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POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

STATUTORY REVIEW OF THE SYSTEM FOR REGULATING RATES AND CLASSES FOR MARKET-DOMINANT PRODUCTS	Docket No. RM2017-3

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

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I. INTRODUCTION

By now, in the third round of this proceeding, parties' positions and arguments are well-known. Like our 2018 reply comments, these reply comments begin with a reminder that the Commission is generally on the right course, and that the industry commenters' arguments for Commission inaction continue to misstate the law and the stakes. The initial, rigid CPI-only price cap has failed to achieve the statutory objectives in an era of density declines not anticipated by Congress. This has occurred not because of some deficiency on the Postal Service's part, but despite historically significant efforts to control costs. Given the potential for such unforeseen circumstances, Congress did not lock in the price cap for all time, but charged the Commission with revising or replacing it, as necessary, after ten years. The possibility of further legislative reform, which the Postal Service strongly believes should occur, cannot be used as a basis to shirk this responsibility. The clear solution is to provide enough price authority to correct the current imbalance between revenues and costs and to revise the cap going forward to forestall a recurrence of its current failure. Fears of a "death spiral" have no empirical basis; even if they had any validity, they would only serve to further justify an approach of eliminating the price cap entirely. In the end, such business concerns are for the Postal Service's Governors to weigh in designing market-dominant prices; the Commission's task is to determine the outer bounds of pricing authority that are consistent with the law. Section II of these comments covers these points in greater detail.

Order No. 5337 proposes prospective annual adjustments to the price cap based on actual changes in density, amortization payments, and productivity, but not a recalibration of rate levels to correct the going-in net loss. As explained in our initial comments, both elements are needed – not one or the other. And as explained in section III (and Appendix A), contrary to the views of some commenters, all of these measures are consistent with case law and price-cap theory. Moreover, basing adjustments on actual data, instead of forecasts, will reduce administrative burden and facilitate orderly resolution of this proceeding.

Sections IV and V address two issues concerning the proposed density rate authority. As discussed in section IV, labor commenters propose to apply the Commission's formula retrospectively, thereby recalibrating going-in rate levels according to the amount of density loss since the PAEA's enactment, when rates were last compensatory. While this proposal has merit, it would be simpler and more direct to provide sufficient rate authority to cover a representative measure of the current and expected net loss. After all, doing so would necessarily account for all factors that contributed to the Postal Service's current financial position: density loss, cost reductions, competitive product growth, and so on.

In section V (and Appendix B), we explain why the Commission's chosen inputs for the density rate authority are supportable. Certain industry commenters have proposed instead to base the adjustment on methodologies that focus on a limited range of cost segments. However, these proposals are unduly narrow, and, unlike the Commission's inputs, they lack the grounding in price-cap theory.

In section VI, we note the widely-shared criticisms of the Commission's proposed performance-based rate authority. Labor and (at least certain) industry commenters agree with the Postal Service that, given the Commission's stated goal of providing seed capital for investment, it is arbitrary to withhold the relevant rate authority until after the intended results have manifested on their own. Nonetheless, the section (along with Appendix A) goes on to detail certain misconceptions among industry commenters about how capital funding and productivity are generally addressed in price-cap practice.

Finally, sections VII and VIII address other misconceptions by industry commenters regarding the proposed workshare rules and the import of the U.S. Court of Appeals for the District of Columbia Circuit's recent *Carlson* decision.

II. THE COMMISSION SHOULD REJECT THE WELL-WORN ARGUMENTS AGAINST ALTERING THE PRICE CAP

Not surprisingly, many industry commenters favor the current system and encourage the Commission to leave it unchanged. Their arguments generally proceed along one or more of the following lines: (1) the CPI-based price cap has worked; (2) even if it has not, the Commission cannot change it; and (3) changing the price cap will aggravate the system's problems in any event. None of these arguments are new; they have been raised and addressed in earlier rounds of this proceeding. As before, these arguments downplay both the financial harm caused by the current system and the Commission's statutory duty to do something about it, while at the same time overplaying the ramifications of the Commission's exercise of that statutory duty. The arguments have not become more persuasive with the passage of time, and the Postal Service's financial situation certainly has not improved since these proceedings began in 2016 or since the Commission concluded in 2017 that the current price-cap system has prevented the Postal Service from maintaining financial stability.

As discussed throughout the Postal Service's earlier comments in this proceeding and as briefly reiterated below, the current price-cap system has produced persistently non-compensatory rates, leaving the Postal Service in a precarious financial position and careening toward a liquidity crisis that will threaten our ability to deliver the mail. The Commission is obligated in this proceeding to correct this failure of the system, and additional rate authority is a necessary step toward that correction.

A. The Current System Has Not Allowed the Postal Service to Achieve Financial Stability and Has Left the Postal Service in a Financially Precarious Position

Some comments downplay the Postal Service's financial crisis and leave the impression that there is not really a problem to be solved here,[1] notwithstanding thirteen consecutive years of multi-billion dollar net losses, cumulative losses of more than $75 billion, and an inadequate level of liquidity (which itself has been maintained only by virtue of a temporary relaxation of the price cap as a result of the Commission's approval of the exigent surcharge, and after failing to make $55 billion in congressionally mandated retirement and retiree health benefits (RHB) payments).[2] In the view of these commenters, the ratemaking system has not prevented the Postal

[1] *See* Comments of the American Bankers Ass'n, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "ABA Comments"], at 18 (arguing that the current system is "working, and has provided the Postal Service with the incentives necessary to modernize its operations in a way that should be commended"); Comments of News Media Alliance, PRC Docket No. RM2017-3 (Jan. 31, 2020) [hereinafter "NMA Comments"], at 12 (price cap has "financed market-dominant postal operations successfully without interruption"); Comments of the National Postal Policy Council, the Major Mailers Ass'n, the National Ass'n of Presort Mailers, and the Association for Mail Electronic Enhancement, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "NPPC *et al.* Comments"], at 9-10 (arguing that "financial stability" means the ability to maintain and develop postal services); *id.* at 53 (claiming that the Postal Service "currently enjoys the financial strength to design and maintain the postal services needed by the United States"); *id.* at 40-41 (asserting that the Postal Service's "operational finances" are in better shape than balance sheet suggests, and noting its significant real-estate holdings and high prefunding levels).

[2] See U.S. Postal Serv., FY2019 Form 10-K (2019), at 52-53 (reporting an accumulated deficit of $74.664 billion since 1971 reorganization); *id.* at 62-63 (reporting cumulative net losses of $77.8 billion from 2007 through 2019); *id.* at 39 (reporting unrestricted cash and cash equivalents of $8.8 billion as of September 2019 and an average daily liquidity balance that would cover 58 days of expenses); *id.* at 63 (reporting $55.4 billion in past-due obligations); *see also* 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 171 (showing the shift from $3.242 billion in retained earnings in FY2006 to a $59.113 billion deficit in FY2016).

Service from delivering the mail without interruption, and there is no reason to revisit it to correct what some commenters creatively characterize as "phantom accounting losses." NPPC *et al.* Comments at 52-55. The Commission has already rejected such arguments. In Order No. 4257, the Commission properly held that the focus must be not merely on whether the Postal Service has remained in business during the post-PAEA period or the extent to which its real-estate holdings or current prefunding levels could pay off its obligations were the Postal Service to be dissolved; rather, the focus must be on whether the system has produced sufficient revenues to allow the Postal Service to satisfy its universal-service mission, fulfill its other obligations under the statute, and fund needed capital investments. Order No. 4257 at 148, 165-71. The system clearly has failed to satisfy this standard.

Other comments appear to acknowledge that the Postal Service's financial circumstances are dire and have deteriorated under the PAEA, but they attribute such deterioration to hypothesized shortcomings in Postal Service leadership rather than in the ratemaking system. Under this view, the Postal Service's financial instability is the product of its inability to adequately cut costs or forestall volume declines, and the price cap must be retained to encourage further cost-cutting or volume growth.[3] This claim is again nothing new, and it remains unsupported.

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[3] *See* Comments of National Taxpayers Union, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "NTU Comments"], at 1 ("USPS's financial challenges are a result of uneven management."); Comments of Small Business & Entrepreneurship Council, PRC Docket No. RM2017-3 (Feb. 3, 2020), at 1-2; Comments of American Forest & Paper Association, PRC Docket No. RM2017-3 (Feb 3, 2020) [hereafter "AFPA Comments"], at 4; Comments of Alliance of Nonprofit Mailers, Association for Postal Commerce, MPA—The Association of Magazine Media, American Catalog Mailers Association, Direct Marketing Association of Washington, Nonprofit Alliance, Envelope Manufacturers Association, Saturation Mailers Coalition, and Continuity Shippers Association, PRC Docket No. RM2017-3 (Feb 3., 2020) [hereinafter "ANM *et al.* Comments"], at 15-17; Comments of Discover Financial Services, PRC Docket No. RM2017-3 (Feb 3., 2020) [hereinafter "Discover Comments"], at 15-16; NPPC *et al.* Comments at 5-6.

With respect to cost-cutting, the Postal Service has a duty to operate efficiently and cut costs where reasonably possible. However, we operate within statutory constraints – including the universal service obligation, the collective bargaining and interest arbitration process, and mandated federal employment and post-retirement benefits obligations – that inhibit our ability to reduce costs or improve efficiency. The Commission has already recognized its obligation to consider those constraints, Order No. 4257 at 21, 157-59, 198-200, 219,[4] and acknowledged the Postal Service's extensive efforts to reduce costs and improve efficiency in the face of them. *Id.* at 148, 165-71. Indeed, the only record evidence on this topic concluded that the remaining cost-cutting opportunities within the Postal Service's control are limited and cannot close the large gap between the Postal Service's revenues and expenses,[5] and the Commission has nowhere indicated that the Postal Service's current financial instability is the result of ineffective management. The commenters, meanwhile, essentially ignore the constraints under which the Postal Service operates.

Similarly unfounded are arguments suggesting that the Postal Service somehow possesses as-yet-untapped powers over volume retention. The volume-retention ideas proffered by the commenters – such as improved marketing efforts or service performance[6] – are themselves dependent on the Postal Service generating sufficient

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[4] *See also* Comments of the United States Postal Service, PRC Docket No. RM2017-3 (Mar. 20, 2017) [hereinafter "USPS 2017 Comments"], at 70-72.

[5] *See generally* PRC Ten-Year Review: Cost Efficiency Study (Alvarez & Marsal with the Inst. for Supply Mgmt. 2017), *filed as* USPS 2017 Comments, app. C; *see also* 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 65-67.

[6] *See* ANM *et al.* Comments at 42-43 (asserting that "weak marketing efforts," non-market pricing, and "poor customer service" are factors "associated with mail volume declines"); NPPC *et al.* Comments at 29-30 (suggesting that the Postal Service could impact volume through more "economically efficient prices," simplified mailing requirements and improved customer service).

revenues to improve in those areas. 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 46-53 (describing how retained earnings to invest in maintenance of high-quality service standards “promotes demand for postal products,” and how that dynamic has broken down as a result of the Postal Service’s persistent net losses). Moreover, whatever volume-retention improvements these ideas may theoretically produce are dwarfed by the broader market trends that are driving mail volume to alternative channels. Indeed, many of the same commenters who allege that the Postal Service has some control over volume simultaneously tout the power of electronic alternatives in driving volume decline.[7] Even with a CPI-based price cap, mail volume has declined precipitously and persistently. *See* Discover Comments at 3 (conceding that “[d]igital marketing channels have become more attractive even as postal prices . . . have been limited by the CPI-based price cap”). Hence, the solution cannot be to simply retain the cap in its current form.

The Postal Service’s financial crisis is the result not of a failure to aggressively manage the business to cut costs or retain volume where possible within statutory constraints, but of a system that has not generated enough revenue to cover the costs that those constraints prevent the Postal Service from shedding. In other words, the system has failed despite, not because of, the Postal Service’s efforts to live within it.

[7] Discover Comments at 9 (acknowledging the “societal and technological trends that are causing the Postal Service to lose volume”); NPPC *et al.* Comments at 27 n.28 (“Unlike in the pre-PAEA era, however, customers now have well-established alternatives which have already badly damaged postal volumes, and mailers readily will pursue those alternatives even more vigorously.”); *see also* ABA Comments at 3, 10 (“Technological innovation, customer preferences, and costs drive banks to consider alternative forms of delivery in the service of our customers[.] . . . Alternatives to the postal service exist – and, in many cases, are preferred by consumers. With the advances in technology and security that have occurred even since this proceeding began, consumers are increasingly using electronic means to conduct banking and other financial transactions for ease, speed, and convenience.”).

See infra note 34. Because the Commission cannot alter the statutory constraints in which the Postal Service operates, the only available option to achieve the statutory objectives is to authorize the Postal Service to generate additional revenue, including retained earnings, that will give it a meaningful chance at financial stability. The Commission should not be swayed by the sheer persistence of evidence-free arguments that the system is working or that the system would have worked but for the Postal Service's purported shortcomings.

B. The Commission Can and Must Correct the System's Failures

Another broad theme advanced in several comments is that, even if the current system has failed to produce adequate revenues (and thus has prevented the achievement of critical statutory objectives), the Commission should not fix it. One familiar variant of that argument is that, despite the fact that 39 U.S.C. § 3622(d)(3) specifically authorizes the Commission to modify or replace the system so that it will achieve the statute's objectives, the Commission cannot alter or replace the feature driving the system's failure: namely, the price cap.[8] The Commission has already rejected that view,[9] and the commenters have presented nothing new that calls that rejection into doubt. The only arguably new point here is ANM *et al.*'s citation to the D.C. Circuit's recent decision in *Carlson*.[10] However, the court's decision did not concern the price cap, let alone whether Section 3622(d)(3) authorizes the Commission

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[8] *See* ANM *et al.* Comments at 11-12, 91-104; NPPC *et al.* Comments at 9-13.

[9] Order No. 4258 at 11-25; Order No. 5337, Revised Notice of Proposed Rulemaking, PRC Docket No. RM2017-3 (Dec. 5, 2019), at 32-57; *see also* Reply Comments of the United States Postal Service in Response to Order No. 4258, PRC Docket No. RM2017-3 (Mar. 30, 2018) [hereinafter "USPS 2018 Reply Comments"], at 7-18; USPS 2018 Initial Comments at 11-12; USPS 2017 Comments at 18-27.

[10] *Carlson v. Postal Regulatory Comm'n*, 938 F.3d 337 (D.C. Cir. 2019).

to alter or eliminate it during these proceedings. In fact, the court's opinion did not mention Section 3622(d)(3) at all.

A second variant of the "do nothing" argument is that, even if Section 3622(d)(3) allows the Commission to modify the price cap to satisfy Objective 5, doing so would necessarily run afoul of other statutory objectives.[11] This assertion makes no sense. If having a price cap tied to CPI were the only way a rate-regulation system would satisfy the other objectives in Section 3622(b), then there would have been no reason for Congress to expressly require that the ratemaking system contain a CPI price cap for ten years, after which time that system is to be modified or replaced if it is <u>not</u> achieving those objectives. In other words, this argument that Section 3622(b) compels a CPI price cap is no different from the argument that Section 3622(d)(3) compels a CPI price cap, and it is also contradicted by the plain language and legislative history of the statute.

It is also not clear how providing additional rate authority would actually violate any statutory objectives. Regarding Objective 8, the rates produced under the CPI price cap have long been non-compensatory, and therefore are inherently unreasonable, so it is the current system and not its potential replacement that violates that objective. *See* USPS 2017 Comments at 46-47, 82-83, 107-110; USPS 2018 Initial Comments at 8-9. Regarding Objective 6, the current price cap is already a formula (reflecting consumer inflation), and adjusting that formula to address specific factors (e.g., mail density declines) does not make the system less transparent or more administratively

[11] *See* ANM *et al.* Comments at 14-22; NPPC *et al.* Comments at 19-24; ABA Comments at 11; Discover Comments at 1, 7-8; NTU Comments at 2; NMA Comments at 5-9.

burdensome. As for Objective 2, the Commission has already interpreted it to be directed primarily at providing mailers with stable expectations about the size and pace of future price changes, Order No. 4257 at 55. And we have already explained why this objective would not foreclose the elimination of the price cap entirely, let alone a price cap that incorporates formulaic adjustments in addition to CPI (or some other measure of inflation). *See* USPS 2018 Initial Comments at 36-44. The PAEA's legislative history strongly supports our position,[12] as does the Commission's conclusion that it has the legal authority to substantially modify the price cap. Order No. 4258 at 6-12.

Finally, regarding Objective 1, the idea that efficiency can be incentivized only by limiting rate increases to consumer inflation, without regard to the actual cost trends affecting the regulated entity, is really just another way of saying "lower is better," a philosophy that, as we previously explained, is supported by no principle underlying price-cap regulation. *See* USPS 2018 Reply Comments at 33-35. While price caps are designed to encourage efficiency, they do not do so by holding the regulated firm chronically underwater or driving it to financial ruin. *See* App. A at 8 ("Efficiency incentives do not depend on whether [the price cap provides rate authority above or below the rate of inflation]."). Doing so violates both the legal requirements of reasonable rates and financial stability (Objectives 5 and 8) and incentive-regulation theory, which values realism over artificial stringency in the setting of price caps. *See generally id.* at 3-6, 8.

[12] As we noted in our 2018 Initial Comments, the House version of the PAEA expressly contemplated that non-price-cap regulatory models would be consistent with Objective 2. *See* USPS 2018 Initial Comments at 38. In the legislative compromise enshrined in Section 3622, the House vision of regulatory autonomy essentially prevails after the decade of the Senate's preferred CPI-only price cap. *See id.* at 12, 33-34.

Shifting gears to what could be called a "policy" argument, several commenters argue that, even if the Commission can modify or eliminate the price cap as a legal matter, it should nevertheless decline to do so. In some commenters' view, Congress created the Postal Service's financial instability by imposing unrealistic burdens (such as the prefunding requirements for post-retirement benefits), and so the Commission should allow Congress to fix the problem (perhaps by eliminating the requirements).[13] In effect, these comments invite the Commission to use regulatory inaction as leverage to force Congress to act.

However, for purposes of this proceeding, Congress has already acted. As the Commission has recognized, current law sets forth a statutory requirement that the Commission is not free to disregard: Congress established the CPI-based price cap and required it to remain in place for 10 years, and directed the Commission to thereafter change the system in this proceeding if it concludes that the system has failed to achieve the statute's objectives. *In re Aiken County*, 725 F.3d 255, 260 (D.C. Cir. 2013) ("[A]llowing agencies to ignore statutory mandates and prohibitions based on agency speculation about future congressional action [ ] would gravely upset the balance of powers between the Branches and represent a major and unwarranted expansion of the Executive's power at the expense of Congress."). As one Commissioner summarized earlier in this proceeding:

> [Despite the need for legislative reform, t]he Commission . . . cannot shirk its lawful responsibility to review and, if necessary, propose and implement regulations to address flaws in the market dominant ratemaking

[13] *See* ABA Comments at 12-13; NMA Comments at 13-14; NPPC Comments at 7-8, 40-41, 43-44; Comments of Mailers Hub LLC, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "Mailers Hub Comments"], at 8, 10-11; AFPA Comments at 2, 8; Explanation of Options for a Financially Stable Postal Service, filed by Greeting Card Association *et al.*, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereafter "GCA *et al.* 'Options' Comments"], at 2.

> system. If the Commission determines that the PAEA's range of objectives are not being met, the law empowers the Commission to attempt improvements via the use of one tool alone – reform to the system for regulating rates and classes for market dominant products. In other words, this singular device – the ratemaking system – may be wielded by the regulator in an effort to achieve these objectives.

Order No. 4258, Supplemental Views of Vice Chairman Acton, at 1; *accord* Order No. 1926 at 42 n.27; *id.*, Separate Views of Comm'r Acton, at 3 ("[The Commission's] responsibility is to uphold the law as it is written, not as some would like it to be."). The Commission is not free to disregard this clear statutory directive based on the possibility that there may be different directives in the future.

While the Postal Service has long supported legislative reform to address our post-retirement benefits obligations and other matters, this is not the appropriate forum to debate Congress's policy choices as set forth in current law (or to place pressure on Congress to make different choices). Rather, in this proceeding the Commission must apply the statute as it exists today. The governing statutes expect the Postal Service to provide universal high-quality postal services <u>and</u> to fund RHB and pension benefits for employees and annuitants (among other things), and they require the Commission to modify or replace the ratemaking system in a way that enables those obligations to be fulfilled.

In any event, it is not appropriate to claim that the price-cap system failed simply because of Congress's policy decision to require prefunding of RHB. To be sure, RHB (and other benefits) payments are a significant component of the Postal Service's total costs, are outside of the Postal Service's control, and are matters that the Postal Service believes should be addressed through legislative reform. But, in establishing the initial system, Congress expected (based on pre-PAEA volume trends and forecasts) that a CPI-based price cap on market-dominant products would yield sufficient revenues to cover those obligations while still enabling the Postal Service to provide universal postal service and fund needed capital investments.[14] Of course, the implicit assumption on which that expectation was based – that mail volume would continue along its then-current trajectory – proved to be false. Mail volume dropped precipitously and persistently almost immediately after the PAEA's enactment, and the austere price-cap system was insufficiently flexible to allow the Postal Service to generate enough revenue to cover costs, let alone produce retained earnings, while continuing to provide quality postal services. The system's inflexibility proved to be its undoing, and that is what the Commission has both the power and the duty to correct in these proceedings.

Finally, the proposed strategy of waiting for legislative change is no guarantee that Congress will act. Several postal reform bills have been introduced in recent years, and none has been enacted. *See* Order No. 4258, Separate Views of Vice Chairman Acton, at 1 ("The last few years have seen significant bipartisan efforts in Congress to craft such reform, and it has yet to come to fruition."). Even if Congress does act, no one can predict exactly what choices it will make or the impact (if any) that those choices will have on the Postal Service's financial position.[15] *See* Order No. 937, Order

[14] As some commenters note, the rate base going into the PAEA already included amounts to fund post-retirement benefits forecasted for FY2008, including (but not limited to) the escrow payments that the PAEA effectively replaced with RHB payments. ANM *et al.* Comments at 53 n.18; NPPC *et al.* Comments at 44-46. That the rate base later proved insufficient to cover those payments is a testament to the price cap's failure to adjust for density loss and other exogenous factors.

[15] Two commenters pin their legislative hopes on a current bill, the USPS Fairness Act (H.R. 2382), which passed the House of Representatives last month. *See* ABA Comments at 9; NMA Comments at 14 n.12. But H.R. 2382 illustrates why waiting for Congress to act is not a viable approach for the Commission in these proceedings. H.R. 2382 would absolve the Postal Service from making RHB prefunding payments into the Postal Service RHB Fund. However, the bill does not address pension prefunding at all and

Denying Motion to Stay and Establishing Further Procedures, PRC Docket No. R2010-4R (Oct. 31, 2011), at 7-8 & n.13 (denying a motion to stay "because the legislative process is uncertain, and the results of pending legislation are highly speculative," and citing supporting case law). In the event that Congress does pass postal-reform legislation prior to the next system review, the Commission can (and plans to) revisit the ratemaking system at that point to see whether further adjustments are appropriate. Order No. 5337 at 94, 243.[16] In the meantime, the Commission is not authorized to disregard the policy decisions that Congress has already made, and it should reject calls to prod Congress into action by abdicating its statutory duty to fix the ratemaking system now. Having found that the current price-cap system has failed to produce adequate revenues to cover the obligations established by Congress and hence has failed to meet the statutory objectives, it must correct the system's failures.

C. Adjusting the Price Cap Will Not (and Cannot) Undermine Objective 5

Several comments assert that providing additional rate authority will lead to a "death spiral" that will actually <u>harm</u> the Postal Service's financial condition, and thus will work against the goal of financial stability.[17] As with the above-mentioned

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would not reduce the Postal Service's liability for covering postal retirees' RHB premiums once the RHB Fund is exhausted. *See* 39 U.S.C. § 8906(g)(2)(A). Therefore, while the Postal Service views the changes as an important part of the legislative reform that it is seeking, as the bill would improve the Postal Service's balance sheet if enacted, the bill would not, by itself, affect the Postal Service's cash flow, improve liquidity, or allow the Postal Service to cover total costs.

[16] With respect to post-retirement benefits costs, adoption of an adjustment factor to pass through changes in those exogenous costs would allow for the impacts of legislative reform to be incorporated automatically into the price cap. *See* App. A at 15-16; USPS 2018 Reply Comments at 21-22.

[17] *See* NPPC *et al.* Comments at 22-23, 36-38; ANM *et al.* Comments at 38; Mailers Hub Comments at 3-7; ABA Comments at 10-11; AFPA Comments at 3; Discover Comments at 4; GCA *et al.* "Options" Comments at 1; NTU Comments at 2; Comments of eBay, Inc., PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "eBay Comments"], at 3-4; Corrected Comments of Parcel Shippers Association, PRC Docket No. RM2017-3 (Feb. 5, 2020) [hereinafter "PSA Comments"], at 6-7.

arguments, there is nothing new here. As before, this argument founders on the complete absence of evidence and a failure to appreciate the distinction between the provision of rate authority and the actual use of such authority.

The “death spiral” hypothesis rests on the premise that demand for market-dominant products has become so elastic that the Postal Service cannot raise prices profitably, i.e., that price increases will drive away so much volume as to leave the Postal Service with less contribution despite the price increases. It is a strange hypothesis to advance in support of a price cap. First, price caps exist in large part to limit the extent to which a regulated firm can <u>improve</u> its finances by charging higher prices to captive customers. Here, though, commenters are arguing that the existing price cap is needed to prevent the Postal Service from <u>harming</u> its finances because its customers are not captive and will leave the mail. We are unaware of any theoretical basis for using a price cap to effectively protect the regulated firm from its own pricing decisions. Second, if the premise of the “death spiral” hypothesis were valid, then there is necessarily no need for a price cap at all. If price increases would be inherently self-defeating because they would drive customers to alternative delivery channels, then those alternatives are already an adequate check on the Postal Service’s pricing power. As we have said twice before, parties cannot have it both ways, arguing on the one hand that customers will leave the mail if the Postal Service raises rates, while arguing on the other hand that a price cap is needed to protect “captive” customers. USPS 2017 Comments at 189-90; USPS 2018 Reply Comments at 29-30.

In any event, the comments advancing the “death spiral” hypothesis continue to cite no empirical evidence to support it. The elasticities of major market-dominant products have remained fairly constant over the past two decades, despite significant technological change.[18] And any suggestion that those elasticities will not hold if prices rise significantly above consumer inflation runs headlong into real-world experience: the exigent increase raised prices of market-dominant products by an average of 4.3 percent above CPI-U and remained in effect for more than two years; the Postal Service has increased prices of several individual products by more than the rate of inflation (including, for example, a 10 percent price increase for Single Piece First-Class Mail in January 2019); and Royal Mail (which has elasticity estimates comparable to the Postal Service's) raised prices considerably in the 2012-13 fiscal year.[19] In each instance, the demand response was in line with the elasticity estimates. In addition, the Commission has already rejected arguments that the Postal Service's elasticity estimates are somehow invalid or will not hold if prices rise substantially above consumer inflation,[20] finding in its decision approving the exigent price increase that "the Postal Service's

[18] As Dr. Michael Bradley notes, ANM *et al.* invent a graph purporting to show potential volume declines with a 50 or 100 percent increase in price elasticities, yet they fail to offer any empirical basis to think that such increases are realistic. App. B at 6-8. Moreover, even at double the level of current elasticity estimates, "market dominant demands would remain inelastic overall." App. A at 14.

[19] Specifically, Royal Mail raised the base rate of single-piece letters by 30-40 percent, and the minimum prices of certain business mail categories by 6-8 percent above inflation. *See* Ofcom, Annual Monitoring Update on the Postal Market, Financial Year 2016-17 (Nov. 23, 2017), at 3, 5, http://tiny.cc/Ofcom-2016-17-ann-rept; *id.*, Interactive Data – Raw Data, http://tiny.cc/Ofcom-2017-report-data, tab "Business prices", cells D16-D17, D71-D72, D82-D83, D93-D94; *see also* Ofcom, Review of the Regulation of Royal Mail (Mar. 1, 2017), at ¶ 3.111-.112, http://tiny.cc/Ofcom-03-17-review.

[20] *See, e.g.*, Comments of the National Postal Policy Council et al. in Opposition to Exigent Rate Increase, PRC Docket No. R2013-11 (Nov. 26, 2013), at 36-38 (arguing that the Postal Service's price-elasticity estimates "do not provide useful insights of how volume would change in response to larger real price changes" under current circumstances, considering that the "market in which [the Postal Service] operates today differs greatly from that of 2006 or earlier years" due to the "rapid improvements in alternative means of communication since 2006 or 2007"). *See also* Order No. 1926 at 148-154 (describing mailer arguments against exigent case on the ground that, because ample alternatives to the mail exist, rate increases by the Postal Service could simply exacerbate the Postal Service's financial problems by driving more volume away than the Postal Service's elasticities would indicate).

model provides the most reliable available estimate of the likely impact on volume of the proposed rate increase."[21] No commenter has provided a new demand model or otherwise supplied a sound basis to believe that demand for market-dominant products has become more price-sensitive, relying instead on unsubstantiated arguments that have been raised and addressed previously.

Even if the "death spiral" hypothesis were somehow valid, moreover, the provision of additional rate authority cannot harm the Postal Service unless the Postal Service actually <u>uses</u> such authority.[22] And this again highlights the critical distinction between the role of the Commission and the role of the Postal Service's Governors. The Commission's role is to establish and revise the ratemaking system to achieve the objectives, such that the outer bounds of available pricing authority will give the Postal Service a reasonable opportunity to achieve and maintain financial stability while it fulfills its duty to operate efficiently within the constraints of the law. The Governors' role is to exercise business judgment in determining whether and how to use that

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[21] Order No. 1926 at 156-57; *see also* Order No. 3100, Order Closing Docket, PRC Docket No. RM2014-5 (Feb. 26, 2016), at 9 (in closing mailer-initiated proceeding to consider elasticity issues without issuing a notice of proposed rulemaking, observing that "neither the commenters nor respondents to the [Notice of Inquiry] provided a new postal demand model to replace the current Postal Service's demand model," and that "there is no indication that issuing a notice of proposed rulemaking based on these proceedings would result in an improvement in the quality, accuracy, or completeness of the data or analysis of data contained in the Postal Service's annual periodic reports to the Commission.").

[22] A small handful of commenters continue to reject this distinction, asserting that the mere <u>possibility</u> of above-CPI rate increases is enough to drive volume from the system. ANM *et al.* Comments at 32-33; Mailers Hub Comments at 8. This assertion is undermined by the fact that there has not been an unexpected change in demand for market-dominant products during the pendency of these proceedings, even though the possibility of additional rate authority has been present at least since the Commission concluded that the current CPI-based price cap has failed to provide adequate revenues. Similarly, the demand model proved robust during and after proceedings on the exigent surcharge, despite the fact that the amount of revenue recoverable by the price increase, and therefore the length of time the surcharge would be in effect, was the subject of considerable dispute and uncertainty for years. *See* Comments of the Major Mailers Ass'n *et al.*, PRC Docket No. RM2017-3 (Mar. 20, 2017), at 22-23 (arguing that "mailers operated from July 2010 until December 2016 under the cloud of either a request for or an actual exigent surcharge," which "made mailers wary of committing to the mail, and has encouraged them to seek electronic alternatives more aggressively").

authority, based on a holistic consideration of the Postal Service's financial needs, best practices of efficient management, and fairness to customers. *See* 39 U.S.C. § 404(c); United States Postal Service Notice of Market-Dominant Price Change, PRC Docket No. R2020-1 (Oct. 9, 2019), at 9-10.

As we have previously explained, in considering the Postal Service's financial needs as part of making pricing decisions, the Governors must contend with the possibility that our elasticity estimates may not accurately predict the demand response to significant rate increases under current circumstances, and that such rate increases could lead to significant (and potentially permanent) level shifts in volumes that could be detrimental to the Postal Service. *See generally* USPS 2018 Reply Comments at 30-33; USPS 2017 Comments at 185-90.[23] The risk that using too much pricing authority will permanently harm the Postal Service's financial position will necessarily be an important consideration in the Governors' pricing decisions. But if the Commission takes that responsibility out of the Governors' hands and artificially limits their pricing discretion out of concern that the Governors will not use it wisely, then the Commission will not only have exceeded its role as regulator but will also have guaranteed that the Postal Service's financial instability will persist. The Commission's role in these proceedings is to give the Postal Service the legal authority to price in a manner that will achieve the purposes of the statute, including compensatory rates and financial stability for the Postal Service.

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[23] Some mailers rely on past practice to suggest that the Governors will necessarily use any pricing authority conferred rather than engage in the kind of business judgment discussed above. ANM *et al.* Comments at 36-38; NMA Comments at 9 n.4; Comments of Meredith Corp., PRC Docket No. RM2017-3 (Feb. 3, 2020), at 2. However, the Postal Service's history of typically using all available rate authority is no meaningful guide. Because the CPI-based price cap was so rigid, there was little choice but to use the authority given in order to sustain operations.

In short, while there is no evidence to suggest that raising prices above CPI will cause a "death spiral" and harm the Postal Service's finances, the Postal Service's Governors are aware of the potential risks and have every incentive to make pricing decisions aligned with market realities. It may well be that market conditions will prevent the Governors from exercising any or all of the additional authority, but that question is a decision for the Governors and should not be used to set the contours of the ratemaking system. The Commission instead should be giving the Postal Service the tools that may allow it to survive and potentially succeed in a challenging marketplace.

III. BOTH A RATE RESET AND DATA-BASED ADJUSTMENTS ARE VALID AND RATIONAL ELEMENTS OF RATE REGULATION

ANM *et al.* and their declarants depict a world in which the only valid form of incentive regulation is a particular form of a pure "I-X" formula based solely on forward-looking values; any deviation from this model is castigated as "a cost of service regime with deferred revenue collection" or, worse yet, illegal "retroactive ratemaking." ANM *et al.* Comments at 17, 51, 65; *see also* Expert Declaration of Robert D. Willig (Feb. 3, 2020) [hereinafter "Willig Declaration"], at 17, *filed with* ANM *et al.* Comments.[24] This depiction of law and regulatory theory and practice is wholly inaccurate. ANM *et al.*'s rigid notion of the anti-retroactivity doctrine – and their belief that it applies here in the first place – is unsupported by case-law. And as for regulation, ANM *et al.*'s interpretation of an "I-X" price cap captures only a narrow range of the varied aspects

[24] Dr. Willig distinguishes between "cost-plus" and "rate of return" regulation, *see* Willig Declaration at 5-6, but that distinction makes no difference to his analysis in chief.

and flavors of incentive regulation, while excluding well-established regulatory tools that use actual data rather than forecasts.

A. The Doctrine Against "Retroactive Ratemaking" Does Not Bar Recalibration or Adjustment of the Price Cap

ANM *et al.*'s argument about "retroactive ratemaking," *see* ANM *et al.* Comments at 17 & n.1, 51 n.17, misses the mark for a number of reasons. First, that doctrine does not apply to the regulation of postal rates under Title 39. The rule against retroactive ratemaking, like the corollary filed-rate doctrine, derives from specific statutory provisions that charge the relevant regulator – in near-identical terms – with fixing the rates (or maximum or minimum rates) "to be thereafter observed." 15 U.S.C. § 717d(a) (Natural Gas Act); 16 U.S.C. § 824e(a) (Federal Power Act); 47 U.S.C. § 205(a) (Telecommunications Act); *see, e.g.*, *City of Anaheim, Cal. v. FERC*, 558 F.3d 521, 523-24 (D.C. Cir. 2009) (Kavanaugh, J.) (discussing *Ark. La. Gas Co. v. Hall*, 453 U.S. 571, 578 (1981) and other D.C. Circuit opinions that ground the anti-retroactivity doctrine in the language of the statutory provisions cited here); *Pub. Serv. Co. of N.H. v. FERC*, 600 F.2d 944, 957-58 (1979) (discussing earlier opinions that did the same). No such provisions govern market-dominant ratemaking under Title 39. *Cf. Trans World Airlines, Inc. v. Civil Aeronautics Bd.*, 637 F.2d 62, 75-76 (2d Cir. 1980) (recognizing the regulator's discretion as to retroactivity under a statute that did not proscribe it).

Moreover, the D.C. Circuit has specifically held that the anti-retroactivity doctrine does not apply to postal ratemaking, for reasons that resonate today:

> Even if the Postal Service were treated as a conventional utility, the rule might be inapplicable in view of the restrictive circumstances surrounding

> the Postal Service's financial decline.[25] In any event, it would be incongruous for us to clamp the shackles of a narrow rule onto the Postmaster General's attempt to return the Postal Service to financial stability, especially in light of the congressional intent to provide the Postal Service with the "unfettered authority and freedom it has been denied for years to maintain and operate an efficient service."[26]

Nat'l Ass'n of Greeting Card Publishers v. U.S. Postal Serv., 607 F.2d 392, 429 (D.C. Cir. 1979) (opinion for the court by Tamm, J.) (affirming the Postal Rate Commission's opinion and recommended decision in Docket No. R76-1).[27] Notably, the D.C. Circuit upheld a proposition that would, in another regulatory context, clearly breach the anti-retroactivity doctrine: the recovery of prior years' losses (in addition to the current or projected before-rates loss) in the rates to be charged going forward. Neither the Commission nor any party has proposed such a retroactive recovery mechanism here.

Even if the anti-retroactivity doctrine did apply to postal ratemaking, moreover, ANM *et al.* are mistaken in believing that it would be implicated by any proposal at issue here. In the statutory frameworks where they apply, the filed-rate and anti-retroactivity doctrines work in concert. If past rates are later found to be too low or too high, the regulated entity cannot collect or owe "reparations" for service already provided, either through retroactive billing adjustments (the filed-rate doctrine) or by including prior years' losses or excess profits in new rates (the anti-retroactivity doctrine). *E.g.*,

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[25] [Footnote 77 in original:] *See Communs. Satellite Corp. v. FCC*, [611 F.2d 883, 898 n.19 (D.C. Cir. 1977)] (where a history of agency strictures has prevented a reasonable rate of return, a company might be entitled to recover its losses).

[26] [Footnote 78 in original:] S. Rep. No. 912, 91st Cong., 2d Sess. 2 (1970).

[27] This reasoning retains its force even after the PAEA abolished the breakeven constraint: the *Communications Satellite Corp.* opinion on which the *NAGCP* court relied likewise concerned regulated entities without a breakeven constraint. Moreover, the ratemaking system is still required to provide the Postal Service with financial stability and "reasonable" rates, which the Commission has interpreted to mean allowing the Postal Service to cover total costs and generate retained earnings over time. Order No. 4257 at 4, 154, 158-59, 165-71, 226, 235-36.

Associated Gas Distribs. v. FERC, 898 F.2d 809, 810-11 (D.C. Cir. 1990) (denying rehearing and rehearing *en banc*) (Williams, J., concurring) (explaining the difference between the two doctrines).

Neither the Commission nor any party has proposed that the rate schedule for, say, 2015 be replaced with a new 2015 rate schedule, and that persons who sent mail in 2015 be assessed the difference. *See id.* (the filed-rate doctrine would be implicated if FERC "substitut[ed] in 1988 a new rate schedule for gas purchased in 1983-86"). Nor is any party proposing that losses from 2015 or any other past year – the Postal Service's accumulated net deficiency – be recovered in future rates.[28] While the Postal Service, labor stakeholders, and the Commission itself (in Order No. 4258) have proposed rate authority that would allow rates to be reset to compensatory (i.e., "reasonable") levels, the focus has generally been on setting a reasoned baseline reflecting the expected net loss going into the new period. Estimating that expected net loss requires reference to current and historical antecedent facts, such as the net loss in representative recent years or, in APWU's recent proposal, the amount of the financial gap attributable to mail-density loss since rates were last at a compensatory level. But mere reference to antecedent facts does not make a regulation retroactive. *Bell Atl. Tel. Co. v. FCC*, 79 F.3d 1195, 1207 (D.C. Cir. 1996) (quoting *Landgraf v. USI Film Prods.*, 511 U.S. 244, 269 n.24 (1994)). Indeed, as discussed in the next section, rate resets

[28] Because the retirement rate authority would be based on actual invoices in each year of the new price-cap period, it cannot reasonably be characterized as "a transparent attempt to retroactively correct the price cap to recover costs that the Postal Service failed to recoup since 2006." ANM *et al.* Comments at 52. Even if it were, as noted earlier, such recovery of a prior year's loss would be permissible in the postal context, even if not in other regulatory contexts.

based on going-in rate and cost levels are an established feature of price-cap regulation.[29]

More specifically, ANM *et al.* claim that the anti-retroactivity doctrine (if applicable) would bar Order No. 5337's proposals to adjust the price cap based on the prior year's changes in mail density and amortization expenses. ANM *et al.* Comments at 7, 17, 39, 41, 51-53. But, according to the very case law that ANM *et al.* cite, there is no retroactivity violation where the charging of "past" costs is part of an established plan. *Town of Norwood v. FERC*, 53 F.3d 377, 381-83 (D.C. Cir. 1995) (discussing *Pub. Sys. v. FERC*, 709 F.2d 73, 84-85 (D.C. Cir. 1983) (transition to tax-normalization accounting), and *Pub. Serv. Co. of N.H.*, 600 F.2d at 950 (fuel adjustment clauses)). Provided that ratepayers have notice about the plan, "it is permissible for a company to <u>defer</u> collection of certain charges until the point at which they become ascertainable." *Id.* at 383 (emphasis in original). What is not allowed is to "adjust future rates to 'recoup past losses'" where a regulated entity "include[d] an estimate of certain costs in its rates and subsequently finds out that the estimate was too low." *Id.* at 381 (quoting *City of Piqua v. FERC*, 610 F.2d 950, 954 (D.C. Cir. 1979)). Here, it is clear that a final rule based on Order No. 5337 would give postal ratepayers notice that future rate authority will be adjusted on account of each prior year's change in density and amortization expenses. Such proposed rate authority would be consistent with *Norwood*.

Moreover, Order No. 5337 does not propose to set specific rates and to adjust them annually. Rather, it would establish a <u>formula</u> that incorporates adjustments

[29] Moreover, if prior years' costs could not serve as a basis for establishing current rates, then the anti-retroactivity doctrine would vitiate the entire body of cost-of-service regulation: the very setting in which it arose.

based on various actual data inputs during the price-cap period (i.e., mail density, amortization payments, and consumer inflation). Given the prior notice that this approach provides ratepayers about the adjustments that will be made, it is the sort of formula-based ratemaking that the D.C. Circuit has upheld in the face of retroactivity-based challenges. *See, e.g.*, *Old Dominion Elec. Coop. v. FERC*, 892 F.3d 1223, 1231 (D.C. Cir. 2018) (citing *West Deptford Energy, LLC v. FERC*, 766 F.3d 10, 22 (D.C. Cir. 2014); *NSTAR Elec. & Gas Corp. v. FERC*, 481 F.3d 794, 801 (D.C. Cir. 2007); *Pub. Utils. Comm'n of Cal. v. FERC*, 254 F.3d 250, 254 (D.C. Cir. 2001); *Transwestern Pipeline Co. v. FERC*, 897 F.2d 570, 577-78 (D.C. Cir. 1990)). Far from working an "illegal" "retroactive true-up," ANM *et al.* Comments at 17 n.1, factors to adjust a price cap for exogenous changes in costs can be necessary to ensure that rate levels "accurately reflect[ ] the [regulated entity's] costs and productivity," rather than allowing profits or losses to accrue "as a result of administrative error." *Bell Atl. Tel. Co.*, 79 F.3d at 1205. That such factors may be based on "antecedent facts" does not make them impermissibly retroactive: more relevant is their effect in determining ratepayers' future, not past, liabilities. *Id.* at 1206-07 (quoting *Landgraf*, 511 U.S. at 269 n.24, and discussing *Ass'n of Accredited Cosmetology Schools v. Alexander*, 979 F.2d 859, 861-66 (D.C. Cir. 1992), and *Adm'rs of the Tulane Ed. Fund v. Shalala*, 987 F.2d 790, 798 (D.C. Cir. 1993)). Thus, both a reset of rates to compensatory levels and formulaic adjustment factors based on antecedent data would be consistent with the anti-retroactivity rule, even if it had any bearing in the postal ratemaking context.

B. Cap Recalibration and Actuals-Based Adjustments Are Consistent with Price-Cap Theory and Practice

ANM *et al.*, following their declarant Dr. Willig, misrepresent several salient aspects of price-cap theory and practice. The critique that follows is supported by the declaration of Drs. A. Thomas Bozzo and Mark E. Meitzen (Appendix A to these comments).[30]

First, Dr. Willig asserts that "a genuine price cap system of regulation" does not allow prices "to rise with increases in the costs incurred by the firm, nor with increases in the firm's capital stock, nor with diminutions in the consumer demand for the firm's outputs." Willig Declaration at 6; *see also* Expert Declaration of Kevin Neels & Nicholas Powers (Feb. 3, 2020) [hereinafter "Neels/Powers Declaration"], at 4, *filed with* ANM *et al.* Comments (relying on this characterization as the basis for analysis). In his depiction, the only periodic consideration is "renegotiation" of the price-cap formula's X-factor; "backward looking true-ups are to be strongly discouraged in an optimal system on incentive grounds." Willig Declaration at 7. It must be noted that this describes, at best, only the original, theoretical ideal of price-cap regulation: as discussed later in this section, it is at considerable variance from actual regulatory practice. Moreover, its logic holds only in regulatory environments where regulated entities are fundamentally profitable, such that the only "just and reasonable" concern is with avoidance of excess profits for the regulated firm, not provision of sufficient revenues for the firm to be financially sustainable. *See* App. A at 4-5.

[30] Drs. Bozzo and Meitzen are economists with years of specialized expertise in incentive regulation, productivity measurement, and postal regulation. App. A at 1-2.

Perhaps most importantly, even as a description of theory, Dr. Willig's depiction captures only the state of play during a price-cap period. Any system of regulation under a "just and reasonable" legal constraint must ensure that rates are compensatory: hence, under standard regulatory practice, price caps are periodically reopened and recalibrated to the regulated entity's current cost structure. *See id.* at 4-5; *accord* Declaration of John Kwoka and Robert Wilson [for the Public Representative], PRC Docket No. RM2017-3 (Mar. 1, 2018) [hereinafter "Kwoka/Wilson Declaration"], at 7, 8 n.5, 9, 17.[31] Hence, despite Dr. Willig's assertion that "backward looking true-ups" are not "optimal," price-cap resets, which, at a minimum, incorporate information on the regulated firm's actual performance, are nonetheless an essential component of price-cap regulation.

Second, in criticizing the proposed density, retirement, and performance-based rate authority as incompatible with price-cap theory, Dr. Willig wrongly asserts that price-cap regulation is limited to "'price index minus X,' where X is a predetermined percentage reflecting a productivity growth target, which would remain in effect for an extended period of time." Willig Declaration at 9; *see also* Neels/Powers Declaration at 6, 20 (focusing solely on the role of a productivity-based X-factor in price-cap regulation).[32] In reality, price-cap regulation features not only inflation and "X," but also "one or more factors to capture exogenous cost changes." *See* Kwoka/Wilson

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[31] Dr. Kwoka played a foundational role in the development of both the FCC's original price cap and the price-cap provisions of the PAEA. Kwoka/Wilson Declaration at 2-3. *See also* William Zarakas et al., Performance Based Regulation Plans: Goals, Incentives & Alignment (Brattle Group 2017), at 15, https://brattlefiles.blob.core.windows.net/files/14487_2017_12_06_-_brown_et_al_-_pbr_plans_goals_incentives_and_alignment_-_for_dte.pdf.

[32] As explained in section V below and Appendix A, however, the density rate authority is actually an algebraic outgrowth of the traditional X-factor formula.

Declaration at 8; *see also* App. A at 5-6.[33] Because these factors (characterized as Y- and Z-factors) inherently reflect forces outside of the regulated entity's control, leaving them within the price cap would undermine the intent of incentive regulation by allowing the entity's financial stability to fluctuate as a function of those forces, rather than of its own performance. App. A at 6. Hence, pertinent incurred costs – determined by a backward look at actual expenses – are "passed through dollar-for-dollar to consumer rates." Kwoka/Wilson Declaration at 8. The proposed density and retirement rate authority are appropriately premised on a regulatory determination that the relevant cost drivers are primarily (if not entirely) external to the Postal Service. *See* App. A at 14; Comments of the Public Representative, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "Public Representative Comments"], at 5-6.[34] As such, contrary to Dr. Willig's apparent belief that a "risk sharing" forecast-based approach is necessary, Willig Declaration at 12-13, it is entirely consistent with price-cap theory and practice to deal with them through annual adjustments based on actual data.

[33] Such exogenous factors date back to the very first price cap in the United States. *See* Christensen Assocs., Analysis of the PAEA's CPI-Based Price Cap System & Options for Future Postal Regulation (Mar. 20, 2017), at 15 (describing the role of Z-factors in the original Federal Communications Commission price cap), *filed as* Comments of the United States Postal Service, PRC Docket No. RM2017-3 (Mar. 20, 2017), app. E.

[34] Indeed, given the financial instability that the Postal Service has experienced under a rigid CPI-only cap, it is hard to see how it has had anything but inherent incentives to strive for volume retention. Thus, it is difficult to attribute the persistence of mail-volume declines to anything other than overwhelmingly external forces. (If anything, any Postal Service influence over mail volumes may have helped keep volumes from falling even farther.) Thus, even if it the Postal Service may theoretically have some margin of indirect influence over mail volume, *see* AFPA Comments at 5; ANM *et al.* Comments at 41-43; Discover Comments at 8-9; NPPC *et al.* Comments at 29-30, that point is irrelevant to the matter at hand. On a practical level, it should also be noted that, following the Public Representative declarant whom they invoke, none of these commenters proposes a method to isolate the (likely small) share of mail-volume declines that are endogenous rather than exogenous.

Third, Dr. Willig fails to recognize another feature of price-cap regulation. Particularly when broad technological and other market-structural factors are driving demand declines, it must be recognized that policy objectives beyond simple cost control may be at play, requiring a more expansive set of regulatory tools than a pure "I-X" formula.[35] In practice, these tools can include above-cap increments of pricing authority aimed at funding capital investment. *See* App. A at 6, 17.[36] They can also include performance incentive mechanisms that reward the regulated entity with additional rate authority on the basis of actual (not merely forecasted) performance against a chosen metric, in furtherance of policy objectives not encompassed by, or even contrary to, the incentives of an "I-X" price cap. *Id.* at 17-18.[37] These two types of

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[35] William Zarakas, *A New Face for PBR: Aligning Incentives in the Electric Utility System*, PUB. UTILS. FORT. (Dec. 2017), https://www.fortnightly.com/fortnightly/2017/12/new-face-pbr?authkey=e0a4230ee85eb602f123c1e633c0e5b5260f9bd3f297c094c055e7868e5a4589 (describing how regulators are increasingly trying out "[a] variety of regulatory options" to further policy goals, such as grid modernization and promotion of grid accessibility, that "[t]he incentives embedded in [traditional price caps] were not intended to promote"). That said, even the sort of forecast-based X-factor that Dr. Willig and ANM *et al.* propound "can include expenditures needed to support" increased infrastructure investment. Mark Newton Lowry & Tim Woolf, Performance-Based Regulation in a High Distributed Energy Resources Future (Lawrence Berkeley Nat'l Lab. 2016), at 43, https://emp.lbl.gov/sites/all/files/lbnl-1004130_0.pdf.

[36] *See also* Zarakas et al., *Performance Based Regulation Plans* at 9, 16 (acknowledging "riders/trackers and similar mechanisms" as regular exceptions to "I-X" during a price-cap plan); Toby Brown, Neil Lessem, & William Zarakas, Incentive Mechanisms in Regulation of Electricity Distribution: Innovation and Evolving Business Models (Brattle Group 2018), at 17, https://brattlefiles.blob.core.windows.net/files/15250_incentive_mechanisms_in_regulation_of_electricity_distribution_-_innovation_and_evolving_business_models.pdf (describing the U.K. gas and electricity regulator Ofgem's decade-long approval of additional rate authority to fund research and development, which had deteriorated since privatization of electricity distribution).

[37] *See also* Zarakas et al., *Performance Based Regulation Plans* at 51-53 (discussing the interaction of targeted performance incentives with price caps); *see generally* Newton Lowry & Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future*; Melissa Whited et al., Utility Performance Incentive Mechanisms: A Handbook for Regulators (Synapse Energy Economics 2015), https://www.synapse-energy.com/sites/default/files/Utility%20Performance%20Incentive%20Mechanisms%2014-098_0.pdf; William P. Zarakas & Philip Q Hanser, Targeted Performance Incentives: Recommendations to the Hawaiian Electric Companies (Brattle Group 2014), https://brattlefiles.blob.core.windows.net/files/5915_targeted_performance_incentives_-_recommendations_to_the_hawaiian_electric_companies__zarakas_hanser_091514.pdf.

mechanisms can even exist side-by-side with respect to a given investment activity. Unlike the Commission's proposed performance-based rate authority, however, the two mechanisms are typically distinguished from one another in recognition of the fact that investment precedes outcomes.[38] Thus, pure "I-X" plans "rarely exist in isolation. Instead, they are part of a larger framework that is, ideally, thoughtfully integrated in a way that balances overall incentives, reward and risk." Zarakas et al., *Performance Based Regulation Plans* at 56-57.

In sum, price-cap regulation encompasses a far more diverse array of regulatory principles, concepts, and tools than Dr. Willig and his sponsors assert. At the level of principle, regulatory goals extend beyond a simple focus on cost control to encompass the assurance of "just and reasonable rates" and the funding of needed infrastructure investments. The resulting tools include, among other things, periodic recalibration of rates to compensatory levels, adjustment factors to pass through (actual) cost increases due to specified exogenous factors, and above-cap rate authority to fund capital needs. Needed refinements aside, the principles animating the Commission's proposals of additional rate authority are well within the bounds of regulatory theory and practice.

C. Data-Based Adjustments Promote Achievement of Objective 6

As explained in the previous section, the essentially exogenous nature of density and retirement-expense changes means that the price cap should be corrected for those changes. As a matter of principle, there is nothing to be "incentivized" by making the Postal Service share any portion of the risk of exogenous cost changes, including

[38] *See* Brown et al., *Incentive Mechanisms in Regulation of Electricity Distribution* at 14 (describing Ofgem's creation of a hybrid mechanism to pass 80 percent of certain capital expenses to consumers, with the remainder, plus an incentive rate, provided on the basis of the volume and cost-effectiveness of the resulting installed capacity).

through the use of forecasts that may prove wrong. *Compare* Willig Declaration at 12-13 *with* App. A at 11, 15-16. In addition to the theoretical basis for using actual data to compute such rate-authority adjustments, doing so would ground the rate authority in empirically verifiable facts. By contrast, a forecast-based approach is inherently subjective and would provide ample room for debate over methodologies, assumptions, and other inputs. Such an approach would represent an incremental retreat to the battles over test-year projections in pre-PAEA ratemaking, thereby "[increasing] the complexity of rate proceedings and [decreasing] the availability of comprehensive understandable material relating to each rate proceeding." *See* Order No. 4257 at 68 (interpreting Objective 6). Rather than engage in further months or years litigating forecasts, there is no conceptual or practical reason why adjustments for density and retirement expenses cannot simply be made on a formulaic, pass-through basis.

IV. A NET-LOSS APPROACH TO A RATE RESET WOULD BE SIMPLER THAN A "ROOT-CAUSE" APPROACH

As discussed in section III.B above, standard regulatory practice is to periodically reset rate authority between price-cap periods to account for variance (in either direction) between rates and total average unit costs.[39] While the adjustment factors proposed by Order No. 5337 are needed to maintain the value of the going-in rate base against exogenous pressures, Order No. 5337 goes awry in discarding (without

[39] This principle applies across the entire price-capped rate base. *See* Kwoka/Wilson Declaration at 7 ("[In a reset exercise], price 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 for that product divided by the number of relevant mail pieces. The total cost combines both variable and fixed cost, and, for the Postal Service, is the sum of attributable and institutional cost."). As such, the Public Representative appears to misunderstand his own declarants, insofar as he invokes them in furtherance of a "[o]ne-[t]ime [r]eset of the [c]ap" for only those products whose average price is below attributable costs. *See* Public Representative Comments at 49-50. This mismatch between the Kwoka/Wilson Declaration and the Public Representative's inexplicably divergent proposals is not new. *See* USPS 2018 Reply Comments at 44-46.

explanation) any effort to reset rate levels to a new baseline. Without a full reset, the adjustment factors will, in principle, merely keep the rate base at a non-compensatory and objective-failing level for reasons unrelated to Postal Service performance. *See* Initial Comments of the United States Postal Service, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "USPS Comments"], at 7-15.

The labor commenters understand this fundamental point, although they present a new approach to a rate reset. Instead of treating recent net losses as a proxy for the expected baseline net loss absent a reset,[40] the labor commenters propose to use the density rate authority formula to determine how much the pre-PAEA rate base's coverage of total costs has been eroded by exogenous changes in density.[41] There is undoubtedly some appeal to such an approach. It would be a rational extension of the Commission's stated goal of addressing the "underlying causes" of the Postal Service's financial condition. *See* Order No. 5337 at 11, 63. In essence, it would recognize that earlier rate levels, such as those just prior to the PAEA,[42] were sufficient to cover what the former Postal Rate Commission (and Congress) considered to be a reasonable cost base, and that volume declines and delivery point growth are major drivers of the rate

[40] *See* Comments of the National Postal Mail Handlers Union, PRC Docket No. RM2017-3 (Feb. 4, 2020), at 3; USPS 2018 Initial Comments at 56-69; USPS 2018 Reply Comments at 42-43 (summarizing similar proposals by APWU, NALC, and NPMHU),

[41] Comments of American Postal Workers Union, AFL-CIO, PRC Docket No. RM2017-3 (Feb. 4, 2020) [hereinafter "APWU Comments"], at 1-4; Comment of National Association of Letter Carriers, AFL-CIO, PRC Docket No. RM2017-3 (Jan. 30, 2020) [hereinafter "NALC Comments"], at 2-10.

[42] Although the APWU and NALC comments refer distinctly to the density losses that the Postal Service has continued to suffer since the end of the ten-year period initially under review in this proceeding, APWU Comments at 3-4; NALC Comments at 5, it would be a mistake to infer that that the formula could validly be run only from that point. The rate base was not compensatory as of FY2017; indeed, it was less so than in the previous year, as of which the Commission found in Order No. 4257 that the current system had failed. Rather, the correct inference is that the density-loss problem is not confined to the FY2007-FY2016 era, but has continued beyond that point as well, and any retrospective formula-based reset should account for the entire post-PAEA period.

base's intervening failure to remain compensatory (notwithstanding Congress's expectations when it imposed the CPI-only cap). In this regard, the approach would resemble the Commission's 2019 decision to update competitive products' minimum-contribution requirement on the basis of a formula applied retrospectively from FY2007, in the interest of reflecting changes in the market since the preexisting requirement level was initially set. *Cf.* 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 95-98.

While this is a valid approach, it would be simpler – and more consistent with established regulatory practice, as discussed in section III.B above – to base a rate reset on some reasonable measure of the current (and expected) total net loss, as we have proposed. While density declines have been a major cause of the system's failings, our proposal would capture the totality of the circumstances that account for the current gap between total costs and revenues. Thus, our proposed net-loss-based approach would avoid debate over which adjustments to the pre-PAEA rate base have merit. Moreover, our proposed approach would also moot all commenters' issues with the Commission's proposed retirement rate authority, insofar as that rate authority would effectively be a true-up of only select expenses within the broader net loss. (That said, the need to adjust the rate base for exogenous changes in retirement-related expenses would remain.) If anything, a net-loss-based reset – even with a supplement to allow a specified margin of retained earnings – would be conservative: it would reset rates merely to the breakeven point (or slightly above breakeven), whereas a retrospective application of density rate authority might result in a substantial profit.[43]

V. THE COMMISSION HAS IDENTIFIED APPROPRIATE INPUTS FOR ITS DENSITY RATE AUTHORITY FORMULA

Several mailing-industry commenters argue that the density rate authority should be based on roll-forward methodologies used in other contexts to measure delivery-point-driven changes in select cost segments. ABA Comments at 11; ANM *et al.* Comments at 46-48; NPPC *et al.* Comments at 30-35. As explained by Dr. Michael Bradley (Appendix B to these comments),[44] however, this argument fails for two reasons. First, the impacts of delivery-point growth on network costs are significantly broader than the cost segments and roll-forward methodologies on which the commenters focus. App. B at 5-6, 11. Second, the commenters propose no alternative way to account for the impact of volume decline on the ability to cover network costs. *Id.* at 4, 9-10. Hence, even if the Commission's approach could theoretically be viewed as overbroad to some degree, the commenters have offered no credible alternative.

Nor is the Commission's approach – focusing on the overall change in volume and delivery points – invalid in its own right. As Drs. Bozzo and Meitzen explain in detail, the density rate authority formula derives algebraically from the traditional X-factor formula. App. A at 10-13; *see also* U.S. Postal Serv. Off. of the Inspector Gen.,

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[43] Of course, a profitable result would hardly be invalid. Rate levels just prior to the PAEA were profitable, providing not only for positive annual net income but also for enough retained earnings to wipe out the longstanding accumulated deficiency. If a retrospective density-based reset resulted in enough rate authority to provide a measure of retained earnings even after all costs were covered, that would not be an aberration or offensive to policy. Rather, it would recognize that the Postal Service should fundamentally be profitable (consistent with Objective 5) and could have been, given our strenuous cost-cutting efforts, but for the overwhelming challenge of density decline.

[44] Dr. Bradley is an economist with years of specialized experience in postal costing. App. B at 12-15.

RARC-WP-13-007, Revisiting the CPI-Only Price Cap Formula 28-32 (2013). The institutional-cost ratio used in the density rate authority formula is "an appropriate proxy" for the network cost elasticity term in the derived formula. App. A at 12. If anything, contrary to commenters' allegations of overbreadth, the density rate authority is conservative in two regards. First, the derivation from the X-factor formula depends on an implicit (and thus far unexplained) assumption that input cost growth and productivity will track the general economy. *Id.* at 11-12.[45] As discussed in the next section, however, that assumption is optimistic in light of historical trends and reasonable near-term expectations. Second, the institutional-cost ratio "will slightly underestimate" cost elasticity, because institutional costs exclude a portion of non-volume-variable costs that are treated as incremental costs. *Id.* at 13.[46]

VI. DESPITE SOME UNFOUNDED CRITICISMS, THERE IS REMARKABLE CONSENSUS THAT THE PROPOSED PERFORMANCE-BASED RATE AUTHORITY IS PROBLEMATIC

For all of their differences on other aspects of Order No. 5337, the Postal Service, labor, and mailers agree on the fundamental flaws with the Commission's proposed performance-based rate authority. There is agreement that conditioning additional rate authority on productivity gains (the "earn it first" approach) is irreconcilable with the Commission's stated rationale of providing additional liquidity in order to invest in productivity gains (the "financial-health cycle" rationale). As stated by one group of commenters:

[45] As Drs. Bozzo and Meitzen note, this assumption would normally be validated by an empirical study. App. A at 11 n.23.

[46] Moreover, while the density rate authority does include price-induced volume effects, the results under historical and realistic elasticity conditions would be rapidly self-dampening, not a self-reinforcing "positive feedback loop." App. A at 13 (criticizing Neels/Powers Declaration at 9).

> the explanation offered by the Commission for why costs have not fallen more – namely, that the Postal Service has not been able to generate the needed investment funds – would not be addressed by this proposal. . . . [E]xtra revenues would be awarded only after productivity gains have been achieved. Rather than allow the Postal Service to reenter the financial health cycle, it would only reward the Postal Service once it had managed to get there on its own.

ANM *et al.* Comments at 69 (citations and internal quotation marks omitted); *see also* APWU Comments at 5-11; Public Representative Comments at 46 (noting the disjunction between the Postal Service's "immediate, serious need for investment capital that can be used to increase its efficiency" and the multi-year lag in providing such capital through the proposed performance-based rate authority).[47]

Moreover, there is agreement that, whatever its merits as a general indicator of operational efficiency, *see* Order No. 5337 at 132-33, TFP is not a suitably precise metric on which to base a consequential award of rate authority. Initial Comments of American Catalog Mailers Association (ACMA), PRC Docket No. RM2017-3 (Feb. 3, 2020), at 3; ANM *et al.* Comments at 76-81; APWU Comments at 6-7; eBay Comments at 4; USPS Comments at 38-40; *see also* App. A at 17.[48]

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[47] The Public Representative appears to assume that the performance-based rate authority will provide additional revenue and that the only issue is how soon. *See* Public Representative Comments at 46 (characterizing the problem not as "the cart [being] before the horse," but as being "so far behind the horse that it's at the end of a cart tongue a mile long"). But it cannot be taken for granted that the proposed TFP-growth condition will necessarily be met, and hence that any additional revenue (let alone "retained earnings" after all other costs are covered) will materialize, in the near or medium term.

[48] To be clear, the Postal Service does not endorse the criticisms of TFP leveled by ANM *et al.*'s declarant Robert Fisher. Indeed, some of Mr. Fisher's criticisms appear to contradict his earlier work on behalf of the Commission in this proceeding. *Compare, e.g.*, Declaration of Robert Fisher: TFP Accuracy for Performance-Based Rate Authority (Feb. 3, 2020), at 2 ("TFP can have a false positive result due to inappropriate factors and component value issues in its calculation methodology."), *filed with* ANM *et al.* Comments, *with* Northwest Postal Consulting, Adequacy of the Postal Service's TFP Model (Mar. 27, 2017), at 64 ("In summary, TFP does contain a complete set of data factors and applies them through an effective methodology to reach an accurate result."), *filed with* Order No. 5337. Be that as it may, any technical issues concerning TFP should be explored, if at all, in separate proceedings. For purposes of this proceeding, that TFP is the result of complex data processing and economic analysis that may be

The appropriate response would be to replace the proposed TFP-based mechanism with a period of unconditional rate authority aimed at returning the Postal Service to the "financial-health cycle." ANM *et al.* and the APWU agree with the Postal Service that the logical consequence of the "financial-health cycle" rationale is that the corresponding rate authority should be provided unconditionally, at least on a temporary basis. ANM *et al.* Comments at 68-69; APWU Comments at 10-11; USPS Comments at 32-38.[49] Indeed, price caps in U.S. and foreign electricity regulation typically allow for above-inflation price increases to encourage investment in projects with long-term paybacks (such as infrastructure modernization), without tying the price increases to extrinsic preconditions. App. A at 6, 17.[50] And because "[p]erformance improvements resulting from investments made via [such supplemental capital funding mechanisms] will likely take time to materialize," it would be unreasonable to expect immediate, measurable performance results. Zarakas et al., *Performance Based Regulation Plans*

subject to refinement is another reason to avoid making TFP the basis for a knife-edge test for whether to provide liquidity that the Commission has already found to be an immediate need. *See* App. A at 17.

[49] The Postal Service disagrees with APWU that the rate authority should be tied to specific capital investment plans. *See* APWU Comments at 5, 11-12. Doing so would risk embroiling the Commission in business decisions committed to the Postal Service's Board of Governors, and well beyond the Commission's statutory remit. *See* 39 U.S.C. § 205(a); USPS 2018 Reply Comments at 82. Moreover, additional liquidity is needed for purposes other than capital investment, such as to service debt (thereby reducing interest expense) and to provide a cushion against contingencies. *See* USPS 2018 Reply Comments at 73-75; Order No. 4258 at 48, 54 (contemplating that the additional rate authority be used to pay down debt, as well as to fund capital investments).

[50] *See, e.g.*, Toby Brown & William Zarakas, Improving the PBR Framework in Hawai'i: Addressing the Risk of "Capital Bias" (Brattle Group 2019), at 8-14, 43, https://brattlefiles.blob.core.windows.net/files/15450_improving_the_pbr_framework_in_hawaii_-_addressing_the_risk_of_capex_bias.pdf; Zarakas et al., *Performance Based Regulation Plans* at 17, 39-42, 44, 55; Newton Lowry & Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future* at 28, 44 ("In the United States, a hybrid approach is used in which revenue that addresses utility opex is indexed, while revenue that addresses capital cost has a [non-indexed, pre-set] stair-step trajectory. . . . Index-based [price caps] cannot easily accommodate occasional, large capital spending surges such as replacement of customer information systems or a system-wide buildout of advanced metering infrastructure. Thus, the utility might postpone some investments that would be beneficial to customers. Capital cost trackers can remedy this problem[.]").

at 54; *see also* App. A at 17. As noted in our earlier comments, such rate authority could be provided either separately or through supplemental rate authority aimed at covering both the baseline net loss and a measure of retained earnings, with the results to be assessed in the next system review. USPS Comments at 36-37.

To the extent that the Commission intends to proceed with a TFP-based component of price cap authority notwithstanding this stakeholder consensus, some additional stakeholder comments merit response. First, as discussed in section III.B above, ANM *et al.* suggest that the only valid way to account for productivity is through a downward (and forecast-based) adjustment to the price cap (through an “X-factor”). *See* ANM *et al.* Comments at 61-65. But that view of price-cap regulation is myopic. For one thing, the primary rationale for the proposed performance-based rate authority is to provide capital for significant investments, asset replacement, and debt service. Order No. 5337 at 121-22; Order No. 4258 at 39-54. Again, established regulatory practice is to account for such capital needs through above-inflation supplements, since a price cap alone will necessarily tend to incentivize short-term cost control efforts, rather than needed longer-term infrastructure investments. In practice, these supplementary forms of rate authority can offset and even overcome the otherwise suppressive effect of a positive X-factor. *See* App. A at 7; Mark E. Meitzen et al., *Debunking the Mythology of PBR in Electric Power*, 31 ELEC. J. 39, 44-45 (2018); Mark E. Meitzen et al., *The Alphabet of PBR in Electric Power: Why X Does Not Tell the Whole Story*, 30 ELEC. J. 30, 35-36 (2017).

For another thing, even within the traditional I-X model, there is no reason that productivity adjustment factors cannot produce additional rate authority. App. A at 7-9.

Dr. Willig acknowledges "that X can be negative," meaning that the X factor would add to rather than subtract from the inflation index in the price cap. *See, e.g.*, Willig Declaration at 7 n.5. "[A]side from industry productivity growth being negative, there are a variety of industry and economy-wide productivity and input price growth combinations that could yield a negative X factor[.] . . . Whether TFP growth or the X factor is positive or negative is not a theoretical matter, but an empirical one." App. A at 7, 9 (quoting Meitzen et al., *Debunking the Mythology of PBR in Electric Power*, 31 ELEC. J. at 43).

After all, productivity expectations depend on various circumstances unique to each industry and firm.[51] It might not be consistent with a "just and reasonable" constraint to expect positive productivity growth (relative to the general economy or other benchmark) from a regulated entity with strong structural and market headwinds. *See id.* at 7 ("Moreover, given the X factor is a measurement of industry performance relative to economy-wide performance, some industries will outperform the economy and others will underperform the economy."). In such circumstances, a target of zero or even negative absolute productivity growth (relative to an external benchmark) would recognize that the firm's productivity is expected to grow slower or decline faster than

[51] For example, price-cap regulation began with in the telecommunications industry in the 1980s and 1990s, when technological changes, rising volumes, and privatization in Europe promised strong productivity growth. But U.S. electric utilities' productivity growth in the same period was less than that of the general economy: they had already booked strong productivity gains in the 1970s, and unlike their European counterparts, they lacked new cost-saving opportunities from privatization. Zarakas, *A New Face for PBR*; *cf.* Newton Lowry & Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future* at 28-29 (discussing the conditions that had favored rate freezes for electric utilities in the past, but concluding that such conditions "are less common today," in a time of low demand growth and high investment needs). And circumstances might "require more intensive use of inputs without generating any corresponding increase in billable outputs" (thereby tending to reduce apparent TFP), such as where substantial investments are required to modernize infrastructure, secure it against more sophisticated threats, and adapt to changing consumer expectations. Meitzen et al., *Debunking the Mythology of PBR in Electric Power*, 31 ELEC. J. at 43. In this connection, Drs. Bozzo and Meitzen criticize Dr. Willig for "inappropriately tr[ying] to force-fit the telecommunications model of incentive regulation onto the Postal Service." App. A at 3.

the benchmarked industry during the price-cap period; the regulated entity's financial performance would depend on its ability to beat the target, just as it would if the target were positive productivity growth.[52] *See id.* at 8 ("[E]fficiency incentives do not depend on whether X is positive or negative; a negative X factor does not diminish utility efficiency incentives (albeit the end result may be less negative productivity growth rather than more positive productivity growth)."). Indeed, the same headwinds that the Postal Service faces – market-based demand decline, inexorable network growth, and substantial fixed network costs, leading average unit costs to rise relative to those of the average firm – have justified upward adjustments to inflation-based price caps (through negative X-factors and more holistic assessments) among other postal and utility regulators. *Id.* at 9.[53]

Moreover, productivity expectations would have to be based on recent data as the most relevant indicator of near-term future trends. Beyond featuring questionable numbers,[54] ANM *et al.*'s invocation of average annual TFP growth rates across several

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[52] X-factors typically reflect not merely the regulated firm's or industry's own expected productivity growth, but the differential between that growth and that of the benchmarked industry or the general economy. App. A at 7-8. Thus, the lack of an explicit X-factor in the PAEA's CPI-only price cap reflected not a desire to "richly reward[ ]" the Postal Service (on the mistaken premise that X must always detract from inflation in the price-cap formula), ANM *et al.* Comments at 62-64, but rather an expectation at the time of the PAEA's enactment that Postal Service productivity growth should generally keep pace with that of the general economy. To the extent that the Postal Service's productivity growth is now expected to be less than that of the general economy, the theory of X-factors would call for revision of the price cap to provide above-inflation rate authority.

[53] *See also* Christensen Assocs., *Analysis of the PAEA's CPI-Based Price Cap System & Options for Future Postal Regulation* at 18, 21-26; *see also* Meitzen et al., *Debunking the Mythology of PBR in Electric Power*, 31 ELEC. J. at 44.

[54] For example, ANM *et al.* include FY2007 as a "post-PAEA" data point, but the PAEA was not enacted until almost the second quarter of that fiscal year, and the PAEA's price cap did not take effect until a full year later. Even FY2008 TFP data more likely reflected initiatives planned and implemented before the PAEA than after it. As for the supposed "pre-PAEA" era, it is unclear how ANM *et al.* derived an average annual TFP growth rate of 0.75 percent; whether starting in FY1964, FY1970, or FY1971, the average annual growth rate is in the 0.4-0.5 percent range. *See* USPS Annual Tables, FY 2019 TFP (Total Factor

decades and ending five years ago are of little value in assessing current productivity trends and opportunities. ANM *et al.* Comments at 70-71 & n.24. Hearkening to prior successes in reducing cost and increasing efficiency might be relevant if similar results were expected to lie ahead, but ANM *et al.* have pointed to no specific basis for the Commission to make such an assumption for the near term.[55] Secular, exogenous trends that hinder TFP growth have continued and can be expected to persist.[56] And the fact that particular measures have already yielded significant efficiency gains and cost reductions necessarily means that achieving additional reduction in costs becomes more difficult, given the statutory constraints under which the Postal Service operates. Indeed, the only record evidence about significant, achievable operational-efficiency measures indicates that any outstanding opportunities within the Postal Service's control are limited.[57] While the Postal Service has pursued and will continue to pursue appropriate cost reductions and efficiency improvements consistent with its statutory mission, the declining average annual TFP growth of the past five years is a far more appropriate basis for the near-term expectations relevant to this proceeding than the positive growth rates of earlier time periods.[58] Against this backdrop, the Commission's

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Productivity) (Feb. 27, 2020), Microsoft Excel file "Table Annual 2019 Public.xlsx", tab "Tfp-52" [hereinafter "USPS FY2019 TFP Table"], column K.

[55] *See* Northwest Postal Consulting, Comparison of Postal Service Productivity Measurement Before and After PAEA Enactment (Mar. 27, 2017) [hereinafter "NWPC Report 2"], at 8-10, *filed with* Order No. 5337 (enumerating more than fourteen major operational-efficiency initiatives that have influenced TFP growth, most of which predate the PAEA and all of which predate FY2016).

[56] *See* NWPC Report 2 at 10-11 (discussing electronic diversion, the growth in higher-cost package volume due to e-commerce, and alternatives to Marketing Mail as the three most prominent exogenous influences on TFP, followed by economic downturns, the impact of which is exacerbated by the first three influences).

[57] *See generally* USPS 2017 Comments, app. C.

[58] Average annual TFP growth was -0.067 percent in FY2014-FY2018 and -0.208 percent in FY2015-FY2019. *See* USPS FY2019 TFP Table at cells K62-K67. By contrast, average annual TFP growth for

proposed standard of any annual growth in the TFP index is, if anything, somewhat aggressive.

For similar reasons, fairness and incentive problems could arise from certain commenters' proposal to couple the year-over-year TFP-growth condition with a second condition that the TFP index level in a given year exceed the level in the starting year. ABA Comments at 14; NPPC *et al.* Comments at 59-60. Consider the following (not-unrealistic) scenario: TFP falls dramatically in an early year of the mechanism, due to volume loss during a recession. The Commission's proposed TFP-based authority would deny the Postal Service pricing authority due to the general economic downturn. If the Postal Service subsequently manages to grow TFP steadily thereafter, albeit not enough to exceed the pre-recession index level for several years, the additional conditions would extend the denial of additional cap authority through the subsequent recovery. It is unclear how such an outcome would be consistent with the Commission's valid motive of providing additional funds for capital investments.

That said, to the extent that ANM *et al.*'s criticism highlights the lack of explanation for the Commission's proposed benchmark, the Postal Service would agree that the benchmark methodology and level must be reasonable and reasonably explained, based on realistic expectations for productivity growth during the new system

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the private nonfarm business sector was approximately 0.42 percent in (calendar years) 2014-2018. *See* Bureau of Labor Statistics, 1987-2018 Major Sector Multifactor Productivity, tab "Data" [hereinafter "BLS TFP Table"], cells AF106-AK106 (index levels), https://www.bls.gov/mfp/special_requests/mfptable.xlsx (release date Mar. 20, 2019). Even over a ten-year span, Postal Service TFP grew at a slower pace than that of the private nonfarm business sector, despite reducing career headcount by 25 percent: a feat that may be difficult, at best, to replicate in the near term. *See* USPS FY2019 TFP Table at cells K57-K66 (average annual growth rate of 0.484 percent in FY2009-FY2018); BLS TFP Table at cells AA106-AK106 (index data yielding average annual growth rate of 0.553 percent in (calendar years) 2009-2018); U.S. Postal Serv., Number of Postal Employees Since 1926 (Feb. 2019), https://about.usps.com/who-we-are/postal-history/employees-since-1926.pdf (reporting 623,128 career employees in FY2009 and 497,157 in FY2018).

period. *But see* Order No. 5337 at 134-35 (justifying the new proposed benchmark method solely in terms of facilitating “a transparent review”). As with a traditional X-factor, determining a non-arbitrary productivity benchmark for the Commission’s proposed mechanism would “be opaque and complex, and the large dollar stakes [would] encourage controversy. The regulatory cost of developing an [appropriate benchmark] can therefore be considerable.”[59] Rather than litigating the reasonableness of TFP-growth expectations, it would promote transparency and reduced administrative burden (Objective 6), as well as operational efficiency and financial stability (Objectives 1 and 5) and the Commission’s stated objective of reentering the “financial-health cycle,” to recast the proposed TFP-based mechanism as a temporary unconditional rate supplement aimed at capital needs, subject to reassessment in the next system review.

VII. INDUSTRY COMMENTERS’ CONCERNS ABOUT THE COMMISSION’S PROPOSED WORKSHARE RULES ARE UNFOUNDED

Several commenters express concern about establishing an 85 to 100 percent passthrough range as a safe harbor.[60] These commenters seem to believe that the Commission’s proposed rules would establish this safe harbor. Yet proposed rule 3010.282(c) would prevent the Postal Service from adjusting passthroughs freely within an 85 to 100 percent passthrough range. As explained in our initial comments, the Commission <u>should</u> establish this passthrough range as a safe harbor, by relaxing rules 282(a) and (c). This would provide needed pricing flexibility, especially in reaction to

[59] Newton Lowry & Woolf, *Performance-Based Regulation in a High Distributed Energy Resources Future* at 43.

[60] ABA Comments at 14-16; NPPC *et al.* Comments at 15-19; Comments of Pitney Bowes Inc., PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter “Pitney Bowes Comments”], at 2-7; PSA Comments at 8-9.

cost avoidance fluctuations. USPS Comments at 48-50. At a minimum, given these differences in interpretation, the Commission should clarify its intent.

From the commenters' perspective, the Commission's proposal would allow the Postal Service to keep passthroughs fixed at or just above 85 percent. For example, NPPC *et al.* claim that "in practice [the proposal] will tend to migrate discounts to 85 percent instead of the desired 100 percent." NPPC *et al.* Comments at 17. Pitney Bowes claims that "[a] static 85 percent passthrough floor would allow inefficient pricing to remain over time." Pitney Bowes Comments at 6.

This concern ignores the normal volatility of estimated cost avoidances, however.[61] This volatility is the product of a complex of competing forces, such as inflation, costing methodology changes, cost reduction measures, and other, likely stochastic factors. For example, suppose a baseline (Stage 1) where the avoided cost is 3.0 cents, the discount is 2.7 cents, and the passthrough is 90 percent. Now assume that when the avoided cost is next estimated, in Stage 2, there is a 50 percent probability that it increases to 3.3 cents, and a 50 percent probability that it decreases to 2.7 cents. In the first case, the passthrough falls to 81.8 percent (= 2.7 / 3.3 * 100). To bring the passthrough up to at least 85 percent, an increase in the discount to, at a minimum, 2.9 cents is required. In the second case, the passthrough increases to 100 percent (= 2.7 / 2.7 * 100), and per proposed rule 3010.282(a), the discount could not be changed at all.

[61] For an example and explanation of a recent substantial cost avoidance change, see Responses of the United States Postal Service to Questions 1-15 of Chairman's Information Request No. 12, Docket No. ACR2019 (Feb. 14, 2020), at 11-14.

But vis-à-vis stochasticity, what goes up tends to come back down, and what goes down tends to rise back up. So, suppose in the next cost iteration (Stage 3), the avoidance estimate "regresses to the mean," returning to 3.0 cents. In the first case, the passthrough will be 96.67 percent (= 2.9 / 3.0 * 100). Per proposed rule 3010.282(c), that passthrough could not be reduced. In the second case, the passthrough returns to its original 90 percent level (= 2.7 / 3.0 * 100).

Note that the expected value of the Stage 3 passthrough is 93.33 percent (= (50 percent x 96.67 percent) + (50 percent x 90 percent)). It has increased from 90 percent in Stage 1: hardly a "safe harbor" outcome. This is a result of asymmetry: regular stochastic increases in the avoided cost can lead to an increase in the minimum required discount, but comparable volatility in the other direction can be free of discount repercussions. As a result, there will be a tendency for passthroughs to drift up towards 100 percent within the 85-100 percent passthrough range.

Separately, Mailers Hub criticizes the use of educational, cultural, scientific, and informational (ECSI) value as a waiver exception for lowering an above-100-percent passthrough. Mailers Hub Comments at 9-10. But an ECSI-value-based preference is relevant whenever changing a passthrough requires price increases for mailers who send material with ECSI value. This principle is reflected in Section 3622(e)(2)(C), which provides for ECSI-based exceptions to the 100 percent passthrough ceiling. Therefore, changes to the Commission's proposal around ECSI value are not warranted.

VIII. THE COMMISSION'S PROPOSED PROCEDURAL CHANGES TO RATE-REVIEW PROCEEDINGS ARE WITHIN THE COMMISSION'S DISCRETION

The Commission has proposed eliminating from pre-implementation proceedings the application of the statutory objectives and factors to the Postal Service's individual rate adjustments. Order 5337 at 239-40. Several commenters challenge this proposal.[62] They rely primarily on the D.C. Circuit's decision in *Carlson*, which stated that "the PAEA requires consideration of all relevant statutory objectives and factors as part of the regulatory process and does not authorize the Commission to defer evaluation of those objectives and factors until after it approves a rate change." *Carlson*, 938 F.3d at 343. However, that opinion does not foreclose the Commission's proposed approach.

To begin with, the court's pronouncements on what the ratemaking "system" requires should be read narrowly, because they are all based on an erroneous premise: that, while the Postal Service may "propose" market-dominant rate changes, the Commission actually sets rates and "adopts" rate changes by issuing a "rate approval order" at the culmination of a "rulemaking."[63] It is not clear where the court derived that notion; no party asserted that the Commission sets rates or adopts rate changes under the PAEA, just as no commenter here is making such an assertion. And it is not true.

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[62] Initial Comments of Greeting Card Association, PRC Docket No. RM2017-3 (Feb. 3, 2020) [hereinafter "GCA Comments"], at 2-5; NPPC Comments at 76-78; Pitney Bowes Comments at 9-10.

[63] *See, e.g., Carlson*, 938 F.3d at 340 (Commission must "approve specific postal rates through rulemaking," but need not hold a hearing "prior to adopting any rate change"); *id.* at 341 (the Postal Service "propose[s]" a rate adjustment and the Commission issues "a final regulation, i.e., the rate approval order"); *id.* at 343 (Commission must weigh statutory objectives and factors before "issuing a rate approval order" and "adopting" a "price hike"); *id.* at 344 ("Commission must apply the relevant objectives and factors" when approving individual rate adjustments); *id.* at 349 (PAEA "charge[s] the Commission with setting rates through rulemaking"); *id.* 24 (PAEA "establishes a robust process for the Commission" to "approve" price increases).

See 39 U.S.C. §§ 404(b), 3622(d)(1)(D).[64] All the same, this mistaken belief that the Commission sets rates led the court to incorrectly view the entire regulatory "system" as nothing more than the (necessarily pre-implementation) "rulemaking" process by which the Commission supposedly adopts price changes. None of the above-mentioned pronouncements were necessary to the court's resolution of the case. The court's actual holding was that the Commission violated the APA by declining to consider whether the 10 percent increase in the price of a First-Class Mail stamp was consistent with various statutory objectives, given that a party to the proceeding specifically raised the issue and that the Commission's regulations allowed for consideration of the statutory objectives and factors in rate-adjustment proceedings. Accordingly, the Court's broader observations regarding the statute are dicta.[65] As such, and particularly because those dicta rest on mistaken premises that are plainly at odds with the statute, the Commission need not and should not feel bound by them. *See, e.g., Murray Energy Corp. v. EPA*, 936 F.3d 597, 627 (D.C. Cir. 2019) (dicta is not binding, and should not be followed if "fundamentally incorrect").

But even if the court's broad pronouncements were somehow binding, they are addressed to the initial "system" that the Commission established under Section 3622(a) and not to the revised system that the Commission is now establishing under

[64] The only instance in which the PAEA conditions rate increases on a Commission "approval" order is the exigent clause. *See* 39 U.S.C. § 3622(d)(1)(E) (allowing an exigent increase only if the Postal Service "requests" such an increase and the Commission "determines, after notice and opportunity for a public hearing and comment," it is "reasonable and equitable and necessary").

[65] Moreover, they represent a misreading of the relevant statutory provisions: Section 3622's only references to the role of the objectives and factors is in relation to the design of the overall ratemaking "system." 39 U.S.C. § 3622(b), (c), (d)(3). By contrast, the provisions on price changes within that system do not similarly require that individual price changes be reviewed for consistency with the objectives and factors.

Section 3622(d)(3). *Carlson* arose under a system that required the Commission to review individual rate adjustments prior to implementation, *see* 39 U.S.C. § 3622(d)(1)(C), and its observations concerned which topics the Commission must address during that pre-implementation period. Under 39 U.S.C. § 3622(d)(3), however, the revised system need not consist of pre-implementation rate review at all; as we explained at length earlier in these proceedings, a regulatory system may achieve the statutory objectives without providing for *ex ante* price regulation.[66] If the pre-implementation review of rate changes is no longer a required feature of the regulatory system, it necessarily follows that the pre-implementation application of the statutory objectives to such rate changes is also not required. Put differently, if Section 3622(d)(3) allows the Commission to modify or replace the "requirement" of a price cap under subparagraphs (A) and (D) of Section 3622(d)(1) (as it reasonably must be construed to do), then, by the same token, the Commission may modify or replace the "requirement" of pre-implementation review under subparagraph (C). One such modification is to redefine the scope of issues to be covered in such a review, insofar as it is retained at all.

Nor is there a compelling policy reason for the Commission to subject rate adjustments to such an amorphous pre-implementation process. Doing so would certainly increase the system's "administrative burden" (Objective 6), and it is unclear what offsetting benefits it would produce. There have been few, if any, examples of the Postal Service establishing rates that are inconsistent with the qualitative standards of the PAEA: even the price increase at issue in *Carlson* itself was ultimately found to

[66] *See* USPS 2017 Comments at 14-17, 176-81; USPS 2018 Initial Comments at 42-44.

comply with such standards. *See generally* Order No. 5285, Order Approving Price Adjustments for First-Class Mail, PRC Docket No. R2019-1 (Oct. 24, 2019). Moreover, there already exist ample post-implementation opportunities to consider whether the Postal Service's rate design has achieved the statutory objectives: the Annual Compliance Determination requires the Commission to engage in such consideration, and the complaint procedures allow parties to bring challenges of their own. These *ex post* proceedings are perfectly adequate to address the policy concerns that the commenters have raised here.[67] Pre-implementation review is therefore wholly unnecessary.

IX. CONCLUSION

Order Nos. 4258 and 5337 make clear that the Commission is aware of its legal authority and responsibility to fix the market-dominant ratemaking system. The Commission has rightly resisted the potential distractions of speculation about legislative reform and unsupported doomsaying about the consequences of additional rate authority. Now it must finish the job.

It is much of the way there already. The Commission clearly understands that any new price cap must self-adjust for exogenous density loss and retiree-benefits expenses, or else it will repeat the current system's failure. And the Commission understands that additional rate authority is needed to spur long-deferred investment in

[67] GCA claims that the complaint process places the burden of proof on commenters rather than the Postal Service, GCA Comments at 5, but this is not necessarily true. Where a commenter argues that the Postal Service's rates violate the statute (and the complaint is not dismissed for other reasons), the Postal Service would presumably have to justify the rate design. *See* United States Postal Service's Motion to Dismiss with Prejudice the Greeting Card Association Complaint, PRC Docket No. C2020-1 (Feb. 19, 2020), at 13-15. If anything, GCA's act of filing the recent complaint (in contrast with the words in its comments here) – undeterred by the Commission's previous resolution of the same issue in pre-implementation and annual compliance review proceedings – represents an endorsement of the complaint process as a potential outlet for such concerns. *See id.* at 1-4, 9-11, 17.

infrastructure. The practice of other price-cap regulators offers numerous templates for mechanisms to achieve these very aims.

Only four key changes to the Commission's proposal in Order No. 5337 are needed to reach a fully supportable conclusion. First, consistent with price-cap theory and practice and the governing statutory objectives, rate authority must be provided to recalibrate costs and revenues. Without it, forward-looking adjustment factors will merely perpetuate the going-in net loss, not relieve it. The traditional approach would also be the simplest: define the rate authority needed to correct the going-in net loss. But labor commenters' proposal of a retrospective density-based adjustment could also be valid. Both approaches would render moot the proposed retirement rate authority (to the extent that it is intended as a partial true-up), which has drawn a variety of criticisms.

Second, to the extent that the proposed retirement rate authority would adjust for changes in relevant expenses, that function should be preserved through an adjustment factor comparable to the "Z factor" in other price-cap systems. It should not be limited to five years, and it should include both normal-cost and amortization payments.

Third, as even certain industry commenters acknowledge, the goal of funding increased infrastructure investment would be best served by unconditional rate authority, consistent with the practice of other regulators. While other regulators may also use conditional rate authority mechanisms, those are separate from rate authority to provide seed capital, in recognition of the fact that investment precedes results. If the Commission wishes to consider such mechanisms or review the Postal Service's use of additional capital, it can do so in the next review or otherwise after concluding this proceeding.

Fourth, all new rate authority should be bankable. Such an approach would preserve the Postal Service's pricing flexibility (Objective 4), whereas the Commission's proposed use-it-or-lose-it approach would, if anything, incentivize maximizing the use of available rate authority. At no time in this proceeding has the Commission offered a reasonable explanation (or, indeed, any explanation) for its proposed no-banking approach.

These are the four fundamental fixes needed to place the Commission's new rules on a sound footing, in line with the governing statute and price-cap theory and practice. (As described in our initial comments and herein, some additional, and more technical, changes to the proposed rules are also warranted.) Contrary proposals aimed at maintaining or deepening the Postal Service's financial instability have no basis in either regulatory practice or empirical reality. The record of this proceeding makes clear the path to the goal. It is for the Commission now to take it.