products to "pay more because th[ose] services are only possible because of the existence of the [Postal Service's market dominant products]." *Id.*

UPS describes multiple purposes for the appropriate share. Similar to ACI, UPS considers section (a)(2) and (a)(3) as "work[ing] in harmony" to require the Postal Service to cover all costs associated with competitive products. UPS Order No. 4742 Comments at 45. It states that the Postal Service's competitive products should bear all of the costs associated with them, including attributable costs through the Commission's

[197] ACI Order No. 4742 Comments at 1-2. ACI appears to equate attributable costs with joint, or variable, costs, and equates institutional costs with overhead, or fixed, costs. *Id.* at 2.

costing methodology (section 3633(a)(2)), and common[198] costs through the appropriate share requirement (section 3633(a)(3)). UPS Order No. 4742 Comments at 4-5. In this way, UPS asserts that one purpose of the appropriate share is to ensure that the Postal Service's competitive products are responsible for the institutional costs associated with them. *Id.* at 28-29. Furthermore, UPS states that the appropriate share requirement is the "only protection" against the Postal Service setting artificially low prices on its competitive products by ignoring costs. UPS Order No. 4402 Comments at 4. UPS also contends that while competition prevents the Postal Service from setting competitive product prices too high, only the appropriate share requirement can prevent the Postal Service from setting prices too low. *Id.* at 6-7. UPS concludes that the Commission's formula-based approach "does nothing to protect fair competition or advance Congress's statutory goals," and that the Commission has failed to tie the formula's components to the statutory objectives of section 3633.[199]

3. Commission Analysis

As noted above, the Commission has previously stated that the primary function of the appropriate share requirement is to act as a safeguard to ensure fair competition on the part of the Postal Service. *See* section II.B, *supra*. In setting the appropriate share, the Commission has flexibility in its chosen approach, and also has the express

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[198] Multiple commenters use the term common costs when describing institutional costs, treating the two terms as synonymous. *See, e.g.,* Sidak Order No. 4742 Decl. at 1 ("…the Postal Service's 'institutional costs,' which are the common costs that the Postal Service claims it cannot attribute to any single product."); *id.* at 36 ("…the Postal Service's recovery of its institutional (or common) costs[.]"); *id.* at 37 n.118 ("…institutional costs, which, by definition, are common costs across all products...."); UPS Order No. 4742 Comments at 4-5 ("Simply put, the Postal Service's package-delivery business should bear all of the costs associated with that business. That includes…the common costs with which competitive products as associated, through the appropriate share requirement."); *id.* at 5 ("…they should be required to cover roughly that same portion of common costs (institutional costs).").

However, the Commission notes that these terms are not synonymous. Institutional costs are the residual costs remaining after attributable costs have been attributed to products, whereas common costs are costs that are incurred by multiple products. Common costs may or may not be attributed to specific products. *See* Order No. 3506, Appendix A. Thus, not every common cost is classified as institutional, as these commenters appear to suggest. The Commission considers all commenters' references to "common costs" as an intended reference to institutional costs.

[199] *Id.* at 6-10; UPS Order No. 4742 Comments at 32-33.

authority to either increase, retain, or eliminate the appropriate share.[200] As noted in Order No. 4402, the only limitation that section 3633 places on the Commission's discretion is that the Commission must consider the elements of section 3633(b) during each appropriate share review. Order No. 4402 at 13. These elements are focused on the assessment of market conditions and fair competition concerns. *See* section II.B, *supra*.

The Commission agrees with the Postal Service that the provisions of section 3633(a) are intended to work in conjunction. However, while section 3633(a)(1) and (a)(2) focus on limitations on the Postal Service's pricing flexibility, section 3633(a)(3) focuses on fair competition. Although section 3633(a)(1) and (a)(2) may contribute to the PAEA's goal of ensuring fair competition, as Pitney Bowes and Amazon suggest, section 3633(a)(3) is the primary safeguard against the Postal Service competing unfairly. Nothing in the statute indicates that the safeguard of section 3633(a)(3) is only necessary when correcting for a market imbalance, as the Postal Service suggests.

In addition, Amazon and Pitney Bowes contend that the Commission's use of a formula-based approach interferes with or diminishes the broad flexibility provided to the Commission by Congress in determining the appropriate share. The Public Representative suggests it is inconsistent with legislative history because the Commission selected a particular approach. The Commission disagrees with these contentions. As explained above, section 3633 provides the Commission with broad discretion in setting the appropriate share. *See* section II.B, *supra.* In using a formula-based approach to set the appropriate share, the Commission is exercising the discretion and flexibility granted by Congress, not limiting it. In addition, the Commission's adoption of the formula in this proceeding does not prevent it from proposing a future change in approach, if necessary. Section 3633(b) itself mandates that the Commission review the appropriate share at least every 5 years, and section

[200] Order No. 4402 at 13, 14; 39 U.S.C. § 3633(b).

3633(a) permits interim revisions to the regulations promulgated under section 3633. *See* Order No. 4402 at 13 n.21.

The use of a formula-based approach is also not inconsistent with prior Commission decisions, as the Public Representative implies. The Public Representative is correct that in Docket No. RM2007-1 the Commission rejected various alternative methodologies for calculating the appropriate share. *See* Order No. 26 at 70. The Commission found that although those methods could all be expressed mathematically in terms of a specific level of institutional cost contribution, a simple appropriate share percentage based on total institutional costs better reflected the directive of section 3633(a)(3). *Id.* However, it is important to note two things: (1) in Docket No. RM2007-1, the Commission described its chosen approach as a “fitting starting point” to setting the appropriate share, not as a permanent approach; and (2) the formula-based approach adopted in this Order was not considered by the Commission in Docket No. RM2007-1.[201] As explained in Order No. 4402, the Commission has determined that circumstances have changed in the years since the PAEA’s enactment, and the adoption of a formula-based approach that directly incorporates prevailing competitive conditions in the market and other relevant circumstances is appropriate at this time. Order No. 4402 at 12.

The Commission also disagrees with ACI’s contention that the appropriate share requirement is intended to protect market dominant products. As noted in Order No. 4402, section 3633(a)(1) and the prohibition against the subsidization of competitive products by market dominant products addresses the concern noted by ACI.[202] In addition, nothing in the statute or the legislative history indicates that Congress intended for competitive products to cover an “equal or larger” share of institutional costs compared to market dominant products.

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[201] Order No. 26 at 70; *see generally* Docket No. RM2007-1.

[202] *See* 39 U.S.C. § 3633(a)(1); Order No. 4402 at 81 n.126.

The Commission disagrees with ACI's and UPS's description of section 3633 as being intended to require that the Postal Service's competitive products "fully recover," or "bear all," costs associated with competitive products.[203] As discussed above in section V.C, *supra*, these descriptions are examples of fully-allocated costing. *See* section V.C, *supra.* The Commission has previously rejected such an allocation method and disagrees that, with section 3633, Congress intended full cost allocation. Order No. 4402 at 81 n.127.

The Commission disagrees with UPS's characterization of the appropriate share requirement as the only protection against the Postal Service setting artificially low prices. As discussed in Order No. 4402, anticompetitive pricing on the part of the Postal Service is effectively mitigated by section 3633(a)(2) and the requirement that each competitive product cover its attributable costs.[204]

In addition, UPS claims that the Commission's formula-based approach fails to protect fair competition or to further Congress's goals related to section 3633. UPS Order No. 4402 Comments at 6-10. First, the Commission notes that it discussed at length in Order No. 4742 how the two components of its formula, the Competitive Contribution Margin and the Competitive Growth Differential, capture the elements of section 3633(b). *See* Order No. 4742 at 49-52, 55-57. Second, the goal of ensuring fair competition is achieved by section 3633 in its entirety. It is not confined to section 3633(a)(3). The legislative history indicates that Congress's intent was for section 3633 in its entirety, along with associated regulations, to provide the Postal Service with pricing flexibility while simultaneously establishing safeguards to ensure fair competition.[205] Section 3633's prohibition against cross-subsidization, and the requirement that competitive products must cover their attributable costs and contribute

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[203] ACI Order No. 4742 Comments at 2; UPS Order No. 4742 Comments at 4-5.

[204] Order No. 4402 at 8 n.18; Order No. 1449 at 15.

[205] *See, e.g.,* S. Rep. No. 108-318 at 14 ("This bill establishes a flexible system of pricing the Postal Service's competitive products which reduces regulatory burdens and permits more customer- and market-responsive pricing. It does this while establishing appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete."); *see also* n.32, *supra.*

an appropriate share to institutional costs, collectively serve to provide the Postal Service pricing flexibility, while also ensuring fair competition in the parcel delivery market. *See generally* 39 U.S.C. § 3633.

B. Prevailing Competitive Conditions

As previously explained in this proceeding, in assessing prevailing competitive conditions in the market, the Commission considers: (1) whether any evidence suggests that the Postal Service has a competitive advantage over competitors; (2) changes in Postal Service market share related to competitive products; and (3) any changes to the market and competitors.[206]

In response to Order No. 4402 and Order No. 4742, commenters discuss both the Postal Service's competitive advantage and fair competition within their comments on "competitive advantage" under prevailing competitive conditions in the market. Therefore, for the purposes of addressing the comments related to prevailing competitive conditions, the Commission separates the comments into three distinct categories, with the first category addressing both competitive advantage and fair competition. As a result, the discussion in this section is organized as follows: (1) whether the Postal Service has a competitive advantage over competitors and whether the Postal Service competes fairly within the parcel delivery market; (2) the degree to which the Postal Service's market share has changed; and (3) changes to the market and competitors.

1. Competitive Advantage and Fair Competition

a. Previous Commission Discussion

In Order No. 4402, the Commission explained that in analyzing the competitive advantage consideration within prevailing competitive conditions, the Commission considers multiple factors, including the FTC's net economic effect finding from its 2007

[206] Order No. 4402 at 8; Order No. 4742 at 48.

report, evidence that the Postal Service engages in predatory pricing, and evidence of antitrust actions filed against the Postal Service. Order No. 4402 at 35-37. In addition, the Commission discussed how these factors are captured by its formula-based approach. *Id.* at 34-40.

In Order No. 4402, the Commission discussed the FTC's finding of a Postal Service net economic disadvantage, and concluded that pursuant to section 703(d), the FTC's finding continued to be valid.[207] The Commission affirmed its conclusion in Order No. 4742. Order No. 4742 at 58. Similar to Order Nos. 4402 and 4742, the Commission provides its analysis pursuant to section 703(d) in a separate section of this Order.[208]

The Commission also discussed how the formula-based approach captured potential competitive advantage in Order No. 4742. The Commission described how a significant increase in the Competitive Contribution Margin may indicate competitive advantage, because such an increase indicates a significant increase in the Postal Service's market power. Order No. 4742 at 49. Any change in the Postal Service's market power, significant or not, would be captured by the formula and would affect the Postal Service's resulting appropriate share.

As it relates to predatory pricing, in Order No. 4402, the Commission explained that the Postal Service would be engaging in predatory pricing if it were to set its competitive product prices below marginal costs in order to gain market share and drive competitors out of the market. Order No. 4402 at 36. In Order Nos. 4402 and 4742, the

[207] *Id.* at 68; *see also id.* at 54-68.

[208] *See* section IX, *infra*. The Commission notes that its findings related to the continuing validity of the FTC Report are one of many considerations relevant to determining a Postal Service competitive advantage and assessing prevailing competitive conditions in the market. As clarified in Order No. 4742, the Commission's section 703(d) analysis "is the primary way the Commission assesses whether Postal Service competitive products have a competitive advantage due to differences in the application of federal and state laws to the Postal Service compared to competitors." Order No. 4742 at 49 n.60.

Commission concluded that there was no evidence to suggest the Postal Service has engaged in predatory pricing.[209]

The Commission further noted that any attempt by the Postal Service to engage in predatory pricing with regard to competitive products as a whole would be captured by the Competitive Contribution Margin, because any such attempt would result in the Competitive Contribution Margin having a negative value. Order No. 4742 at 49. This is because the Competitive Contribution Margin is calculated using the Postal Service's attributable costs and revenue. *Id.* at 13. If the Postal Service were to engage in predatory pricing and set prices below marginal costs, it would also mean that the Postal Service was setting prices below attributable costs. This type of pricing behavior would result in revenue being lower than attributable costs, which, in turn, would result in a negative value for the Competitive Contribution Margin.[210]

In Order No. 4402, the Commission identified one antitrust action filed against the Postal Service. Order No. 4402 at 35 n.61. However, the Commission noted that case did not involve competitive products and was dismissed by the federal district court. *See id.* The Commission is not aware of any other antitrust actions against the Postal Service. *Id.*

In Order No. 4402, the Commission noted that the presence of antitrust actions against the Postal Service is a purely qualitative factor that the formula cannot explicitly capture. Order No. 4402 at 34 n.60. However, the formula does capture the effects of the Postal Service's market power. Thus, the Commission stated that "although

[209] *Id.* at 37; Order No. 4742 at 50. The Commission also noted that the Postal Service's ability to engage in predatory pricing is constrained by 39 U.S.C. § 3633(a)(2), which requires that each of the Postal Service's competitive products "covers its costs attributable." Order No. 4402 at 36 n.64 (quoting 39 U.S.C. § 3633 (a)(2)). Under the current costing methodology pursuant to 39 U.S.C. § 3633(a)(2), the Postal Service cannot price its products below marginal cost. Order No. 4402 at 36 n.64; *see also, e.g.,* Order No. 3506 at 41. The current costing methodology is discussed in more detail in section VIII.C, *infra.*

[210] *Id.* at 49. Although a negative Competitive Contribution Margin would cause the appropriate share to decrease if all else remains constant, a negative Competitive Contribution Margin would trigger further action from the Commission, including revisiting the appropriate share, because it would indicate a violation of section 3633(a)(2) and the possibility that the Postal Service is competing unfairly.

antitrust actions against the Postal Service are not explicitly captured, changes in the Postal Service's market power may offer insight into whether the Postal Service is engaging in the kinds of anticompetitive behavior that would underlie an antitrust action."[211]

b. Comments Related to Competitive Advantage

Pitney Bowes, Amazon, and the Postal Service all concur with the Commission's assessment that no evidence of the Postal Service having a competitive advantage has been found. Pitney Bowes states there is no evidence that the Postal Service has a "dominant market position" in the parcel delivery market, and there is also no evidence of the Postal Service having a competitive advantage. Pitney Bowes Order No. 4402 Comments at 3, 9. Amazon notes that the "competitive playing field…continues to favor private carriers over the Postal Service." Amazon Order No. 4402 Comments at 21. Amazon contends that the benefits the Postal Service receives from its unique legal status as a government entity are outweighed by the costs and burdens it bears, due to its Universal Service Obligation (USO) and other unique requirements.[212] The Postal Service maintains that it operates at a "net competitive disadvantage" compared to its private-sector competitors, who are "free from the federally-imposed obligations and constraints that increase the Postal Service's costs." Postal Service Order No. 4402 Comments at 1.

UPS, Sidak, and Robert J. Shapiro contend that the Postal Service has a competitive advantage over competitors. First, UPS states that the Commission does not "identify any concern, even a hypothetical one, about how the Postal Service could possibly enjoy an artificial competitive advantage over the private sector." UPS Order

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[211] *Id.*; *see* Areeda & Hovenkamp, *supra* n.48, at 107 ("Market structure and market power are often crucial in antitrust analysis.").

[212] *Id*. The Postal Service's USO requires it to "provide postal services to bind the Nation together through the personal, educational, literary, and business correspondence of the people[;]…provide prompt, reliable, and efficient services to patrons in all areas[;] and…render postal service to all communities" and results in additional cost burdens on the Postal Service. Postal Regulatory Commission, Annual Report to the President and Congress, Fiscal Year 2017, January 26, 2018, at 45 (FY 2017 Annual Report).

No. 4742 Comments at 30. UPS states that the Commission claims it is the private sector that has a competitive advantage over the Postal Service. *Id*. Second, UPS maintains that competitors must recover all costs caused by their businesses, but that the Postal Service is not required to do the same in the delivery of its competitive products.[213] UPS contends that the Postal Service can effectively "ignore costs" by labeling them as institutional, thereby creating a competitive advantage because the Postal Service is able to "disproportionate[ly] burden" market dominant products; something that private firms cannot do.[214] UPS states that the Commission's formula further enables this advantage. UPS Order No. 4402 Comments at 10. Third, UPS contends "[p]rivate firms must recover all of their own common costs through the products they sell in competitive markets," but the Postal Service's "is not held to a similar standard" and therefore gains a competitive advantage arising "purely from its statutory monopoly."[215] UPS Order No. 4742 Comments at 8-9 (emphasis omitted). UPS argues that the Commission should "rigorously consider the billions of dollars in cost advantages bestowed by the letter and postal monopolies." *Id.* at 31.

Similarly, Sidak disagrees with the Commission's conclusion that the Postal Service operates at a net competitive disadvantage relative to its private competitors. Sidak states that the Postal Service's monopoly power accrues to competitive products, which, he implies, provides the Postal Service with a competitive advantage. Sidak Order No. 4402 Decl. at 13. Additionally, Sidak contends that "not having access to the letter[]box monopoly substantially increases competitors' costs," which is "valuable to

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[213] UPS Order No. 4402 Comments at 10; UPS Order No. 4742 Comments at 8.

[214] UPS Order No. 4402 Comments at 10; UPS Order No. 4742 Comments at 8.

[215] Commenters discuss and describe the Postal Service's monopoly in varying ways. In this Order, when the Commission references the "letter monopoly," it is referring to the Postal Service's exclusive right to carry and deliver most addressed, paper-based correspondence. *See* FY 2017 Annual Report at 54. When the Commission references the "mailbox monopoly," it is referring to the Postal Service's exclusive right to deliver to and collect from mailboxes. *Id.* When the Commission references the "postal monopoly," it is referring to both the letter and mailbox monopolies together. The Commission uses the term "postal monopoly" in discussing commenters' concerns, unless a commenter specifically references either the letter or mailbox monopoly.

the Postal Service," because it "avoid[s] those higher costs." Sidak Order No. 4742 Decl. at 7.

Shapiro states that the Postal Service "leverages its subsidized monopoly operations" to "advantage[] its competitive business." Shapiro Order No. 4402 Comments at 3. More specifically, he states that the Postal Service's ability to deliver mail, which is supported by "a range of [benefits],"[216] and deliver parcels at the same time, confers a "network advantage" to the Postal Service—one that competitors do not have. Shapiro Order No. 4402 Comments at 4. Shapiro maintains that the Commission should consider these Postal Service benefits, which, he states, are worth $12.8 billion and, in FY 2016, conferred a benefit upon the Postal Service's competitive products worth $9.64 billion. *Id.* at 2-3.

c. Commission Analysis

The Commission disagrees with UPS's, Sidak's, and Shapiro's assertions for multiple reasons. First, UPS contends that the Commission does not exhibit any concern that the Postal Service might have an artificial competitive advantage; however, this is incorrect. UPS Order No. 4742 Comments at 30. The Commission discussed potential evidence of a competitive advantage in both Order Nos. 4402 and 4742, and explained how the existence of a competitive advantage would be reflected in the formula.[217] The Commission also disagrees with UPS's interpretation of the Commission's finding that the "private sector enjoys a competitive advantage over the Postal Service."[218] UPS cites to the Commission's analysis pursuant to section 703(d) and the Commission's determination that the FTC's finding of a Postal Service net

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[216] As discussed in greater detail in section IX, *infra,* due to its government-entity status, the Postal Service does receive certain benefits or advantages, such as those stemming from the postal monopoly, exemption from state and local taxes, the ability to borrow from the United States Department of the Treasury, and access to federal funding and eminent domain. *See* Order No. 4402 at 55-56; *see also* FTC Report at 23-37. Shapiro's comments focus primarily on these benefits.

[217] *See generally* Order No. 4402 at 35-37; Order No. 4742 at 49-50.

[218] UPS Order No. 4742 Comments at 30 (citing Order No. 4402 at 65, 68, 74-76) (emphasis omitted).

economic disadvantage continued to be valid.[219] However, as noted in section IX.A, *infra*, the Commission's determination is based on its limited scope of review pursuant to section 703(d).

Second, as it relates to UPS's allegation that the Postal Service ignores costs by labeling them as institutional, which could disproportionately burden market dominant products, the Commission notes that the Postal Service, like other firms, is expected to recover all of the costs caused by its operations. Neither the ability to "ignore costs," nor the ability to "disproportionately burden" market dominant products are actual advantages for the Postal Service, because both actions are prohibited by section 3633(a)(1) and (a)(2). *See* 39 U.S.C. § 3633(a)(1) and (a)(2). The Postal Service's competitive products are specifically required to cover all costs they incur, both individually and as a whole.[220] Any Postal Service cost that exhibits a reliably identified causal relationship with a specific product is attributed to the product that causes that cost. *See generally* Order No. 3506 at 15-59. Furthermore, because the Commission approves the cost attribution methodology and provides ongoing oversight of cost attribution, the Postal Service is not able to label costs that should be attributed to competitive products as institutional, as UPS alleges.[221] In addition, section 3633(a)(1) prevents the Postal Service from using its market dominant products to benefit its competitive products through section 3633(a)(1)'s prohibition of cross-subsidization. *See* 39 U.S.C. § 3633(a)(1).

UPS, Sidak, and Shapiro all discuss the Postal Service's letter and mailbox monopolies and either explicitly or implicitly suggest that these monopoly powers provide a competitive advantage to the Postal Service's competitive products. UPS, Sidak, and Shapiro contend that the existence of the postal monopoly alone confers benefits on the Postal Service's competitive products.[222] Shapiro more specifically

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[219] *Id.; see* Order No. 4402 at 65.

[220] *See id.*; *see generally* Order No. 3506.

[221] *See, e.g.,* Order No. 3506; *see also* 39 U.S.C. §§ 3633(a)(2) and 3652.

[222] UPS Order No. 4742 Comments at 8-9; Sidak Order No. 4402 Decl. at 13; Shapiro Order No. 4402 Comments at 4.

claims that the Postal Service is able to leverage its monopoly to deliver competitive products “at little additional cost.” Shapiro Order No. 4402 Comments at 4. These commenters contend that the Postal Service’s postal monopoly can be used to benefit the delivery of its competitive products.

It is important to note that the letter monopoly provides the Postal Service with sole authority to deliver “letters and packets,”[223] and that competitive products, including parcels, are not subject to the letter monopoly. Essentially, what the commenters describe as the benefit the Postal Service’s competitive products receive from the postal monopoly is a result of economies of scale and scope.[224] As the Commission previously discussed in Order No. 3506, the Postal Service, like any multi-product firm,[225] enjoys economies of scale and scope, but the associated benefits apply to both market dominant and competitive products. *See* Order No. 3506, Appendix A at 5-6. These benefits include, but are not limited to, productive efficiency (*i.e.,* the ability of a firm to minimize production costs using a combination of the necessary inputs). *See* OECD Paper at 13. Thus, although it is true that the Postal Service’s obligation to deliver market dominant products provides advantages to competitive products, the delivery of competitive products also provides advantages to market dominant products. Furthermore, these shared advantages do not result in any competitive advantage for the Postal Service’s competitive products. This is because section 3633(a)(1) prohibits the subsidization of competitive products by market dominant products, which the

[223] Packets are defined as “two or more letters, identical or different, or two or more packets of letters under one cover or otherwise bound together.” 39 C.F.R. § 310.1(b).

[224] Economies of scale are the cost reductions a firm experiences when volume increases and economies of scope are the benefits a multi-product firm reaps from the production of two or more products with interdependent input costs. *See* Order No. 3506, Appendix A at 5-6; *see also* Carlton & Perloff, *supra* n.45, at 44-45, 391-394; Colander, *supra* n.53, at 228.

[225] Economies of scale and scope are not unique to the Postal Service. Competitors such as UPS and FedEx also receive various benefits from the scale and scope of their operations.

Commission verifies using the incremental cost test,[226] and section 3633(a)(2) requires competitive products to cover the costs that they cause (*i.e.,* their attributable costs).[227]

Furthermore, the postal monopoly was created to "protect the Postal Service's public service mandate," and to help cover the costs associated with the mandated delivery of mail.[228] Any benefits the Postal Service receives from the postal monopoly must be considered in the context of the unique burdens mandated by Congress—obligations that private competitors do not have.[229] The largest of these obligations is the USO, which, as noted above, requires the Postal Service to "render postal service to all communities," and results in additional cost burdens that competitors do not have.[230]

Sidak's contention that the Postal Service has an advantage because competitors incur increased costs due to a lack of mailbox access is inaccurate. *See* Sidak Order No. 4742 Decl. at 7. The mailbox monopoly provides "the exclusive right" to the Postal Service to deliver to any mailbox.[231] However, the Postal Service does not necessarily exercise this right when delivering competitive products for a number of reasons. First, delivery of certain mail products (classified as accountable mail) "require the signature of the addressee or addressee's agent upon receipt to provide evidence of delivery."[232] Therefore, these mail products cannot be left in a mailbox. Second, a

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[226] The incremental cost test requires that the revenues collected from any service (or group of services) must be at least as large as the additional (or incremental) cost of adding that service (or group of services) to the enterprise's other offerings. *See* Order No. 3506 at 12; *see also* Docket No. R97-1, Opinion and Recommended Decision, Volume 1, May 11, 1998, at 230.

[227] *See* 39 U.S.C. § 3633 (a)(1) and (a)(2). It is also worth noting that the Postal Service delivers a notable portion of parcels and Priority Mail Express items to addresses on Sundays when it does not deliver mail products. Delivery of these Postal Service competitive products requires considerable expense, which cannot be shared with market dominant products.

[228] United States Statutes at Large, Volume 84 (Washington, DC: Government Printing Office, 1971), 719.

[229] These obligations include, but are not limited to, regulatory oversight and payments of federal health and retirement benefits to employees.

[230] *See* section VIII.B.1.b, *supra*; FY 2017 Annual Report at 45.

[231] *See* Postal Regulatory Commission, Report on Universal Postal Service and the Postal Monopoly, December 19, 2008, at 10 n.1 (Postal Monopoly Report).

[232] United States Postal Service, Publication 32 - Glossary of Postal Terms, available at: *http://about.usps.com/publications/pub32/pub32_terms.htm*.

large portion of parcels (referred to as deviation parcels)[233] do not fit into a mailbox and are left at a residence's front porch, front-door mail slot, or between doors, similar to parcels delivered by competitors.[234] The Commission also notes that Sidak's view of the Postal Service's mailbox monopoly is one-sided. Private competitors, including UPS, use the Postal Service to complete last-mile delivery, and therefore share the benefits of the Postal Service's mailbox monopoly to the extent that it affects parcel delivery.[235] With his assertions, Sidak also fails to consider the additional burdens placed on the Postal Service by its USO. As noted above, the Postal Service is obligated to "render postal service to all communities," which results in additional cost burdens that competitors do not have.

d. Comments Related to Fair Competition

In regards to whether the Postal Service is competing fairly, Pitney Bowes notes that no evidence exists that the Postal Service has abused its position in the market. Pitney Bowes Order No. 4402 Comments at 9. Amazon and the Postal Service indicate that the Postal Service competes fairly, as both state that the Commission was correct in reaching its conclusion that no evidence of predatory pricing exists.[236] Similarly, Pitney Bowes notes that the Postal Service is not engaging in predatory pricing, and "the record evidence confirms that the Postal Service is pursuing contribution from competitive products by raising prices where it can on a growing volume of competitive products." Pitney Bowes Order No. 4402 Comments at 9.

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[233] *Id.*

[234] *See, e.g.,* Kathleen J. Siviter, The Mailbox Monopoly Conundrum, *Mail System Technology*, March 21, 2017, available at: *https://mailingsystemstechnology.com/article-4145-The-Mailbox-Monopoly-Conundrum.html.*

[235] For a further discussion of "co-opetition" between the Postal Service and competitors, *see* section II.A, *supra.*

[236] Postal Service Order No. 4402 Comments at 7-8; Amazon Order No. 4402 Comments at 16, 21-23.

In opposition, UPS and ACI focus on the Postal Service's pricing and allege it competes unfairly. UPS contends "[t]here is strong evidence that the Postal Service has undertaken a systematic strategy of underpricing its competitive products in violation of the[] statutory goals" and that their "underpricing" is made possible by a low appropriate share. UPS Order No. 4742 Comments at 39, 40. UPS notes that while market dominant products have a statutory price cap, competitive products have a statutory "price floor." *Id.* at 39. UPS states that "Congress saw no danger of the Postal Service overpricing competitive products," and implies that with a "price floor" Congress was concerned about underpricing. *Id.* (emphasis omitted). As proof of underpricing, UPS asserts that the Postal Service's competitive product volume growth is "largely concentrated" in its "low[est]-contribution business" where the Postal Service sells its "lowest-priced" products. *Id.* at 24, 39 (internal citation and marks omitted). ACI asserts that the formula "encourages predatory, or certainly below market pricing – precisely what the PAEA set[] out to prohibit." ACI Order No. 4742 Comments at 5. Furthermore, in asserting that the appropriate share is too low and that the Postal Service's competitive products do not bear their share of institutional costs, UPS appears to suggest that the Postal Service is competing unfairly by "forcing" those institutional costs onto market dominant mailers, and that recent market dominant rate adjustments are evidence of this. UPS Order No. 4742 Comments at 22-23.

Shapiro also contends that the Postal Service competes unfairly. Shapiro states that not only does the Postal Service receive benefits (*e.g.*, the postal monopoly) for its operations,[237] as noted above, but it also "leverages these special rights and [benefits] to support its competitive package delivery business." Shapiro Order No. 4402 Comments at 4. Shapiro describes this as "dynamic cross-subsidization," and claims that the Postal Service uses subsidized, monopoly advantages to artificially reduce

[237] Shapiro's comments also update the analysis "measuring the special subsidies" provided to the Postal Service "to support its monopoly." Shapiro Order No. 4402 Comments at 2. The Commission addresses those comments in section IX.C.2.a, *infra.*

costs for its competitive business and capture a larger market share.[238] He maintains that the Postal Service "has an incentive to overcharge its 'captive' mailers, or monopoly customers in letter mail and mass mailings, because they have no alternatives to the [Postal Service], and undercharge the more price-sensitive customers of its competitive business." *Id.* at 18.

Additionally, Shapiro attempts to calculate the amount of benefits that competitive products receive, focusing his discussion on institutional costs, the mailbox monopoly, and seasonal demand.[239] First, Shapiro states that the Postal Service "has undercharged its competitive business" for its share of institutional costs, and describes this as a cost advantage that benefits the Postal Service's competitive products. *Id.* at 3, 21, 28. Shapiro assumes the existence of a relationship between the Postal Service's institutional costs and its competitive products' revenue and attributable costs and, after applying a number of assumptions and his own methodology,[240] he estimates that competitive products receive a benefit of $4.45 billion. *Id.* at 26. He maintains that his analysis "shows…the [Postal Service]'s systemic undervaluation of the institutional resources drawn on or relied upon by its competitive business…." *Id.* Second, Shapiro estimates that the Postal Service's competitive products receive a benefit of $3.9 billion

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[238] *Id.* at 5, 18. In using the term "cross-subsidization," Shapiro appears to be describing the Postal Service's use of the benefits it receives due to its government status (*e.g.,* tax exemptions, exclusive mailbox access, borrowing authority) to assist its competitive products. The use of this term is much broader than the term used in section 3633(a)(1), which prohibits market dominant products from subsidizing competitive products. *See* 39 U.S.C. § 3633(a)(1). As such, the Commission uses the term "benefits" or "advantages" in place of Shapiro's use of the term "subsidy," unless the Commission explicitly references an implicit subsidy, as identified by the FTC. *See* section IX, *infra.*

[239] *See generally* Shapiro Order No. 4402 Comments at 21-30.

[240] Using competitive product revenue and competitive product attributable costs, Shapiro attempts to estimate "the institutional costs associated with each competitive product." *Id.* at 25. To generate such estimates, he multiplies each competitive product's share of the Postal Service's total revenue by the Postal Service's institutional costs, and then, alternatively, multiplies each product's share of the Postal Service's total attributable costs by the Postal Service's institutional costs. *Id.* He then subtracts the product's attributable costs (as reported by the Postal Service), as well as his own estimate of the product's institutional costs from the total revenues generated by the product. *Id.* He describes the received amount as "the net income earned from each competitive product," and uses it to determine the rate of cross-subsidy by product and, finally, "the total cross subsidy" for the Postal Service's competitive products. *Id.* at 25-26.

from the mailbox monopoly.[241] Third, Shapiro discusses “additional cross-subsidies” that the Postal Service receives. Specifically, he identifies the ability to borrow from the United States Department of the Treasury, exemption from certain taxes, and the ability to reclaim the federal income taxes it pays on net earnings. *Id.* He estimates the value of these benefits enjoyed by the Postal Service’s competitive products as $1.29 billion.[242] Finally, Shapiro states that although the Postal Service “faces the same seasonal demand pressures” as competitors, it is able to “draw on [benefits] to ameliorate” those pressures. *Id.* at 29-30. He contends that the Postal Service “manages its personnel needs to handle the seasonable spike in demand for package deliveries largely by drawing on a surplus labor force supported by its monopoly operations and leveraging those surplus workers to the advantage of its competitive business.”[243]

Finally, as it relates to the Commission’s consideration of antitrust cases, UPS notes that “a private company’s decision whether or not to file an antitrust suit involves weighing a number of considerations” and that “[n]othing should be inferred from the absence of such a filing.” UPS Order No. 4402 Comments at 26.

e. Commission Analysis

As discussed in Order No. 4742, the Competitive Contribution Margin has not had a negative value in the years following the enactment of the PAEA, indicating that the Postal Service did not set overall prices below attributable costs in those years and, thus, has not engaged in predatory pricing. *See* Order No. 4742 at 49-50. However,

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[241] *Id.* at 27. For FY 2016, Shapiro estimates the total value of the mailbox monopoly as $13.6 billion. *Id.* To calculate the amount of cross-subsidy received by the Postal Service’s competitive products, he multiplies this value by 28.7 percent (which he describes as “the midpoint” percentage between the competitive product share of revenue and attributable costs). *Id.*

[242] *Id.* Shapiro estimates these other benefits derived from the Postal Service’s interest rate subsidy, exemption from state and local taxes and fees, and access to income tax payments. *Id.* In his calculation, Shapiro first estimates the total value of these “three direct [benefits] for the [Postal Service’s] monopoly operations,” and then multiplies it by 28.7 percent (which he describes as “the midpoint” between the competitive product share of revenue and attributable costs). *Id.*

[243] *Id.* at 30. Shapiro does not provide any quantitative estimate of this alleged advantage.

UPS, Shapiro, and ACI maintain the Postal Service sets prices too low for its competitive products, which they assert violates the statutory goals of fair competition.[244] An evaluation of the Postal Service's pricing behavior provides insight as to whether the Postal Service is competing fairly. Figure VIII-1 illustrates the Postal Service's average price increases for its competitive products compared to increases in CPI-U for the 10-year period between CY 2008 and CY 2017.[245]

[244] *See* Shapiro Order No. 4402 Comments at 18; UPS Order No. 4742 Comments at 39; ACI Order No. 4742 Comments at 5.

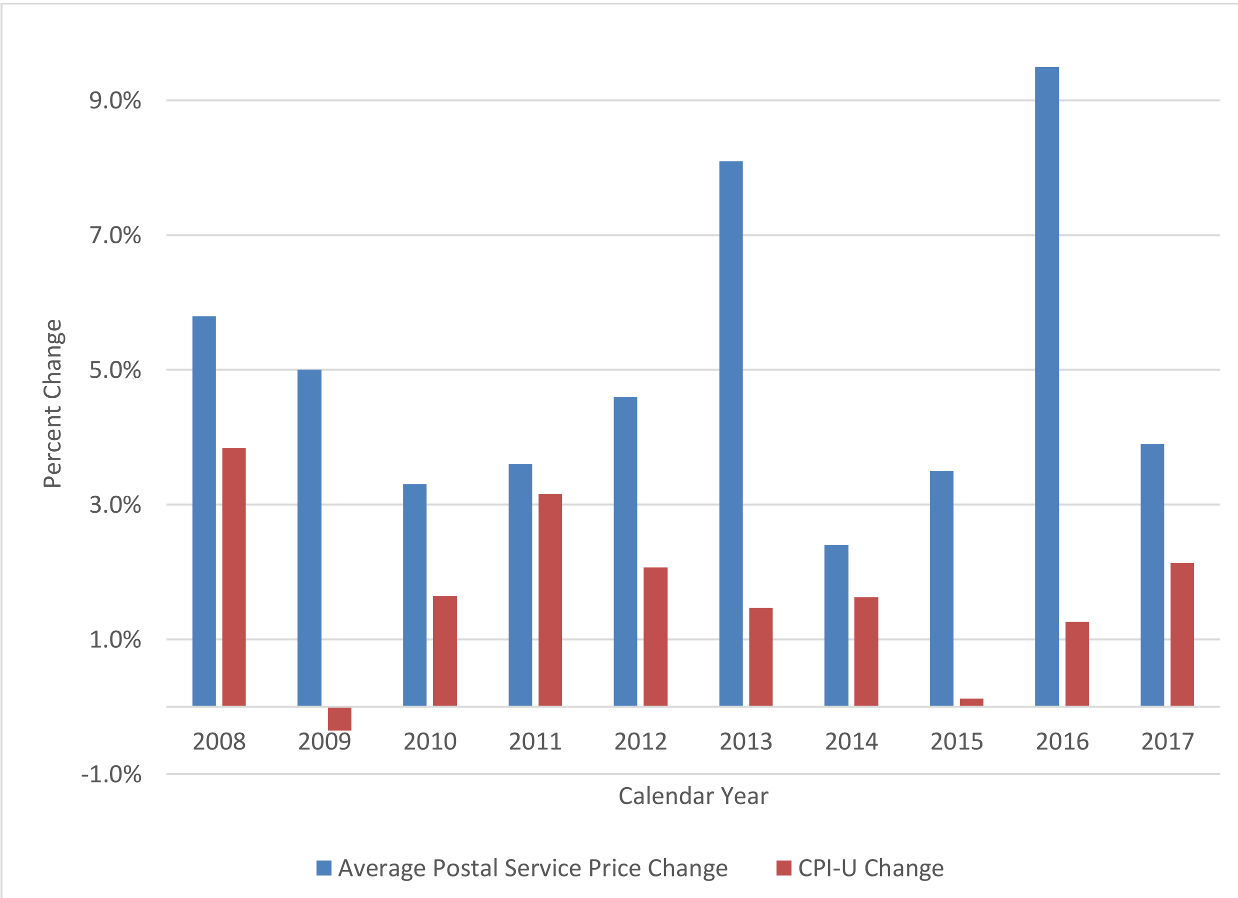
[245] The Postal Service's prices generally increase at the beginning of the calendar year, so calendar year increases are used. CY 2008 was the first year that prices increased for the Postal Service's competitive products after the PAEA's enactment.

Figure VIII-1

Annual Average Change in Competitive Product Prices

and Change in CPI-U

CY 2008 – CY 2017[246]



[246] *See* Library Reference PRC-RM2017-1/3.

As illustrated by Figure VIII-1, the Postal Service has increased its competitive product prices above CPI-U in every year since CY 2008. Considering that a price increase above inflation means an increase in real prices for competitive products, these historic data call into question arguments that the Postal Service has been engaging in underpricing. Moreover, in all but 3 years, average price increases for competitive products have been more than twice as much as the increases in CPI-U, and in several years, they were substantially greater. *See* Figure VIII-1. In addition to increasing prices above inflation, the Postal Service's price increases for its competitive products were similar to its competitors during the same period, particularly in the past 6 years. *See* section II.A, *supra.*

UPS notes that volume growth has been largely concentrated in last-mile parcel delivery, which is one of "the Postal Service's lowest-priced package services," and is part of the Postal Service's "lower-contribution business." UPS Order No. 4742 Comments at 24 (internal citation and marks omitted), 39. UPS argues that this provides "strong evidence" of the Postal Service's strategy of underpricing because the Postal Service's "accounting practices…do not require these products to cover a reasonable share of common costs."[247] The Postal Service, however, explains that last-mile parcel delivery bypasses much of the Postal Service's infrastructure and is "driven largely by the continuing growth of e-commerce." Postal Service Form 10-Q Report at 24. Section 3633(a)(2) requires that each competitive product cover the costs it causes, and in FY 2017, as well as in previous years, last-mile parcel delivery products, such as Parcel Select and Parcel Return Service, satisfied this requirement. FY 2017 ACD at 84-85. Due to the nature of last-mile parcel delivery, it has relatively low unit costs (when compared to other domestic competitive products), and tends to have lower prices (than other domestic competitive products). However, these products have high

[247] *Id.* at 39. UPS cites the Postal Service's Form 10-Q report for Quarter 3 of FY 2018, where the Postal Service discusses Shipping and Package revenue and volume growth and characterizes this business as a "lower-contribution" compared to the Postal Service's traditional business. UPS Order No. 4742 Comments at 24 (citing United States Postal Service Quarterly Report on Form 10-Q, August 9, 2018, at 19, available at: *http://about.usps.com/who-we-are/financials/financial-conditions-results-reports/fy2018-q3.pdf* (Postal Service Form 10-Q Report)).

cost coverage because revenues from these products exceed attributable costs to a greater degree than most other domestic competitive products. This refutes UPS's assertion about underpricing.

UPS's argument that last-mile parcel delivery is not required to cover a "reasonable share of common costs" is misplaced. The PAEA does not require a "reasonable share" of institutional costs to be covered by any particular product or type of service. Section 3633(a)(3) requires that all competitive products collectively cover an appropriate share of institutional costs, but this does not require a specific institutional cost contribution to be provided by individual products, such as Parcel Select and Parcel Return Service.[248]

UPS and Shapiro claim that the Postal Service charges lower prices for its competitive products, and, as a result, must increase prices or overcharge for its market dominant products. UPS Order No. 4742 Comments at 39, 40; Shapiro Order No. 4402 Comments at 18. As illustrated by Figure VIII-1, and as discussed above, competitive product prices have increased, on average, in every fiscal year since the PAEA's enactment, and the rates of increase were in line with the Postal Service's competitors over the past 6 years. *See* section II.A and section VIII.B.1.e, *supra.* Thus, there is no evidence that the Postal Service is lowering competitive product prices or otherwise competing unfairly. Furthermore, the Postal Service's market dominant price increases are regulated by the price cap provision of section 3622. Under section 3622, market dominant products have a class-level price cap that limits annual price increases to the annual change in CPI-U. 39 U.S.C. § 3622(d)(1)(A). As a result, the Postal Service cannot overcharge for market dominant products to make up for lower competitive products prices as the commenters allege. Moreover, UPS's description of recent rate cases as "deviat[ions] from the rate-cap scheme" is incorrect. *See* UPS Order No. 4742 Comments at 23 n.59. UPS implies that the market dominant rate proceedings to which it cites exceeded the price cap. However, the rate proceedings UPS cites were

[248] As noted in section II.A, *supra*, the Postal Service often completes last-mile delivery for UPS, allowing UPS to benefit from the alleged underpricing.

standard rate increases filed pursuant to section 3622 and the Commission's related regulations. The Commission approved the requested price increases because the increases involved were within the Postal Service's available rate adjustment authority pursuant to section 3622.[249]

In response to Shapiro's contention that the Postal Service uses its monopoly to unfairly benefit its competitive products, the Commission finds that this concern is effectively mitigated by section 3633(a)(1) and (a)(2). As noted above, the Postal Service enjoys substantial economies of scale and scope; however, the associated cost benefits affect both the Postal Service's market dominant and competitive products. *See* section VIII.B.1.c, *supra.* Section 3633(a)(1)'s prohibition against cross-subsidization and section 3633(a)(2)'s requirement that competitive products cover their attributable costs prevent competitive products from using the Postal Service's economies of scale and scope to compete unfairly.[250]

The Commission notes that Shapiro, in his attempt to "generate estimates of the institutional costs associated with [the Postal Service's] competitive product[s]," relies on incorrect assumptions and pursues a subjective approach. *See* Shapiro Order No. 4402 Comments at 25. Shapiro incorrectly assumes that each competitive product's share of revenue or attributable costs could determine the portion of institutional costs for which competitive products are responsible. *See id.* This assumption is incorrect and contradicts both the Postal Service's accounting practices and the Commission's costing methodology.[251] Moreover, there is no economically justifiable way to estimate a product's share of institutional costs, because these are residual costs that are left

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[249] *See, e.g.*, Docket No. R2018-1, Order on Price Adjustments for First-Class Mail, USPS Marketing Mail, Periodicals, Package Services, and Special Services Products and Related Mail Classification Changes, November 9, 2017, at 61 (Order No. 4215); Docket No. R2017-1, Order on Price Adjustments for Special Services Products and Related Mail Classification Changes, December 15, 2016, at 16 (Order No. 3670); Docket No. R2017-1, Order on Price Adjustments for First-Class Mail, Standard Mail, Periodicals, and Package Services Products and Related Mail Classification Changes, November 15, 2016, at 55-56 (Order No. 3610).

[250] *See* 39 U.S.C. § 3633; *see also* section VIII.B.1.c, *supra.*

[251] In addition, in his discussion of the Postal Service's cost attribution, Shapiro does not recognize the latest changes to this methodology put in effect by Order No. 3506. *See id.* at 21.

after all other costs have been attributed to products. Order No. 3506, Appendix A at 16. Institutional costs are costs that are not causally related to products under section 3633(a)(2), and these costs are not distributed to products under the Postal Service's accounting system. As explained in section VIII.C.2.b, *infra*, any attempt to assign institutional costs to competitive products based on the competitive products' proportion of attributable costs, revenue, or some other devised proportion, presents multiple problems.[252]

Finally, the Commission disagrees with UPS's contention that "[*n*]*othing* should be inferred" from a lack of antitrust actions against the Postal Service. *See* UPS Order No. 4402 Comments at 26 (emphasis added). These types of actions have the potential to provide insight into the Postal Service's practices within the parcel delivery market. *See* Order No. 4402 at 34 n.60. However, it is important to note that the existence or nonexistence of such actions are only one of many factors the Commission considered qualitatively in the past before proposing its formula-based approach. In addition, the Commission noted that although antitrust actions are not explicitly captured by the formula, "changes in the Postal Service's market power could offer insight into whether the Postal Service [is] engaging in the kinds of anticompetitive behavior that would underlie an antitrust action." Order No. 4742 at 48 n.59.

2. Market Share

a. Previous Commission Discussion

As explained in Order No. 1449, an important aspect of the prevailing market conditions that the Commission considers under section 3633(b) is the Postal Service's market share. Order No. 1449 at 16. This is because increases in the Postal Service's market share could indicate that the Postal Service benefits from an artificial competitive advantage. *Id.* at 18. In its current review of the appropriate share, the Commission

[252] Order No. 4402 at 81-82; *see* section VIII.C.2.b, *infra*.

discussed that, although the Postal Service's revenue-based market share has grown since FY 2007, its overall market share remains relatively low.[253]

In Order No. 4742, the Commission explained that its formula-based approach incorporates changes in the Postal Service's revenue-based market share directly into the calculation of the appropriate share through the Competitive Growth Differential. Order No. 4742 at 50-51. Any increase or decrease in the Postal Service's revenue-based market share would result in a corresponding increase or decrease in the Postal Service's appropriate share, assuming all other factors were to remain constant. *Id.* at 51. Additionally, any growth or decline in the Postal Service's revenue-based market share caused by shifts in demand or pricing strategies is reflected in the Competitive Contribution Margin, because such shifts would affect the Postal Service's ability to price its products above costs, implicating its market power. *Id.*

b. Comments

Pitney Bowes maintains that despite growth in the Postal Service's competitive product volume, the Postal Service's "overall market share remains modest." Pitney Bowes Order No. 4402 Comments at 9. Similarly, the Public Representative appears to conclude that the Postal Service's market share continues to be "relatively small," just as it was during the Commission's previous appropriate share review. PR Order No. 4402 Comments at 11, 13. Amazon states that the record supports the Commission's findings in Order No. 4402 related to market share. Amazon Order No. 4402 Comments at 16. Conversely, UPS contends that "the Postal Service now delivers more packages to American homes than any other enterprise," and states that "the Postal Service's market share can no longer be considered small." UPS Order No. 4402 Comments at 7.

[253] Order No. 4402 at 38-39; section II.A, *supra*.

c. Commission Analysis

The Commission continues to find that although the Postal Service's revenue-based market share has increased steadily since 2007, it still remains relatively low compared to competitors.[254] The Commission notes that should the Postal Service's market share continue to increase, it will be reflected in increases in the Competitive Growth Differential, which will, in turn, be reflected in the appropriate share.

3. Changes to the Market and Competitors

a. Previous Commission Discussion

As the Commission explained in Order No. 4402, when considering changes to the market and competitors the Commission looks at considerations such as overall market growth, innovation, and firms entering and exiting the market. Order No. 4402 at 39. In Order No. 4742, the Commission provided examples illustrating how growth in the market that is caused by the entry or exit of firms, innovation, or overall market growth are captured by both the Competitive Contribution Margin and the Competitive Growth Differential. *Id.* at 51-52.

b. Comments

Amazon describes the growth of UPS and FedEx, including "strong profits, healthy cash flows, and increasing market capitalizations." Amazon Order No. 4402 at 16-17. Furthermore, Amazon notes that competitors continue to invest in expansion and innovation and new competitors are poised to enter the market. *Id.* at 5, 16-21. The Public Representative likewise notes that growth in competitor revenue has increased as the parcel delivery market has grown, indicating that UPS's and FedEx's "profits have not been endangered by the Postal Service's pricing." PR Order No. 4402 Comments at 13-14.

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[254] Order No. 4402 at 38-39; *see id.* at 38, Figure IV-2.

Conversely, UPS states that since the PAEA's enactment, "the competitive landscape has changed for the worse and the Postal Service's rapid expansion into the competitive product markets continues year after year." UPS Order No. 4402 Comments at 25. UPS states that 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." UPS Order No. 4742 Comments at 9. Furthermore, UPS contends that the "*de minimis*" appropriate share allows the Postal Service to charge "rock bottom price[s]" for its competitive products, which has "opened the way for the Postal Service's vast success in displacing private competitors in the package delivery sector over the past decade." *Id.* at 34.

c. Commission Analysis

As discussed in section II.A, *supra*, the parcel delivery market has undergone substantial change since the PAEA's enactment and since the Commission's last review of the appropriate share. *See* section II.A, *supra.* The market as a whole has grown since the PAEA's enactment, and competitors have become more profitable.[255] The Postal Service's market share has also increased steadily since 2007 but remains a relatively low share of the overall market. *See* section II.A and section VIII.B.2, *supra*.

In response to UPS's assertions that the Postal Service's competitive products have rapidly expanded and that the Postal Service has had "vast success in displacing private competitors," the Commission evaluates changes in real revenue for the Postal Service, competitors, and the parcel delivery market as a whole in Figure VIII-2 below.[256] Real revenue answers the question as to whether the Postal Service alone is growing or whether all participants in the market and the market itself are growing. The Commission uses real revenue, which is revenue adjusted for inflation, because it controls for exogenous (*i.e.,* inflationary) growth in prices, allowing the data to focus on price growth from other sources.

[255] *Id.*; *see also* Order No. 4402 at 96, 98.

[256] *See* UPS Order No. 4402 Comments at 25; UPS Order No. 4742 Comments at 34.

The Commission observes that despite allegations of anticompetitive growth on the part of the Postal Service, the delivery industry as a whole has grown since the enactment of the PAEA. Figure VIII-2 shows the real revenue for the Postal Service and its competitors since FY 2007.

Figure VIII-2
Postal Service, Competitor, and Total Revenue
FY 2007 – FY 2017[257]

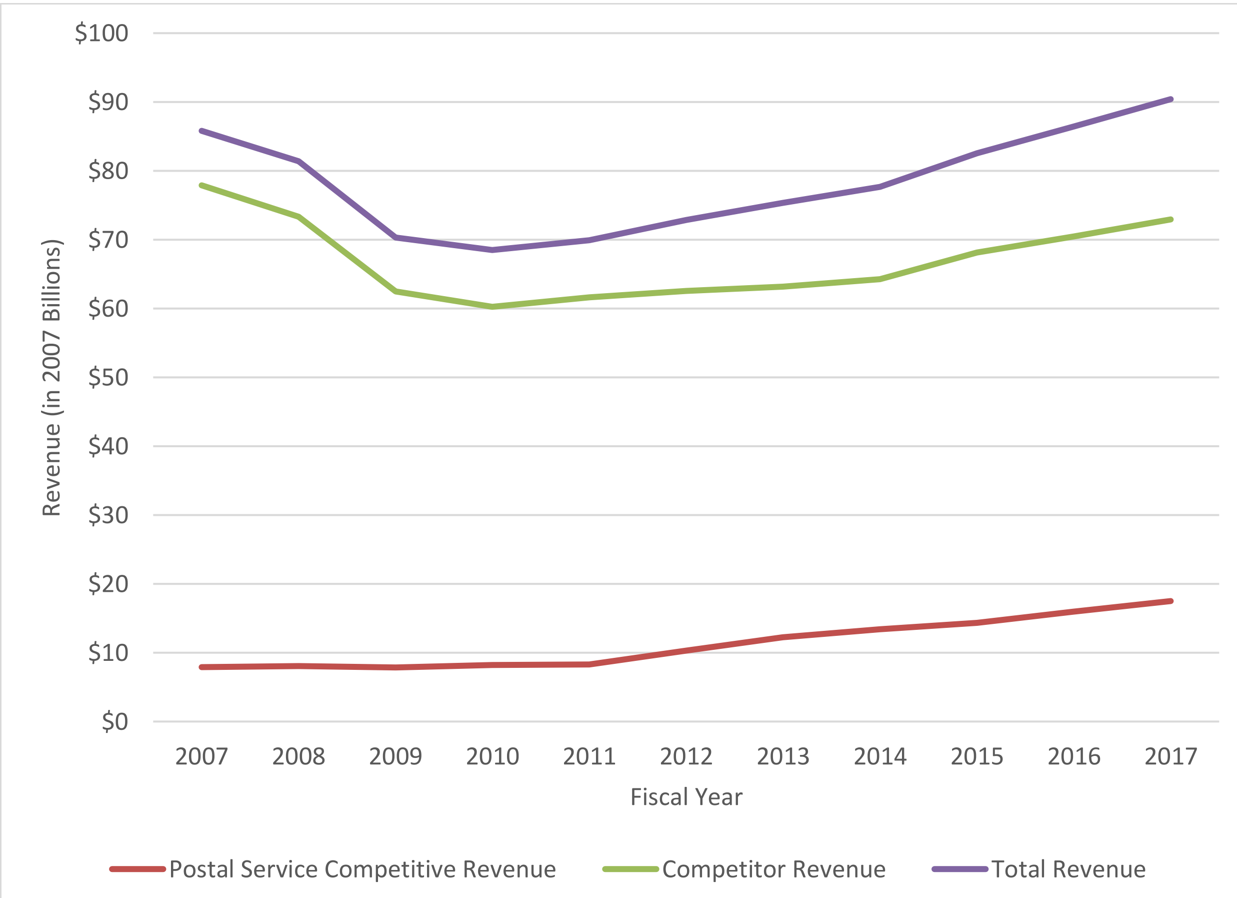

Figure VIII-2 demonstrates that the Postal Service has not replaced private competitors over the past decade as UPS alleges. *See* UPS Order No. 4742 Comments at 34. On the contrary, Figure VIII-2 shows that the Postal Service's

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[257] *See* Library Reference PRC-RM2017-1/3.

revenue has remained a relatively low portion of the total revenue in the market and that the Postal Service's competitors have also thrived as e-commerce has expanded the total market. *See also* section II.A, *supra*. Figure VIII-2 also shows that the Postal Service's growth in the market is not "rapid" as UPS characterizes it, but instead has been steady and relatively modest. *See* UPS Order No. 4402 Comments at 25.

UPS also comments that 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." UPS Order No. 4742 Comments at 9. This comment appears to specifically target the Postal Service's specific growth in last-mile delivery. As discussed in section II.A, *supra*, FedEx and UPS use the Postal Service to complete last-mile delivery of many of their parcels. *See* section II.A, *supra.* This "co-opetition" results in lower costs for each of the competitors and was a contributing factor to the increases in real revenue seen by both the Postal Service and its competitors in Table II-2. *See id.* For additional discussion of last-mile delivery, *see* section VIII.B.1.e, *supra.*

C. Unique or Disproportionate Costs

1. Previous Commission Discussion

In Order No. 4402, the Commission discussed the two types of costs associated with the Postal Service's products: attributable costs and institutional costs. Order No. 4402 at 43-45. Under the Commission's costing methodology, attributable costs are costs that are assigned to products on the basis of reliably identifiable causal relationships.[258] In accordance with 39 U.S.C. § 3633(a)(2), each competitive product must cover all of its attributable costs. Institutional costs are those that cannot be causally linked to either market dominant or competitive products through reliably identified causal relationships and are the residual costs of the Postal Service. Order No. 4402 at 2, 44.

As noted previously, section 3633(b) requires that the Commission consider "the degree to which any costs are uniquely or disproportionately associated with any competitive products" when reviewing the appropriate share. 39 U.S.C. § 3633(b). In Order No. 4402, the Commission found that there are no costs uniquely or disproportionately associated with competitive products that are not already attributed to those products. Order No. 4402 at 43. This is because all costs that are uniquely or disproportionately associated with competitive products exhibit a reliably identified causal relationship with a specific competitive product or group of products and are therefore attributed. *Id.* The Commission described "unique" costs as product-specific

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[258] *Id.* at 2, 43. The Commission's analysis of "the degree to which any costs are uniquely or disproportionately associated with any competitive products" relied on current costing methodologies approved in Docket No. RM2016-2. *Id.* at 40-45; *see* Order No. 3506. UPS challenged the Commission's costing methodologies approved in Order No. 3506 in the United States Court of Appeals for the District of Columbia Circuit. *See* Petition for Review, *United Parcel Serv., Inc. v. Postal Reg. Comm'n*, No. 16-1354 (D.C. Cir. filed Oct. 7, 2016). The Court issued its opinion on May 22, 2018. *See UPS*, 890 F.3d at 1053. In its opinion, the Court denied UPS's Petition for Review and found that the Commission exercised reasonable judgment in "settling on a cost-attribution methodology that implements its statutory mandate and falls well within the scope of its considerable discretion." *Id.* at 1069. UPS petitioned for rehearing *en banc*, which was denied by the United States Court of Appeals for the District of Columbia Circuit. *See* Petition for Rehearing *En Banc*, *United Parcel Serv., Inc. v. Postal Reg. Comm'n*, No. 16-1354 (D.C. Cir. filed July 6, 2018), *denied per curiam*, No. 16-1354 (D.C. Cir. filed July 27, 2018); Petition for a Writ of Certiorari, *United Parcel Serv., Inc. v. Postal Reg. Comm'n,* No. 18A398 (U.S. Dec. 26, 2018).

costs and determined that any cost that is uniquely associated with a competitive product is attributed to that product through a reliably identified causal relationship. *Id.* As examples, the Commission cited advertisements for a specific product and supplies for money orders. *Id.* at 44. In addition, the Commission found that any cost disproportionately associated with a competitive product is attributed to that product through the costing methodology's use of cost drivers. *Id.* at 43. Cost drivers include mail characteristics such as weight and shape (*e.g.*, letters or parcels). Costs are distributed to products in proportion to the prevalence of the cost driver within each product. For example, heavier competitive products have more weight-driven costs attributed to them than lighter products. *Id.* In this way, the costs attributed to products reflect any disproportionate association of those costs with specific products. As a result, the Commission determined that both types of costs are attributed to the competitive products that cause them. *Id.*

Multiple commenters submitted comments in response to the Commission's "unique or disproportionate costs" analysis in Order No. 4402.[259] Although some commenters agree with the Commission's assessment of this consideration of section 3633(b), others commenters disagree.[260] These comments are organized into three categories below: (1) those dealing with the meaning of the specific statutory language related to unique or disproportionate costs; (2) those dealing with the cause of Postal

[259] In Order No. 4742, the Commission deferred its consideration of those comments to a subsequent order, which it now discusses as part of this Order. Order No. 4742 at 53.

[260] *See, e.g.,* Pitney Bowes Order No. 4402 Comments at 3 ("There are no institutional costs uniquely associated with competitive products that would justify an increase [in the appropriate share]."); Amazon Order No. 4402 Comments at 8 (citing 39 U.S.C. § 3633(b); Order No. 4402 at 45-46) ("A minimum contribution requirement is also unnecessary to ensure that competitive products cover 'any costs [that] are uniquely or disproportionately associated with' competitive products."); Postal Service Order No. 4402 Comments at 11-12 ("The Commission properly rejected these arguments in concluding that there are no costs uniquely or disproportionately associated with competitive products that are not already attributed to competitive products."); PSA Order No. 4402 Comments at 2 (citing Order No. 4402 at 75) ("Indeed, much of the Commission's reasoning, with which PSA agrees….") (regarding the Commission's conclusion in Order No. 4402 related to unique or disproportionately associated costs); UPS Order No. 4402 Comments at 27 (The Commission's conclusion related to uniquely or disproportionately associated costs "violates basic principles of statutory analysis….").

Service institutional costs; and (3) those dealing with the costing methodology used in the calculation of the Postal Service's attributable costs.

2. Meaning of Specific Statutory Language

a. Comments

UPS disagrees with the Commission's assessment of the meaning of the second element of section 3633(b): "the degree to which any costs are uniquely or disproportionately associated with any competitive products."[261] First, UPS states that "disproportionately associated" in section 3633(b) "must be broader" than "reliably identified causal relationships" in section 3622(c)(2), or "it would serve no purpose."[262] UPS asserts that to find otherwise would have "the 'appropriate share' requirement…merely duplicate the analysis conducted under 39 U.S.C. § 3633(a)(1) and 39 U.S.C. § 3633(a)(2)." UPS Order No. 4402 Comments at 26. UPS notes that even if section 3633(a)(2) and the requirement that competitive products cover their attributable costs "were functioning perfectly by identifying all 'uniquely associated' costs,"[263] it "says nothing about costs that are 'disproportionately associated with any competitive products.'" UPS Order No. 4402 Comments at 27 (quoting 39 U.S.C. § 3633(b)) (emphasis omitted).

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[261] UPS Order No. 4402 Comments at 26-28; UPS Order No. 4742 Comments at 17-22.

[262] UPS Order No. 4402 Comments at 26; UPS Order No. 4742 Comments at 21.

[263] In response to Order No. 4402, UPS states that the Commission's finding that costs uniquely associated with a product are attributed as product-specific costs "violates basic principles of statutory analysis" and is "highly problematic." *Id.* at 27. However, in response to Order No. 4742, UPS states that "costs with a reliably identifiable causal relationship are those costs that are *uniquely caused* by a specific product," and it uses this statement to support its assertion that the statute requires more than the consideration of just unique costs, "*but also* those costs that are 'disproportionately' associated with competitive products." UPS Order No. 4742 Comments at 19 (emphasis in original). Thus, UPS focuses mainly on the Commission's findings related to "disproportionately associated" costs. *See generally* section headings in UPS Order No. 4402 Comments at 26 ("The Order Renders the 'Disproportionately Associated' Language in 39 U.S.C. § 3633(b) a Nullity") and UPS Order No. 4742 Comments at 17 ("The Commission Erroneously Declines to Consider Costs that are 'Disproportionately Associated with Competitive Products'").

Second, UPS asserts that the “or” between uniquely and disproportionately is disjunctive, and that “[i]t is illogical for the Commission to point to the fact no institutional costs are ‘uniquely associated’ with competitive products as proof that no such costs are ‘disproportionately associated’ with competitive products.” *Id.*

Third, UPS suggests that “‘disproportionately’ implies that the relevant costs might be ‘associated with’ more than one kind of product,” and claims that “[t]he Commission’s proposed interpretation would impermissibly render the statutory language (‘disproportionately associated with’) to be mere surplusage.” *Id.* at 28 (internal citation omitted). UPS states that “[b]y definition, a cost can only be ‘disproportionately associated’ with ‘competitive products’ if it is at least partially associated with some other products as well.” UPS Order No. 4742 Comments at 19. UPS contends that 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.” *Id.* at 20.

Fourth, UPS suggests that the statutory language requires the Commission to “investigate” which costs currently classified as institutional may also be “disproportionately associated with” competitive products.[264]

Finally, UPS claims that the Commission previously indicated, through its appellate counsel in the *UPS* case, that the appropriate share should be based on some proportion of institutional costs “that would reflect the contributions of competitive products to costs that cannot be easily attributed to individual products.” UPS Order No. 4402 Comments at 17-18. UPS cites to the Commission’s appellate counsel’s statement in that proceeding that unattributable inframarginal costs “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.” *Id.* UPS contends that this statement constitutes a recognition by the Commission that institutional costs should be

[264] UPS Order No. 4402 Comments at 28; UPS Order No. 4742 Comments at 19.

"parcel[ed] out," or, in other words, should be proportionally allocated to competitive products. *Id.* at 18. In addition, UPS states that the Court's decision "strongly implies" the expectation that the appropriate share address "competitive concerns at the heart of the PAEA—by requiring competitive products to bear costs above and beyond the narrow set that are attributed to competitive products." UPS Order No. 4742 Comments at 21-22. UPS states that "the D.C. Circuit was convinced to affirm the Commission's narrow interpretation of attributed costs under 39 U.S.C. § 3633(a)(2) because the '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."[265] It further argues "the Commission's proposals in this docket would do nothing to assure that the 'statutorily mandated price floor is not too low as to promote undue competitive behavior.'" *Id.* at 29-30 (internal citation and emphasis omitted).

The Postal Service maintains that UPS misconstrues the intent of the "uniquely and disproportionately" clause of section 3633(b). Postal Service Order No. 4402 Comments at 12. The Postal Service contends that particular clause of section 3633(b) is intended to "explore the potential ramifications" of any attributable costs (not institutional costs) that might be associated with competitive products. *Id.* It maintains that the clause was included because at the time of the PAEA's enactment the Postal Service employed facilities that were used exclusively by certain competitive products, and the costs associated with those facilities were fully attributed to the competitive products handled there. *Id.* at 12-13. The Postal Service notes that the intention was that if the Postal Service expanded its resources that were dedicated solely to competitive products, then the Commission should consider that fact and require competitive products to cover a smaller share of institutional costs, because competitive products would not be using established common networks and contributing to the associated institutional costs. *Id.* at 13. The Postal Service explains that the dedicated facilities for competitive products were discontinued. *Id.*

[265] *Id.* at 29 (quoting *UPS*, 890 F.3d at 1067 (internal citation omitted)).

b. Commission Analysis

UPS expresses several concerns with the Commission's approach to considering "the degree to which any costs are uniquely or disproportionately associated with any competitive products" in the context of its review of the appropriate share.

First, UPS contends that "disproportionately associated" in section 3633(b) "must be broader" than "reliably identified causal relationships" in sections 3622(c)(2) and 3631(b), or "it would serve no purpose."[266] However, in its argument, UPS overlooks key terms in section 3633(b), as well as the context of the statutory scheme as a whole. The PAEA's focus on Postal Service pricing flexibility and fair competition in the provision of competitive products is encompassed in the three provisions of section 3633(a). Section 3633(a)(1) prohibits the subsidization of competitive products by market dominant products. *See* 39 U.S.C. § 3633(a)(1). Section 3633(a)(2) requires each competitive product cover its attributable costs. *See* 39 U.S.C. § 3633(a)(2). Finally, section 3633(a)(3) requires competitive products to collectively cover what the Commission determines to be an appropriate share of institutional costs. *See* 39 U.S.C. § 3633(a)(3). As the Commission noted in Order No. 26, these provisions "are designed to act in concert to ensure that competitive rates are lawful." Order No. 26 at 64.

Taken together, the provisions of section 3633(a) offer the Commission considerable discretion in administering each requirement. For example, section 3633(a)(1) allows for the Commission to choose the appropriate test for determining cross-subsidization. *See generally id.* at 63-67. With section 3633(a)(2), although Congress defined "attributable costs" as part of section 3631(b), it left to the Commission "considerable discretion" in determining the appropriate attribution

[266] UPS Order No. 4402 Comments at 26, 27; UPS Order No. 4742 Comments at 21.

methodology."[267]

An even higher degree of flexibility is inherent in the appropriate share provisions of section 3633. In section 3633(a)(3), Congress did not define the term "appropriate share," and its meaning was left for the Commission to determine based on consideration of all the relevant factors. Order No. 26 at 69. The relevant factors are set forth in section 3633(b): (1) the prevailing competitive conditions in the market; (2) the degree to which any costs are uniquely or disproportionately associated with competitive products; and (3) all other relevant circumstances. 39 U.S.C. § 3633(b). Each relevant factor uses flexible language for the Commission to interpret and only requires the Commission's "consideration," *i.e.,* for the Commission to take the relevant factors into account when determining the appropriate share.[268] Thus, no specific finding related to a relevant factor would mandate a specific result with regard to the appropriate share level.

For the relevant factor at issue, "the degree to which any costs are uniquely or disproportionately associated with any competitive products," UPS focuses on only a portion of the statutory language—"disproportionately associated." However, in reading the relevant factor in its entirety, the use of the words "degree" and "any" plainly contemplate that there may be no uniquely or disproportionately associated competitive product costs. Congress does not require costs to be found; only for the Commission to "consider" whether "any" exist. Nothing in section 3633(b) prevents the Commission from concluding as it has—that all costs uniquely or disproportionately associated with competitive products are, in fact, captured by the costing methodology it currently employs pursuant to section 3633(a)(2).

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[267] S. Rep. No. 108-318 at 9; *see UPS*, 890 F.3d at 1069 (internal citation omitted) ("In establishing this causal requirement, Congress expected that 'the expert ratesetting agency, exercising its reasonable judgment' would 'decide which methods sufficiently identify the requisite causal connection between particular services and particular costs. Here, the Commission did exactly that, settling on a cost-attribution methodology that implements its statutory mandate and falls well within the scope of its considerable discretion.").

[268] *See* Merriam-Webster Dictionary, available at: *https://www.merriam-webster.com/dictionary/consider.*

Second, UPS claims that the Commission did not address the disjunctive "or" between "uniquely" and "disproportionately," and that the Commission used "the fact that no institutional costs are 'uniquely associated' with competitive products as proof that no such costs are 'disproportionately associated' with competitive products." UPS Order No. 4402 Comments at 27. These claims misunderstand Order No. 4402. Disjunctive is defined as "expressed by mutually exclusive alternatives joined by *or*."[269] In Order No. 4402, the Commission found that costs disproportionately associated with competitive products are those associated with cost drivers and distributed to products in proportion to the prevalence of the driver within each product. Order No. 4402 at 43. The Commission found that uniquely associated costs are product-specific costs. *Id.* Given that there is no overlap between costs associated with cost drivers and product-specific costs, these two types of costs are mutually exclusive. As a result, the Commission appropriately viewed "uniquely associated" and "disproportionately associated" as distinct terms and has not used the absence of "uniquely associated" costs to prove that there are no "disproportionately associated" costs, as UPS alleges.

Third, UPS asserts that "'disproportionately' implies that the relevant costs might be 'associated with' more than one kind of product," and claims that "[t]he Commission's proposed interpretation would impermissibly render the statutory language ('disproportionately associated with') to be mere surplusage."[270] However, the Commission's approach is consistent with UPS's view of "disproportionately associated with." As the Commission stated in Order No. 4402, it views disproportionately associated costs as those associated with cost drivers, and "[t]he costs associated with a cost driver are *distributed to products in proportion to the prevalence of the driver within each product*." Order No. 4402 at 43 (emphasis added). The Commission's example in Order No. 4402 further illustrates that the costs associated with a cost driver are associated with more than one kind of product: "heavier products (*e.g.*, parcels)

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[269] *See* Merriam-Webster Dictionary, available at: *https://www.merriam-webster.com/dictionary/disjunctive.*

[270] UPS Order No. 4402 Comments at 28; UPS Order No. 4742 Comments at 19.

have more weight-driven costs attributed to them than lighter products (*e.g.*, letters)." *Id.*

Fourth, UPS suggests that the statutory language requires the Commission to "investigate" which costs currently classified as institutional may also be "disproportionately associated with" competitive products. UPS Order No. 4402 Comments at 28. As noted above, section 3633(b) requires the Commission to "consider," which means "to think about carefully," or "to take into account."[271] As a result, the statutory language (*i.e.,* "the degree to which any costs are uniquely or disproportionately associated with any competitive products") compels the Commission to consider whether "any costs" (and not solely institutional costs) are "uniquely or disproportionately associated with any competitive products." The Commission did this in Order No. 4402 by considering both attributable and institutional costs' link to any competitive products.

UPS's suggested approach also appears to reassert a prior stance that has been repeatedly rejected by the Commission in previous orders. In suggesting that the Commission investigate whether any institutional costs are "disproportionately associated with" competitive products, UPS appears to be seeking for the Commission to take a proportional approach to identifying and dividing institutional costs, and then applying the devised proportion to competitive products through the appropriate share.[272] However, the Commission has rejected this approach in prior orders. *See* Order No. 4402 at 81-82. As noted in Order No. 4402, any attempt to assign a proportion of institutional costs to competitive products, such as competitive products' proportion of attributable costs, revenue, or some other devised proportion, presents

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[271] *See* Merriam-Webster Dictionary, available at: *https://www.merriam-webster.com/dictionary/consider.*

[272] This suggestion aligns with UPS's assertion that competitive products should bear all of the costs associated with the Postal Service's competitive business, which UPS claims can be accomplished by assigning some proportion of institutional costs to competitive products. *See* UPS Order No. 4742 Comments at 4-5 (emphasis in original) ("[T]he 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* the common costs with which competitive products are associated, through the appropriate share requirement.").

multiple problems. *See id.* This suggestion is equivalent to fully-allocated costing, which has previously been rejected as being inherently arbitrary. *See id.* at 81. It also fails to take into account the prevailing competitive conditions in the market and other relevant circumstances, as required by section 3633(b). *See id.*

Finally, UPS appears to make two arguments related to the *UPS* case. First, UPS focuses on the statement by appellate counsel at oral argument that institutional costs are "going to be parceled out according to the Commission in a reasonable way." UPS Order No. 4402 Comments at 17-18. UPS argues that this statement constitutes recognition by the Commission that institutional costs "were meant to be allocated in a 'reasonable' manner that would reflect the contributions of competitive products…." *Id.* at 18. UPS further claims that nothing in the formula "has anything to do with parceling out costs to products at all." *Id.* In making this argument, UPS appears to suggest that appellate counsel's statement mandates the allocation of a proportion of institutional costs to competitive products that, "at a minimum account for the fact that a significant amount of institutional costs are associated with competitive products." *Id.* at 17. The Commission disagrees with UPS's interpretation of the Commission's appellate counsel's statement at oral argument. UPS appears to be reiterating its proportional approach that is discussed above and that was previously rejected by the Commission. *See* Order No. 4402 at 81-82. To the extent UPS is arguing that the Commission's approach does not "parcel out" institutional costs "in a reasonable way," the Commission disagrees and reaffirms its prior finding that the formula-based approach appropriately sets a minimum appropriate share in consideration of the relevant statutory criteria.

Second, UPS states that the D.C. Circuit was "convinced to affirm the Commission's narrow interpretation of attributable costs" because the appropriate share requirement would "adequately ameliorate any competitive deficit left by the Commission's approach to cost attribution."[273] UPS further appears to contend that the Commission "assured the Court" that the appropriate share requirement would be used

[273] UPS Order No. 4742 Comments at 29; *see UPS*, 890 F.3d at 1067.

to ensure that the Postal Service did not engage in undue competitive behavior due to the unattributed costs. UPS Order No. 4742 Comments at 29. UPS asserts that the Commission's formula-based approach fails to prevent "undue competitive behavior." *Id.* at 29-30. The Commission disagrees with UPS's assertion. In section II.A, *supra,* the Commission described the parcel delivery market's expansion and growth since the PAEA's enactment, and in section VIII.B, *supra*, the Commission analyzed the Postal Service's competitive behavior, including its pricing behavior, and found no evidence of anticompetitive behavior. Further, the Commission explained in Order No. 4742 how its formula-based approach would capture changes in the Postal Service's market power and its market share by revenue, as well as provide indications of attempts by the Postal Service to engage in predatory pricing with regard to its competitive products. Order No. 4742 at 13-19, 23-32, 49-52. The Commission considers both the Postal Service's previous competitive behavior, as well as how its formula-based approach captures future competitive behavior. In this way, the Commission's approach does utilize the appropriate share to "ameliorate any competitive deficit" left by the Commission's costing methodologies.

As it relates to the Postal Service's comments, the Postal Service contends that the "uniquely or disproportionately" clause of section 3633(b) was intended to "explore the potential ramifications" of any attributable costs (not institutional costs) that might be associated with competitive products. Postal Service Order No. 4402 Comments at 12. In support of this, the Postal Service maintains that the "uniquely or disproportionately associated" clause of section 3633(b) was included due to the existence of facilities used exclusively by certain competitive products—facilities which are, in fact, no longer operating. *Id.* at 12-13. The Commission is unable to confirm the Postal Service's conclusions. The Commission continues to find that the statutory language requires the Commission consider whether "any costs," not solely attributable costs (as the Postal Service suggests), or institutional costs (as UPS suggests), are uniquely or disproportionately associated with any competitive products.

3. Cause of Institutional Costs

a. Comments

ACI maintains that the Postal Service's institutional costs are associated with competitive products because "many mail trucks hold only or mostly competitive products and services." ACI Order No. 4402 Comments at 2. As it relates to the Postal Service's investments, ACI contends the Postal Service is "currently shopping for delivery trucks specifically designed for package delivery…." *Id.* As a result, in recommending an increase to the appropriate share, ACI suggests that competitive products should "share the brunt" of institutional costs. *Id.*

UPS similarly associates increases in the Postal Service's institutional costs with its competitive products, based on current and future Postal Service investments. Like ACI, UPS notes that the Postal Service has invested in a "new fleet of trucks expressly designed for delivering packages." UPS Order No. 4402 Comments at 3-4, 5. UPS maintains that the Postal Service classifies these types of investment costs as institutional, despite their association with package delivery. *Id.* UPS states that the "obvious explanation" for the institutional cost growth "is that the Postal Service is devoting more of its resources to delivering competitive products," and that "at least some of the costs of doing so are associated with the competitive products business." *Id.* at 5. In addition, UPS notes that the "future growth [of the Postal Service] will require major investments," and these investments will be also "geared toward competitive products." UPS Order No. 4742 Comments at 53. UPS concludes that based on increases in institutional costs, "[t]hese investments are well underway," and "they should be paid for by competitive products." *Id.* at 53-54.

Additionally, as further evidence that the Postal Service's competitive products are disproportionately associated with institutional costs, UPS links changes in the Postal Service's competitive product revenue and volume with changes in its institutional costs. First, UPS links an increase in the Postal Service's institutional costs to an increase in competitive product revenue. UPS Order No. 4742 Comments at 57-59. UPS presents a figure illustrating gradual increases in both the Postal Service's institutional costs and competitive product revenue, as well as decreases in market dominant revenue over the same time period. *Id.* at 58. As UPS states, the figure shows that 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…despite the dramatic decline of the market dominant business." *Id.* For that reason, UPS concludes that "the competitive products business is necessarily relying upon, benefiting from, and causing a greater and greater share of total institutional costs." *Id.* at 58-59.

Second, UPS contends that the Postal Service's institutional costs have increased, even though market dominant mail volumes "continue to plummet." UPS Order No. 4402 Comments at 5. UPS then describes package volume increases and cites to a Postal Service statement that it "delivers 'more e-commerce packages to the home than any other shipper.'" *Id.* at 15-16 (internal citation omitted). UPS describes these trends as the driver of institutional cost increases over the "the last couple [of] years." *Id.* UPS asserts that the Commission does not explain how its findings that there are no institutional costs uniquely or disproportionately associated with competitive products are consistent with "the fact that the Postal Service's institutional costs have increased…when competitive products are [] driving the vast majority of volume growth." *Id.* at 16; *see also* Order No. 4402 at 43-45.

In response to UPS's contention that increases in institutional costs are related to competitive product growth, Amazon states that such "growth…does not mean that all (or even most) recent investments and expenditures by the Postal Service [should be] attributed to competitive products." Amazon Order No. 4402 Comments at 10. Amazon explains that many of those costs are fixed or common costs and cannot be linked to competitive products through reliably identified causal relationships. *Id.* Amazon maintains that the Postal Service's institutional costs "have risen mainly because of factors largely independent of increased package volumes, such as accelerated growth in delivery points, and an increase in government employee retirement benefit payments." *Id.* at 11-12.

b. Commission Analysis

ACI appears to allege, in part, that competitive products should "share the brunt" of institutional costs because those products occupy a higher percentage of space in the Postal Service's delivery trucks, and thus institutional costs related to delivery of competitive products are disproportionately associated with competitive products. *See generally* ACI Order No. 4402 Comments at 2. ACI seems to be suggesting that the Commission increase the appropriate share because competitive products do not cover the cost of the proportion of space in a truck that they occupy. The Commission disagrees with this suggestion because the space a competitive product occupies on a truck is attributed to that product under the Commission's current costing methodology. In other words, parcels are already held responsible for these types of costs, in the proportion that they are caused. The cost attribution is accomplished through the use of cost drivers, such as cubic-foot-miles.[274] For parcels, "cubic-feet information [is] obtained…[from their]…dimensional information (length, width and height)…." TRACS Documentation at 4. This information, combined with the data on route distance (miles traveled), is used to attribute the accrued costs for the highway transportation cost pools to individual products. For city delivery of parcels, which is the intended use of the new trucks that UPS and ACI reference, volume is a cost driver, and parcel costs are

[274] Rule 39 C.F.R. Section 3050.60(f) Report for FY 2017 (Summary Descriptions), July 2, 2018, file "CS14_17.docx" (Summary Descriptions Report); Docket No. ACR2017, Library Reference USPS-FY17-36, December 29, 2017, file "USPS_FY17_36_TRACS.Preface.pdf," at 5 (TRACS Documentation).

estimated separately from other mail shapes in multiple cost pools.[275] These separate cost pools reflect the unique characteristics and costs of parcels compared to other mail shapes.[276] As explained in Order No. 4402, heavier products (*e.g.,* parcels) have more weight-driven costs attributed to them than lighter products (*e.g.,* letters).[277] Similarly, to the extent that competitive products make up a greater proportion of volume, those costs are "distributed to [competitive] products in proportion to the prevalence of the driver within each product." Order No. 4402 at 43.

If ACI is suggesting that the Commission require competitive products to cover a larger share of institutional costs simply because competitive products may occupy more space in a delivery truck, the Commission finds that this suggestion is also inappropriate. ACI's suggestion appears to be another example of a commenter recommending that the Commission take a proportional approach to dividing and assigning institutional costs. As discussed above, the Commission has repeatedly rejected proportional approaches similar to this because such an approach would lead to arbitrary results. *See* section V.C, *supra.*

The Commission also disagrees with UPS's conclusion that institutional costs have continuously increased in the last decade. In Figure 7 of its comments, UPS displays institutional costs over time, but omits some institutional costs from certain cost components that it considers "uncontrollable." *See* UPS Order No. 4742 Comments at 58 n.158. These omissions include Retiree Health Benefit Fund (RHBF) prefunding

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[275] In using volume as a cost driver, distinctions are drawn to assign costs based on the shape of the mailpieces. Specifically, drivers of delivery costs include: volume of letters; volume of flats; volume of parcels that fit in a mail receptacle; and volume of parcels that require deviation from normal delivery (because the parcel is too large for the receptacle and/or requires a signature for delivery). As a result, the cost attributed for each unit of mail differs by shape, with a higher cost for a parcel than for a letter or flat. *See generally* Docket No. RM2015-7, Order Approving Analytical Principles Used in Periodic Reporting (Proposal Thirteen), October 29, 2015 (Order No. 2792).

[276] The most significant cost in delivery is the cost of carriers' labor. Associated indirect delivery costs, including delivery vehicles' fuel, depreciation, and maintenance costs, are attributed in the same proportion as the direct labor costs. *See* Summary Descriptions Report, Appendix I, file "APPI-17.docx," at I-2 and file "CS07-17.docx."

[277] Order No. 4402 at 43; *see* Docket No. ACR2017, Library Reference USPS-FY17-1, December 29, 2017; Order No. 4402 at 18 n.33.

payments and other obligations.[278] UPS's omission is inappropriate for two reasons. First, the Postal Service's competitive products are currently required to contribute at least 5.5 percent to these UPS-omitted institutional costs in order to comply with section 3633(a)(3). The Commission includes these institutional costs when calculating the dollar amount that competitive products must contribute annually. It is inappropriate for UPS to exclude costs as part of its analysis when competitive products are required by statute to cover a percentage of those excluded costs. Second, this omission skews the resulting institutional cost totals in Figure 7. As an example, in Figure 7, the institutional cost columns indicate an *increase* in institutional costs from FY 2016 to FY 2017. *See* UPS Order No. 4742 Comments at 58. However, the Commission notes that for FY 2016 and FY 2017, the Postal Service's institutional costs totaled $36.363 billion and $29.700 billion, respectively.[279] Contrary to UPS's presentation, these figures demonstrate that there was, in fact, a $6.663-billion decrease in institutional costs between FY 2016 and FY 2017.

In addition, the Commission disagrees with UPS's contention that institutional cost changes are tied to changes in competitive product volume or revenue. First, the Commission reiterates that institutional costs are, by definition, not tied to any individual product or class; rather, they are residual costs that cannot be attributed to either market dominant or competitive products.[280] Second, Figure VIII-3 illustrates how institutional costs fluctuated between FY 2007 and FY 2017, despite the growth in

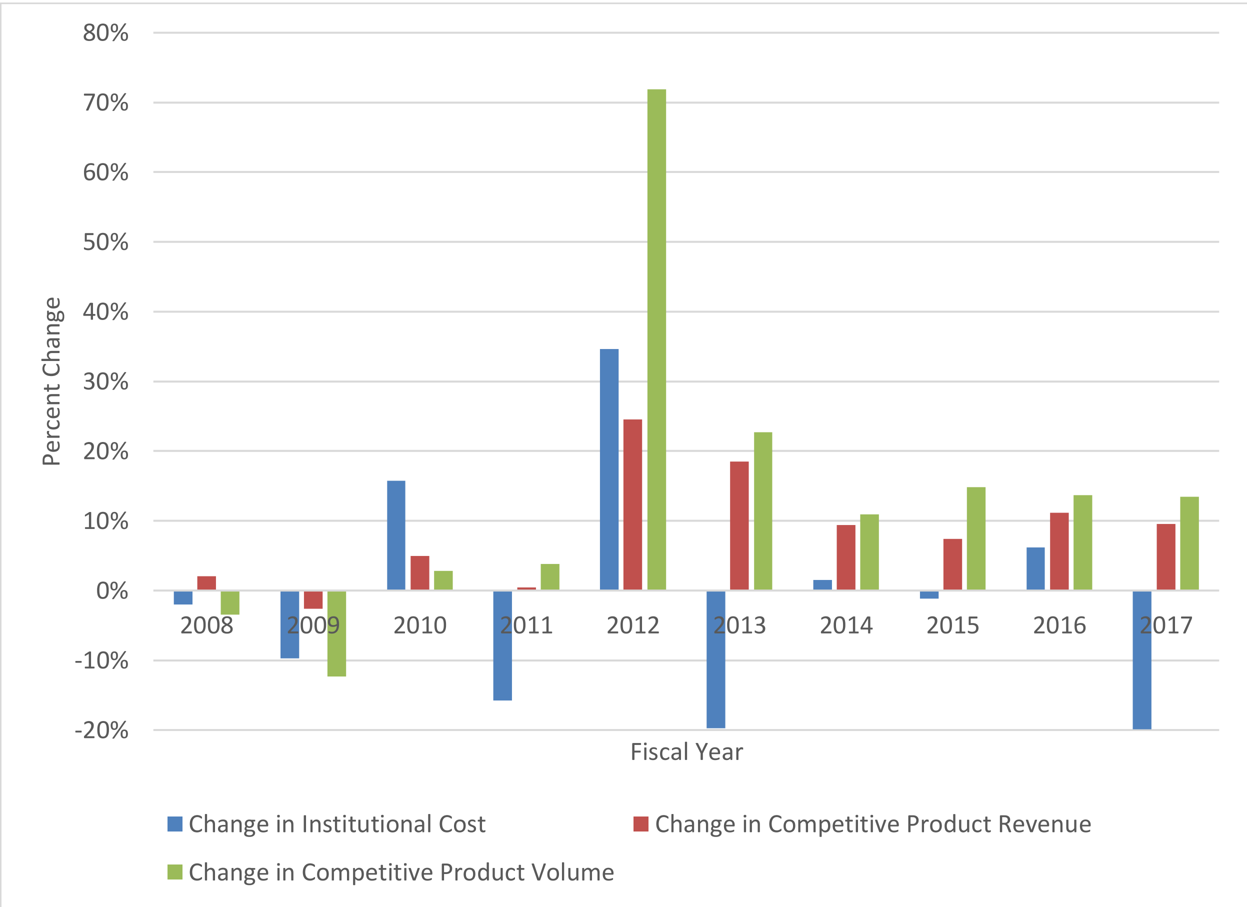
[278] *See id.; see also, e.g.,* Docket No. ACR2016, Library Reference USPS-FY16-2, December 29, 2016. UPS omits certain cost segments such as Cost Segment 18.3.4, which is the cost segment related to workers' compensation, and Cost Segment 18.3.6, which is the cost segment related to annuitant health benefits and earned Civil Service Retirement System pensions. *See* UPS Order No. 4742 Comments at 58 n.158.

[279] Docket No. ACR2016, Postal Regulatory Commission, Annual Compliance Determination, March 28, 2017, at 88; FY 2017 ACD at 92.

[280] *See* section I, *supra*; *see also, e.g.,* Order No. 4402 at 43; Order No. 3506 at 10.

competitive product volume and revenue.[281]

Figure VIII-3
Annual Change in Total Institutional Costs and Competitive Products' Revenue and Volume, FY 2007 – FY 2017[282]



[281] The figure presents percent change in real terms, rather than nominal terms, for revenue and institutional cost. As noted above, "real" values are those that are adjusted for inflation. *See* section III.B.2, *supra.* Real values are better for purposes of this analysis because institutional costs are subject to input price inflation, which obscures any possible relationship between institutional costs and volume. Removing the inflationary effect permits a clearer evaluation of whether these costs change with volume or revenue. Because the figure presents percent change in real institutional costs, it also presents percent change in real revenue for consistency.

[282] *See* Library Reference PRC-RM2017-1/3.

This figure demonstrates that annual changes in the Postal Service's institutional costs do not correspond to the growth in its competitive product revenue or volume. This indicates that there is no link between institutional costs and competitive product volume or revenue as UPS alleges.

Despite UPS's assertions that institutional costs have increased, they have in fact decreased in real terms since the PAEA's enactment. Institutional costs in real terms have decreased by 20 percent, from $31.58 billion in FY 2007 to $25.12 billion in FY 2017. This decrease was largely due to the end of the RHBF prepayment schedule and the Postal Service experiencing negative workers' compensation costs in FY 2017.[283]

Finally, in response to ACI's and UPS's contention that the Postal Service's investments are focused on competitive products and result in an increase in institutional costs, the Commission disagrees and instead concurs with Amazon's assessment that institutional costs are caused by factors unrelated to competitive products. *See* Amazon Order No. 4402 Comments at 11-12. In the FY 2016 and FY 2017 Financial Reports, the Commission discussed changes in the Postal Service's institutional costs and the major causes of those changes.[284] For example, for FY 2016, the Commission noted that delivery network costs, workers' compensation, and annuitant health benefits were the primary causes of institutional costs increases. FY 2016 Financial Report at 39-40. In FY 2017, the Commission noted the same causes of institutional cost changes; however, in FY 2017, these changes resulted in a decrease in institutional costs. FY 2017 Financial Report at 37. As explained in the FY 2017 Financial Report, "institutional cost will increase or decrease depending on changes to retirement obligations (initiated by [the Office of Personnel Management]), interest rate fluctuations that impact the workers' compensation liability, and increases in delivery

[283] Docket No. ACR2017, Postal Regulatory Commission, Financial Analysis of the United States Postal Service Financial Results and 10-K, Fiscal Year 2017, April 5, 2018, at 10 (FY 2017 Financial Report).

[284] Docket No. ACR2016, Postal Regulatory Commission, Financial Analysis of United States Postal Service Financial Results and 10-K Statement, Fiscal Year 2016, March 31, 2017 (FY 2016 Financial Report); FY 2017 Financial Report.

points or changes due to restructuring routes." *Id.* These are primarily non-operational changes that have no relationship to any increases in competitive product revenue or volume, or to the Postal Service's investments.

4. Cost Attribution Methodology

a. Comments

In support of its assertion that some costs currently classified as institutional are uniquely or disproportionately associated with competitive products, UPS points to "economic incremental costs," *i.e.,* the costs that would go away if the Postal Service stopped offering competitive products.[285] UPS maintains that "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." UPS Order No. 4742 Comments at 13 (emphasis in original). Furthermore, UPS states that although the Commission's current costing methodology refers to a product's attributable costs as the "incremental" costs caused by that product, the methodology "misses many costs that are in fact incremental to competitive products."[286] UPS cites to a declaration filed by Carlton[287] in this proceeding that described institutional costs that would disappear if the Postal Service ceased its competitive product business, such as a reduction in headquarters expenses and data processing supplies and service.[288] UPS criticizes what it considers to be the Commission's failure to "determine the proportion or amount of institutional costs the Postal Service could eliminate under an efficient reorganization if it stopped providing competitive products." UPS Order No. 4402 Comments at 13.

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[285] UPS Order No. 4402 Comments at 10, 12; UPS Order No. 4742 Comments at 12-15.

[286] UPS Order No. 4402 Comments at 11, 14-15; UPS Order No. 4742 Comments at 12-13. As noted above, UPS also contends that competitors must "eventually recover *all* of the costs caused by their business" and that the Postal Service enjoys a competitive advantage because it is able to "ignore costs by classifying them as 'institutional.'" UPS Order No. 4402 Comments at 10 (emphasis in original); *see* section VIII.A.3, *supra*.

[287] *See generally* Declaration of Dennis W. Carlton, March 9, 2017.

[288] UPS Order No. 4402 Comments at 12-13; UPS Order No. 4742 Comments at 14-15.

UPS claims that the Postal Service's financial statements (including a recent Form 10-Q report) confirm points made by Carlton about the existence of costs classified as institutional that are associated with competitive products.[289] UPS contends that the Postal Service Form 10-Q Report shows that competitive products are contributing to not only overall cost increases, but also to overall losses. UPS Order No. 4742 Comments at 15. UPS asserts that Postal Service's "controllable losses" (*i.e.,* losses arising from costs that the Postal Service should be able to control) are caused in part by delivering parcels. *Id.* UPS states that "the largest portion" of the Postal Service's controllable losses was due to increased compensation and benefits costs. *Id.* UPS ties these higher costs to increases in the "labor-intensive package business." *Id.* at 16. As UPS contends, "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." *Id.* UPS maintains that the current costing methodology does not attribute these types of increased labor, transportation, and other operational expense costs, which it claims the Postal Service "acknowledges are driven by its package-delivery services" and are labeled as institutional despite their association with competitive products. *Id.* at 16-17.

Sidak contends that some operational costs that result from delivering competitive products are currently classified as institutional costs, as if they were fixed costs. Sidak Order No. 4742 Decl. at 39 n.119. Sidak alleges that, under the current costing methodology, the Postal Service does not attempt to attribute "combinatorial costs," or costs "caused jointly by a subset of two or more products (but fewer than all of its products collectively)." Sidak Order No. 4402 Decl. at 1. He maintains that if the Postal Service were to attribute these costs "to subsets of two or more of its products," then the Postal Service's total institutional costs would shrink and consist only of costs caused jointly by all products. *Id.* Sidak contends that the Commission's "willful choice to ignore combinatorial costs is to exaggerate the share" of costs that cannot be attributed, and "erroneously" label them as institutional. *Id.* at 55.

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[289] UPS Order No. 4742 Comments at 14-15; *see* Postal Service Form 10-Q Report.

Amazon disagrees with UPS's assertion that the Commission's costing methodology "understates" competitive products' attributable costs and contends that UPS has "offered no persuasive challenge to the conceptual sufficiency of the attributable cost test." Amazon Order No. 4402 Comments at 8. Amazon notes that the Commission has scrutinized the accuracy of its costing methodology over the last decade and that UPS failed to identify any significant errors in the methodology. *Id.* at 9. Amazon also concurs with the Commission's prior conclusion that UPS failed to provide evidence of reliably identified causal relationships between institutional costs and specific competitive products. *Id.* at 10.

Pitney Bowes states that the Commission's "comprehensive review" of cost attribution in Docket No. RM2016-2 "confirmed there are no costs uniquely or disproportionately associated with competitive products that are not already attributed," and that the Commission "properly held that institutional costs include no unique or disproportionate costs associated with competitive products." Pitney Bowes Order No. 4402 Comments at 10. It further notes that the Commission's "causality-based approach to costing is compelled by the plain language of the PAEA and reflects a consensus view in regulatory economics." *Id.*

Similarly, the Postal Service notes that the PAEA "requires cost attribution methods must be based on 'reliably identified causal relationships,'" and that the existing methodologies were "developed and approved by the Commission through public, adversarial proceedings." Postal Service Order No. 4402 Comments at 12 (internal citations omitted). In addition, the Postal Service urges the Commission to "reject any attempts by UPS to relitigate previously addressed arguments concerning cost attribution under [s]ection 3633(a)(2)…."[290]

b. Commission Analysis

The Commission disagrees with UPS's and Sidak's claim that the current costing methodology fails to attribute certain causally related costs. In response to UPS's argument that the Commission's current methodology "misses many costs that are in fact incremental to competitive products" and would disappear if the Postal Service ceased its competitive product business, it is important to note that these are hypothetical costs. *See* UPS Order No. 4402 Comments at 14-15. Neither Sidak nor UPS present a method by which the Commission could reliably estimate these costs, and the Commission concludes that the estimation of such costs is outside the scope of the Commission's current costing methodology.[291] The purpose of the Commission's current costing methodology is to calculate costs incurred by the Postal Service for the given time period that the costs are evaluated (*i.e*., a fiscal year).[292] The Commission evaluates competitive product compliance with applicable statutory requirements on a fiscal year basis in its ACD, and the current costing methodology is structured to evaluate costs retroactively on a fiscal year basis, not proactively based on the hypothetical scenarios proposed by UPS.

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[290] *Id*. at 15. As noted previously, cost attribution pursuant to section 3633(a)(2) was most recently considered in Docket No. RM2016-2, wherein the Commission examined the concept of reliably identifiable causally related costs and expanded the scope of Postal Service cost attribution as part of Order No. 3506. *See generally* Order No. 3506. UPS challenged the Commission's costing methodologies approved in that Order in the United States Court of Appeals for the District of Columbia Circuit. *See* Petition for Review, *United Parcel Serv., Inc. v. Postal Reg. Comm'n*, No. 16-1354 (D.C. Cir. filed Oct. 7, 2016). The Court issued its opinion on May 22, 2018. *See United Parcel Serv., Inc. v. Postal Reg. Comm'n*, 890 F.3d 1053 (D.C. Cir. 2018). In its opinion, the Court denied UPS's Petition for Review and found that the Commission exercised reasonable judgment in "settling on a cost-attribution methodology that implements its statutory mandate and falls well within the scope of its considerable discretion." *Id.* at 1069; *see* Order No. 4742 at 7 n.8; *see also* section VIII.C.1, *supra.*

[291] Although UPS identifies these costs as incremental, they are not the same as the incremental costs incurred by the Postal Service and recognized by the current costing methodology. As a multi-product firm, the Postal Service's "incremental costs are costs that result from providing a specific product, and can be traced to that specific product." Order No. 3506 at 8.

[292] *See, e.g.,* Summary Descriptions Report, file "PREF-17.pdf," at 1.

In criticizing the Commission's current costing methodology, Sidak argues that the Commission fails to attribute so-called "combinatorial costs." Sidak Order No. 4402 Decl. at 1, 53-55. This term, however, is neither recognized by the Commission's current costing methodology nor well accepted by economic accounting literature. In addition, the research papers Sidak references to support his assertions related to "combinatorial costs" do not directly study those costs.[293] While Sidak defines combinatorial costs as those "caused jointly by a subset of two or more products (but fewer than all of its products collectively)," he fails to explain whether these costs bear a reliably identifiable causal relationship to competitive products as required by section 3622(c)(2). *See* Order No. 3506 at 14.

Despite Sidak's use of the unfamiliar term "combinatorial," the Commission notes that a portion of the costs described by Sidak are, in fact, costs incurred collectively by all competitive products and are already attributed to competitive products. Under the current costing methodology, volume-variable costs, product-specific fixed costs, and inframarginal costs that are part of competitive products' incremental costs are attributed to competitive products. *Id.* at 51-53. These costs are incurred not only at the product level, but also in some cases by all competitive products collectively. The collectively incurred competitive product costs are a combination of inframarginal costs and group-specific costs. *Id.* at 55. As part of Order No. 3506,[294] the Commission began attributing these collectively-incurred competitive product costs when it began

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[293] *Id.* at 53 n.178. For example, in one of the referenced papers from 1985, there appears to be only a general reference where the author notes that "the combinatorics of joint costs and revenues" could be a "breakthrough in accounting." *See* H. Peyton Young, *Cost Allocation: Methods, Principles, Application* x (1985), available at: *http://pure.iiasa.ac.at/id/eprint/2596/1/XB-85-003.pdf*.

[294] Under the costing methodology effective prior to Order No. 3506, costs for each competitive product were evaluated at the product level, and the collective competitive costs were not included in individual products' attributable costs. *Id.* at 9-10. Collective competitive costs, however, were reflected in the incremental costs for competitive products as a whole, which the Commission calculated as part of its test for cross-subsidization under section 3633(a)(1). *Id.* at 10.

interpreting attributable costs to mean the incremental costs of a class or product.[295]

For all other costs described by Sidak, the Commission notes that if the costs are "caused jointly by a subset of two or more products," but lack a reliably identifiable relationship with competitive products or a class of market dominant mail, those costs continue to be appropriately classified as institutional. *See* FY 2017 ACD at 10.

The Commission also rejects UPS's claim that because competitive products partially contribute to the controllable losses reported in the Postal Service Form 10-Q Report, they should be responsible for a higher portion of institutional costs. *See* UPS Order No. 4742 Comments at 15-16. First, the Commission notes that competitive products must cover their attributable costs and make a contribution to institutional costs pursuant to section 3633(a)(2) and (a)(3). Without the institutional cost contribution from competitive products, the Postal Service's controllable losses would be larger. Thus, competitive products do not contribute to controllable losses, as UPS claims, but in fact reduce them. Second, UPS's assertion lacks merit because the Postal Service Form 10-Q Report, by definition, "includes unaudited financial statements and provides a continuing view of the company's financial position during the year."[296] These financial statements provide "raw" accounting data, including the Postal Service's incurred costs. To develop the Postal Service's attributable costs at the component level and then allocate those costs to products, the Postal Service applies the Commission's costing methodology to the raw costs derived from the postal accounting system.[297] As noted previously, cost attribution must be based on reliably identified causal relationships, and the Commission's current costing methodology

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[295] Order No. 3506 at 60; FY 2017 ACD at 8-10; *see also* Library Reference PRC-LR-ACR2017-1, March 29, 2017. This methodology was further refined in Order No. 4719. *See* Docket No. RM2018-6, Order on Analytical Principles Used in Periodic Reporting (Proposal Three), July 19, 2018 (Order No. 4719).

[296] *See* United States Securities & Exchange Commission, Fast Answers, Form 10-Q, available at: *https://www.sec.gov/fast-answers/answersform10qhtm.html.*

[297] *See, e.g.,* Summary Descriptions Report, file "PREF-17.docx."

attributes all reliably identified causally related costs that can be traced to competitive products.[298]

For the reasons discussed above, the Commission affirms its previous findings that there are no costs uniquely or disproportionately associated with any competitive products that are not already attributed to competitive products under the Commission's existing costing methodology.[299]

D. Other Relevant Circumstances

As the Commission explained in Order Nos. 4402 and 4742, in its assessment of other relevant circumstances, the Commission considers the effects of: (1) products that have been transferred from the market dominant product list to the competitive product list since the Commission's last review of the appropriate share; (2) changes to the mail mix (*i.e.*, the relative proportions of market dominant volumes and competitive product volumes) since the last review of the appropriate share;[300] (3) uncertainties in the marketplace; and (4) the risks associated with setting the appropriate share either too high or too low.[301]

1. Changes in Competitive Product Offerings and Mail Mix

a. Previous Commission Discussion

The Commission considers product transfers from the market dominant product list to the competitive product list and changes in the mail mix as part of its appropriate share review. As explained in Order No. 1449, this is because substantial changes in competitive product volume (through product transfers or shifts in postal product

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[298] *Id.*; 39 U.S.C. §§ 3622(c)(2) and 3631(b); Order No. 4402 at 43; Order No. 4742 at 52.

[299] Order No. 4402 at 43-44; Order No. 4742 at 52.

[300] For the purposes of this Order, the Commission analyzes the effects of product transfers and mail mix changes together, as both considerations are similarly affected by changes in the Postal Service's mail volume.

[301] Order No. 4402 at 45-53; Order No. 4742 at 53-57.

demand) relative to market dominant product volume could indicate, under certain circumstances, the need to revise the appropriate share. *See* Order No. 1449 at 23.

In Order No. 4402, the Commission identified four product transfers to the competitive product list since its last review of the appropriate share in Docket No. RM2012-3. Order No. 4402 at 46. In addition, the Commission noted that the Postal Service's market dominant volume continues to decline, while its competitive product volume continues to increase. *Id.* at 47. However, despite product transfers and the decline in market dominant volume, the Commission found that the Postal Service's competitive product volume continues to make up only a small portion of the Postal Service's total mail volume compared to market dominant product volume.[302]

As it relates to the formula, the Commission explained that its formula captures changes in the market caused by product transfers and changes in the mail mix. Order No. 4742 at 55-56. The Competitive Growth Differential incorporates product transfers because it includes the revenue of any transferred product. *Id.* at 55*.* Similarly, the Competitive Growth Differential captures changes in the mail mix because it reflects the change in revenue that results from any decrease or increase in competitive product volume. *Id.* at 55-56. Furthermore, if a product is transferred to the competitive product list, or if the mail mix changes and competitive product volumes increase, then the Competitive Contribution Margin reflects any changes in the Postal Service's market power because the component incorporates the transferred product's or increased volume's attributable costs and revenue in its calculation. *Id.* at 55.

b. Comments

Pitney Bowes concurs with the Commission and states that despite product transfers to the competitive product list, "there has not been a significant increase in competitive products volume relative to market dominant products volume." Pitney Bowes Order No. 4402 Comments at 11. Amazon similarly notes that product transfers

[302] *Id.* at 48. Relative proportions of the Postal Service's competitive products and market dominant products are depicted in Figure IV-4 of Order No. 4402. *See id.*

to the competitive product list have not had a "large relative influence on the overall level of competitive products' institutional cost contribution." Amazon Order No. 4402 Comments at 24.

As it relates to changes in the mail mix, both Pitney Bowes and Amazon contend that although there has been a decline in demand for market dominant products, competitive product volumes have not increased significantly.[303] Both Pitney Bowes and Amazon note that the Postal Service's market dominant products made up nearly 97 percent of its mail mix in FY 2017.[304]

UPS appears to indicate a concern with the formula's ability to reflect mail mix changes. UPS notes that, between FY 2014 and FY 2017, competitive product revenue increased, while market dominant revenue decreased. UPS Order No. 4742 Comments at 35-36. UPS contends that if "current trends" in changes in revenue continue "competitive product revenue would surpass that of market dominant revenue in FY[]2024," yet the appropriate share would "barely change" based on the Commission's formula. *Id.*

c. Commission Analysis

Pitney Bowes' and Amazon's comments related to product transfers and mail mix changes are in line with their general position that the appropriate share should be eliminated. However, in response to their comments, the Commission notes that although the Postal Service's competitive product volume is small relative to market dominant mail volume, product transfers and overall economic recovery over the last decade have led to a steady increase in the Postal Service's market share, competitive product volumes, and competitive product contribution to institutional costs. *See* Order No. 4402 at 12. These circumstances were part of the Commission's rationale to modify "the static 5.5-percent appropriate share," and develop a formula-based approach that would "better reflect the modern competitive market." *See id.*

[303] Pitney Bowes Order No. 4402 Comments at 11; Amazon Order No. 4402 Comments at 24.

[304] Pitney Bowes Order No. 4402 Comments at 11; Amazon Order No. 4402 Comments at 24.

Furthermore, the Commission noted the importance of capturing product transfers and mail mix changes in its formula because these changes can expand the scope of the parcel delivery market and potentially increase the Postal Service's market share in the parcel delivery market. *See* Order No. 4742 at 16-17. Product transfers may also offer opportunities for the Postal Service to exercise market power by setting prices on the transferred products above marginal cost. As a result, the formula is designed to capture these changes by increasing or decreasing the appropriate share as the Postal Service's market power and market position increase or decrease.

In response to UPS's concern that the formula may not properly reflect mail mix changes, the Commission notes that UPS's assumptions rely on growth rates exclusively from FY 2014 to FY 2017, which may not be representative of future developments for the Postal Service or its competitors. Furthermore, should such change in the mail mix occur, the Commission notes that any interested person may petition for a rulemaking proposing changes to the appropriate share, or the Commission may consider such occurrences during the next appropriate share review. In addition, the Commission is able to revisit the formula at any time in the future if necessary.

2. Uncertainties

a. Previous Commission Discussion

During the Commission's previous review of the appropriate share, it stated that uncertainties might affect the level of contribution that the Postal Service's competitive products are able to achieve. Order No. 1449 at 23-24. In Order No. 4402, the Commission noted that significant innovative developments and changes in e-commerce and the parcel delivery industry had occurred since its last review of the appropriate share. Order No. 4402 at 49. In addition, the Commission indicated that setting the appropriate share through its formula-based approach would capture uncertainties that relate to shifts in market demand or macroeconomic conditions, as well as other uncertainties. *Id.*

In Order No. 4742, the Commission described how the formula captured market uncertainties through changes in the Competitive Contribution Margin and the Competitive Growth Differential. Order No. 4742 at 56. If changes in market demand occur due to a recession or other market conditions, it may require the Postal Service to decrease competitive product prices, which would reduce the Competitive Contribution Margin. *Id*. Should such changes affect competitor pricing, it would be reflected in the Competitive Growth Differential. *Id.* In addition, the Commission explained how the formula captures innovation efforts and changes in e-commerce through the Competitive Growth Differential. *Id.*

b. Comments

The Postal Service maintains that ongoing changes in the market, "including a shift among major retailers towards developing in-house logistics capabilities and a surge in the number of firms providing last-mile delivery," create uncertainties in the Postal Service's ability to sustain competitive product contribution. Postal Service Order No. 4402 Comments at 1. Amazon contends that uncertainties in the market exist and that, despite economic strengthening, multiple pending dockets and new legislation "militate against raising the minimum contribution requirement…." Amazon Order No. 4402 Comments at 25. Pitney Bowes states that although the economy has stabilized, the Postal Service's long-term financial stability remains uncertain. Pitney Bowes Order No. 4402 Comments at 11. It further notes that the market is dynamic; that customer expectations continue to evolve; and that "[c]hanges in the way consumers interface with the digital economy create new challenges and additional uncertainty." Pitney Bowes Order No. 4742 Comments at 2. The Public Representative suggests that the Postal Service is in "less stable financial condition" than its competitors. PR Order No. 4402 Comments at 8. He notes that uncertainties exist, such as excessive Postal Service RHBF payments, declining mail volumes, proposed legislation, and other unknown impacts that could affect competitive products' ability to contribute to institutional costs. *Id.* at 9.

c. Commission Analysis

As discussed in Order Nos. 4402 and 4742, the Commission agrees with commenters that uncertainties in the market continue to exist.[305] It is for that reason that the Commission noted the importance of the formula's ability to adapt to uncertainties in the market. The formula would capture many of the changes arising from market uncertainties. Order No. 4742 at 56. Furthermore, should any uncertainties occur that potentially affect competitive products' ability to contribute to institutional costs, the Commission notes that interested persons may petition for a rulemaking proposing changes to the appropriate share, or the Commission may consider these occurrences during the next appropriate share review.[306] In addition, the Commission is able to revisit the formula at any time in the future if necessary.

3. Risks

a. Previous Commission Discussion

In Docket No. RM2007-1, the Commission noted that there were inherent risks related to a mandatory contribution level such as the appropriate share. Order No. 26 at 73. The Commission concluded that setting the appropriate share too high could hinder the Postal Service's ability to compete, while setting the appropriate share too low could give the Postal Service an artificial competitive advantage.[307] These concepts were reiterated in Order No. 4402, where the Commission noted that a high appropriate share would force the Postal Service to raise its prices to non-competitive levels in order to meet the requirement, thereby driving consumers to cheaper competitors. Order No. 4402 at 50. Such a result could lead to the Postal Service's exit from the parcel delivery market and to less robust competition. *Id.* Conversely, if the appropriate share were set too low, the Postal Service may discount its prices in order to gain market share, thereby creating an artificial competitive advantage for the Postal Service. *Id.*

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[305] *See* Order No. 4402 at 49-50; Order No. 4742 at 56.

[306] Possible examples could include unforeseen market changes or changes in legislation.

[307] *Id.*; *see* Order No. 4402 at 7.

However, in Order No. 4402, the Commission noted that an attempt by the Postal Service to discount its prices would come at the expense of profitability, and the Commission found that little incentive for such actions exist, given both the structure of the PAEA and the Postal Service's financial challenges. *Id.* at 50-51.

In Order No. 4742, the Commission explained that its formula-based approach limits increases in the appropriate share to those appropriate to account for the Postal Service's growth in market power and market position. Order No. 4742 at 56. In addition, the Commission affirmed its previous conclusion that the risk of setting the appropriate share too low, thereby enabling the Postal Service to discount prices, was minimal because the Postal Service faces disincentives to decrease profitability at a time when it continues to face financial challenges. *Id.* at 56-57.

b. Comments

The Postal Service, PSA, Amazon, the Public Representative, and Pitney Bowes all maintain that the risk of setting the appropriate share too high is significant. Each commenter notes that setting the appropriate share too high could force the Postal Service to artificially raise prices, thereby harming consumers.[308] These commenters contend that setting the appropriate share too high would only benefit the Postal Service's competitors.[309]

Conversely, UPS discusses the risk of setting the appropriate share too low, which it claims would enable the Postal Service to set artificially low prices and provide it with a competitive advantage. UPS Order No. 4402 Comments at 8. UPS states that the Commission's formula-based approach "would facilitate the Postal Service's ability

[308] Postal Service Order No. 4402 Comments at 1, 5-6; PSA Order No. 4402 Comments at 1-2; Pitney Bowes Order No. 4402 Comments at 3, 7-8; Pitney Bowes Order No. 4742 Comments at 3; PR Order No. 4402 Comments at 7-8, 9, 11, 14; PR Order No. 4742 Comments at 13-14; Amazon Order No. 4402 Comments at 2, 4-5, 25-27, 34; Amazon Order No. 4742 Comments at 2.

[309] *See, e.g.,* Amazon Order No. 4402 Comments at 4-5; Pitney Bowes Order No. 4402 Comments at 7-8; Postal Service Order No. 4402 Comments at 5-6.

to underprice its products in order to increase its scale while marginalizing private sector competition." *Id.* at 30.

However, both Amazon and the Postal Service concur with the Commission's determination related to the risk of setting the appropriate share too low. Both commenters note that the risk is minimal because the Postal Service has strong incentives to maximize contribution and little incentive to significantly discount prices.[310] Similarly, Pitney Bowes contends that "there is virtually no risk of setting a minimum contribution requirement that is too low." Pitney Bowes Order No. 4402 Comments at 12.

c. Commission Analysis

Commenters largely agree with the Commission's assessment of the precise risks associated with setting the appropriate share. As it relates to the Postal Service's, PSA's, Amazon's, the Public Representative's, and Pitney Bowes' comments, the Commission acknowledges the risk of setting the appropriate share too high and continues to find that its formula-based approach limits increases in the appropriate share to no greater than necessary to account for the Postal Service's growth in market power or market position.

In addition, the Commission previously addressed UPS's concern regarding the risk of setting the appropriate share too low. The Commission stated, and multiple commenters agreed, that the risk of setting the appropriate share too low is minimal, given that little incentive exists for the Postal Service to set artificially low prices and sacrifice its profitability.[311] Furthermore, as noted above, there is no evidence to support the assertion that the Postal Service seeks to lower prices in the manner

[310] Amazon Order No. 4402 Comments at 5-6; Postal Service Order No. 4402 Comments at 8; *see* Order No. 4402 at 50-51.

[311] *See* Order No. 4402 at 50-51; Order No. 4742 at 56-57; *see* Amazon Order No. 4402 Comments at 5-6; Postal Service Order No. 4402 Comments at 8.

described by UPS, as the Postal Service has continuously increased prices above the rate of inflation. *See* section VIII.B.1.e, *supra*.

IX. COMMENTS SPECIFIC TO SECTION 703(d) AND COMMISSION ANALYSIS

As part of the PAEA, Congress sought to determine whether the Postal Service's competitive products enjoyed any legal advantages over private competitors offering similar products.[312] In section 703 of the PAEA, Congress directed the FTC to prepare a report identifying any federal or state laws that applied differently to the Postal Service's competitive products than to similar products offered by private competitors, make recommendations concerning how to end any such legal differences, and in the interim, to account for the net economic effect resulting from such differences.[313] Section 703 also directed the Commission, when "revising regulations under section 3633 of title 39," to "take into account the recommendations of the [FTC], and subsequent events that affect the continuing validity of the estimate of the net economic effect."[314]

A. Previous Commission Discussion

The Commission's proposal in Order No. 4402 was the first proposed revision to a regulation issued under 39 U.S.C. § 3633 since the PAEA's enactment and was therefore the first to trigger a section 703(d) analysis by the Commission. For the first time, the Commission addressed section 703 by discussing the FTC Report and its findings, describing the scope of a Commission review pursuant to section 703(d), and performing the required analysis.

In its discussion of the FTC Report, the Commission noted the FTC considered both the implicit subsidies enjoyed by and legal constraints imposed on the Postal Service's competitive products due to the Postal Service's unique legal status. Order

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[312] *See* PAEA, 120 Stat. 3244; *see also* S. Rep. No. 108-318 at 29.

[313] PAEA § 703(a). Section 703 was not codified. It is reproduced in the notes of 39 U.S.C.A. § 3633. *See* FTC Report.

[314] PAEA § 703(d).

No. 4402 at 55. The Commission acknowledged that although the FTC discussed multiple implicit subsidies and legal constraints,[315] it analyzed only those implicit subsidies and legal constraints that were quantifiable as part of its net economic effect determination.[316] The Commission explained that, based on the quantifiable implicit subsidies and legal constraints, the FTC concluded the Postal Service's unique legal status placed it at a net competitive disadvantage. *Id.* at 55, 58, 64.

As noted above, after its discussion of the FTC Report, the Commission provided its interpretation of the statutory language of section 703, including the scope of its review pursuant to section 703(d). In focusing on the key terms of the statute, the Commission considered the meaning of "take into account" and what occurrences might qualify as a "subsequent event" under section 703(d). *Id.* at 61-62. The Commission determined that the statute requires it to consider only those changes in federal or state law that the FTC included as part of its net economic effect finding. *Id.* at 62. Although the FTC discussed other federal or state laws that created implicit subsidies and legal constraints, the FTC estimated the value of only those implicit subsidies and legal constraints that could be quantified as part of its net economic effect finding. *Id.* at nn.89, 92. Therefore, in identifying any subsequent event that could alter that finding, the Commission concluded the event must relate to one of the quantifiable implicit subsidies or legal constraints that made up the FTC's net economic effect finding of a Postal Service net competitive disadvantage. *Id.* at 61-62.

The Commission identified one subsequent event occurring since the issuance of the FTC Report that had an effect on the FTC's finding. This event is the elimination by Congress of the Department of Transportation's authority to regulate prices paid by the Postal Service for air transport of international mail, which the FTC had included as a

[315] The full list of unquantified implicit subsidies and legal constraints can be found in Order No. 4402. *See id.* at 55 n.89; FTC Report at 29-45, 47-52, 64.

[316] Order No. 4402 at 55-58 nn.89, 92. The quantifiable implicit subsidies assessed by the FTC included the Postal Service's exemption from various types of taxes, fees, parking tickets, tolls and favorable borrowing authority. *Id.* at 55-56. The quantifiable legal constraints included costs associated with the Alaska Bypass, employment and labor law restrictions, pricing restrictions for Periodicals and non-profit mail, and restrictions associated with international mail transportation. *Id.* at 57-58.

quantifiable legal constraint in its net economic effect finding. *Id.* at 63-64. The Commission concluded that after removing this constraint, the overall legal constraints imposed on the Postal Service continued to outweigh the implicit subsidies enjoyed by the Postal Service. *Id.* at 65-68. For those reasons, the Commission concluded the FTC's finding of a Postal Service net economic disadvantage continued to be valid.[317]

In Order No. 4742, the Commission affirmed its findings in Order No. 4402 as it did not identify any additional subsequent events that would affect its section 703(d) analysis from Order No. 4402. Order No. 4742 at 58. As Order No. 4742 concentrated on the Commission's proposed modifications to its formula-based approach, the Commission noted it would address comments related to section 703(d) in a subsequent order. *Id.* at 58 n.69. Those comments are discussed below.

Many commenters either agree with the FTC's finding of a Postal Service net economic disadvantage or the Commission's conclusion that the FTC's determination continues to be valid.[318] Commenters taking issue with the Commission's approach to section 703(d) can be divided into three categories. Some commenters suggest that the FTC's original finding and the Commission's reliance upon that finding are erroneous. Others maintain that, as part of its section 703(d) analysis, the Commission must substitute its own or another estimate of the postal monopoly, despite the FTC's finding that the benefit was unquantifiable. Finally, some commenters argue other occurrences qualify as a "subsequent event" for the purposes of section 703(d). The

[317] *Id.* at 65. The Commission also provided supplemental analysis, updating both the high-end legal constraints and implicit subsidies values in order to align both figures with the FY 2017 competitive product revenue percentage. *Id.* at 65-67. The Commission likewise updated the total estimated range for both the legal constraints and implicit subsidies. *Id.* The Commission determined these updates supported its conclusion that the FTC's initial finding of a Postal Service net economic disadvantage remained valid. *Id.*

[318] *See, e.g.,* Amazon Order No. 4402 Comments at 16 (quoting Order No. 4402 at 55-68) ("…[d]evelopments since 2007 are fully consistent with the December 2007 finding of the Federal Trade Commission under [s]ection 703(d) of the PAEA that 'the Postal Service's unique legal status placed it at a net competitive disadvantage in offering competitive products relative to private competitors.'"); Postal Service Order No. 4402 Comments at 1 ("…the Postal Service operates at a net competitive disadvantage compared to its private-sector competitors."); Pitney Bowes Order No. 4402 Comments at 8 ("The Commission appropriately looks to the Federal Trade Commission's [] determination that the Postal Service operates with a net economic disadvantage in offering competitive products as valid and determinative.").

Commission discusses the comments that fall under each of these three categories and provides its related analysis in the remainder of this section.

B. Accuracy of the FTC Report Finding

1. Comments

UPS states that the FTC Report excluded the advantages from the postal monopoly even though the FTC recognized that the advantage existed.[319] UPS maintains that the Postal Service "holds a strong and unassailable advantage" due to the postal monopoly. *Id*. at 24; *see* section VIII.B.1.b, *supra*. It contends that the FTC's inability to quantify the Postal Service's monopoly advantages "nullifies the findings" and that the Commission's reliance on those findings is erroneous. UPS Order No. 4402 Comments at 23-25. UPS maintains that the Commission's continued reliance on the FTC Report as the "fundamental premise" for its finding of no evidence that the Postal Service has a competitive advantage "renders all conclusion flowing from that premise" as arbitrary and capricious. *Id.* at 25.

Similar to UPS, Sidak maintains that the Commission continues to "rely on the incomplete and outdated analysis" of the FTC Report and alleges that the proposed rulemaking is based on the "false foundation" that the Postal Service operates at a net economic disadvantage, notwithstanding the Postal Service's exploitation of the postal monopoly. Sidak Order No. 4402 Decl. at 6. Sidak contends the Commission failed to acknowledge the FTC's inability to quantify some Postal Service implicit subsidies and legal constraints and this failure was misleading because the Commission itself has previously quantified the value of the postal monopoly. *Id.* at 10.

[319] UPS Order No. 4402 Comments at 23. The postal monopoly is made up of both the Postal Service's exclusive right to carry and deliver certain types of mail (letter monopoly) and deposit mail into mailboxes (mailbox monopoly). *See* Postal Monopoly Report; *see also, e.g.,* FY 2017 Annual Report at 54; *see* section VIII.B.1.b, *supra*.

2. Commission Analysis

UPS and Sidak challenge the Commission's reliance on the FTC Report findings as part of its section 703(d) analysis. Both claim the FTC Report was incomplete because it did not quantify the cost advantages associated with the Postal Service's letter and mailbox monopoly (*i.e.,* postal monopoly).[320] Furthermore, both UPS and Sidak characterize the Commission's consideration of the FTC Report as the "fundamental premise" or "false foundation" for its findings that a Postal Service competitive advantage does not exist.[321] However, these characterizations are incorrect.

First, when determining the scope of a review pursuant to section 703(d), the Commission stated that section 703(d) requires the Commission to "consider[] whether the laws behind the implicit subsidies and legal constraints quantified by the FTC have changed since the FTC's Report's issuance, and if so, whether those changes affect the continuing validity of the FTC's estimate of the net economic effect of those laws." Order No. 4402 at 62. Thus, the Commission determined that the scope of section 703(d) in reviewing the FTC's net economic finding was limited. *See generally id.* at 54-68. Commenters initially questioned the accuracy of the FTC Report and its exclusion of the postal monopoly in response to Order No. 4402. *See id.* at 58-60. In that Order, the Commission found that a reassessment of the FTC's original conclusions was outside the scope of the Commission's review pursuant to section 703(d). *See id.* at 62-63. Commenters provide no basis for expanding the scope of a Commission review pursuant to section 703(d).

Consequently, the Commission reiterates that the FTC was unable to quantify and include in its assessment of net economic effect, the value of the postal monopoly as well as many other implicit subsidies and legal constraints. Among the implicit subsidies that the FTC was unable to estimate were the value of the postal monopoly, the value of access to federal funding and eminent domain, preferential customs

[320] UPS Order No. 4402 Comments at 23-25; Sidak Order No. 4402 Decl. at 6.

[321] *See* UPS Order No. 4402 Comments at 25; Sidak Order No. 4402 Decl. at 6.

treatment, and immunity from certain conduct under the Federal Tort Claims Act. *See id.* at 55 n.89. However, the FTC was also unable to quantify a number of legal constraints that the Postal Service faces. These legal constraints include pricing restrictions on competitive products, the costs associated with the Postal Service's USO, the limited ability of the Postal Service to close post offices, the inability to outsource delivery routes to private carriers, requirements related to retirees, and restraints on financing and investing. *See id.* Because the FTC was unable to quantify these implicit subsidies and legal constraints and did not include them in its assessment of net economic effect, the Commission does not include them in its consideration of "subsequent events that affect the continuing validity of the estimate of the net economic effect." PAEA § 703(d).

Second, any concern regarding the potential incompleteness of the FTC's finding due to its inability to quantify some implicit subsidies or legal constraints is mitigated by the fact that the Commission considers multiple factors, beyond those discussed in the FTC Report, when determining whether evidence of a Postal Service competitive advantage exists. As discussed above, along with taking into account its analysis in accordance with section 703(d), the Commission also looks at evidence of Postal Service predatory pricing by evaluating the Postal Service's pricing behavior since the PAEA's enactment. *See* section VIII.B.1.e, *supra.*

Third, nothing in the statute indicates the Commission may disregard the FTC Report in its entirety based on the information the FTC used in its analysis, thus the Commission's reliance on the FTC Report pursuant to section 703(d) is reasonable and necessary.

C. Use of Alternative Estimates of the Postal Monopoly Value and Other Advantages

1. Comments

UPS implies that the Commission should have used previous estimates of the cost advantages the Postal Service receives due to its postal monopoly as part of its competitive advantage analysis and claims that the Commission "fail[ed] to acknowledge its own estimates."[322] UPS states that both the Commission and Shapiro have previously estimated the benefits of the postal monopoly, and that because it is "perhaps the most important" Postal Service advantage, "any competitive analysis disregarding it is severely flawed." UPS Order No. 4402 Comments at 25 (emphasis omitted).

Sidak maintains the Commission should have considered its own valuation of the postal monopoly, as provided in the Annual Report to the President and Congress, or the third-party analysis of Shapiro, as provided in a white paper commissioned by UPS.[323] Additionally, Sidak argues the Commission should have considered the United States Postal Service Office of Inspector General's (OIG) estimate of how much the Postal Service saves by being able to deliver to mailboxes instead of customer doors, as competitors must do. Sidak Order No. 4402 Decl. at 14. He contends that, had the Commission attempted to account for these benefits as part of its section 703(d) analysis, it would have found the Postal Service operated at a net competitive advantage. *Id.*

Shapiro's comments[324] update the analysis from his previous study on "detailing and measuring the special [benefits] provided to the [Postal Service] to support its monopoly, public service operations."[325] As part of this update, Shapiro focuses on the quantifiable and unquantifiable implicit subsidies mentioned in the FTC Report. *See generally id.* at 7-18.

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[322] UPS Order No. 4402 Comments at 24-25; *see also* UPS Order No. 4742 Comments at 31.

[323] Sidak Order No. 4402 Decl. at 10-14; Sidak Order No. 4742 Decl. at 6-7.

[324] Because UPS and Sidak suggest the Commission use Shapiro's estimates of the value of the postal monopoly as part of its section 703(d) analysis, the Commission addresses the relevant portion of Shapiro's comments in this section.

[325] Shapiro Order No. 4402 Comments at 2. Shapiro's comments also update the analysis "detailing and measuring how the [Postal Service] leverages its subsidized monopoly operations to cross-subsidize its competitive business." *Id.* The Commission addresses those comments in section VIII.B.1, *supra.*

Shapiro notes that the costs associated with the USO[326] are "accompanied by certain monopoly privileges or rights that provide substantial [benefits]" for Postal Service operations. Shapiro Order No. 4402 Comments at 11. As it relates to those subsidies, Shapiro notes that he accepts the Commission's estimate of the letter monopoly, but he describes the Commission's valuation of the mailbox monopoly as "understated" and "unjustified." *Id.* at 2, 12-13. Shapiro attempts to estimate the value of the mailbox monopoly as the difference between "the cost of leaving mail in a mailbox," and the cost of delivering mail to a customer's door by utilizing data from multiple reports[327] and by applying his own methodology to the calculations. *Id.*

Shapiro also provides his own estimate of the implicit subsidy that the Postal Service receives from its borrowing authority, which allows it to borrow from the United States Department of the Treasury "at preferential [interest] rates." *Id.* at 11-12, 14-15.

Shapiro discusses the FTC estimates of other implicit subsidies the Postal Service receives by virtue of its status as a government entity and contends that the actual value of these implicit subsidies "is much greater" than the FTC estimated.[328] Shapiro specifically discusses the Postal Service's exemption from property taxes as an example of an implicit subsidy with a "much greater" value than the FTC's estimates. *Id.* at 17.

2. Commission Analysis

UPS and Sidak each suggest that the Commission should reassess the FTC's net economic effect estimate by including the value of the Postal Service's letter and mailbox monopoly estimated by either a third party (*e.g.,* Shapiro or the OIG) or the

[326] The Postal Service's USO requires the Postal Service to "…render postal service to all communities" and results in cost burdens on the Postal Service. FY 2017 Annual Report at 45; *see also* section VIII.B.1, *supra.*

[327] These are the reports developed by the OIG and the United States Government Accountability Office (GAO). *See id.* at 13.

[328] *Id.* at 16-17. These other implicit subsidies include various exemptions from taxes, fees, and other transportation related costs. *See id.* at 16.

Commission itself.[329] However, the Commission disagrees with those commenters' calls to recalculate the FTC's net economic effect finding, for both legal and economic reasons.

First, as noted above, the scope of a Commission review pursuant to section 703(d) is limited to considering "whether the laws behind the implicit subsidies and legal constraints quantified by the FTC have changed since the FTC Report's issuance, and if so, whether those changes affect the continuing validity of the FTC's estimate of the net economic effect of those laws." *See generally* Order No. 4402 at 54-68. The Commission previously addressed comments suggesting that the Commission attempt to recalculate the FTC's net economic effect finding based on valuations of the postal monopoly by the Commission or other parties. *See id.* at 62-63. The Commission continues to find that the recalculation requested by UPS and Sidak is outside the scope of what section 703(d) requires the Commission to do.

Second, attempting to recalculate the FTC's net economic effect finding would be inappropriate from an economic standpoint, for two reasons. First, it is not feasible for the Commission to attempt to estimate all unquantifiable implicit subsidies and legal constraints discussed by the FTC. Second, currently available alternative estimates discussed by commenters are inappropriate for use in this context.

In determining the net economic effect of federal and state laws on the Postal Service, the FTC completed a balanced analysis by considering both the implicit subsidies and the legal constraints that affect the Postal Service due to its unique government status. UPS and Sidak discuss only the implicit subsidies received by the Postal Service and focus on the value of the postal monopoly specifically. This approach is one-sided because it ignores a number of legal constraints. This creates misleading results and is inconsistent with the FTC's balanced approach. A balanced approach to recalculating the FTC's net economic finding would require the Commission

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[329] UPS Order No. 4402 Comments at 24-25; Sidak Order No. 4402 Decl. at 13-14. The Commission notes that the Postal Service identifies similar concerns to that of the Commission, when it describes "UPS-affiliated parties[']" "subsidy" figures as "inflated," "even leaving aside the patent flaws in their methodology." Postal Service Order No. 4742 Comments at 5 n.13.

to estimate all unquantifiable implicit subsidies and legal constraints the FTC discusses. However, such an attempt to re-estimate the net economic effect is not feasible because of a lack of available data and established methodologies, which would create a high risk of inaccurate and unreliable results.

These commenters also suggest that the Commission use available estimates of the postal monopoly, including the Commission's own estimates, and adjust the FTC's estimate of the net economic effect accordingly.

The use of the Commission's own estimates of the postal monopoly is inappropriate because it would not improve the accuracy of FTC's findings for a number of reasons. First, such an approach would be one-sided, because, as stated above, other implicit subsidies and legal constraints would still be omitted from any final estimate. Second, the Commission previously noted that the postal monopoly estimates "should be viewed as an upper bound on the value of the [postal] monopoly." *Id.* at 148. Although the Commission includes estimates of the postal monopoly's value in its Annual Report to the President and Congress, it does so to provide context for the legally required estimates of the Postal Service's USO costs. *See* 39 U.S.C. § 3651(b).

It is also important to note that the Commission does not specifically estimate the portion of the postal monopoly's value associated with competitive products, nor is there an established methodology that would allow the Commission to do so. Further, the methodology and assumptions underlying the Commission's estimates of the value of the postal monopoly are not identical to those underlying the analysis in the FTC's Report. These obstacles prevent the Commission from using its own estimates of postal monopoly and combining them with the FTC's other estimates.

The use of Shapiro's estimates of the postal monopoly values would also be inappropriate. In regards to his valuation of the letter monopoly, Shapiro states that he accepts the Commission's estimate of the value of the letter monopoly; however, the value he discusses is his own estimate, not one specifically determined by the Commission. *See* Shapiro Order No. 4402 Comments at 2. Furthermore, Shapiro's estimate of the value of the letter monopoly is incorrect. This is because in order to calculate his estimate of the value of the letter monopoly, Shapiro calculates the difference between the estimated values of the postal and mailbox monopolies reported by the Commission in its Annual Report to the President and Congress. *See id.* at 12 n.26. While the Commission does provide estimates of the value of the postal and mailbox monopolies, it notes that "subtracting the value of the mailbox monopoly from the value of the postal monopoly [would] not yield the value of the letter monopoly because there is an overlap in the contestable mail and a different frequency of delivery by the competitor." FY 2017 Annual Report at 54. The Commission also noted that it did not provide a "separate estimate of the value of letter monopoly alone" because "[w]ithout access to mailboxes, it is unlikely that the competitor could successfully capture mail directed to a specific person or address because those mail pieces are delivered to and collected from mailboxes." *Id*.

In addition, in discussing the postal monopoly and mailbox monopoly estimates for FY 2016, it appears that Shapiro assumes the Commission's monopoly values are static, and that the difference in the Commission's estimates for FY 2013 and FY 2016 are only due to an adjustment for inflation. Shapiro Order No. 4402 Comments at 2. However, that is incorrect. The Commission reports its annual estimates of the value of the postal and mailbox monopolies in current dollars that are not adjusted for inflation. Each year, the Commission revises the postal monopoly and mailbox monopoly values by relying on the methodology described in the Postal Monopoly Report. *See* Postal Monopoly Report at 112-118, 143-152. This methodology employs many assumptions related to delivery frequency and costs, as well as price discounts offered by the Postal Service. *Id.* Estimates of the postal monopoly and mailbox monopoly rely on the economic and financial data for that particular year, which affects the resulting annual values.

In regards to the mailbox monopoly, Shapiro defines it as "the difference in the cost of leaving mail in a mailbox, compared to delivering it to a customer's door." *See* Shapiro Order No. 4402 Comments at 13. However, his definition of the mailbox monopoly is incorrect. Shapiro appears to incorrectly assume that since the mailbox monopoly covers not only the market dominant classes of First-Class Mail and

Marketing Mail, but “all ‘mailable’ matter,” the Postal Service delivers all its mail products to customers’ mailboxes. *Id.* at 12. However, in practice, the exclusive right to deposit mailable matter in any mailbox does not mean the Postal Service actually deposits all mail items into the mailbox. As discussed in section VIII.B.1.c, *supra,* a large portion of Postal Service parcels and other competitive products are not delivered into a mailbox and are instead left at a residence’s front porch, front-door mail slot, or between doors, similar to deliveries by competitors. *See* section VIII.B.1.c, *supra.*

Shapiro’s approach to estimating the mailbox monopoly is also incorrect because he attempts to assess the value of the existence of the delivery box in a broad sense (including curbsides and centralized locations) instead of the value of the exclusive right to access it. However, there is nothing in the statute that prevents competitors from having customers accept delivery at designated (non-Postal Service) receptacles, rather than at the door.

Furthermore, in his calculations, Shapiro applies his own estimates of the additional costs of delivering mail to customers’ door compared to the costs of delivering mail to the mailbox. He primarily relies on the estimates of costs per-delivery-point-per-year and number of deliveries for three delivery modes (delivery to curbsides, delivery to centralized locations, and door-to-door delivery), which were provided in OIG and GAO reports.[330] Shapiro estimates the difference in costs per-delivery-point-per-year between door-to-door delivery and delivery by the two other modes. He then concludes that the resulting differences in costs represent additional costs per-delivery-point-per-year accrued in delivery to customers’ doors compared to delivery to either curbsides or centralized locations. Such a conclusion is incorrect for several reasons.

[330] *See* United States Postal Service, Office of Inspector General, Audit Report Number DR-AR-11-006, Modes of Delivery, July 7, 2011, at 9 (2011 OIG Report); United States Government Accountability Office, Report Number GAO-14-444, U.S. Postal Service Delivery Mode Conversions Could Yield Large Savings, but More Current Data Are Needed, May 2014, at 24-26 (GAO Report).

First, Shapiro makes incorrect assumptions. He appears to equate door-to-door delivery with “delivery to a customer’s door.” However, the OIG and the GAO define door-to-door delivery as “delivery to mail slots in the door or receptacles [such as ‘house-mounted mailbox’], mailboxes attached to the business near the door, or locations within office buildings.”[331] The 2011 OIG Report clearly distinguishes between door-to-door delivery and delivery to a customer’s door.[332] Furthermore, the GAO Report specifically analyzes how the number of delivery points by mode changed between FY 2008 and FY 2013. GAO Report at 6-7. Thus, the number of deliveries to customers’ doors that Shapiro uses in his calculations actually represent door-to-door deliveries (as defined by the OIG and the GAO). For these delivery points, curbside or centralized deliveries were unavailable. As a result, Shapiro’s definition of door-to-door delivery is inconsistent with the OIG’s and GAO’s definition. Additionally, Shapiro appears to incorrectly assume that a delivery point can have multiple modes of delivery. The 2011 OIG Report, however, makes it clear that each delivery point uses only one of the three modes of delivery, and that curbside and centralized delivery are, in fact, more cost-efficient than door-to-door delivery. 2011 OIG Report at 1-3, 9, 12, 19. That is why the number of door-to-door deliveries used by Shapiro is not a good proxy for the number of deliveries to customers’ doors.

Second, Shapiro’s conclusions are undermined by inaccurate updates of outdated information. The 2011 OIG Report upon which Shapiro relies uses delivery modes and cost estimates from a 1994 Postal Service study.[333] The estimates the OIG (and by extension Shapiro) use are merely the 1994 estimates of delivery mode costs adjusted by CPI-U.[334] Although such an adjustment is important, there have been other non-inflation-related changes in the economy since 1994 that could have also affected

[331] 2011 OIG Report at 1, 7; GAO Report at 3.

[332] The OIG states that “[i]n 1923, the Postal Service mandated that every household have a mailbox or mail slot to receive home delivery of mail” while previously carriers “often had to wait for a customer to answer the door.” 2011 OIG Report at 7.

[333] 2011 OIG Report at 9 n.5; GAO Report at 8 n.12.

[334] 2011 OIG Report at 9; GAO Report at 8-9.

delivery costs.[335] The GAO therefore concludes that it is unclear whether the estimates are generally understated or overstated. *Id.*

In addition, in his estimate of the value of the mailbox monopoly, Shapiro uses data from multiple sources (such as the GAO, the OIG, and the Postal Service) and for different years. Shapiro Order No. 4402 Comments at 13. However, he does not consider that different agencies apply their own methodologies when developing the estimates he uses for his analysis. These differences might be critical, and there is no indication Shapiro made any special adjustments to account for differences in the methodologies used. Also, because Shapiro relied on data for different years, he employed several assumptions in an attempt to make volume estimates consistent (*e.g.,* he used annual changes in mail volume as proxies for changes in number of deliveries), but still applied 2011 estimates of cost of delivery per-delivery-point-per-year provided by the OIG. *Id.* When employing assumptions, Shapiro does not provide any references or analyses to support them.

As to Shapiro's estimates of other implicit subsidies,[336] the Commission finds those estimates are misleading, as they ignore the burdens directly associated with such subsidies.[337] Further, in regard to borrowing authority, the Commission notes that the FTC Report contains the estimate of the Postal Service's borrowing advantage. FTC Report at 58. Shapiro does not provide any criticism of the FTC's estimate and instead performs his own estimate for 2017 based on his own subjective methodology. For the reasons discussed above, the Commission finds it appropriate to use the FTC's estimates.

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[335] As the GAO notes, factors related to postal wage rates, postal benefit costs, and gasoline prices could increase the Postal Service's delivery costs. GAO Report at 9. These increases, however, "may have been offset by gains in postal productivity, such as automated mail sorting by delivery sequence…." *Id.*

[336] These were the estimates for the Postal Service's borrowing authority, federal "tax arrangements," and property tax benefits. Shapiro Order No. 4402 Comments at 13-17.

[337] These would include the Postal Service's inability to borrow from the private sector, obligations to invest into the Postal Service Fund, and the USO.

Shapiro criticizes the implicit subsidies quantified by the FTC related to the Postal Service's exemption from various types of taxes, fees, parking tickets, and tolls. Shapiro Order No. 4402 Comments at 16-17. Shapiro mainly focuses on the FTC's valuation of the Postal Service's real estate and property tax exemptions. *See id.* at 17. Unlike the FTC's estimate that used historic book values to assess property tax exemptions,[338] Shapiro bases his estimates on the fair market value of the properties.[339] However, the FTC concluded, and the Commission agrees, that using fair market value to determine the value of propriety tax exemptions is inappropriate for the Postal Service for two main reasons. FTC Report at 58 n.271.

First, it is difficult to make "a true market value estimate of real estate taxes," because "[t]he Postal Service does not routinely assess the market value of the individual properties it owns."[340] The fair market value of the real estate holdings that Shapiro relies on are OIG estimates provided in an advisory report, which discussed how the Postal Service could leverage its financial obligations.[341] Specifically, the OIG suggested that by using the "fair market value of real property" as "an alternative to the annual prefunding payments" to the RHBF, the Postal Service would be able "to cover the remaining unfunded obligation." 2012 OIG Report at 1. By providing these estimates, the OIG did not challenge the Postal Service's accounting principles to any extent and acknowledged that "[t]he Postal Service does not maintain fair market or assessed tax value records for its properties." *Id.* at 6 n.19.

Second, the Commission notes that Shapiro ignores the fact, emphasized by the FTC, that the Postal Service's USO requires "far more facilities than would be expected

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[338] In its calculations, the FTC included the value of buildings, land, and leasehold equipment before depreciation as reported in the Postal Service' Statement of Operations. FTC Report at 58 n.271; *see* United States Postal Service, Annual Report, 2006, at 44, available at: *http://about.usps.com/who-we-are/financials/annual-reports/fy2006.pdf* (Postal Service 2006 Annual Report).

[339] Shapiro Order No. 4402 Comments at 17; *see* FTC Report at 58 n.271.

[340] *Id.* (quoting Postmaster General John Potter and citing Institute for Research on the Economics of Taxation, IRET Advisory, N.155, June 24, 2003, at 2).

[341] United States Postal Service, Office of Inspector General, Advisory Report Number FT-MA-12-002, Pension and Retiree Health Care Funding Levels, June 18, 2012 (2012 OIG Report).

for a competitive products operation." FTC Report at 58 n.271. As noted in the FTC Report, the costs and values of the facilities that "primarily…service the [USO]" should be "attributed directly to the market dominant products," and this would reduce "the market value of properties used to calculate the implicit subsidy had market values been known." *Id.*

While the FTC would reduce the market values had they been used, Shapiro updates the OIG estimates of the Postal Service's fair market value, provided in the 2012 report, by applying a 32.8-percent increase in the "the value of commercial real estate" from January 2013 to December 2017. Shapiro Order No. 4402 Comments at 17. An increase of this magnitude directly contradicts the Postal Service's data on this issue. According to the Postal Service, the book value of the Postal Service's real property as defined by FTC has not changed significantly between September 2012 and September 2017, increasing only by 2.8 percent.[342] Between the FTC Report's issuance in 2006 and 2017, the book value of the Postal Service's real property value has increased by 16.6 percent, which is less than rate of inflation during the same time period.[343]

In summary, the Commission maintains that the scope of its review pursuant to section 703(d) is limited to considering whether the laws behind the implicit subsidies and legal constraints quantified by the FTC in the net economic effect calculation have changed since the FTC Report's issuance. However, even when one considers the alternative estimates promoted by commenters, it is clear that such alternative estimates are flawed and inappropriate for use in this context from an economic standpoint.

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[342] *See* United States Postal Service, 2013 Report on Form 10-K, November 15, 2013, at 76, available at: *https://about.usps.com/who-we-are/financials/10k-reports/fy2013.pdf*; United States Postal Service, 2017 Report on Form 10-K, November 14, 2017, at 58, available at: *https://about.usps.com/who-we-are/financials/10k-reports/fy2017.pdf.*

[343] *See* United States Postal Service 2017 Report on Form 10-K at 58; Postal Service 2006 Annual Report at 44. To assess the CPI-U increase, the Commission used the CPI-U historic data provided by the Bureau of Labor Statistics at: *https://data.bls.gov/cpi/tables/historical-cpi-u-201709.pdf.*

D. Subsequent Events

1. Comments

UPS suggests that because the "competitive landscape has changed for the worse" and the Postal Service has "rapidly expanded" within the market, those changes should constitute a "subsequent event[]" for the purposes of section 703(d). UPS Order No. 4402 Comments at 25.

Sidak maintains that "the quantification of the value of the Postal Service's postal and letter-box monopolies…constitutes a 'subsequent event' affecting the validity of the FTC's conclusion" of a Postal Service net economic disadvantage compared to competitors. Sidak Order No. 4742 Decl. at 8.

In his comments, the Public Representative continues to state that the transfer of "most market dominant parcels" to the competitive product list means the Postal Service can compete more directly with competitors for those transferred products.[344] He maintains these transfers represent an "alteration of federal law" that result in a "further leveling of the parcel market playing field" and "change[s] the previous net effect of federal law treating the Postal Service differently than other companies."[345] The Public Representative disagrees with the Commission's conclusion that these product transfers do not fall within the definition of a "subsequent event" for the purposes of section 703(d). *Id.* at 12 n.18; Order No. 4402 at 66.

2. Commission Analysis

As it relates to the "subsequent events" identified by commenters, the Commission finds the events that UPS, Sidak, and the Public Representative describe as "subsequent events" fall outside the Commission's interpretation of a "subsequent event." In Order No. 4402, the Commission found a change to a subsequent event was

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[344] *See* PR Order No. 4402 Comments at 12; *see also* PR Order No. 3624 Comments at 12-13.

[345] PR Order No. 4402 Comments at 12. The Public Representative uses this contention as support of his position that the appropriate share should be maintained and not increased. *Id.*

a change to the law underlying the implicit subsidies or legal constraints quantified by the FTC. Order No. 4402 at 62. UPS, Sidak, and the Public Representative provide no statutory basis for their stance that a subsequent event under section 703(d) should be viewed more broadly. Furthermore, consideration of the Postal Service’s growth in the market (as suggested by UPS), the postal monopoly (as suggested by Sidak), and product transfers (as suggested by the Public Representative) are considered in the Commission’s analysis pursuant to section 3633(b). *See* section VIII.B and section VIII.D, *supra.*

The comments received in response to Order Nos. 4402 and 4742 have not identified any subsequent events pursuant to the Commission’s interpretation of section 703(d). The Commission has also not identified any subsequent events that would affect its section 703(d) analysis in Order Nos. 4402 and 4742. As such, the Commission affirms its findings in Order Nos. 4402 and 4742 that the FTC’s conclusion regarding the Postal Service’s operation at a net economic disadvantage continues to be valid.

X. REGULATORY FLEXIBILITY ACT ANALYSIS

The Regulatory Flexibility Act requires federal agencies, in promulgating rules, to consider the impact of those rules on small entities. *See* 5 U.S.C. § 601, *et seq.* (1980). If the proposed or final rules will not, if promulgated, have a significant economic impact on a substantial number of small entities, the head of the agency may certify that the initial and final regulatory flexibility analysis requirements of 5 U.S.C. §§ 603 and 604 do not apply. *See* 5 U.S.C. § 605(b). In the context of this rulemaking, the Commission’s primary responsibility is in the regulatory oversight of the United States Postal Service. The rules that are the subject of this rulemaking have a regulatory impact on the Postal Service, but do not impose any regulatory obligation upon any other entity. Based on these findings, the Chairman of the Commission certifies that the rules that are the subject of this rulemaking will not have a significant economic impact on a substantial number of small entities. Therefore, pursuant to 5 U.S.C. § 605(b), this rulemaking is exempt from the initial and final regulatory flexibility analysis requirements of 5 U.S.C. §§ 603 and 604.

XI. ORDERING PARAGRAPHS

It is ordered:

1. Part 3015 of title 39, Code of Federal Regulations, is amended as set forth below the signature of this Order effective 30 days after the date of publication of the amended rules in the *Federal Register*.

2. The Secretary shall arrange for publication of the amended rules and general statement as to the basis and purpose of the amended rules in the *Federal Register*.

By the Commission.

Stacy L. Ruble
Secretary

List of Subjects for 39 CFR Part 3015

Administrative practice and procedure.

For the reasons stated in the preamble, the Commission amends chapter III of title 39 of the Code of Federal Regulations as follows:

PART 3015—REGULATION OF RATES FOR COMPETITIVE PRODUCTS

1. The authority citation for part 3015 continues to read as follows:

Authority: 39 U.S.C. 503; 3633.

2. Amend § 3015.7 by revising paragraph (c) to read as follows:

§ 3015.7 Standards for Compliance.

* * * * *

(c)(1) Annually, on a fiscal year basis, the appropriate share of institutional costs to be recovered from competitive products collectively, at a minimum, will be calculated using the following formula:

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

Where,

AS = Appropriate Share, expressed as a percentage and rounded to one decimal place

CCM = Competitive Contribution Margin

CGD = Competitive Growth Differential

t = Fiscal Year

If t = 0 = FY 2007, AS = 5.5 percent

(2) The Commission shall, as part of each Annual Compliance Determination, calculate and report competitive products’ appropriate share for the upcoming fiscal year using the formula set forth in paragraph (c)(1) of this section.

APPENDIX A

COMMENTS AND RELATED FILINGS

Commenter	Citation	Citation Short Form
Amazon.com Services, Inc. (Amazon)	Comments of Amazon.com Services, Inc. on Order No. 4402, April 16, 2018	Amazon Order No. 4402 Comments
Amazon	Comments of Amazon.com Services, Inc. on Order No. 4742, September 12, 2018	Amazon Order No. 4742 Comments
American Consumer Institute Center for Citizen Research (ACI)	Comments of American Consumer Institute Center for Citizen Research, April 16, 2018	ACI Order No. 4402 Comments
ACI	Comments of American Consumer Institute Center for Citizen Research, September 12, 2018	ACI Order No. 4742 Comments
Parcel Shippers Association (PSA)	Comments of the Parcel Shippers Association, April 16, 2018	PSA Order No. 4402 Comments
Pitney Bowes Inc. (Pitney Bowes)	Comments of Pitney Bowes Inc., April 16, 2018	Pitney Bowes Order No. 4402 Comments
Pitney Bowes	Comments of Pitney Bowes Inc. on Order No. 4742, September 12, 2018	Pitney Bowes Order No. 4742 Comments
Public Representative	Public Representative Comments in Response to Notice of Proposed Rulemaking, April 16, 2018	PR Order No. 4402 Comments
Public Representative	Public Representative Comments in Response to Revised Notice of Proposed Rulemaking, September 12, 2018	PR Order No. 4742 Comments
Soiliou Daw Namoro for the Public Representative (Namoro)	Declaration of Soiliou Daw Namoro for the Public Representative, April 16, 2018	Namoro Order No. 4402 Decl.
Namoro	Additional Declaration of Soilou Daw Namoro for the Public Representative, September 12, 2018	Namoro Order No. 4742 Decl.

Commenter	Citation	Citation Short Form
Robert J. Shapiro	Declaration of Robert J. Shapiro, April 16, 2018	Shapiro Order No. 4402 Comments
United Parcel Service, Inc. (UPS)	Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, April 16, 2018	UPS Order No. 4402 Comments
UPS	Comments of the United Parcel Service, Inc. on Revised Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, September 12, 2018[1]	UPS Order No. 4742 Comments
UPS	Motion of United Parcel Service, Inc. to Supplement the Record in Light of the Postal Task Force Report Issued Under Executive Order 13829, December 17, 2018[2]	Motion to Supplement the Record
J. Gregory Sidak for UPS (Sidak)	Declaration of J. Gregory Sidak on Behalf of United Parcel Service, April 16, 2018	Sidak Order No. 4402 Decl.
Sidak	Declaration of J. Gregory Sidak on Behalf of United Parcel Service, September 12, 2018	Sidak Order No. 4742 Decl.
United States Postal Service (Postal Service)	Comments of the United States Postal Service in Response to Order No. 4402, April 16, 2018	Postal Service Order No. 4402 Comments
Postal Service	Comments of the United States Postal Service in Response to Order No. 4742, September 12, 2018	Postal Service Order No. 4742 Comments

[1] In conjunction with its comments, UPS filed one public library reference. *See* Notice of United Parcel Service, Inc. of Filing of Public Library Reference UPS-RM2017-1/2, September 12, 2018.

[2] The Postal Service and PSA *et al.* filed oppositions to UPS's Motion to Supplement the Record. *See generally* Response of the United States Postal Service to United Parcel Service, Inc.'s Motion to Supplement Record, December 26, 2018 (Postal Service Answer to Motion); Answer to United Parcel Service. Inc's Motion of Parcel Shippers Association, Alliance of Nonprofit Mailers, American Catalog Mailers Association, Continuity Shippers Association, Envelope Manufacturers Association, National Association of Presort Mailers, PSI Systems, and Stamps.com ("PSA et. al."), December 26, 2018 (PSA *et al.* Answer to Motion). The Motion to Supplement the Record was denied. *See* n.8, *supra.*