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BEFORE THE
POSTAL REGULATORY COMMISSION

ANNUAL COMPLIANCE REPORT, 2014	: : :	**Docket No. ACR2014**

COMMENTS OF UNITED PARCEL SERVICE ON
POSTAL SERVICE'S FY 2014 ANNUAL COMPLIANCE REPORT

(February 2, 2015)

United Parcel Service ("UPS") respectfully submits the following comments on the United States Postal Service's FY 2014 Annual Compliance Report (December 29, 2014) ("ACR").

I. INTRODUCTION

UPS's review of the Postal Service's FY 2014 ACR and the supporting data indicates that there are serious, deeply embedded problems with the manner in which the Postal Service is accounting for the costs of its competitive products business. These problems prevent the Commission, the public, and indeed likely the Postal Service itself from knowing the true costs associated with this business.

At the same time, the ACR data and public reports confirm that the Postal Service is increasingly making large investments in its competitive products business. UPS sought access (for its outside counsel and consultants) to much of the non-public, domestic ACR data (*see* Order No. 2321) to analyze whether the Postal Service is properly accounting for these and other significant expenditures for competitive products. Even with that access, however, it was not possible to determine how the

Postal Service is accounting for these large expenditures, principally because the data does not contain all of the necessary information.

This lack of transparency is unacceptable. Congress mandated in the Postal Accountability and Enhancement Act ("PAEA") that Postal Service accounting be subject to effective oversight to ensure its competitive products business stands on its own financial footing, without subsidies from its market dominant business. Compliance with this mandate requires transparency about how the Postal Service is accounting for major expenditures. Accordingly, UPS has identified a set of information the Commission should require the Postal Service to provide in this proceeding and future ACR proceedings. *See* Section III *infra*.

The FY 2014 ACR also shows that the Postal Service classifies nearly *half* of its costs as institutional. The Postal Service does not attribute such costs to competitive products as a whole or to individual products. As a result, classifying costs as institutional means that they are largely ignored under the tests the Commission conducts, pursuant to 39 U.S.C. §§ 3633(a)(1) and (2), to ensure that the Postal Service's market dominant business is not subsidizing its competitive products business.[1]

When the Postal Service misclassifies costs as institutional, it undermines these no-subsidization tests. Misclassified institutional costs also place upward price pressure on market dominant mail, because institutional costs are borne disproportionately by market dominant mailers: the meager 5.5% "appropriate share" requirement for competitive products set by the Commission pursuant to § 3633(a)(3) means that

[1] A small category of costs (competitive group specific-costs), while not attributed, are considered as part of the § 3633(a)(1) test.

market dominant products are asked to bear 94.5% of the Postal Service's institutional costs.

The data shows that institutional costs that Postal Service models treat as "fixed" are especially problematic. A complete analysis of the Postal Service's data regarding fixed costs is simply not possible within the limited time frame of this ACR proceeding. But it is clear from publicly available data regarding (i) the Postal Service's "fixed" costs, (ii) market dominant volume declines, and (iii) competitive volume increases, that many of the costs the Postal Service treats as "fixed" are not fixed at all. The data strongly suggests that many of these costs vary with volume and should be attributed, in many instances, to competitive products. While a complete solution to this problem is beyond the scope of this proceeding, the Commission should, at a minimum, require the Postal Service to explain what steps it is taking to ensure it is not overstating its fixed costs. *See* Section IV *infra*.

The gravity of these problems warrants a comprehensive reevaluation of the tests used to measure compliance with 39 U.S.C. § 3633, and the application of those tests to the Postal Service's competitive products business. UPS recognizes, however, that such a reevaluation is beyond the scope of this ACR process. Accordingly, UPS intends to file a petition to initiate a proceeding for a thorough evaluation of the Postal Service's costing methodologies and the analytical principles employed by the Commission pursuant to its obligations under § 3633.

II. IN PAEA, CONGRESS REQUIRED ACCURATE COST ATTRIBUTION FOR THE POSTAL SERVICE'S COMPETITIVE PRODUCTS BUSINESS.

Congress in PAEA granted the Postal Service a new level of freedom in setting the prices of its competitive products. But Congress also recognized that the Postal

Service could be tempted to prop up its competitive products business with revenues from its market dominant business. And Congress knew that such subsidization would harm competition, the public, and even the Postal Service itself.

As a result, Congress mandated throughout PAEA that the Postal Service's competitive products business must stand on its own financial footing and compete on a "level playing field" – without relying upon any advantages arising from the Postal Service's market dominant business.[2] Of particular relevance here, Congress directed the Commission to "prohibit the subsidization of competitive products by market-dominant products." 39 U.S.C. § 3633(a)(1). Congress further instructed the Commission to "ensure that each competitive product covers its costs attributable," § 3633(a)(2), and that "all competitive products collectively cover . . . an appropriate share of the institutional costs of the Postal Service." *Id.* at § 3633(a)(3).

Congress expected that, in complying with these mandates, the Postal Service would increase the amount of costs attributed to competitive products.[3] Nearly a decade later, however, the Postal Service has done little to improve its cost attribution.

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[2] *See, e.g.,* H.R. Rep. No. 109-66, at 44 (2005) ("Under the legislation, the Postal Service will compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors, albeit with stronger controls, oversight, and limitations in recognition of its governmental status."). A number of PAEA provisions reflect Congress's mandate that the Postal Service's competitive products business stand on its own footing. *See, e.g.,* 39 U.S.C. § 2011 (establishment of Competitive Products Fund to ensure competitive product finances are tracked separately); 39 U.S.C. § 409(e)(1)(B) (waiver of antitrust immunity for competitive products business); 39 U.S.C. § 3634 (requiring payment of assumed Federal Income Tax by competitive products business).

[3] *See, e.g.,* S. Rep. No. 108-318, at 29-30 (2004) ("The Postal Service should be able to attribute a greater percentage of its costs. If they do this, it is likely that a greater share of costs can be attributed to competitive products and, to the extent that they can be, should be reflected in the rates charged for those products.").

While the Postal Service has acknowledged the need to focus on improving attribution,[4] there is no evidence it is doing so. The FY 2014 ACR certainly shows no meaningful improvement.

Since the Postal Service has not improved cost attribution on its own accord, it must be held to account by the Commission. As discussed below, the Commission should, at a minimum, require the Postal Service to provide information regarding how it is accounting for large investments and operational changes related to competitive products and what it is doing to attribute the large amount of costs currently classified as institutional.

III. THE POSTAL SERVICE SHOULD PROVIDE CLEAR AND TRANSPARENT EXPLANATIONS OF HOW IT IS ACCOUNTING FOR LARGE EXPENDITURES TIED TO COMPETITIVE PRODUCTS.

The ACR data and public reports confirm that the Postal Service is rapidly expanding investments in its competitive products business and making related operational changes. The following examples illustrate this trend:

- In FY 2014, the Postal Service made large investments in Delivery Scanning Systems (DSS) and Passive Adaptive Scanning Systems (PASS). "DSS allows offices and other delivery units to efficiently capture arrival at unit scans on packages, and it tells the operator which route the package belongs on" and "improves our ability to provide efficient and timely delivery for packages that have just arrived in unit from large eRetailers." USPS Report to Congress, 56 (2014). PASS "serves a similar purpose as DSS," only for "larger postal facilities." *Id.* The Postal Service purchased and deployed over 12,500 Delivery Scanning Systems and over 2,700 Passive Adaptive Scanning Systems in FY 2014. *Id.*

- The Postal Service also began purchasing hundreds of thousands of Mobile Delivery Devices (MDD) in FY 2014. "The MDD is the latest generation

[4] *See, e.g.,* Reply Comments of the United States Postal Service, Dkt No. ACR2013, at 12 (Feb. 14, 2014) ("It seems fair to say that a host of matters that have unexpectedly arisen since enactment of the PAEA have led to less ability to focus on attribution issues than might have been expected.").

handheld device used by delivery carriers to record near real-time delivery tracking of packages." USPS Report to Congress, 56 (2014). After a lengthy selection process, the Postal Service signed a purchase contract with Honeywell for a maximum value of $250 million for up to 225,000 scanners.[5] These purchases continue: since September 2014, the Postal Service has deployed approximately 5,500 MDDs per week, and expects full deployment by September 2015. USPS Report to Congress, 56 (2014). The Postal Service had to spend $1 billion to upgrade its IT infrastructure to handle the increased load the MDD's would create.[6]

- In a break from the Postal Service's traditional six-day delivery schedule, in FY 2014 the Postal Service began Sunday delivery of competitive products in addition to Priority Mail Express, but not market-dominant letters. By the end of FY 2014, the Postal Service had expanded Sunday delivery "to over 650 cities and 3,892 five-digit ZIP Codes." USPS Report to Congress, 4 (2014). In addition, the Postal Service delivers "nearly half a million packages each Sunday" in each of seven areas, within 43 districts, where it provides Sunday delivery. *Id.* at 56. During the peak 2014 holiday season, "more than 20 million packages were delivered on the five Sundays prior to Christmas."[7]

- The Postal Service is also implementing weekday package-specific delivery runs in light of the growth of the competitive products business. "[S]ome mail carriers tend their routes twice a day, once with letters and once with packages."[8]

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[5] USPS Report to Congress, 56 (2014); Postal Reporter, *USPS Awards Contract for 225,00 for Mobile Delivery Devices*, http://www.postal-reporter.com/blog/usps-awards-contract-for-22500-for-mobile-delivery-devices/ (Mar. 24, 2014); Letter from U.S. Postal Service to Richard Duvall, *available at* https://about.usps.com/suppliers/disagreement-decisions/sdr14sr-05.pdf (Jun. 12, 2014).

[6] Post & Parcel, *USPS to Deploy 75,000 Next-Generation Package Scan Devices*, http://postandparcel.info/60503/news/it/usps-to-deploy-75000-next-generation-package-scan-devices/ (Mar. 19, 2014) ("US Postal Service chief information officer Jim Cochrane described the major IT upgrade associated with the new scanning systems [MDD's] and the massive amount of data it will involve as a 'billion dollar bet on the future of the shipping business.'").

[7] U.S. Postal Service, *Holiday Records*, https://liteblue.usps.gov/news/link/2015/01jan/news07s1.htm (Jan. 6, 2015).

[8] Laura Stevens, *For FedEx and UPS, a Cheaper Route: the Post Office*, WALL ST. J., (Aug. 4, 2014), http://www.wsj.com/articles/u-s-mail-does-the-trick-for-fedex-ups-1407182247.

These investments and operational changes entail procurements of billions of dollars. According to Postmaster General Donahoe, "The Postal Service is aiming to more than double its package-delivery business within a few years," and it "plans to invest $10 billion over the next four years for improvements, including buying new vehicles, retrofitting old ones and upgrading package-sorting equipment."[9] This includes investments in a large new fleet of "UPS sized" vehicles designed to accommodate parcels.[10]

This long-term focus by the Postal Service on large investments related to competitive products makes it essential for the Commission to ensure that the Postal Service is properly accounting for these costs. As noted, UPS's consultants reviewed (in the limited time allotted for these comments) much of the non-public domestic data submitted by the Postal Service with its ACR. But this data does not clearly show how the Postal Service is accounting for these investments.

This lack of clarity is partly the result of the complexity of the Postal Service's costing procedures and the resulting difficulty of tracing where specific expenditures end up. But it also is because the data itself is incomplete. While the data does provide high-level cost segment information, it does not always provide sufficiently detailed line-item data showing what comprises the costs that flow into the various cost

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[9] Laura Stevens, *For FedEx and UPS, a Cheaper Route: the Post Office*, WALL ST. J., (Aug. 4, 2014), http://www.wsj.com/articles/u-s-mail-does-the-trick-for-fedex-ups-1407182247.

[10] Mike Colgan, *Familiar White Postal Service Trucks Too Small For Increasing Amount Of Parcels Being Mailed*, (January 19, 2015), http://sanfrancisco.cbslocal.com/2015/01/19/familiar-white-postal-service-trucks-too-small-for-increasing-amount-of-parcels-being-mailed/.

segments.[11] The data also does not identify the assumed lifetimes and other depreciation parameters that would tie reported depreciation charges back to visible, identifiable capital expenditures. And where data relating to a new investment *is* reported, it is nearly impossible to identify and evaluate (i) the accuracy of the "distribution keys" used to assign costs to products, (ii) the methodologies employed to develop these distribution keys, or (iii) the underlying cost pools to which these keys apply. This lack of clarity is especially great for newly created equipment cost pools that do not fit neatly into previously defined cost categories.

These gaps in the data make it effectively impossible to understand how the Postal Service is treating large expenditures relating to competitive products. Without more transparency regarding these issues, neither the Commission nor the public can have confidence in any compliance determination regarding competitive products.[12]

As a result, the Commission should require the Postal Service to disclose fully and with specificity how these costs are (and will be) attributed to competitive products. Specifically, the Postal Service should explain in detail, and support with data, how it is accounting for any significant new capital investments, such as those constituting more

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[11] For example, while UPS consultants have identified a pool of depreciation charges related to PASS/DSS scanners, they have not been able to determine whether these charges include any IT or infrastructure expansion costs associated with the scanners. Nor have they been able to identify any IT costs associated with MDD deployment.

[12] In PAEA, Congress did not require structural separation between the Postal Service's market dominant and competitive products business. Instead, it directed that such separation would occur through precise and rigorous accounting. This approach demands transparency of the type that has been lacking since Congress passed PAEA. Indeed, if anything, the Postal Service has reduced the transparency of its accounting, as evidenced, for example, by its treatment of the statutorily mandated Competitive Products Fund.

than five- to ten-percent of total annual capital expenditures, including those identified above. This explanation should include:

(1) how each such investment will be depreciated;

(2) precisely where within the cost segment reports the resulting depreciation charges will appear; and

(3) what portions of the costs will be attributed to competitive products, to market dominant products, and to institutional costs, and the rationale for this division.

Similarly, the Postal Service should disclose its accounting treatment of significant operational changes relating to competitive products. The Postal Service should not blindly apply legacy costing models to changed operational circumstances. For example, the new Sunday-only parcel-delivery routes should not reflexively be treated the same for costing purposes as routes involving delivery of both mail and parcels. The Postal Service should thus be asked to disclose the following information regarding any significant operational change involving competitive products:

(1) precisely where within the cost segment reports the resulting operational cost appears; and

(2) what portions of the costs will be attributed to competitive products, to market dominant products, and to institutional costs, and the rationale for this division.

Finally, the ACR data also does not show whether or how the Postal Service is accounting for the increased time and attention Postal Service management is devoting to competitive products. Statements by Postal Service officials regarding investment plans and service changes for the competitive products business reflect how much time and attention is increasingly being devoted to this business at the highest levels of the Postal Service. The more than 500 competitive negotiated service agreements executed since the beginning of FY 2008 undoubtedly occupied a significant amount of managerial attention. Attention implies costs. Yet, very few of the costs of Postal Service senior management are attributed.[13] The Commission should thus also require the Postal Service to explain how it is accounting for the costs of increased management attention on competitive products.

IV. THE POSTAL SERVICE IS SIGNIFICANTLY OVERSTATING ITS INSTITUTIONAL COSTS.

As noted above, the FY 2014 ACR shows that nearly *half* of Postal Service costs were classified as institutional in 2014 – and thus were not attributed at all. Without cost accounting practices that give a fuller view of the costs associated with competitive products, the Postal Service may be staking its future on investments that are economically irrational, with the consequences of those decisions hidden for now but ultimately to be borne by the public.[14]

Private businesses could not survive with such low levels of cost attribution, because it is not possible to ensure that prices are set at profitable levels when so many costs are ignored. Certainly, the Postal Service's pricing practices regarding competitive products raise red flags. For example, despite the significant investments noted above, the Postal Service did not in 2015 increase rates for two of its largest competitive products, Priority Mail and Priority Express, either on the residential or commercial side.[15]

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[13] "Headquarters," cost segment 18.1.1, has over $742 million in institutional costs, compared with less than $11 million in attributable costs. *See* Postal Service Cost Segments and Components Report, FY2014.

[14] *See, e.g.,* U.S. Postal Service, Annual Report (Form 10-K) at 32 (Dec. 5, 2014) (noting that "it is unlikely that in the event of a cash shortfall, the Federal Government would allow us to significantly curtail or cease operations").

[15] Other analysts have raised concerns that the Postal Service does not sufficiently understand its costs to make informed decisions. *See* Report of A.T.

Today, the Postal Service has a strong incentive to classify costs as institutional: the more costs the Postal Service classifies as institutional, the easier it is for the Postal Service to pass the no-subsidization tests of §§ 3633(a)(1) and (2), since those tests ignore institutional costs. Congress intended that § 3633(a)(3), which requires the Postal Service's competitive products to cover an "appropriate share" of institutional costs, would counter this incentive. But the Commission currently only requires the Postal Service's competitive products to cover 5.5% of the Postal Service's institutional costs, even though competitive products represented nearly 23% of Postal Service revenue in FY 2014. This 5.5% threshold is far too easy to meet for this requirement to counter the Postal Service's incentive to classify costs as institutional.[16] This situation necessitates close scrutiny by the Commission of whether institutional costs are being classified correctly.

Institutional costs are comprised of two components: inframarginal costs (which decrease on a per-unit basis as volume grows) and fixed costs (which do not vary with volume). Inframarginal costs were the subject of recent papers prepared at the Commission's request. *See* Charles McBride, *The Calculation of Postal Inframarginal Costs* (2014); John Panzar, *The Role of Costs for Postal Regulation* (2014). Public data indicates that, out of $13.4 billion in reported inframarginal costs, the Postal Service included only $216.9 million in its incremental cost calculation for competitive products

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Kearney, commissioned by the Postal Service Office of Inspector General, *Greenfield Costing Methodology, An Opportunity to Deliver Transformative Change* (Jan. 7, 2014). The Public Representative in past ACR proceedings has also stressed the need for greater and more accurate attribution of competitive costs. *See, e.g.*, Public Representative Comments, Docket No. ACR2013, at 46 (Jan. 31, 2014).

[16] UPS recognizes that a reevaluation of the "appropriate share" percentage is beyond the scope of this proceeding.

– meaning just over 1.5% of total Postal Service inframarginal costs are considered when testing whether competitive products as a whole cover their costs.

UPS recognizes that the issue of how to account for the inframarginal costs of competitive products is a complex one that is beyond the scope of this proceeding. But the Commission should in this proceeding demand more information regarding the costs the Postal Service classifies as fixed.

Figure 1 is a graph showing trends in reported volumes and inflation-adjusted fixed costs.[17] It shows that many "fixed" costs are likely not fixed at all – they initially declined when mail volumes fell precipitously, and then more recently increased as competitive product volumes have grown.

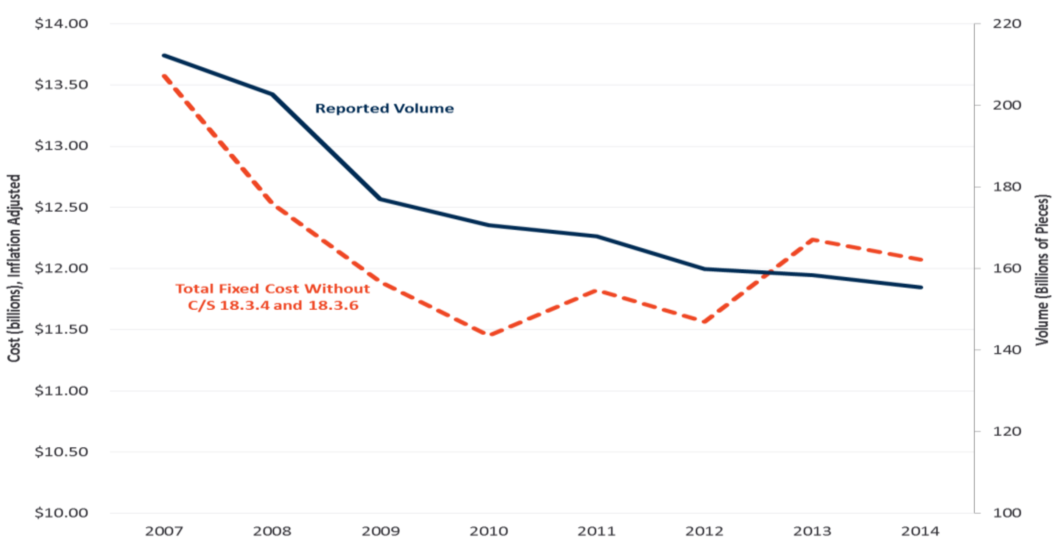

Figure 1: Fixed Costs Over Time

[17] Volume data in Figure 1 comes from the public Revenue Pieces and Weights ("RPW") reports filed by the Postal Service in ACR proceedings. The fixed cost data comes from public Cost Segments and Components reports filed by the Postal Service, and the work-papers to the McBride paper cited above. Cost segments 18.3.4 (workman's compensation) and 18.3.6 (retiree health benefit repayments) experienced large, exogenous shifts in recent years, and so were removed to illustrate more clearly underlying operational cost trends. Inflation adjustments are based on an index reflecting changes in average postal service hourly wage levels.

Examination of specific cost categories further demonstrates the point. For example, the Postal Service reports low variabilities in numerous employee-related cost categories, and thus treats employee costs as largely institutional.[18] Yet the data shows that the Postal Service has re-sized its workforce over time in ways that strikingly correspond to changes in volume, as seen in Figure 2.[19]

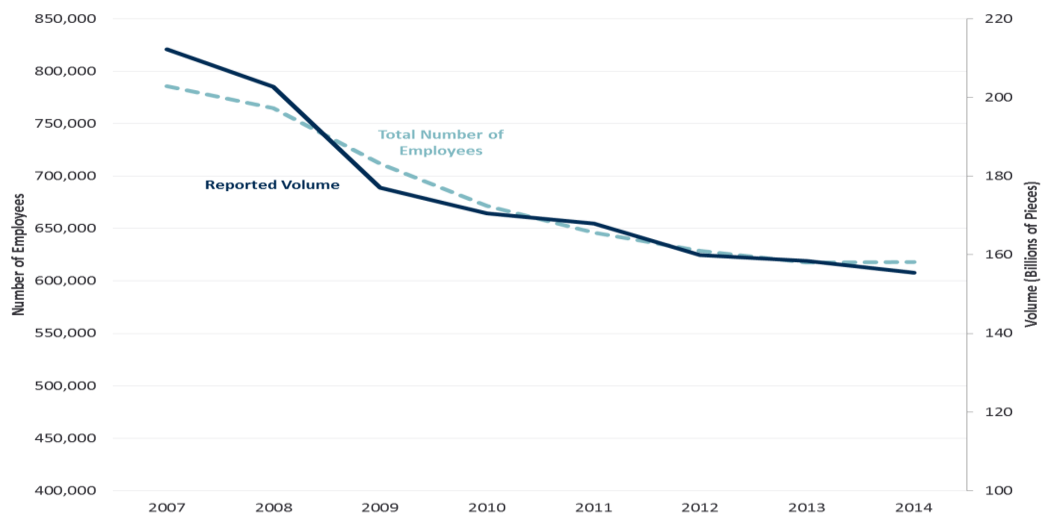

Figure 2: USPS Number of Employees, 2007-2014

An example of employee costs that appear to be misclassified is the over $400 million in bonus compensation paid in FY 2013, all of which the Postal Service treated as institutional costs. In their paper, Robert Cohen and John Waller noted “a spike of $166.6 [million] in Segment 13, Employee Awards, and in Segment 18 $36.5 million in ‘Individual Awards’ and $215.3 million in ‘Miscellaneous Personnel Compensation’” in

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[18] Variabilities range from 0 (completely institutional) to 1 (completely volume variable, and hence, completely attributable to products). Variabilities for each cost segment can be derived from Postal Service CSC Reports. Based on publicly reported data, UPS has calculated the following low employee-related variabilities among others: Postmasters EAS 23 & Below (.182); Higher Level Supervisors (.276); Window Service (.381), and MVS City Delivery Activity (.428).

[19] The employee data underlying Figure 2 come from 2008-2014 10-Ks filed by the Postal Service. The volume data again comes from the RPW reports.

FY 2013.[20] Since bonuses are tied to the number of employees and their performance, a significant portion of them should logically be classified as volume variable and distributed to competitive products.

While a full examination of the Postal Service's treatment of fixed costs is beyond the scope of this proceeding, the Commission should, *at a minimum*, require the Postal Service to explain what it is doing to assess whether costs that it currently treats as fixed actually vary with volume and thus should be attributed.

Clearly, the Postal Service will not conduct such an evaluation without prompting from the Commission. In light of the changes in the Postal Service's business model, reflected in its heavy investments in competitive products, the Commission should direct the Postal Service to focus on these attribution issues now.

V. CONCLUSION

UPS is aware of the limited nature of this proceeding. At the same time, Congress intended the Commission's Annual Compliance Determination to involve close scrutiny of the Postal Service's cost accounting practices to ensure that the mandates of 39 U.S.C. § 3633 are fully met. Thus, the Commission should demand the type of transparency that is necessary to make this determination. As discussed above, UPS has identified a set of information the Postal Service should be directed to provide in this ACR proceeding and in future proceedings.

UPS also recognizes that a comprehensive analysis of how the Postal Service is accounting for the costs of competitive products requires a more thorough examination of the data than has been possible within the compressed time frame for comments in

[20] *See* Robert Cohen and John Waller, *The Postal Service Variability Raito and Some Implications,* at 20 (2014).

this proceeding. Addressing these issues may also require the modification of accepted analytical principles. Thus, as noted, UPS intends to submit a petition initiating a proceeding on these matters.

Respectfully submitted,

UNITED PARCEL SERVICE, INC.,

By: /s/ Steig D. Olson

Steig D. Olson
Quinn Emanuel Urquhart & Sullivan, LLP
51 Madison Ave., 22nd Floor
New York, NY 10010
(212) 849-7152
steigolson@quinnemanuel.com
Attorney for UPS