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STATUTORY REVIEW OF THE SYSTEM FOR REGULATING RATES AND CLASSES FOR MARKET-DOMINANT PRODUCTS

Docket No. RM2017-3

INITIAL COMMENTS OF THE UNITED STATES POSTAL SERVICE IN RESPONSE TO ORDER NO. 5337

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I. INTRODUCTION

The Postal Service continues to agree with the Postal Regulatory Commission ("Commission") that the current ratemaking system has failed to achieve critical objectives of 39 U.S.C. § 3622, including, in particular, objective 5 ("adequate revenues, including retained earnings, to maintain financial stability") and objective 8 ("just and reasonable rates," i.e., rates that are compensatory but not excessive). The Postal Service also agrees with the Commission's goal in this proceeding of designing a system that corrects those failures in a manner that will "provide the Postal Service with the ability to meet the objectives." Order No. 5337, Revised Notice of Proposed Rulemaking, PRC Docket No. RM2017-3 (Dec. 5, 2019), at 10.

Several aspects of the Commission's revised proposal are significant improvements on the initial proposal in Order No. 4258. As the Commission understands, one of the principal inadequacies of the current price-cap system is its inflexibility, which leaves the system incapable of dealing with significant changes in circumstances. The Commission's proposal to allow future adjustments to the CPI-based price cap in response to declines in mail density helps to avoid perpetuating this shortcoming. In addition, the Commission's revised approach to the productivity aspect of its proposed performance-based rate authority should make such rate authority more realistically achievable in some years. And the Commission has improved its proposed rate authority for non-compensatory classes by making such authority optional rather than mandatory.

While these revisions are positive steps, the Commission's new proposal unfortunately still falls far short of remedying the effects of the legacy ratemaking system and of giving the Postal Service a realistic opportunity to maintain financial

stability. Achieving that goal will require the Commission to further revise its proposals for both supplemental and performance-based rate authority, as discussed respectively in sections II and III below.

The Commission states that its revised notice focuses principally on improving "the mechanism for the supplemental rate authority," Order No. 5337 at 11, and Section II discusses the Commission's new approach. As articulated in response to the Commission's initial proposal, we reiterate that a price-cap ratemaking system can achieve the Commission's articulated goal of medium-term stability only if the system has two essential elements: (1) a baseline set of compensatory rates; and (2) adjustment mechanisms that prevent such rates from becoming non-compensatory in the future due to factors outside of the Postal Service's control. The Commission's revised proposal does go some distance toward addressing the second element, but it appears to abandon its effort to satisfy the first.

To be sure, the absence of adjustment mechanisms was a major reason why the legacy price cap produced enormous annual net losses and decimated the Postal Service's financial health. Adding such mechanisms now is essential to avoiding a repeat of the current system's failures. But those mechanisms alone will not give the Postal Service a reasonable opportunity to cover its total costs (and foster what the Commission defines as medium-term financial stability). To achieve that goal, the Postal Service also needs the authority to recalibrate its prices to compensatory levels, given the large net losses that the Postal Service is currently incurring. Yet the Commission – in an unexplained departure from Order No. 4258 – does not propose to provide the rate authority needed for such a reset. The Commission's proposal to

authorize pricing authority to cover certain amortization payments is not a substitute for the necessary rate reset, and Section II discusses additional problems with the proposed retirement rate authority that the Commission must address. Section II also discusses an unjustified weakness with the Commission's proposed mechanism to account for mail density declines.

Section III concerns the Commission's proposal for performance-based rate authority, which is intended to produce retained earnings for needed capital expenditures and thereby allow the Postal Service to reenter what the Commission characterizes as the "financial-health cycle." As noted above, the Commission should be commended for making the productivity aspect of such authority more realistically achievable in some years. But that improvement is undermined by the Commission's new proposal to tie both aspects of the performance-based rate authority together, effectively conditioning all such authority on keeping service standards unchanged. Moreover, as the Commission continues to view such rate authority as a necessary first step toward long-term financial stability, it must be guaranteed for at least some time, in light of lags in the relevant data needed to reasonably determine whether the Postal Service has used such authority in an efficiency-enhancing manner. The most straightforward approach would be to make the rate authority unconditional until the next system review, which could include a review of whether the rate authority has achieved its aims. Otherwise, for a conditional mechanism to be activated sooner, the Commission would need to conduct separate proceedings to determine an appropriate activation point and to resolve several other issues with the proposal in Order No. 5337.

Although it is clear that considerably more pricing authority would be required for the Commission's proposals to meet its stated goals and achieve the statutory objectives, it must again be emphasized that market pressures and other business considerations may place considerable limits on the extent to which the Postal Service could actually use such pricing authority. But the purpose of these proceedings is for the Commission to fulfill its role as the regulator and to carry out Congress's directive to design a system that meets the statutory objectives, including ensuring that rates can be compensatory and allow for the achievement and maintenance of financial stability. It is a separate question whether (and the extent to which) such authority would actually be exercised in practice, given the prevailing market conditions. The statute has assigned that question to the Postal Service's Governors, and it therefore must be beyond the scope of these proceedings.

The remainder of these comments discusses other aspects of the Commission's revised notice. Section IV renews an argument from the Postal Service's 2018 comments that Order No. 5337 does not address: that prices set by the Universal Postal Union, rather than by the Postal Service, should be excluded from both the price cap and the Commission's proposed rate-rebalancing rules for underwater products. Section V argues that the Commission's revised rules for workshare discounts are too rigid as drafted, and certain changes to the waiver provisions and the procedural schedule are necessary to avoid undermining price predictability and stability or otherwise producing arbitrary results. Section VI asks the Commission to resolve several issues concerning the timing of any new rate authority's availability and to make certain adjustments in the procedural schedule for rate filings. Section VII notes that the

proposed reporting requirements for investment decisions and cost-reduction efforts should be reconsidered or narrowed; as proposed, such requirements do not serve a clear regulatory purpose and present a significant risk of commercial harm to the Postal Service. Section VIII requests clarification on three interpretive points.

Finally, while Order No. 5337 addresses some of the shortcomings of Order No. 4258 and lays out the reasoning behind many of the Commission's revised proposals, Section IX points out several persistent issues from the Postal Service's 2018 comments that the Commission has failed to address. In particular, the Commission has not explained why new forms of rate authority may not be banked for future use, whether legacy mail classes can be modernized, and why it has proposed to maintain a price-cap system rather than adopt an alternative form of rate regulation to achieve the statutory objectives. Settled principles of administrative law require the Commission to consider these arguments (and other subjects raised elsewhere in these comments) and discuss them in its final rule.

II. THE PROPOSED SUPPLEMENTAL RATE AUTHORITY, WHILE ADDRESSING SOME OF THE FLAWS OF THE CURRENT SYSTEM, DOES NOT ACHIEVE THE GOAL OF "MEDIUM-TERM" FINANCIAL STABILITY

Order No. 5337 may have recast its proposed solution, but it does not disavow that the problem to be solved is the current ratemaking regime's failure to satisfy Objectives 5 and 8. Nor does the Commission repudiate its fundamental interpretation of what Objectives 5 and 8 require: to place the Postal Service on the path toward medium-term stability or, in other words, to give the Postal Service a reasonable opportunity to cover its total costs. Order No. 5337 at 13, 59; *accord* Order No. 4258, Notice of Proposed Rulemaking for the System for Regulating Rates and Classes for Market Dominant Products, PRC Docket No. RM2017-3 (Dec. 1, 2017), at 40-42; Order

No. 4257, Order on the Findings and Determination of the 39 U.S.C. § 3622 Review, PRC Docket No. RM2017-3 (Dec. 1, 2017), at 146-48, 165-71, 228-36. Indeed, citing a desire to "strengthen and improve" its initial proposals announced in Order No. 4258, Order No. 5337 at 11, the Commission suggests that its new proposals go "beyond the . . . goal of placing the Postal Service on the path to medium-term financial stability" by allowing "the system to adjust appropriately to changes in the operating environment that are driving the Postal Service's net losses." *Id.* at 13.

In one key respect, the Commission's new proposal is a significant improvement: the Commission would now provide mechanisms that will allow future rate authority to adjust in response to certain exogenous trends. Those mechanisms go some distance toward preventing the Postal Service's annual net losses from dramatically growing over time due to future declines in economies of density. They also offer some temporary and partial protection from net-loss growth arising from increases in amortization payments concerning future pension or health-benefits obligations.

However, those mechanisms will bring the Postal Service only fractionally closer to covering its net losses: the very goal that the Commission has articulated throughout this proceeding as necessary to achieving Objectives 5 and 8. And in one sense, the Commission's new proposal has taken a major step backward from that goal. Unlike its initial proposal, which would have authorized a phased-in rate reset based on the total net loss that the Postal Service suffered in FY2017, the Commission's new proposal contains no comparable rate reset. As we explained in our 2018 Comments and as we repeat below, authority for a complete rate reset is a necessary step toward the Commission's articulated goal of achieving medium-term stability.

In addition, we propose amendments to the two adjustment factors proposed by the Commission. First, the Commission's proposal concerning amortization payments is conceptually flawed and is in need of technical corrections. Second, the Commission's two-pronged approach to the density rate authority is unwarranted and should be replaced with a single formula.

A. Neither Density Rate Authority Nor Retirement Rate Authority Is a Substitute for a Meaningful Recalibration of Rates

As explained in our earlier comments, price-cap systems have two basic elements: a going-in "baseline" rate level, and a going-forward formula (typically consisting of a measure of inflation and adjustments to account for things such as expected unit-cost changes) that governs how much that baseline level can change over time. *See* Initial Comments of the United States Postal Service in Response to Order No. 4258, PRC Docket No. RM2017-3 (Mar. 1, 2018) [hereinafter "USPS 2018 Initial Comments"], at 49-50. A price-cap system will provide a regulated entity with a reasonable opportunity to cover its total costs if: (1) the baseline rate level is compensatory; and (2) the going-forward formula contains mechanisms that allow rates to adjust to exogenous factors, so that the rates do not fall to a non-compensatory level for reasons apart from the firm's performance. Nothing in Order No. 5337 suggests that the Commission disagrees with these basic principles.

Nor does the Commission disagree that the fundamental problem with the legacy price-cap regime is its inflexibility. *See* Order No. 5337 at 13 (noting that the "original system's inability to adapt and respond to" changes in the Postal Service's operating environment was a "major contributor to the Postal Service's inability to meet the objectives of the PAEA"); *id.* at 62 (a functioning system must "adequately respond to

ongoing changes that drive the Postal Service's inability to achieve net income"); *accord* USPS 2018 Initial Comments at 52. While the going-in rate level at the time of the PAEA's passage was generally compensatory, its going-forward formula allowed rates to adjust only for changes in inflation, and therefore did not enable prices to adjust in response to significant, exogenous headwinds beyond inflation-based cost growth. As a direct result of the system's inflexibility, and because the Great Recession began soon after it became law, the Postal Service suffered large net losses in every year of the current system.

Order No. 4258 took the necessary first step toward solving this problem by proposing to reset rates (on a phased-in schedule) to generate $2.7 billion in additional annual revenues, an amount equal to the Postal Service's (then-)most recent annual net loss. However, as our 2018 comments pointed out, that proposal was inadequate in two respects. First, while it was aimed at resetting the rate baseline to a compensatory level, the revenue target that the Commission chose – the unadjusted $2.7 billion net loss that the Postal Service suffered in FY2017 – was an unrepresentatively low figure. Accordingly, adjusting rates to recover $2.7 billion in annual net losses would not give the Postal Service a reasonable opportunity to cover its expected costs. Second, the Commission did not further propose (or even consider) altering the "going-forward" formula to respond to future exogenous volume and cost trends; without such adjustments, even a more adequate rate recalibration would not be sustainable over time. *See* USPS 2018 Initial Comments at 48-80; *see also* Declaration of John Kwoka and Robert Wilson [for the Public Representative], PRC Docket No. RM2017-3 (Mar. 1, 2018) [hereinafter "Kwoka/Wilson Declaration"] at 11-12 (concluding that the Order No.

4258 proposal "does not correctly reflect either [the Postal Service's] longer-term average loss or its likely future revenue shortfalls"). Accordingly, under the Commission's initial proposal, the Postal Service both would be left underwater and would continue to sink, leading to certain failure to achieve the stated goal of medium-term stability during the course of the new regulatory period.

To the Commission's credit, Order No. 5337 acknowledges that its initial proposal was deficient and should be "strengthen[ed] and improve[d]" so that it can satisfy the goal of giving the Postal Service an opportunity to cover its total costs. Order No. 5337 at 11. And in a significant respect, the Commission's new proposal is an improvement: unlike its initial proposal, the new proposal would allow rate authority to adjust on a going-forward basis to account for ongoing exogenous cost drivers that continue to destabilize the Postal Service's financial position. As we explained in our 2018 comments, and as the experience with the PAEA-mandated price cap showed, such adjustment factors are necessary for the new ratemaking system to have any chance at allowing the Postal Service the opportunity to maintain medium-term stability. The Commission's recognition of the need for adjustment factors goes a long way toward addressing the second concern we raised with the Commission's earlier proposal. *See* USPS 2018 Initial Comments at 53, 69-77.

At the same time, however, the Commission's new proposal essentially skips the necessary first step of any new system: to allow rates to be reset at compensatory levels. *See* USPS 2018 Initial Comments at 52-53, 56-69; *see also* Kwoka/Wilson Declaration at 8 fn.5, 9 (discussing the general practice in price-cap systems of resetting rates to average costs every four or five years "before those deviations

escalate and jeopardize the plan itself"); Public Representative Comments, PRC Docket No. PI2016-3 (June 15, 2016), at 42-43 (discussing academic literature about the "need to provide periodic revenue reset adjustments" because "a price cap must operate with a breakeven constraint"). Providing mechanisms that allow rate authority to adjust in response to future exogenous unit-cost growth should help protect the Postal Service's year-over-year net losses from growing appreciably, but they do not (and are not designed to) reduce – let alone eliminate – the baseline net loss going into the new period. General principles of "just and reasonable" price-cap regulation and the goal of medium-term stability require that the Postal Service have the authority to recalibrate rates to cover current costs.

Nothing in Order No. 5337 explains the apparent abandonment of the Commission's earlier attempt to reset rates to a compensatory level. The Commission insists that its goal, pursuant to Objective 5, is still to provide "medium-term financial stability," i.e., coverage of total costs, and it does not contradict its earlier interpretation of Objective 8 as requiring compensatory rates. Authorizing rates that actually cover the Postal Service's costs would be the obvious way to ensure that the modified ratemaking system is "designed to achieve" those objectives. 39 U.S.C. § 3622(b). Order No. 5337 further states that the Commission seeks not only to address the root cause of the original system's failure, but to remedy the effects of that failure. Order No. 5337 at 11 (stating that the Commission's proposal achieves the statutory objectives by "remedying the deficiencies of the ratemaking system and addressing the underlying causes of the failure to achieve the objectives"); *id.* at 79-80 (illustrating how much density rate authority would have been available over the past seven years had it

then been authorized, and thereby implicitly acknowledging that the past absence of such authority was a cause of the Postal Service's ongoing net losses).

By allowing future rates to adjust to certain future exogenous events and trends, the proposed adjustment factors aim at avoiding a repeat of the PAEA's failure, but they do not remedy the current financial instability and unreasonable rates that result from the absence of such adjustment factors in the legacy system. Objectives 5 and 8 do not charge the Commission merely to hold the line at current levels of financial instability and unreasonableness in rates; they require positive "achieve[ment]" of stability and reasonableness. A rate reset is needed for that purpose. *See* Kwoka/Wilson Declaration at 7 ("[P]rice cap plans need to adjust the level of price to reflect changes in the economic factors that cause underlying costs to change. Ideally, prices for any particular product should be set at the level of the average total cost, which is equal to the Postal Service's total cost [i.e., the sum of attributable and institutional cost] divided by the number of relevant mail pieces.").

To be sure, the Commission's previous effort to reset rates was insufficient because of its choice of an unrepresentative and therefore arbitrary baseline. Order No. 5337 appears to concede that the $2.7 billion figure used in Order No. 4258 was an inappropriate reference point, *see* Order No. 5337 at 60-62, but misstates the reason why. The figure was not arbitrary because it failed to account for "ongoing changes that drive the Postal Service's inability to achieve net income," Order No. 5337 at 62; that failure is the motivation for adjustment factors, but not for a rate reset. Rather, the $2.7 billion figure was arbitrary because, as explained at length in our 2018 comments and in other parties' comments, it was an artificially low and unrepresentative baseline against

which to recalibrate the Postal Service's rates as of the beginning of the new regulatory regime.[1] As we explained, the $2.7 billion figure could not be defended either as a snapshot of the Postal Service's then-current financial performance or as a reasoned expectation of the annual net losses that the Postal Service would be expected to suffer going forward (even assuming that adjustment factors offset further growth in the net losses). *See* USPS 2018 Initial Comments at 56-64.

The cure for such arbitrariness is a more appropriate baseline, not abandonment of the rate-recalibration effort. We explained why $6.0 billion was a reasoned baseline for a rate reset: it represents the median annual net loss (excluding the effects of the exigent surcharge and certain non-cash accounting adjustments) that the Postal Service had suffered since the Postal Service's cost reduction efforts in the wake of the Great Recession began to bear fruit. *See* USPS 2018 Initial Comments at 60-64. Order No. 5337 does not address (let alone dispute) the recommended $6.0 billion figure, and it is worth noting that the Postal Service's financial performance over the two years since the comments were filed strongly supports the soundness of that figure. Over the past two years, the Postal Service has reported net losses of $3.9 billion (FY2018) and $8.8 billion (FY2019), for a two-year average of $6.35 billion.[2] But when non-cash adjustments for workers' compensation are excluded, as we argued they should be, *see*

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[1] *See* Reply Comments of the United States Postal Service in Response to Order No. 4258, PRC Docket No. RM2017-3 (Mar. 1, 2018) [hereinafter "USPS 2018 Reply Comments"], at 41-43; USPS 2018 Initial Comments at 56-69; Initial Comments of the Public Representative, PRC Docket No. RM2017-3 (as refiled Mar. 7, 2018), at 19; Comments of the American Postal Workers Union, AFL-CIO on the Notice of Proposed Rulemaking for the System for Regulating Rates and Classes for Market-Dominant Products, PRC Docket No. RM2017-3 (Mar. 1, 2018), at 7-8; Comment of the National Association of Letter Carriers, AFL-CIO, PRC Docket No. RM2017-3 (Mar. 1, 2018), at 11-14; Comments of the National Postal Mail Handlers Union, PRC Docket No. RM2017-3 (Mar. 1, 2018), at 3-4.

[2] *See* U.S. Postal Serv., FY2019 Form 10-K (2019), at 15, 18.

USPS 2018 Initial Comments at 58-60, those adjusted net-loss figures are $5.3 billion (FY2018) and $6.7 billion (FY2019), for a two-year average of $6.0 billion. That figure is precisely in line with the average net losses the Postal Service suffered since FY2013, the year in which the Commission concluded that the Postal Service's cost-reduction efforts in the wake of the Great Recession began showing meaningful results. *See* USPS 2018 Initial Comments at 60-61 & n. 158. Accordingly, whether viewed as a short-term snapshot or a longer-term average, $6.0 billion is an eminently reasonable estimate of the level of annual net loss with which the Postal Service has been saddled due to the deficiencies of the original PAEA price cap, and therefore represents a reasonable "going-in" adjustment for purposes of resetting the market-dominant rate baseline.

But while the Commission's proposed $2.7 billion baseline figure missed the mark, it was aiming at the correct target; it was seeking to authorize rates that would enable the Postal Service to cover its total costs. As we explained, this is not the <u>only</u> component that a revised price-cap system must have in order to make medium-term stability possible; Order No. 5337 recognizes that the revised system must also allow rate authority to adjust for exogenous factors going forward. But it is nevertheless a <u>necessary</u> component. The fact that the Commission's original proposal missed the rate-recalibration target does not justify scuttling the effort altogether.

Order No. 5337 appears to suggest that, rather than treating the effect of the PAEA system's failure (large net losses), it should focus instead on treating the root cause of such failure (the system's inflexibility). Order No. 5337 at 63 (the Commission ""recognizes" that "targeting underlying causes of ongoing financial losses is

warranted"); *id.* at 71 (the new proposed rules "address th[e] shortcoming of the existing system"); *accord id.* at 12, 62. To meet the Commission's "medium-term stability" goal, however, the Commission must do both. Solely allowing rates to adjust in the future in response to recurring or ongoing declines in density (or increases in benefits costs) might have been sufficient if such a mechanism had been in place from the beginning of the PAEA era. But the Postal Service has now operated for 13 years under a regime that lacks such a mechanism (among others), resulting in non-compensatory rates. Those non-compensatory rates will merely be perpetuated, not corrected, if such a mechanism is now added on a prospective basis only, without meaningfully addressing the harms that were wrought by the lack of such a mechanism up to now.[3]

Finally, the need for a rate recalibration is not satisfied by the Commission's proposal to allow the Postal Service to recover a portion of its congressionally mandated amortization payments for pension and retiree health benefits (RHB) obligations. In addition to the many problems with Order No. 5337's retirement rate authority proposal discussed in the next section, the proposal does not come close to allowing the Postal Service to cover its existing annual net losses.[4] Indeed, the

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[3] By way of illustration, consider a scenario where the only house in a neighborhood without a sump pump is also the only house in the neighborhood that sustains flood damage during a heavy rain, which, in turn, leads to mold growth and a cracked foundation that render the house uninhabitable. It would be reasonable to infer that the root cause of the damage was the absence of a sump pump. Installing a sump pump would be a seemingly necessary step to prevent a recurrence of the flood damage during future storms. But a sump pump would do nothing to restore the house to a habitable condition. The damage that the last storm caused would still need to be repaired.

[4] To be sure, the Kwoka/Wilson Declaration proposed that funding for retirement obligations be assured through a dedicated "Z factor" separate from the rest of the rate base. Kwoka/Wilson Declaration at 12-13. But that proposal came in the context of a broader proposition that rates should be reset "to recover both operating costs and these exogenous costs." *Id.* at 13; *see also id.* at 8. While a Z factor might make sense in the face of a new exogenous cost, the retirement benefits obligations at issue here are already incorporated into the Postal Service's cost structure. Hence, the most straightforward approach to covering "both operating costs and these exogenous costs" would be simply to allow for recovery of the

proposal does not even purport to allow the Postal Service to cover the entirety of the amortization costs, let alone total costs or even all exogenous retirement benefits costs. As such, this proposal will not allow the Postal Service to achieve medium-term stability or compensatory rates. Achieving that goal will require both a recalibration of rates to compensatory levels and adjustment factors that prevent history from repeating itself.[5]

B. The Proposed Retirement Rate Authority Is Unreasonably Restrictive and Would Leave the Postal Service Worse Off

As discussed in our 2018 comments and as repeated above, the approach most consistent with the statutory objectives (particularly the Commission's interpretation of objective 5 as requiring "medium-term financial stability") and best practices of price-cap regulation would be to authorize a reset of the Postal Service's revenue base to a compensatory level going into the new period and to provide mechanisms for subsequent rate adjustments that would counteract exogenous cost pressures. Doing so would ensure that the price cap's incentives focus on the efficiency gains that the Postal Service can reasonably achieve, and that the regulatory system avoids producing non-compensatory – and thus unreasonable – rates for reasons apart from the Postal Service's performance. To that effect, the Postal Service had proposed two adjustment mechanisms in addition to the rate reset discussed above. The first

baseline net loss, and then to allow rate authority to adjust going forward in response to changes in density and retirement benefits obligations.

[5] It bears repeating, again, that the focus of this proceeding must remain on the amount of pricing authority that would be needed to meet the goal of medium-term financial stability, which Section 3622 charges the Commission with determining, and not the use of such authority, which is committed to the Postal Service's Governors. *See* USPS 2018 Initial Comments at 2-3, 55, 79-80; USPS 2018 Reply Comments at 7, 30-33. Even if the Commission authorized rates that would allow the Postal Service to cover its total costs, the Postal Service's Governors have the authority and responsibility to determine whether and how to exercise that authority, in light of market conditions and other business realities. By contrast, the Commission's role is to determine the amount of rate authority sufficient to satisfy the statutory objectives, and neither its earlier proposal nor its current proposal satisfies that standard.

mechanism consisted of a formula to correct for three exogenous market trends that hinder the revenue base's ability to cover network-related costs: namely, falling volume, a shifting mail mix, and rising delivery points. USPS 2018 Initial Comments at 69-74. The second mechanism that the Postal Service proposed would adjust the revenue base on account of any increase, or decrease, in pension and RHB payments billed by the Office of Personnel Management (OPM), given the Postal Service's lack of control over OPM's actuarial methods and other factors that determine those payments (such as legislative mandates or relief).[6] *Id.* at 74-77. Order No. 5337 largely adopted the first mechanism with its density rate authority proposal, albeit with modifications such as those discussed in the next section.

By contrast, the retirement rate authority proposal essentially represents a combination of an incomplete true-up of the rate base to costs, and a temporary adjustment mechanism for changes in amortization costs billed by OPM. It thus falls short both of ensuring compensatory rates and of accommodating changes in costs billed by OPM over the longer term. As noted in the preceding section, insofar as the retirement rate authority is aimed at a rate reset, it covers only a small portion of any reasonably representative net loss; indeed, it does not even cover the entirety of the amortization payments that it specifically seeks to address. Order No. 5337 at 95

[6] As the Postal Service proposed, this second mechanism would essentially adjust the revenue base by the change in billed payments divided by total market-dominant revenue. For example, all other things being equal, if the payments increased by $450 million and total market-dominant revenue was $45 billion, then revenue would need to increase by 1 percentage point (= ($0.45 billion ÷ $45 billion) x 100) to cover the change. Conversely, if the payments decreased by $450 million on total market-dominant revenue of $45 billion, then that cost decline could be passed on to ratepayers by adjusting the revenue base downward by 1 percentage point. Of course, the change in rate authority would actually need to have a somewhat greater absolute value to account for elasticity effects. USPS 2018 Initial Comments at 77 n.195. Such an adjustment would follow the same "r^*_t" approach discussed later in this section and in the technical appendix.

(relying on an expectation that the remaining portion of the amortization payments could be funded by "an equivalent rate increase" for competitive products).

Insofar as the retirement rate authority attempts to serve as a mechanism to adjust the revenue base for exogenous fluctuations in retirement benefits costs, it has two significant shortcomings. First, while the retirement rate authority formulas would update the revenue target for changes in OPM's invoices during the five-year phase-in period, they provide for no subsequent adjustments once the rate authority is phased in. This does not meet the concern in the Postal Service's 2018 comments about the need to ensure that the regulatory system accounts for significant exogenous changes, including fluctuations in OPM's bills as a result of actuarial changes, inputs, or even legislative change. Second, it is unclear why Order No. 5337 singles out the amortization payments for recovery, and not normal cost payments to the Federal Employees Retirement System or the Postal Service Retiree Health Benefits Fund. These payments are occasioned by the same statutory benefits programs as the amortization payments, and they fluctuate for reasons no less exogenous.[7]

[7] Even if a portion of the normal cost payments may respond to Postal Service-induced changes in the number of postal employees, a quantifiable portion of the changes in payments results from exogenous determinations by OPM's Board of Actuaries. OPM's RHB invoices show the normal cost amount per participant and the number of participants used to determine the normal cost payment due in a given year. *See, e.g.*, Letter from Dennis D. Coleman, Chief Financial Officer, OPM, to Joseph Corbett, Chief Financial Officer & Executive Vice President, U.S. Postal Serv. (July 30, 2017), at 1, *filed with* U.S. Postal Serv., Notice of Filing Supplemental Information, PRC Docket No. RM2017-3 (Aug. 10, 2017); *see also* Order No. 5337 att. A at 66 (proposed rule 3050.21(n)) (proposing to require such letters to be filed annually with the Commission). By adjusting for the change in participant count between one year's invoice and the next, it can be determined how much the normal cost payment changed due to OPM's actuarial assumptions. Those assumptions are patently exogenous to the Postal Service. (Note that the full figure calculated from OPM's invoices may vary from the "change in normal cost due to revised actuarial assumptions" listed in the Postal Service's Form 10-Ks.) But it should also be noted that even the number of postal employees is not without its exogenous aspects, due to conditions imposed in binding labor arbitration, the need to fulfill the Postal Service's universal service obligation, and other statutory factors that drive such numbers. And then, of course, there is the fact that the Postal Service's overall obligation to fund pension and retiree health benefits programs, including the normal cost payment obligations, is entirely the product of exogenous statutory mandates.

As for the revenues generated by the retirement rate authority, the Commission's proposal dictates how those revenues must be spent. By mandating that the new revenue be remitted to OPM, under penalty of losing the entirety of the future retirement rate authority installments (plus any unspecified penalties imposed in further proceedings), *id.* at 63, 91, 95-96, 98-103 & att. A at 27-28, 31-36 (proposed rules 3010.181(a), .184, .185), the Commission would usurp the Postal Service's business discretion and its statutory responsibility to prioritize among its myriad payment obligations. In particular, the remittance requirement prevents the added rate authority from improving the Postal Service's liquidity position at all. The sole benefit to the Postal Service consists of a relative improvement in the funded position of its long-term liabilities. While these liabilities do eventually need to be funded, whether limited liquidity should be devoted to that aim or other business needs in the near term is a decision vested in the Postal Service Board of Governors, not the Commission. Such a directive might be acceptable if the Commission were truly proposing to create a regulatory structure that provides the Postal Service with the rate authority needed to cover all expenses (not just a portion of the amortization payments) and generate retained earnings, as the Commission has determined that Objectives 5 and 8 require. So long as any final rule, like Order No. 5337, falls short of that, the Commission should not dictate the Postal Service's decisions regarding such limited additional liquidity.

Moreover, while Order No. 5337's proposal might rest on an assumption that the remittance obligation will have a neutral effect on the Postal Service's finances in the short run, the proposal has a major flaw that would instead make it affirmatively harmful to the Postal Service unless remedied. Specifically, the Commission's proposed

remittance formula (Formula IV-3 in Order No. 5337) is based on an accumulation of amounts of approved rate authority (designated as "r_t"), which is calculated on a "before-rates" basis. *See id.* at 97-98 & att. A at 30-35 (proposed rules 3010.183-.185). However, as is well known, a given amount of (above-CPI) rate authority will result in a smaller percentage increase in revenue, because the price increase will induce some decrease in the quantity demanded. *E.g.,* Supp. Decl. of Timothy J. Brennan for the Public Representative, PRC Docket No. RM2017-3 (Mar. 1, 2018), at 4-5. By relying solely on before-rates r_t values in determining the fraction of market-dominant revenue that must be remitted, the remittance formula overstates the amount of revenue that would be realized from the rate authority. As a result, the Postal Service would be required to relinquish more money to OPM than the revenue actually generated by the retirement rate authority. And the retirement rate authority's insufficiency is not trivial: as shown in the appended Excel workbook, it represents approximately one-third of the annual remittance obligation on average, and almost half of the obligation in the first year: an underfunded mandate of several hundreds of millions of dollars.[8] Particularly if the new rules do not restore the Postal Service's revenue base to a compensatory position, it is impossible to square a new, liquidity-straining mandate with Objectives 5 and 8.

The excessive-remittance problem can be solved either by modifying the retirement rate authority, given the remittance requirement in proposed Formula IV-3, or by modifying the remittance formula to reflect the revenue actually produced by the rate

[8] Microsoft Excel file "USPS 2020 RRA workbook.xlsx", tab "RRA & Remittance 2", column W. While the spreadsheet necessarily relies on some assumed figures, the computation of the shortfall is not materially sensitive to those figures. The key factor is elasticity, the value for which is computed on the basis of recently-filed demand models and volume data. *See* appendix A at 6-7.

authority in proposed Formula IV-1. The choice of solutions depends on the amount of revenue the Commission intends to provide and to be remitted. The Postal Service interprets Order No. 5337 as intending to provide and remit approximately the market-dominant revenue share multiplied by the amortization obligations, with the rate authority determined accordingly.[9] Order No. 5337 at 95 ("The proposed formula is designed to add sufficient additional rate authority so that at the end of that 5-year period, the Postal Service should generate sufficient additional revenue to pay for the amortization segment of the Postal Service's liability, if accompanied by an equivalent rate increase on Competitive products."). In this case, the needed retirement rate authority (r^*_t) provided in a new Formula IV-5 (styled as IV-5a in the technical appendix) would have to be greater than r_t described in Formula IV-1 to yield the revenue required to be paid per the remittance formula (Formula IV-3), which would remain unchanged.[10]

Alternatively, the rate authority could continue to be based on r_t, if the remittance formula's revenue calculation is appropriately revised downward to reflect the after-rates revenue produced by r_t. In this second case, the r_t term in the remittance formula (Formula IV-3) would be replaced with a new term (r^{**}_t) that reflects the amount of after-rates revenue generated by r_t, based on a different Formula IV-5 (styled as IV-5b in the technical appendix). This scenario would yield less retirement rate authority, and revenue generated by such authority would fall considerably short of the amount apparently intended by the Commission in characterizing its design. While these

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[9] This assumes the full authority is used and fully phased in. At this time, the Postal Service considers the proration and phase-in provisions of the Commission's proposal not to be problematic in themselves.

[10] As noted in the technical appendix, a new Formula IV-6 would also have to be added in order to define one of the input variables in Formula IV-5a.

modifications somewhat complicate the retirement rate authority, the needed adjustments are formulas of observed quantities, including the r_t values from Formula IV-1, own-price elasticities from the accepted market-dominant demand models, and other components of the price cap authority.

The derivation of the formulas for r^*_t and r^{**}_t (i.e., Formulas IV-5a and IV-5b, respectively), as well as an Excel workbook demonstrating the shortfall problem and its resolution by either r^*_t or r^{**}_t, are filed as separate documents with these comments. Again, unless either the r^*_t formula is used to calculate the final rate authority or r^{**}_t is used to calculate the remittance obligation, the rate authority and the remittance obligation will not cancel one another out, as the Commission likely intends; rather, the remittance obligation will substantially and persistently encroach on Postal Service revenues beyond those raised due to the retirement rate authority.[11]

Of course, not even an r^*_t or r^{**}_t fix would solve the structural problems noted earlier in this section. And further problems remain with the Commission's proposal. The rigid forfeiture provisions proposed in Order No. 5337, combined with the no-banking rule, are unfair and unreasonable. *See* Order No. 5337 att. A at 28, 35-36 (proposed rules 3010.182(c)(4)-(5) & .185). If the Commission believes that the statutory objectives (taking into account the factors) require the Postal Service to raise a certain amount of funds to be applied toward its retirement benefits obligations, then that is what is required. However, there may well be circumstances that would lead the Postal Service to decide that it cannot use the full authority or remit the full amount in a given year (e.g., out of concern for effects on volume or available cash, respectively,

[11] Once again, the r^*_t and r^{**}_t solutions are alternatives, not components of a single solution.

during a recession). If such circumstances arise, they would not nullify whatever rationale the Commission may have for partially funding the amortization obligations over time. There is no reason why the authority should not continue to serve its intended purpose in the following years.

Ultimately, the simplest way to ensure funding of the Postal Service's retirement benefits obligations, in light of the statutory objectives and consistent with the Postal Service's statutory discretion to manage its business, is to provide sufficient rate authority to cover all expenses going into the new period, and then to adjust the revenue base going forward to reflect changes in retirement benefits obligations.

C. The Proposed "Lesser of Two Formulas" Approach to Density Rate Authority Is Unjustified

As explained in section II.A above, the Commission's proposed density rate authority gets much right. But it does contain a flaw. The Commission proposes to compute the density rate authority twice – once with market-dominant volume only and once with total volume – and to use whichever computation produces less rate authority. Order No. 5337 at 72-75, 79 & att. A at 26 (proposed rule 3010.162(b)(2)). This aspect of the Commission's proposal lacks statutory support, conflicts with Commission precedent, and produces arbitrary results.

The Commission's rationale for this "lesser of two formulas" approach – which no party proposed – rests entirely on a purported concern for "prevent[ing] cross-subsidization" of competitive products by market-dominant products.[12] Such a concern

[12] Order No. 5337 at 72 & n.150 (citing 39 U.S.C. § 3633(a)(1)); *id.* at 73 (using the alternative market-dominant-only formulation ensures that "revenue from Market Dominant products is not used to subsidize per-unit cost increases that result from the decline in Competitive density"); *id.* at 74-75 ("Either way, Market Dominant mailers are protected from additional price increases that would subsidize Competitive products, in keeping with the statutory prohibition against such subsidies.").

is misplaced. For decades, including during the pendency of this proceeding, the Commission and its predecessor have repeatedly held that the proper and sufficient safeguard against cross-subsidization, including under 39 U.S.C. § 3633(a)(1), is the incremental-cost test.[13] So long as competitive products' revenue covers their collective incremental costs, then such products are not being cross-subsidized by market-dominant products. The Commission has consistently applied the test to find that no cross-subsidization is evident. *E.g.*, Postal Regulatory Comm'n, Annual Compliance Determination Report, Fiscal Year 2018 (Apr. 12, 2019), at 99-101. Accordingly, under the Commission's established cross-subsidization test, there is no problem to be solved.

Order No. 5337 points to no practical shortcoming in the incremental-cost test and therefore articulates no need for an additional measure to guard against cross-subsidies. Indeed, the Commission has rejected measures that "would go beyond" the incremental-cost test for that purpose, as such measures would artificially constrain the Postal Service's competitive pricing flexibility with respect to products that are not actually being cross-subsidized. Order No. 3506 at 59, *aff'd*, *United Parcel Serv., Inc. v. Postal Regulatory Comm'n*, 890 F.3d 1053 (D.C. Cir. 2018), *cert. denied*, 139 S. Ct.

[13] *E.g.*, 39 C.F.R. § 3015.7(a); Order No. 4963, Order Adopting Final Rules Relating to the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Jan. 3, 2019), at 121-22; Order No. 4402, Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Feb. 8, 2018), at 74-75; Order No. 3506, Order Concerning United Parcel Service, Inc's Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), PRC Docket No. RM2016-2 (Sept. 9, 2016), at 10, 13, 57-59 & app. A at 17; Order No. 399, Order Accepting Analytical Principles Used in Periodic Reporting (Proposals Twenty-Two Through Twenty-Five), PRC Docket No. RM2010-4 (Jan. 27, 2010), at 2-5; Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, PRC Docket No. RM2007-1 (Aug. 15, 2007), at 65-67, ¶¶ 3040-3044; Order No. 56, Notice and Order Providing an Opportunity to Comment on Treasury Report, PRC Docket No. PI2008-2 (Jan. 28, 2008), at 4 n.3 & 6 (citing U.S. Department of the Treasury, Report on Accounting Principles and Practices for the Operation of the United States Postal Service's Competitive Products Fund 4-5 (2007), and William J. Baumol, John C. Panzar and Robert D. Willig, Contestable Markets & the Theory of Industry Structure 351-356 (1982)); Opinion & Recommended Decision, PRC Docket No. R97-1 (Postal Rate Comm'n May 11, 1998), at 235-36, ¶ 4026.

2614 (2019). The Commission has offered no explanation for such a sudden and significant departure from well-established precedent. *See U.S. Postal Serv. v. Postal Regulatory Comm'n* ("*First-Class Parcels Transfer*"), 842 F.3d 1271, 1273-74 (D.C. Cir. 2016); *LePage's 2000, Inc. v. Postal Regulatory Comm'n*, 642 F.3d 225, 232-34 (D.C. Cir. 2011).

The sole Section 3622 provision that Order No. 5337 cites to connect its "lesser of two formulas" concept with "cross-subsidization" concerns is Objective 9. Order No. 5337 at 72 n.150. But Objective 9 does not deal with cross-subsidization. Rather, it relates to the "appropriate[ ]" "allocat[ion]" of "total institutional costs" – not the incremental costs used to test for cross-subsidies – between market-dominant and competitive products. 39 U.S.C. § 3622(b)(9) (emphasis added). As such, earlier in this proceeding, the Commission definitively interpreted Objective 9 as satisfied by the "appropriate share" of institutional costs that competitive products contribute, pursuant to 39 U.S.C. § 3633(a)(3) and (b). Order No. 4257 at 243-47. Under the Commission's established interpretation, then, Objective 9 has nothing to do with cross-subsidization, and it requires no new measures beyond the "appropriate share" that the Commission recently went to great lengths to redesign. *See generally* PRC Docket No. RM2017-1. That established interpretation is reasonable; it would be overly presumptuous to think that Congress, through Objective 9, intended to authorize new safeguards that could supersede those established under Section 3633's explicit framework. *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions – it does not, one might say, hide elephants in mouseholes." (citations omitted)). And here,

too, Order No. 5337 offers no reasoned explanation for reversing the Commission's precedential interpretation of Objective 9 earlier in this very proceeding. *LePage's*, 642 F.3d at 232-34 (vacating a Commission order that conflicted, without explanation, with an interpretation in an earlier order in the same proceeding); *see First-Class Parcels Transfer*, 842 F.3d at 1273-74.[14]

The record of this proceeding offers no basis to believe that the incremental-cost test and the appropriate share are inadequate to their statutory purposes, or that they would suddenly become inadequate if the market-dominant ratemaking system were modified. As such, there is no reasonable basis to create new safeguards. *Cf. UPS*, 890 F.3d at 1057 ("UPS offers no reason to doubt that the Accountability Act's prohibition on cross-subsidization, 39 U.S.C. § 3633(a)(1), and requirement that competitive products cover a share of institutional costs, *id.* § 3633(a)(3), will adequately ameliorate any competitive deficit left by the Commission's approach to cost attribution[.]" (other citations omitted)). Indeed, doing so merely risks hamstringing the Postal Service's ability to compete in the market for competitive products. *See* Order No. 3506 at 59.

In addition to lacking a legal basis, the Commission's "lesser of two formulas" approach creates a "heads I win, tails you lose" situation that is unreasonable and unfair (contrary to Objective 8). The Commission should choose one formula or the other.

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[14] *See also* Order No. 2686, Order Denying Transfer of First-Class Mail Parcels to the Competitive Product Category, PRC Docket No. MC2015-7 (Aug. 26, 2015), Joint Dissent of Acting Chairman Taub & Vice Chairman Hammond, at 7 ("If the Commission is to change [a] standard in the middle of an ongoing proceeding, it should notice the public of the change and provide a reasonable opportunity to comment[.]"); Order No. 1926, Order Granting Exigent Price Increase, PRC Docket No. R2013-11 (Dec. 24, 2013), Dissenting Opinion of Vice Chairman Taub, at 3-4 (faulting the majority for "[m]oving the goal posts" by imposing new standards "with no opportunity for input or comment, and contrary to" the interpretation definitively reached in an earlier order).

Each of the two formulas, if applied on its own, would use the inclusion or exclusion of competitive-product volume (depending on the formula) to offset the available market-dominant rate authority under one set of conditions but not the other. This is the natural way in which such a formula should operate. The only question is what perspective should guide the choice of formula.

One option is to determine the density adjustment on the basis of the combination of market-dominant and competitive volume. If competitive-product volume is growing, as has historically been the case, or at least is not falling as rapidly as market-dominant volume, then overall density will not fall as rapidly as market-dominant-only density. Under these conditions, competitive products' relative volume growth or stability would partially offset the rate of market-dominant volume decline; thus, less density-based rate authority for market-dominant products would be needed to cover rising network costs than if the focus were solely on market-dominant density. Order No. 5337 at 73; USPS 2018 Reply Comments at 57-58.[15] If, however, competitive volume were to fall faster than market-dominant volume, then the total-volume formula's inclusion of competitive volume would result in more (market-dominant) density rate authority than the market-dominant-only formula. Order No. 5337 at 73. In essence, the total-volume formula might suppress density rate authority while competitive volume is relatively healthy. But that benefit is balanced by a recognition that, in order to sustain the postal network on which mailers rely, the market-

[15] To be clear, using total volume might not be the only or optimal way to address this concern, but it is certainly one way to do so.

dominant rate authority may need to increase in a compensatory manner in the event of a significant downturn in the competitive market.

This symmetry is natural: for the Postal Service to be financially viable, revenues must cover total costs, and current law provides no third source of funding. Given that the costs in question are institutional and, by definition, do not "belong to" competitive products only, acknowledgment of this basic fact would not amount to a "subsidy" or a windfall to the Postal Service.[16] In a competitive market downturn, competitive volume is less capable of generating incremental contribution toward institutional network costs, and it may stand to reason that the Postal Service's pricing power for competitive products would also be impaired. *See* 39 U.S.C. § 3642(b)(1).[17] In such cases, appropriate incentive regulation should relax the price cap. *See* Jeffrey I. Bernstein & David E.M. Sappington, *Setting the X Factor in Price Cap Regulation Plans* 14 (Nat'l Bureau of Econ. Research 1998), https://www.nber.org/papers/w6622.pdf, *published in* 16 J. REG. ECON. 5 (1999) ("[I]f the prices of uncapped services are rising less rapidly than is necessary to ensure the regulated firm zero profit based upon its overall

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[16] Once again, cross-subsidies are a function of whether competitive products are covering their incremental costs, and not of the quantum of market-dominant pricing authority.

[17] In opposing a dramatic increase in competitive products' minimum-contribution requirement, numerous industry stakeholders representing market-dominant mailers have voiced the concern that competitive volume decline cannot be offset by price increases, and the Commission has likewise recognized the concern's validity. Order No. 4963 at 169; Order No. 4402 at 50; *See* USPS 2018 Reply Comments at 51 n.139 & 55-56 (quoting comments in Docket No. RM2017-1 by the Greeting Card Association, the National Postal Policy Council, the National Association of Presort Mailers, the Association for Postal Commerce, the Parcel Shippers Association, the Alliance of Nonprofit Mailers, the American Catalog Mailers Association, the Continuity Shippers Association, the Data & Marketing Association, the Envelope Manufacturers Association, the National Association of Presort Mailers, the National Newspaper Association, PSI Systems, and Stamps.com). Rather than expecting more from competitive products when they are in decline, the Commission recast the "appropriate share" as a formula that would "adapt" to "capture many of the changes arising from market uncertainties" – in other words, would automatically lower competitive products' minimum required contribution – and indicated that the Commission could even revisit the formula if still further relief were needed. Order No. 4963 at 167.

productivity and input price growth rates, then the prices of capped services should be permitted to rise more rapidly than the standard [price-cap] rate in order to allow the firm to earn zero profit overall.”). The total-volume formula would merely reflect the reality that competitive volume would no longer be as capable of contributing toward coverage of network costs.

Assuming that the Commission could articulate an appropriate conceptual rationale, the Commission could conceivably take the alternative view that market-dominant rate authority should be based solely on market-dominant mail characteristics: thus, the density rate authority would be based on market-dominant volume only, rather than on total volume. Consequently, the density rate authority to which market-dominant mailers would be subject would be insulated from competitive volume trends, whether healthy (relative to market-dominant products) or otherwise. Here, too, a fair and reasonable application of the concept would require it to operate symmetrically.

Whichever policy premise the Commission adopts, it must choose one and apply it consistently. Either market-dominant and competitive volumes must share responsibility for funding the network no matter what, or else market-dominant products must be sequestered from both the risks and rewards of competitive volume trends. To choose only the half of each approach that yields less market-dominant pricing authority, as Order No. 5337 proposes, is arbitrary. Instead, the Commission should adopt a single, symmetrical formula.

III. THE PROPOSED PERFORMANCE-BASED RATE AUTHORITY SHOULD BE REFORMED

Order No. 5337’s approach to the productivity aspect of the proposed performance-based rate authority makes that rate authority more realistically achievable

than Order No. 4258's five-year-average benchmarking approach, and in that respect is a significant improvement. *See* USPS 2018 Initial Comments at 96-108. While this ameliorates certain of the issues with the previous proposal, the Order No. 5337 proposal is in need of further reform in three broad respects. First, the proposal to make the entire rate authority hinge on joint fulfillment of both components (productivity and service standards) is unduly punitive and infringes on the Postal Service's statutory discretion over service standards. Second, the productivity component continues to be plagued by problems that could be solved by making the rate authority unconditional, at least until it can fairly and reasonably be determined whether the Postal Service's has effectively used such authority to enhance productivity. Third, the service-standards component warrants procedural improvements.

A. The Rate Authority Should Again Be Subdivided

Under Order No. 4258, the Commission would have split the proposed 1 percentage point of performance-based rate authority, with one part contingent on productivity and the other on service standards. Order No. 5337 now proposes to merge the two conditions, such that the entire 1 percentage point of rate authority depends on meeting both criteria in a given year. Under this proposal, if the Postal Service were to reduce service standards for even a small segment of mailers, it would receive no credit for even a record-breaking productivity improvement. Tying the rate authority to joint achievement of both conditions increases the effective reward or penalty for either productivity gains or service-standards maintenance from Order No. 4258's allocation of 0.75 and 0.25 percentage points, respectively, to 1 percentage point in either case. Far from addressing problems of fairness and institutional responsibility

that the Postal Service raised in its 2018 comments, this proposal deepens those problems.

Regarding fairness, the Postal Service has already pointed out the "significant cliff effect" that an all-or-nothing approach to TFP-based rate authority posed when it was worth 0.75 percentage points, and how such a cliff effect fails to account for statistical noise, fails to appropriately maximize incentives, and departs from regulatory practice. USPS 2018 Initial Comments at 100-101, 125-27. The Postal Service further explained that other regulators have addressed the issue through step and smoothing functions: essentially, breaking rate authority into multiple increments to recognize different levels of achievement. *Id.* at 125-27.[18] Instead of recognizing the problem and adopting such a stepwise solution, Order No. 5337 would increase the "all" side of "all or nothing" to 1 percentage point. Making the cliff steeper by increasing the amount of rate authority tied to TFP does not solve the problem; it worsens it.

Regarding institutional responsibility, the entire percentage point would also depend on maintaining service standards. Like the TFP-based rate authority, this raising of the stakes exacerbates, rather than resolves, a problem that the Postal Service raised in its 2018 comments. Basing any rate authority on maintenance of service standards sets an effective "price" on reducing service standards. By doing so, the Commission would be exercising unprecedented and undue influence over decisions that Congress expressly delegated to the Postal Service, well beyond the limited adjudicatory and consultative role that Congress envisioned for the Commission

[18] To be clear, the Postal Service's earlier comments about deadbands and rounding do not necessarily hold as much force in relation to Order No. 5337's revised proposal.

regarding service standard changes. *See* 39 U.S.C. §§ 3653(b)(2) & (c), 3662(a), 3691. What is more, that influence would be locked in as a permanent deterrent against changes that might be necessary to make the mail more efficient and effective for customers. And it would impose an unwarranted gloss on Objective 3, which accommodates even downward changes so long as service standards remain of "high quality." While such influence would be present even at 0.25 percentage points of rate authority (as under Order No. 4258), a fourfold increase in that effective price for service-standard changes places a significantly heavier thumb on the scales in decisions committed by statute to the Postal Service. *See* USPS 2018 Initial Comments at 130; USPS 2018 Reply Comments at 87-88 (quoting similar objections by Netflix, the American Catalog Mailers Association, and the Parcel Shippers Association).

If the Commission is committed to basing the additional rate authority on productivity and service standards, it should return to Order No. 4258's approach of dividing the rate authority between the two independent components. Whatever the proper increment for the productivity component, the service-standards component should be valued so as to minimize the risk of undue influence on the Postal Service's statutory discretion. As the Postal Service noted previously, *see* USPS 2018 Initial Comments at 87-88, 0.25 percentage points appears, at this juncture, unlikely to pose such a risk.

B. To Reconcile Competing Rationales and Account for Timing Issues, the Commission Should Provide Unconditional Rate Authority as an Interim Measure

As noted above, Order No. 5337 dispenses with Order No. 4258's deeply problematic proposal to base rate authority on whether TFP growth rates exceed a historically implausible benchmark. Instead, Order No. 5337 proposes to change the

condition to the achievement of any year-over-year growth in the TFP index (measured to three decimal places). Order No. 5337 at 105, 136 & att. A at 37 (proposed rule 3010.201). This new proposal goes a fair distance toward making the rate authority achievable in some years, which was not true for Order No. 4258's version. Yet the new proposal still has a number of significant flaws.

1. A period of unconditional rate authority is necessary to solve several arbitrariness problems

Order No. 5337 perpetuates Order No. 4258's advancement of conflicting rationales for the TFP-based rate authority. The Postal Service needs "retained earnings" to invest in productivity growth (the "financial-health cycle" rationale), yet it may not receive rate authority for such retained earnings until it has first grown productivity without it (the "earn-it-first" rationale). The Commission's proposal may be consistent with the earn-it-first rationale, but it is not consistent with the financial-health-cycle rationale. If both rationales are to be fulfilled, then the proposal must be restructured to reconcile them in a logical manner.

In doing so, there must be at least an interim period of unconditional rate authority. To begin with, the Commission claims that "one of the goals of the performance-based rate authority is to maximize incentives for the Postal Service to reduce costs and increase efficiency." Order No. 5337 at 116. This is evident in the rationale that the Postal Service must "earn" rate authority by first fulfilling its "responsibility" "to achieve efficiency gains." *Id.* at 124. For an incentive to work, the regulated entity must be aware of the incentive and capable of acting upon it. As such, it would be irrational if the new rule were to reward or punish the Postal Service on the basis of TFP growth (or the lack thereof) that occurred before the new rule took effect.

Yet Order No. 5337's would-be incentive mechanism would start on just such an irrational footing. If a final rule along the lines of Order No. 5337 took effect in the summer of 2020, for example, the first available TFP data after the new rule – the data on which the first round of performance-based rate authority would be based – would pertain to FY2020. But most or all of FY2020 will have predated the rule and therefore could not conceivably have reflected the Postal Service's response to the new incentive mechanism.[19]

Deferring the performance-based rate authority until post-rule TFP data is available would create a second arbitrariness problem. To continue the example above, the first post-rule TFP data (for FY2021) would not be available in time for the January 2022 price change.[20] Any rate authority would instead be made available for the price change that would take effect in January 2023: more than two years after the final rule is established. But Order No. 5337, like Order No. 4258, justifies the additional rate authority as a way "to allow the Postal Service to reenter the financial health cycle." Order No. 5337 at 14; *see* Order No. 4258 at 46-47. As the Commission goes on to explain, the cycle begins with "retained earnings," which the Postal Service can invest in capital improvements that improve operational efficiency and service; the end result is lower costs and retained or increased revenue, which allow for further retained earnings. Order No. 5337 at 105-106; Order No. 4258 at 35-37, 46-47. The

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[19] To be clear, this is merely an illustrative example. Similar problems would arise if the timing of the final rule were different. A final rule issued in the fall of 2020 would mean that the entirety of FY2020 TFP data (which would still be the first available after the new rule) would predate the rule. And if the final rule were issued after the filing of FY2020 TFP data, then that would present the same problem in FY2021 (i.e., part of the year's TFP results would predate the rule), as well as a potentially lengthy lag before even that pre-rule TFP data were available to evaluate.

[20] For an explanation of the assumption that price changes would tend to be scheduled for January, see *infra* footnote 40.

Commission diagnosed the PAEA-era lack of retained earnings, along with the concomitant inability to make capital investments, replenish capital assets, and pay down debt, as contributors toward the ratemaking system's failure to achieve Objectives 1, 3, and 5. Order No. 5337 at 106; Order No. 4258 at 47-52. Given the Commission's finding that the financial-health cycle has already languished for most of the post-PAEA era, it makes no sense to defer restarting the cycle for several years after the final rule is implemented.

Despite the Commission's suggestion to the contrary, *see* Order No. 5337 at 115-16, this problem is not ameliorated by the other forms of rate authority that the Commission proposes to provide. Once again, the Commission has repeatedly explained that "retained earnings" are needed as a first step to restarting the financial-health cycle. The Commission could have proposed supplemental rate authority sufficient not only to cover total costs (with adjustments to guard against erosion from exogenous pressures), but also to guarantee a measure of surplus capital for capital investment. But the Commission has not made such a proposal. Rather, under Order No. 4258, the supplemental rate authority was theoretically aimed at a mere opportunity to cover total costs (and it would have achieved not even that aim, as discussed in section II.A above). For that reason, Order No. 4258's discussion of the financial-health cycle occurs entirely in the context of explaining the purpose of the performance-based rate authority, not the supplemental rate authority. And as explained in section II.A above, the retirement rate authority proposed in Order No. 5337 would cover even less of the cost base than Order No. 4258's supplemental rate authority, leaving the Postal Service still farther from garnering retained earnings. (The density rate authority is

aimed at allowing the Postal Service to maintain overall cost coverage, not improve it.) The "available resources as a result of the proposed modifications to the ratemaking system" are simply not designed to allow the Postal Service to cover operating costs, let alone to provide surplus capital with which to "make improvements to efficiency and maintain service standards." *Id.* at 116.

Even if the Commission intends to enact a conditional mechanism whereby the Postal Service must "earn" rate authority for capital investments and other business needs, its repeated pronouncements in this proceeding indicate that something – "retained earnings" – must be provided first in order for the Postal Service to have a chance at earning such rate authority later. Thus, reconciliation of the Commission's rationales fundamentally requires providing some additional rate authority – beyond what is needed to cover total costs – unconditionally until it can be determined whether that rate authority has resulted in efficiency gains, consistent with the financial-health cycle and the theory of incentive regulation.[21] Only at that point would a fair and reasonable basis exist to activate an efficiency-based conditional mechanism. That point certainly does not exist immediately, when only pre-rule TFP data is available. It might not exist for some time thereafter, given the timeline for implementation of new efficiency measures that respond to the new rate authority's incentives and the potential lag for any such measures to meaningfully influence TFP. Given the comprehensive nature of TFP and the longer-term headwinds reflected in it, early results from new capital spending might serve only to ameliorate what would otherwise be TFP declines

[21] It bears emphasizing that temporarily unconditional rate authority would be consistent with the statutory objectives. *See* USPS 2018 Initial Comments at 93-95.

in the near term, rather than necessarily yielding absolute increases. *See* USPS 2018 Initial Comments at 86-88.

In contrast to the proposals in Order Nos. 4258 and 5337, there are multiple non-arbitrary ways to implement such a reconciled approach. All solutions begin with providing rate authority unconditionally during the period when post-rule TFP data is not yet available. In the illustration above, the rate authority should be made unconditionally available for the price changes effective in 2022 and, time permitting, 2021.

Having thus gotten the rate authority off on a more sound footing, the question turns to the point at which the rate authority can fairly and reasonably be made conditional. Where TFP is the relevant condition, the question is essentially when the seed capital could reasonably be expected to result in TFP improvement. Whatever the precise answer, it is clear that that threshold will not be met for some years. The simplest approach would be to provide the intended rate authority unconditionally until the next ratemaking-system review. By that time, the Commission would have multiple years of data on TFP since the new capital became available. *See* Order No. 5337 at 243 (five years is the "optimal review period" and the "most appropriate . . . balance[between] the competing needs of sufficient time to allow the effects of the changes to be fully known [and] a review period short enough to protect postal stakeholders from unintended consequences stemming from the changes"). The Commission would thus be in a better position to conduct a holistic evaluation to determine whether the unconditional rate authority has worked as intended or whether a conditional mechanism is necessary to maximize efficiency incentives.

A related approach would be to provide supplemental rate authority sufficient not only to cover total costs (as discussed in section II.A above), but also to provide a measure of retained earnings. This approach would make good on Order No. 5337's remarks to the effect that other rate authority could provide the retained earnings needed to reenter the financial health cycle. Here, too, the adequacy of the retained-earnings supplement and the effectiveness of the Postal Service's use of it could be evaluated in the next review.[22]

Alternatively, the Commission could attempt to conduct separate proceedings to develop a non-arbitrary date certain. But that approach, beyond being undoubtedly subjective and contentious, would be fraught with potential error, as the Commission would have to evaluate the potential uses of the seed capital and their potential impact on TFP relative to other, countervailing influences on TFP. And by selecting a date based on specific projections and assumptions about investment choices, the exercise could also risk unduly influencing the Postal Service's business discretion as to how it deploys its capital. The result of such a complex exercise would likely be to activate a mechanism that would be in place for as little as two rate cycles before the next system review, a period that the Commission has deemed too short to "allow the cumulative effects [of the new rate authority] to be fully explored." *Id.* Once again, it would be more straightforward simply to conduct a holistic evaluation in that review and to provide the rate authority unconditionally in the meantime.

[22] Under this approach, the Commission should be mindful of its existing determination of the amount of additional rate authority per year that would permit a reasonable schedule of increased capital investment, asset replacement, and debt service. Order No. 4258 at 47-52.

Regardless of which approach the Commission takes, however, it would not make sense to reward or punish the Postal Service regarding its use of seed capital until after it has actually obtained that seed capital and after its use of such capital (and thus its response to the mechanism's incentives) can fairly be judged. As such, a non-arbitrary application of the principles that the Commission has set forth should result in the rate authority being made unconditional for at least an interim period. The simplest approach would be to provide the rate authority unconditionally (either as a discrete form of rate authority or as part of a broader form of supplemental rate authority) until the next review in five years, at which time sufficient data should be available for a holistic review.

2. Other issues with the proposed TFP-based mechanism would require resolution

If the Commission decides to activate a conditional mechanism prior to the next system review, then it should use the period of temporarily unconditional rate authority to devise a truly robust conditional mechanism, without further delaying resolution of this proceeding. And more work is necessary. While Order No. 5337's year-over-year-index-growth approach avoids many of the pitfalls of Order No. 4258's accumulating-average-growth-rate-comparison approach, the new methodology remains subject to at least four design flaws, and possibly others.

First, TFP is indisputably a comprehensive, robust tool for evaluating productivity generally. *See, e.g.*, Northwest Postal Consulting, Adequacy of the Postal Service's TFP Model 69 (Mar. 27, 2017) [hereinafter "NWPC Report 1"], *filed with* Order No. 5337; Northwest Postal Consulting, Comparison of Postal Service Productivity Measurement: Before and After PAEA Enactment 86-87 (Mar. 27, 2017) [hereinafter

"NWPC Report 2"], *filed with* Order No. 5337. But that does not mean that productivity is an appropriate subject of a performance-based rate incentive mechanism; indeed, it is an atypical one, to say the least.[23] Thus far in this proceeding, the Commission has established only that the underinvestment problem is the result of insufficient capital, and not of some deficiency in incentive mechanisms. *See* USPS 2018 Initial Comments at 85. Order No. 5337 does not offer a contrary analysis. Thus, the record of this proceeding does not support adoption of a TFP-based conditional mechanism.

Second, TFP's very comprehensiveness makes it, at best, a noisy measure of whether (and the extent to which) the Postal Service's capital investments produced operational-efficiency gains. That comprehensiveness therefore detracts from, rather than enhances, the appropriateness of using TFP in a mechanism intended to restore the Postal Service's financial health cycle by funding capital investments. Unlike the specific performance areas traditionally targeted by performance-based incentive mechanisms (e.g., employee safety, customer service, reliability), TFP is sensitive to exogenous factors outside the Postal Service's control (e.g., business cycles, market trends). TFP is also affected by endogenous factors unrelated to operational performance (e.g., operational-efficiency gains unrelated to capital spending, as well as capital expenditures unrelated to operations). *See* USPS 2018 Initial Comments at 86-89; NWPC Report 2 at 10-11. Moreover, many operational-efficiency initiatives, and

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[23] *See* Mark Newton Lowry & Tim Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*, Lawrence Berkeley National Laboratory, Report No. 3 (2016), at 4, http://tiny.cc/Newton-Lowry-Woolf-paper ("Important areas of utility performance such as general cost containment could in principle be addressed by [such mechanisms], but typically are not."), *cited in* Order No. 4258 at 56 n.74. Contrary to the Commission's goal of encouraging capital investment, performance incentive mechanisms "allow regulators to offset or mitigate current financial incentives that create a bias toward capital investments." *Id.* at 48 (emphasis added).

especially large capital projects, take some time to implement, so efficiency-improving investments affect TFP with variable and potentially long lags. By the same token, the Postal Service cannot respond instantaneously to exogenous workload changes. Thus, TFP gains that might have been expected from earlier-planned initiatives could be swept away by a sudden recession, with the undesirable consequence that the proposed mechanism would reduce rate authority just when it is needed most. The Postal Service's response to that recession might not be fully reflected in TFP until economic recovery begins to boost workload anyway. These considerations make TFP a poor candidate for use in such an incentive mechanism.

Third, the focus on year-over-year growth would also be inconsistent with the stated goal of maximizing efficiency incentives, and could even create perverse incentives. In a year when TFP is expected to grow, this rate authority would not afford any credit for, and thus would not incentivize, growth above +0.001; if anything, higher growth would only raise the bar for future years. Instead, contrary to Objective 1 (maximizing incentives to increase efficiency), the incentive would be to defer TFP gains so as to distribute them across the years as widely and thinly as possible.

Fourth, as noted in section III.A above, Order No. 5337, like Order No. 4258, proposes to make the mechanism binary: all or nothing. No credit is given for positive achievement below the benchmark,[24] nor is credit given for significant overachievement. Even if the magnitude of the reward were reduced to the Order No. 4258 level (0.75

[24] In the case of Order No. 5337's proposed test of any positive year-over-year index growth, for instance, partial credit could be given for negative growth that is smaller than what might otherwise be expected, in recognition of the efforts that are required to slow the rate of TFP decline amid prevailing headwinds.

percentage points), the problem would remain unless a step or smoothing function were added. USPS 2018 Initial Comments at 100-101, 125-27.

If the Commission is intent on adopting a conditional productivity-based mechanism before the next system review, then it must devise one that is not arbitrary or capricious in concept or execution. But these problems need not be solved in this proceeding. Attempting to do so would only further delay resolution of this review. Instead, the Commission should afford interim relief toward restarting the financial-health cycle and – if it does not intend to await the next system review – use that interim period both to conduct a separate proceeding to design a workable performance-based mechanism and to determine when it can fairly be activated.

C. The Service Standards Component Should Focus Less on Whether Service Standards Changed Than on Whether They Remain High-Quality

Like Order No. 4258, Order No. 5337 proposes that: (1) the Postal Service certify on December 31 that it did not diminish service standards during the preceding fiscal year; and (2) other parties be given three and a half months to challenge that certification (which the Commission would then take an unspecified amount of time to adjudicate). Order No. 5337 att. A at 36-38 (proposed rules 3010.200(b) & .202(a)-(b)). The basis for such a procedure is unclear. Changes in service standards are abundantly transparent already. The Postal Service’s service standards for market-dominant products are set forth in the Code of Federal Regulations, and so any changes require public notice. Moreover, to change service standards in a way that affects service on a nationwide or substantially nationwide basis, the Postal Service must seek an advisory opinion under 39 U.S.C. § 3661(b). The advisory-opinion process is subject to public participation under 39 U.S.C. § 3661(c) and 39 C.F.R. Part

3001, Subpart D. Finally, existing Commission regulations require the Postal Service to report the service standards in place during each fiscal quarter and year. 39 C.F.R. §§ 3055.2(c), .31(a).

Against this existing regulatory backdrop, it is difficult to see how uncertainty could exist as to whether service standards have been changed or what their effect might be. It is highly implausible to suppose that the Commission would somehow be unaware of a change in service standards absent a Postal Service certification or a third-party challenge.[25] Indeed, as of the proposed December 31 certification date, the Postal Service would have notified the Commission only days before of the service standards in place during the relevant fiscal year; making the Postal Service report the same information again seems inconsistent with Objective 6 (reducing administrative burden). Like other proposals discussed in earlier sections, the proposed certification-and-challenge procedure is unwarranted.

That said, the Commission should provide an avenue for resolving a different question concerning service-standard changes. The relevant statutory objective does not provide that the ratemaking system must be designed to maintain existing service standards *per se*; rather, the objective is the maintenance of "high quality service standards." A reduction in service standards does not necessarily mean that the new service standards fall outside the "high quality" range. Indeed, the Commission has already observed that service standards remain "high quality" despite having been

[25] Even if that concern were material, there arguably is already a process for third parties to seek Commission adjudication of whether the Postal Service somehow implemented a service standard change without proper notice: namely, the complaint process. 39 U.S.C. §§ 3662(a), 3691(d); 39 C.F.R. § 3030.2(a).

reduced during the post-PAEA era.[26] Thus, while an inquiry as to the maintenance of "high quality service standards" can start with observation of a downward change in service standards, it cannot end there. Furthermore, the maintenance of "high quality service standards" is but one objective among nine, "each of which shall be applied in conjunction with the others," and the Commission must also weigh a number of other factors. 39 U.S.C. § 3622(b)-(c); *see also* Order No. 4257 at 15-21.

A fair and proper application of the objectives would be to treat any diminution of service standards as a trigger for evaluation of: (1) whether the reduced service standards remain of "high quality" for purposes of Objective 3; and (2) if the new service standards are not "high quality," whether the change, on balance, nonetheless furthers other Section 3622 criteria (e.g., reducing costs and increasing efficiency (Objective 1)) that outweigh the impact on Objective 3. If the answer to either question is yes, then either Objective 3 or the overall balance of objectives is being achieved, and it would be arbitrary to deny the rate incentive. Thus, in any year when the Postal Service has diminished service standards for a given mail class,[27] the Postal Service should be allowed to present a justification for receiving the incentive based on the quality of the new service standards or their furtherance of other objectives. Since the threshold for the proposed performance-based rate authority is identical to the threshold for an

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[26] *See* Order No. 4257 at 269 ("the decline of service standards during the PAEA era . . . creates a danger that the Postal Service could reduce service standards below a high quality level," implying that even the reduced service standards remain of "high quality"); *id.*, Supp. Views of Comm'r Tony Hammond, at 3 (opining that both the original post-PAEA service standards and the later, reduced service standards met the "high quality" objective). Indeed, Order No. 5337 apparently presumes that current service standards are "high quality": it does not propose that the Postal Service <u>raise</u> service standards above current levels. This buttresses Order No. 4257's implication that current service standards are of "high quality" despite having been reduced from prior levels.

[27] *See infra* section VIII.

advisory-opinion proceeding under 39 U.S.C. § 3661, this crucial qualitative question can be addressed and resolved in the relevant Section 3661 proceeding, without delaying any subsequent determination of rate authority.[28]

IV. NEITHER A PRICE CAP NOR FORCED RATE-REBALANCING MAKES SENSE FOR RATES THAT THE POSTAL SERVICE DOES NOT SET

Order No. 5337 does not mention, let alone address, an arbitrary aspect of the ratemaking system – and of the proposed rules – that the Postal Service previously identified as in need of revision. *See* USPS 2018 Initial Comments at 153-58. The Postal Service does not set rates for Inbound Letter Post letters and flats.[29] Those rates are set by the Universal Postal Union (UPU), an international body in which the United States has only one vote. That vote is exercised by the State Department, to which the Postal Service and Commission serve as mere advisors. *See* 39 U.S.C. § 407(b)-(c). To inform its advice to the State Department on UPU proposals affecting the rates at issue here, the Commission has established a public notice-and-comment process distinct from typical price-change cases. *See* 39 C.F.R. pt. 3017.

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[28] It is not apparent how any daylight could exist between the range of service-standard changes subject to Section 3661 proceedings and those on which the proposed rate authority would be based. If the Commission nonetheless believes that there is a realistic risk of such a gap, then it could, on a case-by-case basis, create an opportunity to evaluate the "high quality" question through the annual compliance review or, failing that, some other procedural venue. It is unlikely that a dedicated period is necessary for this purpose, but it bears noting that the sheer existence of a service change – the question for which the Commission proposed a "challenge period" – is less likely to require evaluation than the "high quality" question.

[29] On January 1, 2020, certain segments of Inbound Letter Post (namely, small packets and bulky letters), along with Inbound Registered Mail, were transferred to the competitive product list and are no longer subject to the price cap. *See generally* Order No. 5372, Order Granting Postal Service's Motion & Approving Prices for Inbound Letter Post Small Packets & Bulky Letters, PRC Docket Nos MC2019-17 & CP2019-155 (Dec. 19, 2019). For the transferred small packets and bulky letters, a recent change in the UPU Acts permits the Postal Service to self-declare rates. For the portion of Inbound Letter Post that remains market-dominant (particularly letters and flats), however, the UPU will continue to set the rates. *See generally* Decisions of the 2019 Geneva Extraordinary Congress (UPU 2019).

It does not make sense to include, in a cap on the Postal Service's prices, rates that the Postal Service does not set. Whatever incentives and disciplinary effects that a price cap might impose on a regulated entity, those incentives and effects are nonexistent where an unregulated third party sets the prices. The UPU is not bound to abide by a domestic price cap, and it is not just or reasonable (Objective 8) to hold the Postal Service responsible for whether UPU-set rates comply with the cap. Prices – and their "compliance" with a price cap – may fluctuate without any action by the Postal Service; decisions by the third-party UPU could make the prices "fail to comply" with the price cap, resulting in a mistakenly perceived need for cost discipline by the Postal Service, or *vice versa* (thus interfering with the achievement of Objective 1). Meanwhile, the fluctuations in UPU-set rates can distort and obscure the amount of remaining cap space available for the rates that the Postal Service does set, diminishing both the price cap's predictability and the Postal Service's pricing flexibility (Objectives 2 and 4). The premise of subjecting such rates to the price cap is artificial to the point of arbitrariness. It may be understandable that the Commission viewed rate cases as at least offering transparency into international rates when the price-cap rules were initially set – and when, not incidentally, the PAEA's strengthening of the Commission's oversight of international mail had not yet ripened. At this point, however, that purpose is served by better-tailored procedural mechanisms, such as the 39 C.F.R. Part 3017 process referenced above.[30]

[30] To be clear, excluding these market-dominant rates from the price cap would be an exercise of the Commission's discretion over the market-dominant ratemaking system under Section 3622(d)(3), not a reclassification of the rates pursuant to Section 3642. An alternative (albeit somewhat more complicated) approach with the same effect would be to leave UPU-set Inbound Letter Post rates nominally subject to

Similar problems arise in the application to UPU-set rates of the proposed rate-rebalancing rule for underwater products within an above-water class.[31] *See* Order No. 5337 att. A at 38 (proposed rule 3010.221). It does not matter how much cap space is theoretically allotted to these products: the Postal Service does not set the prices, and so it does not control whether the cap space is used. In such circumstances, it would not be rational to hold the Postal Service responsible for any lack of compliance. It would be no more rational to insist that the Postal Service forfeit any cap space allocated to these underwater rates.

The price cap and rate-rebalancing rule should focus solely on rates that are within the Postal Service's control. Rates set by the UPU are not, and so they should be excluded from the price cap and rate-rebalancing rule. If the price cap and the rate-rebalancing rule continued to apply to these rates, the sole effect would be to hinder the price cap's achievement of multiple objectives, to the benefit of no other objective, as a result of decisions beyond the Postal Service's control.

V. THE COMMISSION SHOULD CREATE EXCEPTIONS TO ITS WORKSHARE REQUIREMENTS TO ADDRESS THREE POTENTIAL ISSUES

The proposed workshare rules are too restrictive. While it is very hard to determine how the new rules will apply to actual pricing scenarios, the Postal Service is concerned that, in some cases, addressing workshare passthroughs might determine most or even all of the prices for a product. Adjusting prices unrelated to workshare

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the price cap, while creating an adjustment factor to offset any impact on available class-level rate authority from changes in the UPU-set rates. *See* USPS 2018 Initial Comments at 156.

[31] This point applies even if the Commission were to decide to maintain Inbound Letter Post within the price cap.

discounts, whether to improve operational efficiency or meet other business goals, could be foreclosed.

The Commission's rules should recognize workshare discounts for which a cost avoidance methodology change is pending. Proposed rule 3010.280 states that "the cost avoided by the Postal Service for not providing the applicable service refers to the amount identified in the most recently applicable Annual Compliance Determination, unless the Commission otherwise provides." Order No. 5337 att. A at 49. In some cases, the Postal Service may file a cost methodology rulemaking after the Annual Compliance Determination that, if adopted, would change the cost avoidance. If such a rulemaking is pending at the time that an application for waiver is due under proposed rule 3010.286, the Postal Service believes that the pendency of such a rulemaking should be grounds for a waiver from complying with the passthrough rules using the cost avoidance that the Postal Service has requested to change. Such a waiver condition should apply to discounts that either exceed or fall below avoided costs. Alternatively, an exception could be added to proposed rules 3010.283 and 3010.284 to cover the impact of a pending rulemaking on the cost avoidance.

Second, it is not clear why the Commission limits application of 39 U.S.C. § 3622(e)(3)(B) in proposed rule 3010.286 to excessive discounts. According to proposed rule 3010.286(c)(7), the Postal Service could obtain a waiver if reducing or eliminating the excessive workshare discount would result in a further increase in the rates paid by mailers not able to take advantage of the workshare discount. *Id.* att. A at 55-56. The complex interplay between the Commission's proposed rules warrants expanding waivers to discounts that must be increased to reach at least an 85 percent

passthrough. Increasing discounts may frequently require raising benchmark prices, which are paid by mailers not able to take advantage of the discount. Within Periodicals, for instance, all In-County discounts fall below avoided costs using Docket No. R2020-1 prices and FY2019 cost avoidances. Given the product's non-compensatory status, no individual rates can be reduced under proposed rule 3010.127(b).[32] Therefore, discounts could be increased only by raising benchmark prices. Given this reality and the detrimental impact it could have on mailers accessing benchmark prices, increasing In-County discounts by at least 20 percent, or otherwise meeting the requirements of proposed rule 3010.284, could unduly harm mailers not able to take advantage of the discounts. Therefore, the Commission should modify proposed rule 3010.286(g) to expand the application of 39 U.S.C. § 3622(e)(3)(B) to discounts that fall below their avoided costs.

Third, the Postal Service requests some additional pricing flexibility for discounts when the passthrough is at least 85 percent and no more than 100 percent.[33] Proposed rule 3010.282(a) prohibits any change in the discount when the passthrough is exactly 100 percent. *Id.* att. A at 50. Proposed rule 3010.282(c) prohibits the reduction of a discount if the passthrough is less than 100 percent, even if the resulting passthrough is at least 85 percent. *Id.* Because the prices associated with these discounts might affect other workshare discounts (e.g., a discounted price might be the benchmark for

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[32] The Commission's Order would allow prices to rise if the cost coverage for the product does not decrease. Order No. 5337 at 162. But the impact on the cost coverage cannot be determined at the time prices are being developed. As a result, it would risk a remand to move forward with any price reductions.

[33] For example, a discount might reach a passthrough of 100 percent simply because of a change in the cost avoidance after the filing of the most recent price change.

another discount), the Postal Service requests changes to proposed rules 3010.282(a) and (c), allowing reductions in the discount as long as the resulting passthrough is at least 85 percent.[34]

The Postal Service believes that a passthrough floor of 85 percent adequately serves Objective 1 (maximizing efficiency incentives). It is not necessary to go further and prohibit a decrease in the size of the workshare discount within the 85-100 percent passthrough range. In fact, such a prohibition works against Objective 4 (pricing flexibility) and is best avoided for the following reasons.

Allowing the Postal Service to both increase and decrease workshare discounts within the 85-100 percent passthrough range could serve Objective 2 (predictability and stability in rates). Rate changes could be tempered to smooth out the normal ups and downs of estimated avoided costs.

Moreover, prohibiting a decrease in the size of the discount works against utilizing price cap space, all other things being equal. To the extent that volume is concentrated in workshared rate cells and/or in a limited number of rate cells ("blockiness"), the Postal Service could at times find it difficult to fully exercise its rate authority if no decrease in the size of a workshare discount is permitted.

If, as a network industry characterized by economies of scale and density, the Postal Service's longer-run marginal cost curve is downward-sloping, unit attributable cost will be pushed up (beyond inflation) after work is outsourced to workshare partners. Under certain conditions, this can require a passthrough of less than 100 percent for the

[34] This would be consistent with proposed rules 3010.282(b) and 3010.284(e), which permit a passthrough to change from over 100 percent to under 100 percent, as long as the resulting passthrough is at least 85 percent.

Postal Service to be kept financially whole. For the same reason, a passthrough of less than 100 percent can be warranted if attributable costs are not as volume-variable as measured. These contingencies would be well-served by preserving the Postal Service's pricing flexibility within the 85-100 percent passthrough range.

Finally, as with any estimate, there is a real risk of overestimating the cost avoidance. In that case, setting the passthrough at 100 percent or above could unnecessarily transfer work from the Postal Service to a workshare partner. Not only would this be inconsistent with optimizing economic efficiency, it would unnecessarily deprive the Postal Service – and, by extension, its customers – of economies of scale and density. Given this risk, financial theory (considering risk aversion) would support pricing the workshare rate categories with a risk premium. Such a premium would be in the form of a passthrough below 100 percent. Once again, this aim would be well-served by preserving the Postal Service's pricing flexibility within the 85-100 percent passthrough range.

VI. STILL UNRESOLVED ARE ISSUES WITH THE TIMING OF BOTH INITIAL IMPLEMENTATION AND ANNUAL RATE CYCLES

While Order No. 5337 discusses the timing issues that the Postal Service raised in its 2018 comments, the order does not resolve them. The issues are explained again here in reference to Order No. 5337.

A. The Final Rule's Rate Authority Should Be Made Available Sooner

One issue is the timing of the first new rate authority under the rule. Order No. 5337 proposes that the Postal Service file proposed determinations of rate authority at the end of December, whereupon the Commission will take an unspecified amount of time to validate them. After that validation, the Postal Service will have another year to

"use" the rate authority.[35] If a final rule in this docket is issued later in 2020, the new rate authority would not actually manifest in rates until January 2022, because the Commission would not even have received the proposed rate-authority determinations, let alone validated them, until after its review of the January 2021 price change.[36] Given the Commission's finding in Order No. 4257 that the current rate-regulation system had already failed as of four years ago (FY2016), it is unreasonable for remediation to wait another two years (or longer, if the final rule is issued in 2021). The Commission already has access to much or all of the relevant data, and so it should be possible to determine at least the first round of pricing authority soon after issuance of the final rule, in the interest of speeding remediation of the broken regulatory system.[37]

B. Procedures to Determine Rate Authority Should Not Be Redundant or Unrealistic

The proposed rule provides for an annual procedure that would begin with the Postal Service's filing of rate-authority calculations on December 31 of each year. But almost all of the relevant data would already be available to the Commission in the ACR filed just days earlier (and only a short time later in the case of TFP, as discussed

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[35] As noted in section VIII below, the Commission still has not clarified whether rate authority is "used" when a price change is filed or when it is implemented.

[36] For an explanation of the general assumption that price changes would tend to be scheduled for January, see *infra* footnote 40. Of course, that assumption might yield in appropriate circumstances, such as a need to implement a final rule in this proceeding.

[37] As an additional, minor comment regarding the availability of new rate authority, it appears that the Commission intends to make the non-compensatory-class rate authority available immediately upon issuance of the final rule, instead of awaiting some ACR-based proceeding. Order No. 5337 at 173 ("Additionally, as suggested by the Postal Service, the Commission clarifies that the additional rate authority be made available for the first price adjustment following the new rules."). After all, no ACR-based calculation is necessary: the rules can simply specify that the authority is 2 percentage points. *See id.* att. A at 39 (proposed rule 3010.222(a)). In light of that, it is not clear why the proposed rule goes on to require that the Commission "announce" this rate authority in some manner, apparently as a condition precedent to the rate authority's availability. *Id.* at 40 (proposed rule 3010.222(b)). The Commission should clarify its intent.

below). Mandating separate filings of the same data and holding concurrent proceedings would seem to run contrary to the objective of reducing administrative burden, without benefiting transparency (Objective 6). Instead, the Postal Service can file initial rate-authority calculations when it files the ACR, and the Commission can then use the ACR process to validate the calculations. In the interest of regulatory certainty, the Commission should accordingly commit to providing its determination of the rate authority in the Annual Compliance Determination.[38]

Moreover, Order No. 5337 would accelerate the filing date of TFP data from March 1 to the filing date of the Annual Compliance Report (ACR), just days before the filing of rate-authority calculations. *Compare* 39 C.F.R. § 3050.60(e) *with* Order No. 5337 att. A at 65-66 (proposed rule 3050.21(a) & (m)). While some acceleration of TFP data preparation may be possible, TFP depends heavily on cost data in the Cost and Revenue Analysis and International Cost and Revenue Analysis reports, which are filed with the ACR. Given the already-intense effort to finalize those reports in time for their filing deadline, it is simply not feasible to accelerate completion of those reports in the interest of finalizing TFP data before the same deadline. If TFP data is desired earlier than March 1, it would be more reasonable to move the deadline up to February 1, so as to allow time to incorporate ACR data. As discussed in section III.B.2 above, the Commission should grant the proposed TFP-based rate authority unconditionally at first. But in the event that the Commission chooses to activate a TFP-based mechanism sooner or later, it should not be problematic to allow any TFP-based rate authority

[38] If the Commission nonetheless intends to maintain separate proceedings, it should incorporate the ACR data automatically, rather than requiring the Postal Service to make separate filings of the same data, and it should provide a date certain for issuance of its rate-authority determination.

calculations to be initiated a few weeks later than other forms of rate authority, particularly given the straightforward nature of the calculation proposed in Order No. 5337.

C. An Unjustified Lengthening of Rate Case Schedules Would Pose Practical Problems for the Postal Service and Mailers

As the Commission notes in Order No. 5337, the Postal Service opposed Order No. 4258's proposed changes to the rate adjustment timeline. The Commission justifies extending its initial review period from 34 days to 51 days, and remand review from 21 to 31 days as facilitating "meaningful participation and improved accountability." Order No. 5337 at 236. The revised proposed rules significantly weaken this justification. First, the proposed rules provide for a separate, pre-rate-adjustment-filing proceeding to consider workshare-discount waiver requests, during which interested parties would have a minimum of 7 days to submit comments. *Id.* att. A at 53-57 (proposed rule 3010.286).[39] This process should resolve workshare issues before the rate-adjustment proceeding. Second, the proposed rules streamline individual rate-adjustment proceedings by removing any requirement to address the qualitative statutory objectives and factors. Order No. 5337 at 239-40. Accordingly, the subject matter of rate-adjustment proceedings would be substantially narrower than is the case today.

If anything, these material changes should expedite the Commission's review, not encumber it. As such, Order No. 5337 fails to justify its proposed extension of initial

[39] Rejection of a workshare discount waiver request could have a significant impact on the Postal Service's development of prices; therefore, certainty is needed with regard to the waiver review period. The Postal Service believes that a review period of no more than 30 days (= 9 days for comments + 21 days) may be workable. The Postal Service requests that the Commission incorporate a definitive review period of no more than 30 days into the text of the final rule.

and remand review periods. The Postal Service requests that the Commission consider shortening the review periods or, at the very least, retain the current 34-day initial review period and 21-day remand review periods. After all, using the same amount of time to consider less subject matter would represent a proportional extension. (Put another way, removing issues of workshare-discount exceptions to a separate advance proceeding is already an extension of the overall period to consider the issues addressed under the current system's procedural schedule; no additional extension of the procedural schedule is warranted.)

With regard to the Commission's proposed 31-day remand review, the Postal Service reiterates that this extension would not provide enough time for rate certainty before implementation. Recent experience with remand cases has raised concerns from mailers and the Postal Service about the need for a final Commission Order before programming and testing the significant software changes to implement a price change. Under the current review periods, totaling 55 days for initial and remand reviews (= 34 + 21 days), filing at least 106 days before implementation has generally provided enough time for a final Order at least 45 days before implementation. The proposed review periods would extend the 55 days to 82 days (= 51 + 31 days). Thus, to maintain the same 45-day period for pre-implementation programming, the Postal Service would have to push back the filing date to over 130 days before implementation, or risk delaying implementation.[40] Filing that far before the implementation date could push

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[40] In addition to the disruption and expense to mailers who must invest in software changes, a delay in implementation would run counter to the interest of mailers who favor a single implementation date for changes to market-dominant and competitive product prices. (A corresponding delay in the competitive-product price change would additionally disrupt mailers who prefer Postal Service price changes to be

back the hybrid year used in the rate filing, thus risking the loss of billing determinant data reflecting the current prices and unduly shortening the time for preparing the filing and presenting it to the Governors.[41] This loss of billing determinants data reflecting the impact of the prices from the preceding year's price case is one more reason for retaining the current review periods.

Although a few parties might have voiced some support, no party sought an extension of the review periods or advanced a clear justification for doing so. Given the Commission's proposals to streamline the issues in rate-adjustment cases and to address workshare-discount exceptions through separate proceedings, the rational effect should be to expedite rate-adjustment reviews, not lengthen them. Despite the lack of clear benefit or justification, lengthening case schedules either would cause a cascade of disruptive effects on mailers and the Postal Service or could deprive the Postal Service Governors and the Commission of important data. The Commission therefore should maintain its current review periods, if not shorten them.

VII. THE PROPOSED REPORTING REQUIREMENTS ARE NOT NECESSARY AND RISK DISCLOSURE OF HIGHLY SENSITIVE COMMERCIAL INFORMATION

The proposed reporting requirements are intended to solve a nonexistent problem, yet they risk creating significant commercial injury to the Postal Service, given the highly sensitive nature of the information that would be disclosed. The Commission

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close in time to those of competing delivery providers.) And, of course, the Postal Service loses out on any incremental revenue from a price increase during a delay.

[41] Because of the earlier filing date, the hybrid year billing determinants "most recently available" to the Postal Service would end at Quarter 2. *See* Order No. 5337 att. A at 15 (proposed rule 3010.128(b)). The Quarter 2 data would be the most recently available data at the time that the Governors would be reviewing the prices being developed for filing, even though Quarter 3 billing determinants would have been filed with the Commission by the time the Postal Service filed the rate case. The Postal Service requests that the Commission concur with this interpretation of proposed rule 128(b).

states that its proposal is designed to "balance[ ] the commenters' concerns" over supposedly weakened cost-cutting incentives "with the Postal Service's role as the operator to make its own business decisions." Order No. 5337 at 221. As discussed below, however, the commenters' concerns are unfounded; it is unclear how the reporting requirements relate to those concerns; and the Commission does not address the negative impact that preparing and disclosing the reports may have on the Postal Service's role as the operator.

A. The Reporting Requirements Are Not Necessary to Create Incentives for the Postal Service to Reduce Costs

The Commission correctly identifies the appropriate distribution of responsibilities between regulator and operator when it declines to require the Postal Service to obtain prior approval before making capital investments or enacting cost reduction efforts, recognizing that "requiring prior approval could hinder, rather than improve, the efficiency of cost reduction efforts." *Id.* at 226. This acknowledgement that the Commission should not be involved in making capital-investment decisions raises the question of why the additional reporting requirements are necessary or appropriate.

The Commission's justification is based on its purported concern that the "additional rate adjustment authority might weaken the Postal Service's incentives with regard to cost reductions." *Id.* at 223. Any such concern is unfounded. Even without a price cap, the Postal Service has a strong, inherent incentive to reduce costs and improve efficiency given market realities and persistent volume and density declines: declines that the Commission acknowledges are outside of the Postal Service's control. *See id.* at 12-13, 60, 62, 64, 70, 77; Comments of the United States Postal Service, PRC Docket No. RM2017-3 (Mar. 20, 2017) [hereinafter "USPS 2017 Comments"], at

190-92. But the proposed rules "generally maintain an inflation-based price cap." Order No. 5337 at 35; *see also id.* at 71 ("The Commission's proposed regulations addressed this shortcoming of the existing system by authorizing additional rate authority to address increases in per-unit cost resulting from declines in mail density."). While the proposed rules also provide additional rate adjustment authority to offset exogenous pressures and correct economic imbalances, the proposal is still fundamentally a price-cap system, maintaining an inflation-based cap within which the Postal Service must manage its operating costs. Thus, the reporting requirements are unnecessary.

Moreover, the Commission's rationale for the reporting requirements ignores the fact that the additional rate authority is proposed to make the price-cap structure work as intended. This is not additional authority without restraint. Even if the price cap were initially reset at a fully compensatory level and adjusted for exogenous trends going forward, as we proposed in 2018 and echo in section II above, the point of a price-cap system is to make the regulated entity responsible for operating efficiently to live within that cap. Fundamentally, price caps are a form of "incentive regulation" because they create inherent incentives to reduce costs without the need for regulatory scrutiny of cost-reduction efforts.

> By severing the link between authorized prices and realized costs – a link that is a defining feature of rate-of-return regulation – price cap regulation can provide the regulated firm with stronger incentives to reduce production costs and improve its operating efficiency than does rate-of-return regulation. . . . Under such a policy, the firm will gain financially if it achieves productivity growth that exceeds expectations and will suffer financially if its productivity growth falls short of expectations. Consequently, the firm will face strong incentives to operate diligently and to secure productivity gains.

Bernstein & Sappington, *Setting the X Factor in Price Cap Regulation Plans* at 1, 6.

This incentive principle is no less true where, similar to the proposal at issue here, an

effective “negative X factor” raises the cap each year in recognition of exogenous pressures on expected productivity growth. Mark E. Meitzen et al., *Debunking the Mythology of PBR in Electric Power*, 31 ELEC. J. 39, 44 (2018).

As proposed, not even a promise of rate authority for retained earnings (after a fully compensatory rate reset) would mitigate the inherent efficiency incentives. To the extent that the Commission’s concern that performance-based rate authority uniquely “might weaken the Postal Service’s incentives with regard to cost reductions,” that would run counter to the Commission’s own justification for the authority. Specifically, the Commission explains that, “[b]y obligating the Postal Service to focus its efforts on efficiency gains that increase TFP and maintain its service standards, the proposal acts as <u>both an incentive and a control</u> on the Postal Service’s access to and use of any additional funds.” Order No. 5337 at 114 (emphasis added); s*ee also id.* at 117 (“The Commission is satisfied that the performance-based conditions on the additional rate authority provide <u>both a sufficient incentive and control</u> on the Postal Service’s use of funds to make capital investments that will be focused on increasing efficiency and maintaining high quality service standards.” (emphasis added)). The Commission’s articulated reasoning for conditioning the authority on TFP growth is to create an incentive for the Postal Service to reduce costs and increase efficiency on its own. *See, e.g.*, *id.* at 116. Since the Commission believes that the TFP-based mechanism is sufficient as a control, there is no need for these additional reporting requirements.[42]

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[42] To be clear, the Postal Service is not conceding that a conditional TFP-based mechanism is necessarily appropriate in the near term, as discussed in section III.B above. The point remains, however, that the Commission’s adoption of such a mechanism – whether immediately or, as discussed in section III.B.1 above, prospectively, after an interim period of unconditional rate authority – undermines the justification for increased reporting on specific efficiency measures.

Regulatory review of capital investments and cost-reduction efforts could perhaps be justifiable in cost-of-service regulation or in a deregulated environment without market-based efficiency incentives. But a fundamental purpose of price-cap regulation and incentive mechanisms is to reduce the need for regulatory scrutiny by shifting efficiency risks to the regulated entity. In that context, to insist nonetheless on oversight of capital investments and cost-reduction initiatives would serve little purpose but to increase administrative burden.

B. The Commission Should Consider the Risk of Commercial Injury to the Postal Service and Remove or Narrow the Reporting Requirements

The Commission articulates its approach to the reporting requirements as one that "balances the commenters' concerns with the Postal Service's role as the operator to make its own business decisions." *Id.* at 221. In discussing the commenters' concerns, however, the Commission is hesitant to articulate a genuine risk – only that there is "the <u>possibility</u> that, with increased revenue, the pressure on the Postal Service to practice cost discipline <u>might</u> be reduced" or that "additional rate adjustment authority <u>could, in theory</u>, weaken the Postal Service's incentives to reduce its costs." *Id.* at 221, 222. This risk is quite attenuated, particularly since the Commission also "appreciates the Postal Service's argument that it possesses inherent incentives to pursue cost reductions." *Id.* at 22. And as discussed in the preceding section, the Commission repeatedly acknowledges that its proposed modified price-cap system and performance-based rate authority are intended to strengthen the Postal Service's

inherent efficiency incentives, calling into question the added benefit of regulatory reporting.[43]

An attenuated risk and an unclear benefit might be sufficient to justify further reporting if there were not also legitimate concerns about commercial harm to the Postal Service on the other side of the balancing analysis. Yet the Commission fails to consider any potential commercial harm to the Postal Service if these reports are made public. The Cost Reduction Initiative Report and the Decision Analysis Report (DAR) summary reports cover a wide range of projects and almost inevitably involve some combination of procurement information that would not yet be available to potential suppliers; sensitive intellectual property information; information related to real estate decisions that could harm the Postal Service's negotiating position; and predecisional, confidential information, particularly since not all DARs are approved or implemented. Predecisional information is specifically implicated by proposed rules 3050.55(c), which would require "analysis of each planned cost reduction initiative," and 3050.55(f), which would require summaries of "all planned projects that will require a Decision Analysis Report in the next fiscal year." *Id.* att. A at 68, 70.

As an example, DARs often contain detailed information regarding procurement timelines; current suppliers and performance issues; concerns about upcoming procurements; and other sensitive information (such as certain cost breakdowns that would be business sensitive information for our suppliers) that would undoubtedly influence the procurement process if disclosed. Some of this information could impact

[43] The discussion on the need for increased transparency and accountability appears to exclusively apply to the cost reporting requirements, not the Cost Reduction Initiative Report or the DAR summary report.

future procurements and is information that potential suppliers should not be allowed to use to their benefit when participating in competitive solicitations. While the proposed rules require summaries, not the full DARs, even the summary data could carry the same risks, as could responses to follow-up inquiries related to the summary reports. Similarly, if a DAR relates to an innovation for which the Postal Service wants to pursue intellectual-property protection, premature release of that information could interfere with the Postal Service's future attempts to implement and monetize the innovation. Given the potential for commercial injury and the lack of clear justification, the Commission should eliminate the Cost Reduction Initiative Report and the DAR summary report requirements.

Moreover, if the Commission maintains the reporting requirements generally, they should be narrowed in a manner consistent with the Commission's rationale. The Commission recognizes that a $5 million threshold is appropriate to limit the burden with respect to the Cost Reduction Initiative Report. Order No. 5337 att. A at 68 (proposed rule 3050.55(c)). A similar threshold should also be appropriate for the DAR summary report.

Finally, with respect to both the Cost Reduction Initiative Report and the DARs, the Commission states that there would be minimal administrative burden on the Postal Service because the information is "already collected" by the Postal Service or the "reports are already produced internally." *Id.* at 229, 231. This is not true for "planned projects that will require a [DAR] in the next fiscal year" as required by proposed rule 3050.55(f). Any project that the Postal Service is considering, but that does not yet have a DAR, would not yet be developed in a meaningful way. All DARs are

predecisional at some stage, as the DAR must be created before the project can be vetted through the established process, and DARs may be rejected or returned for further development. Projects that are under consideration but do not yet have a DAR are so predecisional that the information is not "already collected" or "already produced internally," and their disclosure would have no utility.

If the Commission truly is trying to balance the considerations it articulates, it should weigh the real risk of commercial harm against the uncertain benefits of "transparency" and "monitoring" aimed at addressing the nonexistent "possibility" "in theory" that the proposal "might weaken" the Postal Service's incentive to reduce costs and increase efficiency. *Id.* at 221-23. Both the need for and the benefit of the reports are highly questionable, and are outweighed by the harm. At the very least, the Commission should remove the reporting requirements related to "planned" DARs (proposed rule 3050.55(f)) and apply a $5 million threshold consistently to DARs as well as Cost Reduction Initiative Reports.

VIII. THREE ADDITIONAL POINTS WARRANT CLARIFICATION

If the Commission retains rate authority based on the maintenance of service standards (or of "high quality" service standards), it should clarify that such rate authority is awarded separately for each mail class, based on the evaluation of service standards for that class. For instance, if the Postal Service made a qualifying diminution in service standards for First-Class Mail but not for USPS Marketing Mail, then the rate authority could be awarded for the latter but not the former. This appears to be the likely intent of the current proposal, but it is not clearly stated. *See* Order No. 5337 at 149, 255 & att. A at 36 (proposed rule 3010.200(a)).

The Postal Service should retain the flexibility to file limited rate-adjustment cases without triggering the application of rules requiring the use of new forms of price cap authority. The rules proposed in Order No. 5337 would generally require additional authority to be used in the "first generally applicable rate adjustment after the Commission's determination" of the additional authority amount. *Id.* att. A at 23, 28, 37, 39 (proposed rules 3010.160(c)(2), .181(c)(2), .200(c)(2), .222(b)(2)). The Postal Service requests clarification that a limited price-change case for less than all classes, such as a stand-alone change to one or two (generally applicable) price cells, would not be considered a "generally applicable rate adjustment," if such a case were to be followed by a broader rate adjustment in the class later in the same calendar year. Omitting this exception would force the Postal Service to delay small price changes until an annual rate adjustment, even where doing so would be contrary to good business practice.

The Postal Service also is uncertain about the Order's statement that "[p]roposed § 3010.221 sets forth the rate setting criteria for non-compensatory products in classes for which overall class revenue exceeds overall class attributable cost." *Id.* at 163. While the Commission apparently intends to limit this rule to classes for which overall class revenue exceeds overall class attributable cost, such a limitation is not reflected in the actual language of proposed rules 3010.220 and .221. *See id.* att. A at 38. The limitation is necessary: without it, the "2 percentage points above the class-average price increase" rule would be impossible to apply to a class in which all of the products (or the majority of them, by volume) are underwater.

IX. ORDER NO. 5337 RETAINS PROBLEMATIC ASPECTS OF ORDER NO. 4258 WITHOUT ADDRESSING SIGNIFICANT COMMENTS

Order No. 5337 laudably addresses some of the shortcomings of Order No. 4258, such as the lack of a density adjustment factor and the unachievable nature of the initially proposed productivity-based rate authority. In some important respects, however, the Commission has failed to address material comments concerning unduly rigid aspects of its proposals. As the Commission is aware, failure to respond to "significant points raised by the comments, especially when those comments challenge a fundamental premise," can be grounds for vacatur of a Commission rule. *Carlson v. Postal Regulatory Comm'n*, 938 F.3d 337, 344-48 (D.C. Cir. 2019).

Significantly, Order No. 5337 perpetuates Order No. 4258's failure to explain the Commission's disinclination to allow new forms of rate authority to be banked for future use, just as inflation-based rate authority is bankable today and would remain so under the proposed rule. The Postal Service presented substantial comments explaining why banking would promote the statutory objectives, and why banking is consistent with modern postal regulatory practice. USPS 2018 Initial Comments at 131-35.

As discussed in section IV above, Order No. 5337 does not mention the Postal Service's reasoned proposal to exclude Inbound International Letter Post and Inbound Registered Mail from the price cap. USPS 2018 Initial Comments at 153-58. The omission is of note, since, in a separate proceeding, the Commission both acknowledged the Postal Service's 2018 comments and invoked this proceeding as the basis to decline ruling on the issue there. *See* Order No. 4984, Order Closing Docket, PRC Docket No. RM2019-2 (Jan. 10, 2019), at 6-7, 11.

Nor does Order No. 5337 mention or resolve serious interpretive questions regarding the timing of the new rate authority. USPS 2018 Initial Comments at 135-38, 140-41.[44]

And Order No. 5337 neglects another significant proposal: that the Commission, through its now-manifest powers to modify Section 3622's former requirements, clarify that the legacy mail classes can be modernized. *Id.* at 160-62.

Finally, the Commission still has not adequately justified the maintenance of a price cap. The Postal Service previously argued at length, and continues to believe, that a price cap is unnecessary, given that there are market alternatives for every product that we offer, which effectively constrain our ability to adjust all of our prices.[45] In order to satisfy the requirements of administrative law, the Commission's response must be more substantive than Order No. 4258's cursory treatment of alternatives to price-cap regulation.[46]

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[44] For instance, Order No. 5337 continues to use Order No. 4258's vague language concerning rate authority being "made available" and "used," without clarifying what those terms mean.

[45] In the 2017 comments, the Postal Service and several other parties argued at length that a price cap was no longer justified in light of the statutory criteria, and that an alternative approach modeled on postal rate regulation in the United Kingdom would most appropriately be "designed to achieve" those criteria. USPS 2017 Comments at 175-228; Comments of the American Postal Workers Union, AFL-CIO, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 29-31; Comment of the National Association of Letter Carriers, AFL-CIO, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 2, 15-18; Comments of the National Postal Mail Handlers Union, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 5. The Commission gave these significant comments short shrift, dismissing them with a single sentence about "predictability and stability, as required by Objective 2." Order No. 4258 at 33. The Postal Service pointed out that this response was both facially incorrect and insufficient to satisfy well-established standards of administrative law. USPS 2018 Initial Comments at 32-48. Order No. 5337 contains no discussion of the subject.

[46] *Action on Smoking & Health v. Civil Aeronautics Bd.*, 699 F.2d 1209, 1217-1218 (D.C. Cir. 1983) (overturning agency rule where the agency asserted merely that it "was aware of the pros and cons of each alternative" and that the record contained evidence supporting its position, without having explicitly responded to comments in the rule itself) (citing *Ala. Power Co. v. Costle*, 636 F.2d 323, 384 (D.C. Cir. 1979)); *see also Indep. U.S. Tank Owners Comm. v. Lewis*, 690 F.2d 908, 919 (D.C. Cir. 1982) (vacating an agency rule that lacked "any attempt to discuss, much less respond to, the comments received," with only a one-sentence conclusory statement that the court found to be "wholly uninformative"); *Indep. U.S.*

X. CONCLUSION

With Order No. 5337, the Commission has made a notable step toward addressing some of the current price-cap system's legacy failures in the modified regulatory system. Such a system should guard against exogenous forces that may erode the rate base, such as declining economies of density and changes in retirement benefit obligations. With proper adjustment factors, the system can ensure that the Postal Service's financial health is driven by its success in managing its costs: the point of incentive regulation.[47]

Nevertheless, Order No. 5337 leaves much to be done in order to enact a regulatory system that is truly "designed to achieve" the statutory objectives. Consistent with Objectives 5 and 8 and standard practices in price-cap regulation, the Commission must provide sufficient authority to correct the persistent net losses going into the new period, which the Commission has demonstrated are largely due to a legacy of exogenous pressures. Otherwise, prospective adjustment factors can serve only to avoid a deepening of the existing net losses; they will not, by themselves, provide financial stability or compensatory rate levels. While Order No. 4258's initial effort was flawed in this regard, Order No. 5337 does not justify abandoning the exercise altogether.

As for the adjustment factors, the proposed density rate authority is generally aimed in the right direction, but its "lesser of two formulas" aspect is unjustified and

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Tank Owners Comm. v. Dole, 809 F.2d 847, 851-54 (D.C. Cir. 1987) (vacating a second final rule in the same rulemaking on similar grounds of "unsatisfying" responses to significant comments).

[47] Of course, this presupposes that incentive regulation remains necessary and appropriate: a conclusion that the Commission still has not justified in a manner compliant with standards of administrative law.

arbitrary in its practical effects. The retirement rate authority falls short of being an appropriate adjustment factor, in terms of both the duration and the scope of covered payments. And its deficiency as a measure to relieve a portion of the net loss, while problematic in its own right, is overshadowed by the misspecified remittance obligation's overbreadth. A more sensible approach would be to follow the standard practice in price-cap regulation: provide sufficient rate authority to cover the net loss, which inherently reflects all relevant retirement benefits obligations, and then adjust that authority for any changes in those obligations.

Despite making the TFP-based component more realistically achievable, Order No. 5337 moves in the wrong direction on performance-based rate authority. Conditioning the full percentage point on both productivity gains and the maintenance of service standards sets too high a price tag on either condition, undermining both fairness and the statutory allocation of operational responsibility. Other changes are warranted to each component. To reconcile conflicting rationales, the productivity-based component should be made unconditional until the effects of that rate authority can fairly be judged. The most straightforward venue for that evaluation would be the next system review. If the Commission nonetheless desires a conditional mechanism sooner, then it should conduct separate proceedings both to determine the appropriate starting point and to resolve design flaws with the Commission's proposed performance-based mechanism. Beyond lowering the price tag for the service-standards component, the Commission should do away with the proposed "challenge period" and should base the rate authority on maintenance not merely of service standards *per se*, but of "high quality" service standards.

A number of other clarifications and changes are warranted: removal of UPU-set rates from the price cap and the new rate-rebalancing rules; additional grounds for waiver of the workshare-discount rules; revisions to procedural schedules; earlier availability of any new rate authority; reconsideration of proposed reporting requirements; and other interpretive clarifications. And a number of significant issues from the Postal Service's 2018 comments remain unaddressed by Order No. 5337, such as the lack of banking for new forms of rate authority, modernization of the mail-classification system, and justification for continued price-cap regulation.

Finally, we emphasize again that the Commission's responsibility is to establish a ratemaking system designed to achieve the statutory criteria. To the extent that it does so through a price-cap system, the resulting rate authority represents the outer limit of the Postal Service Governors' pricing discretion. That outer limit must be set according to what is necessary to fulfill the requirements of governing law. The setting of the limit does not obligate the Governors to price to that limit: far from it. Rather, the Governors must – and will – exercise their pricing discretion within that limit in a manner that balances America's need for a sustainable postal operator against the inherent business constraints of a dynamic, challenging market environment.