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BEFORE THE
POSTAL REGULATORY COMMISSION

Periodic Reporting (UPS Proposals One, Two, and Three)	: : :	**Docket No. RM2016-2**

PETITION OF UNITED PARCEL SERVICE, INC. FOR THE INITIATION OF PROCEEDINGS TO MAKE CHANGES TO POSTAL SERVICE COSTING METHODOLOGIES

(October 8, 2015)

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Pursuant to 39 C.F.R. § 3050.11, United Parcel Service, Inc. ("UPS") respectfully petitions the Commission to initiate rulemaking proceedings to change how the United States Postal Service accounts for the costs of competitive products in its periodic reports. Pursuant to 39 U.S.C. § 3652(a), these periodic reports apply the Postal Service's costing methodologies to determine, among other things, whether Postal Service "costs, revenues, rates, and quality of service" comply with Title 39, including 39 U.S.C. § 3633, which applies to competitive products.

UPS proposes three changes to the Postal Service's current costing methodologies. These proposals are separately attached to this petition as UPS Proposals One, Two, and Three. Although the proposals address different aspects of Postal Service costing, they are, in some respects, interrelated.

I. OVERVIEW

Since 1775, the United States Postal Service has been entrusted with the universal delivery of the nation's letter mail, a service so important Congress saw fit to grant the Postal Service a legal monopoly on letter mail delivery in the United States.[1] In recent years, however, the Postal Service appears to have shifted its focus from delivering the nation's letter mail to competing against private companies to deliver parcels (such as packages from e-commerce retailers). This change in focus has been accompanied by reductions in letter delivery standards, some of which are so significant that Congress intervened to stop them.[2] At the same time, the Postal Service has

[1] 18 U.S.C. §§ 1693–1696; 39 U.S.C. §§ 601–606.

[2] *See, e.g.*, Financial Services and General Government Appropriations Act of 2012, Pub. L. No. 112-74, 125 Stat. 786, 923 (Dec. 23, 2011) (mandating continued 6-day mail delivery); *House Committee Approves Amendment To Restore Postal Service*

appealed to the Commission, courts, and Congress to *raise* rates on captive letter mailers above the statutorily-mandated rate cap.[3]

The Postal Service is not the first regulated entity that has gone beyond its regulatory mandate in order to compete head-to-head against private companies in unregulated markets. It is well understood that, when this occurs, the regulated entity has a natural incentive to leverage the monopoly revenues it is making from sales to its captive customers (here, those purchasing letter mail services) to finance the competitive ventures.[4] From telecommunications and airports to electrical power and water utilities, public utilities have an economic incentive to leverage their governmentally-conferred monopoly power by expanding into competitive markets. The utility can act on this incentive by using revenue it generates in the monopolized market to subsidize its operations in the competitive market, thus enabling the utility to charge artificially low prices for the competitive products and expand its scale more broadly than would be possible in the absence of the monopoly.

If left unchecked, a regulated utility acting in this way can cause significant harm to the captive customers of the monopoly products, who are forced to subsidize the competitive venture, and to the participants in the competitive market, who will see the efficient operation of their market disrupted. To address this problem, lawmakers and

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Standards (June 17, 2015), http://www.apwu.org/news/web-news-article/house-committee-approves-amendment-restore-postal-service-standards; Press Release, Senator Jon Tester, *Tester Introduces Bill to Improve Rural Mail* Delivery (July 15, 2015), http://www.tester.senate.gov/?p=press_release&id=4043.

[3] *See, e.g.*, *All. of Nonprofit Mailers, et al., v. Postal Regulatory Comm'n*, 790 F.3d 186 (D.C. Cir. 2015); Dkt. No. R2013-11.

[4] *See generally* T.J. Brennan, *Cross-Subsidization and Cost Misallocation by Regulated Monopolists*, 2 J. REG. ECON. 37-51 (1990).

regulators have required such utilities to employ rigorous and transparent accounting practices to ensure that the competitive venture is earning revenues sufficient to cover all of the costs fairly attributable to it.

Congress imposed these requirements on the Postal Service in 2006, in the Postal Accountability and Enhancement Act ("PAEA"), as a condition of giving the Postal Service more freedom to compete in competitive parcel markets. Before PAEA, all Postal Service products (including letters *and* parcels) were subject to the same rate-making oversight. Rates could be changed only through litigated rate cases before the Commission which often took many months to complete. As it sought to expand its parcel delivery business, the Postal Service complained that these requirements hampered its ability to compete against more nimble, private companies like UPS and FedEx Corporation. The Postal Service asked Congress to free it from those rate-making constraints for parcels so it could be more flexible and responsive to market conditions.

Congress responded in PAEA by granting the Postal Service new freedoms to set and adjust prices for a newly defined category of "competitive products," which includes products sold in competition with private parcel delivery companies. With this new pricing freedom, the Postal Service has invested billions of dollars in its competitive products business since PAEA was passed. Parcel delivery is increasingly a major focus of the Postal Service's business and the cornerstone of its future plans. This has become especially true in recent years, as the Postal Service sees demand for letter mail steadily decline with the rise of electronic communications.

But the new freedom Congress allowed came with a price. Congress recognized the inherent incentive of the Postal Service to expand its scale in competitive markets at the expense of captive mail customers and fair competition. To the extent the Postal Service is allowed to understate the costs of providing or investing in competitive products, it can set artificially low prices that cover only the understated cost of the products, rather than their actual costs. Thus, Congress mandated in PAEA that the Postal Service could not subsidize its expansion into competitive parcel delivery markets with revenues it enjoys from the products it sells pursuant to the letter monopoly. Instead, the Postal Service must make sure its competitive products earn enough revenues to cover *all* of the costs fairly attributable to that business (including an appropriate share of the overhead costs of the enterprise as a whole). Congress insisted upon these requirements to prevent the Postal Service from leveraging its monopoly over the mail to compete unfairly in competitive markets and to protect the Postal Service's captive mail customers from paying for the Postal Service's overtures into those markets.

Congress codified this mandate in 39 U.S.C. § 3633, which directs the Commission to promulgate and thereafter revise regulations to "prohibit the subsidization of competitive products by market-dominant products,"[5] § 3633(a)(1), to "ensure that each competitive product covers its costs attributable," § 3633(a)(2), and to "ensure that all competitive products collectively cover . . . an appropriate share of the

[5] As defined in PAEA, "[t]he market-dominant category of products shall consist of each product in the sale of which the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products. The competitive category of products shall consist of all other products." 39 U.S.C. § 3642(b)(1).

institutional costs of the Postal Service." § 3633(a)(3). These provisions entrust the Commission with preventing the Postal Service from subsidizing its competitive products business with revenues from market dominant products and with ensuring that *each* competitive product covers *all* variable and fixed costs attributable to it *and* that competitive products collectively bear their fair share of the remaining costs that cannot be attributed to any products — that is, the "institutional" costs of Postal Service operations.

UPS is filing this petition after conducting an exhaustive analysis over the past nine months, involving a close study of Postal Service cost methodologies and its actual cost data. This analysis reveals, with stunning clarity, that the Postal Service is not upholding its end of the bargain struck by Congress in PAEA. As it rushes to expand in competitive parcel markets, using the pricing freedom Congress granted to it and spending billions of dollars in the process, the Postal Service is failing to ensure that its competitive products business is recovering all costs fairly attributable to that business. Instead of setting prices for competitive products sufficient to recover the costs of those products, the Postal Service's competitive products business is effectively riding on the backs of those mail customers who have little or no choice but to use the Postal Service.

The Postal Service's disregard of the obligations placed upon it by PAEA threatens to distort competition in parcel delivery markets and to harm the public and those captive mailers who must finance this expansion. While captive mailers are paying significantly increased prices and experiencing reduced service standards, the Postal Service is slashing prices of its competitive products to drive up its market share.

As just one example, the Postal Service cut its commercial Priority Mail rates by as much as 58% in September 2014. The Postal Service is only able to slash its prices for competitive products in this way because it is not accounting fully for the true costs of those products. In short, the Postal Service is doing exactly what Congress said it should not do.

UPS is not alone in raising these concerns. Similar concerns have been raised by captive mail customers as well, with many questioning how their cost coverage has decreased even in light of postage rate increases and lower quality services. They have repeatedly asked the Postal Service to better explain the trends, to no avail.[6] These mailers' concerns are even more heightened by the Postal Service's continued push to extend the exigent rate increase indefinitely and its relentless appeals to Congress to remove the rate cap on market dominant mail.

UPS's analysis of these issues is assisted by a close study of available Postal Service cost data conducted by economist Dr. Kevin Neels. Dr. Neels is a principal at The Brattle Group, an economic consulting firm, where he leads the company's transportation consulting practice. He has been involved in postal issues for decades and has appeared before this Commission many times. His work here, as presented in the expert report which accompanies this petition, presents what is likely the first major critical analysis of the Postal Service's costing methodologies, utilizing actual data, since the passage of PAEA. *See* Report of Dr. Kevin Neels Concerning UPS Proposals One, Two, and Three (Oct. 8, 2015) ("Neels Report").

[6] *See, e.g.*, Dkt. No. ACR2014, Association for Postal Commerce Comments at 1-4 (Feb. 2, 2015).

As detailed in the attached proposals, UPS's analysis shows that the Postal Service is improperly classifying billions of dollars of costs that are variable costs (that is, they vary with the volume of products sold) as so-called "institutional" costs. This misclassification undermines compliance with PAEA because, while variable costs are supposed to be attributed to individual products, institutional costs are not attributed to products. Thus, because of this large-scale cost misclassification, the Postal Service ignores billions of dollars of misclassified variable costs when it sets prices for its competitive products. As a result, Postal Service competitive products are not bearing the full scope of the variable costs attributable to them, either individually or as a group — a practice that directly contradicts Congress' mandate.

Two specific flaws in the Postal Service's current costing approach are primarily responsible for this massive misclassification and under-attribution of costs. First, the Postal Service attributes only the "marginal" costs of its competitive products to those products when it reports its costs and sets its prices.[7] In the process, it largely ignores other costs that vary with product volume. In particular, the Postal Service fails to attribute to products the additional variable costs that are incurred in producing all the units of output up to, but not including, the current (or "marginal") level of production. These additional variable costs are called "inframarginal" costs.

Put another way, the Postal Service's cost accounting methodologies assume that the cost of delivering *each* unit of its competitive products is equivalent to the cost

[7] There is one very minor exception: in addition to marginal costs, the Postal Service attributes a very small amount of "product-specific fixed" costs to competitive products. These costs comprise only 0.54% of total attributable costs. *See* Public Cost and Revenue Analysis, FY 2014, https://about.usps.com/who-we-are/financials/cost-revenue-analysis-reports/fy2014.xls ("FY 2014 CRA").

of delivering only the *last* unit of those products. This assumption is reasonable only when the marginal cost of producing the last unit is constant for all levels of volume. But when marginal cost varies with the level of volume being produced, such as when economies of scale and scope make producing additional units of output cheaper, this assumption is unreasonable and inaccurate, and it leads to a dramatic understatement (and thus under-attribution) of variable costs.

The Postal Service undeniably does enjoy substantial economies of scale and scope across its network. Thus, its use of this assumption is unreasonable and it leads to a dramatic understatement of the variable costs actually attributable to its competitive products. By assuming the cost of the *last* unit is the same as the cost of *all* units, the Postal Service effectively turns a blind eye to the extra costs incurred when adding earlier units to its network. Dr. Neels' analysis confirms that the variable costs the Postal Service disregards are staggering — in FY 2014, the Postal Service failed to attribute over *$2.68 billion* to its competitive products business due to this methodological flaw alone.[8]

This flaw means that the Postal Service may itself be in the dark about the true costs of its competitive products, which, in turn, means it is unable to make fully informed pricing or investment decisions. It is also unable to ensure that its market dominant products are not subsidizing its competitive products. And the Commission is unable to ensure that the Postal Service is competing fairly in parcel markets.

Remarkably, the Postal Service's exclusive focus on attributing only marginal costs (and not inframarginal costs) violates longstanding principles of cost attribution

[8] Neels Report at 30, Table 6.

recognized by the Commission. The Commission has recognized that *all* variable costs are caused by products and thus can and should be attributed to products. And it has criticized the Postal Service's effort to limit cost attribution to marginal costs alone. Yet, notwithstanding the Commission's views, the Postal Service maintains this flawed approach today.

The Postal Service's failure to attribute inframarginal costs to competitive products is utterly indefensible after PAEA. By failing to attribute inframarginal costs to products, the Postal Service is not accounting fully for the costs of each and every product it sells in competitive markets. As a corollary of this flaw, the Postal Service is giving virtually all of the benefits of its economies of scale and scope to the customers of its competitive products business and none to the customers of its market dominant products. Captive customers of market dominant products wind up paying for the great bulk of the cost burdens of the Postal Service's network and scale, while being deprived of the benefits.

UPS Proposal One shows how this flaw should be corrected. Inframarginal costs can and should be attributed to competitive products in a straightforward manner that comports with PAEA and aligns with past Commission decisions. Specifically, the Commission should direct the Postal Service to attribute inframarginal costs to products using the same "distribution keys" it has long used to distribute marginal costs among the various postal products.

The second (and related) flaw with Postal Service cost attribution practices is that the Postal Service is misclassifying billions of dollars of variable costs as "fixed" costs of the enterprise as a whole. By misclassifying variable costs as fixed costs, the Postal Service can largely ignore them when setting the prices of competitive products.

The Postal Service has never shown that these costs are fixed using reliable methodologies; it often treats them as fixed today based largely on subjective, *ad hoc* classifications made many years (even decades) ago. Based on little more than these stale, subjective classifications, the Postal Service does not attribute these costs to its competitive products.

This flaw too is long overdue for correction. These misclassified fixed costs have historically avoided detection partly because they are scattered across the various components and segments that comprise the structure of Postal Service costing. Dr. Neels has now done the hard work of identifying these purportedly "fixed" cost categories and putting them to the test. As detailed in his report, Dr. Neels' work demonstrates that a majority of cost pools classified by the Postal Service as fixed actually tend to change with volume — that is, they are variable. He further demonstrates that there is a virtually *zero* chance that these results represent mere random noise. These striking results demonstrate that the Postal Service has a *systematic tendency* to misclassify costs as fixed, rather than variable — a practice that contributes to the Postal Service's dramatic understatement of the costs attributable to its competitive products business. **<u>UPS Proposal Two</u>** shows how, applying Dr. Neels' results, many of these misclassified costs should be reclassified as variable and then attributed to products utilizing accepted attribution methods.

Making the changes identified in UPS Proposals One and Two would be a major step forward. It will increase the percentage of costs that are attributed to products through reliable causal relationships and significantly decrease the amount of costs treated as institutional. These are both outcomes that Congress (and others) expected would flow from PAEA.[9] To date, however, the opposite has occurred: the amount of Postal Service costs classified as institutional not only remains extraordinarily high; it has actually increased since PAEA, with unattributed costs accounting for over 46% of total costs, or *$34.2 billion*, in 2014.[10] Making the changes discussed in UPS Proposals One and Two will mean that "institutional" costs will be the truly fixed and common costs of the enterprise as a whole. The Postal Service will have much greater visibility into the costs of the parcel business upon which it is staking its financial health and the future of its enterprise.[11]

Nevertheless, the institutional cost category will remain significant. Dr. Neels' work estimates that, if UPS Proposals One and Two are accepted, Postal Service

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[9] In 2004, then-Secretary of the Treasury John W. Snow observed that the size of Postal Service institutional costs – then 42% of total costs - "[was not] close to being satisfactory." *Reform of the United States Postal Service: Hearing Before a Joint Session of the H. Comm. on Gov't Reform and S. Comm. on Governmental Affairs* (Mar. 23, 2004) (statement of the Honorable John W. Snow, Secretary, Dep't of the Treasury), http://www.treasury.gov/press-center/press-releases/Pages/js1255.aspx. He identified "this large unallocated portion [as] sort of 'the elephant in the room,'" and argued that the public interest and trust demands improved transparency.

[10] *See* FY 2014 CRA.

[11] Accepting UPS Proposals One and Two would also reduce Postal Service costs by streamlining the number and type of econometric analyses necessary for Postal Service cost reporting purposes. For example, the Postal Service recently spent years developing and executing two special studies to determine the marginal cost of city carrier street time for each of its products. *See* Dkt. No. RM2015-7, City Carrier Street Time Study (Dec. 11, 2014). Acceptance of UPS Proposal One would reduce or potentially even eliminate the need for this type of costly and burdensome study. Once the Postal Service determines that a component has a constant elasticity cost structure, no further econometric analysis is needed, since the Postal Service would no longer need to differentiate between marginal and inframarginal costs; it would instead attribute all variable costs.

institutional costs will remain above ***$17*** billion dollars, or approximately ***24%*** of the enterprise's costs.[12] Accordingly, because institutional costs are not attributed to products, it will remain essential that the Postal Service's competitive products bear their "appropriate share" of institutional costs, as required by 39 U.S.C. § 3633(a)(3).

UPS Proposal Three addresses this "appropriate share" requirement. Today, the "appropriate share" is set at a minimum contribution level of just 5.5% — a level that has not changed since the Commission first adopted it in 2007, even as the revenues and costs of competitive products have, by every measure, exploded, while the revenues and costs of market dominant products have sharply declined.

Keeping the share of institutional costs that competitive products must cover fixed at a low 5.5% level cannot be reconciled with the fact that competitive products are responsible, under any measure, for a much greater share of the Postal Service's overall institutional costs today than they were in 2007. The current appropriate share level thus is arbitrary and capricious, and it is not based on the type of "reasoned decisionmaking" federal law requires.[13] It needs to be changed to reflect current conditions.

UPS Proposal Three explains how the Commission can update the appropriate share requirement in 39 U.S.C. § 3633(a)(3) to ensure that it does, in fact, "reflect the ways in which institutional resources are spent on the competitive enterprise." Dkt. No. RM2012-3, Order No. 1449 at 13 ("Order 1449"). Specifically, the Commission should require the Postal Service's competitive products business to bear a share of

[12] Neels Report at 30, Table 6; 50, Table 15.

[13] *See, e.g.*, *U.S. Postal Serv. v. Postal Regulatory Comm'n*, 785 F.3d 740, 756 (D.C. Cir. 2015) (rejecting Commission decision as "arbitrary and capricious for lack of reasoned decisionmaking").

institutional costs that corresponds to the share of overall *attributable* costs for which the Postal Service's competitive products are responsible. UPS proposes that the figure be set using a three-year trailing average of the share of overall attributable costs for which competitive products are responsible, which yields a new appropriate share level of 24.6%. The Commission could further consider (i) permitting the Postal Service to phase in this new level over a short period of time and (ii) allowing the level to stay current by adjusting each year, based on the average of the prior three years.

II. LEGAL REQUIREMENTS APPLYING TO COMPETITIVE PRODUCTS

The foremost job of the Commission is to implement PAEA's directives. In doing so, it is necessary to consider, in addition to the plain language of 39 U.S.C. § 3633, the Act's legislative purpose and its structure as a whole. It is a "fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme." *Util. Air Regulatory Grp. v. EPA*, 134 S. Ct. 2427, 2441 (2014) (internal quotation marks omitted).[14]

The legislative history of PAEA firmly demonstrates that Congress required the Postal Service to compete fairly in competitive markets as a condition of its willingness to give the Postal Service more freedom to set prices for competitive products. For example:

- S. Rep. No. 108-318 at 14 (2004) ("This bill establishes a flexible system of pricing the Postal Service's competitive products which reduces regulatory burdens and permits more customer- and market-responsive pricing. ***It does this while establishing appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete***.") (emphasis added);

[14] *See also King v. Burwell*, 135 S. Ct. 2480, 2496 (2015) ("A fair reading of legislation demands a fair understanding of the legislative plan.").

- 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***. The Postal Service will be given flexibility to price competitive products, but competitive products and services will have to pay their own costs without subsidy from market-dominant mail revenues.") (emphasis added);

- S. Rep. No. 108-318 at 7 ("In addition, the Postal Service's Board of Governors is permitted to more directly manage and price the Postal Service's competitive products; subject to minimal Regulatory Commission oversight ***to ensure that the Postal Service competes fairly with the private sector delivery services***.") (emphasis added).

The legislative history further makes clear that the fair competition requirement goes hand in hand with Congress' goal of ensuring that market dominant revenues do not subsidize the growth of the competitive products business — only by ensuring that each of the Postal Service's competitive products is covering the costs attributable to it, and that the products as a group are covering the costs attributable to them, can the Commission be sure that competitive products are not subsidized by captive mail customers.

To accomplish these goals, Congress charged the Commission with promulgating and revising regulations to: "(1) prohibit the subsidization of competitive products by market-dominant products; [and] (2) ensure that each competitive product covers its costs attributable." 39 U.S.C. § 3633(a)(1) & (2). The "appropriate share" requirement of 39 U.S.C. § 3633(a)(3) was also "intended to ensure that the Postal Service competes fairly in the provision of competitive products." S. Rep. No. 108-318 at 15. After all, if the Postal Service's competitive products business were a private entity, it would generally have to cover all of the costs it treats as "institutional" in order to stay in business.[15]

These related goals of ensuring fair competition and preventing subsidization are embedded deeply in PAEA's structure. Beyond the provisions of 39 U.S.C. § 3633, these goals explain, for example, why Congress ordered the creation and use of the Competitive Products Fund. 39 U.S.C. § 2011; *see* H.R. Rep. No. 109-66 at 53 ("The 'Competitive Products Fund' is in addition to the current Postal Service Fund. The intent of this section is to level the playing field for the Postal Service and its competitors in the Competitive product market by requiring the Postal Service to keep separate financial accounts for Market Dominant and Competitive products.").[16]

These related goals also explain why Congress requires the Postal Service's competitive products business to pay an assumed federal income tax, receive equal customs procedures as its private competitors, obey environmental regulations, and obey antitrust and fair-trade laws. 39 U.S.C. § 3634 (assumed federal income tax); *Id.* at § 407(e) (equal customs procedures); *Id.* at § 409(f)(2) (zoning, land use, and

[15] *See, e.g.*, Dkt. No. MC2015-7, Order No. 2686, Joint Dissent of Acting Chairman Robert G. Taub and Vice Chairman Tony L. Hammond at 14 (Aug. 26, 2015) (noting that "when the Postal Service's competitors price their products, they generally must begin at a price floor that covers both attributable and institutional costs if they are to remain profitable").

[16] The Postal Service has inexplicably failed to comply with Congress' mandate that it maintain a functioning Competitive Products Fund. The Competitive Products Fund was one of the key reforms enacted by Congress in PAEA, yet the Fund is unused for all but two days a year: to transfer the amount of the assumed federal income tax into the Fund, only to transfer it back out again the next day. *See* Dkt. No. PI2013-1, Order No. 2329 at 3 (Jan. 23, 2015). PAEA also clearly requires that all "revenues from competitive products" "shall be deposited in the Competitive Products Fund," 39 U.S.C. § 2011(b), yet the Postal Service has acknowledged it does not comply with this mandate. Dkt. No. PI2013-1, Responses of the Postal Service to Commission Information Request No. 1 at 3 (Aug. 2, 2013).

environmental laws to which the federal government is normally immune); *Id.* at § 409 (subjecting the Postal Service to antitrust and fair trade laws); *see also* H.R. Rep. No. 109-66 at 44-45 ("In addition, the bill, for the first time, subjects the Postal Service's competitive products to many of the same laws as private companies, such as—Antitrust laws, Fair-trade laws, Equal customs procedures, An assumed federal income tax payment").

These goals further explain why Congress sharply limited the Postal Service's rulemaking power when acting as a competitor in private markets and prohibited the Secretary of State from favoring the Postal Service over private competitors in intergovernmental negotiations. 39 U.S.C. §§ 404a, 407(e)(3); *see also* S. Rep. No. 108-318 at 28 ("This legislation makes clear that the Postal Service is barred from using its rulemaking authority to put itself at a competitive advantage or put another party at a competitive disadvantage."). And these goals explain why Congress required the Federal Trade Commission to identify legal disparities between the Postal Service and its competitors and tasked the Commission to remedy these and other disparities under 39 U.S.C. § 3633. PAEA, Pub. L. No. 109-435, § 703 (2006); *see also* H.R. Rep. No. 109-66 at 30.

The Commission must, therefore, evaluate Postal Service costing practices applicable to competitive products to determine whether those practices are consistent with Congress' related goals of ensuring fair competition and preventing subsidization. As discussed in UPS Proposals One, Two, and Three, current Postal Service costing practices fall far short of these mandates. In fact, as demonstrated within each proposal, current practices allow the Postal Service to compete in ways its private competitors could never match, no matter how efficient they are. This type of unfair competition distorts competitive markets to the detriment of competitors and consumers alike. Current practices also give rise to the very type of hidden subsidization of competitive products by captive mail customers that Congress expressly said should not occur.

III. POSTAL SERVICE INSTITUTIONAL COSTS REMAIN HIGH, EVEN AS THE POSTAL SERVICE INCREASINGLY FOCUSES ON COMPETITIVE PRODUCTS.

The scope of the problem with the Postal Service's current practices is reflected in the fact that Postal Service institutional costs have remained at very high levels now for nearly a decade after PAEA was passed. In enacting PAEA, Congress recognized that improving Postal Service cost attribution practices was necessary to prevent subsidization and to ensure that the Postal Service was actually covering the costs of its competitive products:

> The goal of [improved accounting] is to prevent the subsidization of competitive products by market-dominant products by better identifying the costs incurred by the Postal Service in providing competitive products. The President's Commission points out that the Postal Service today is able to attribute less than 60 percent of its costs among its various products. This means that more than 40 percent of costs are labeled as institutional. . . . The Committee agrees with the President's Commission when they say that this situation should be improved. ***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***.

S. Rep. No. 108-318 at 29-30 (emphasis added).

The Postal Service has failed to improve cost attribution since PAEA. In fact, cost attribution has actually *declined*. Neels Report at 12, Table 4 (showing a decrease from 62% attributable in FY 2008 to 58% attributable in FY 2014). The trend is shown in Figure 1.

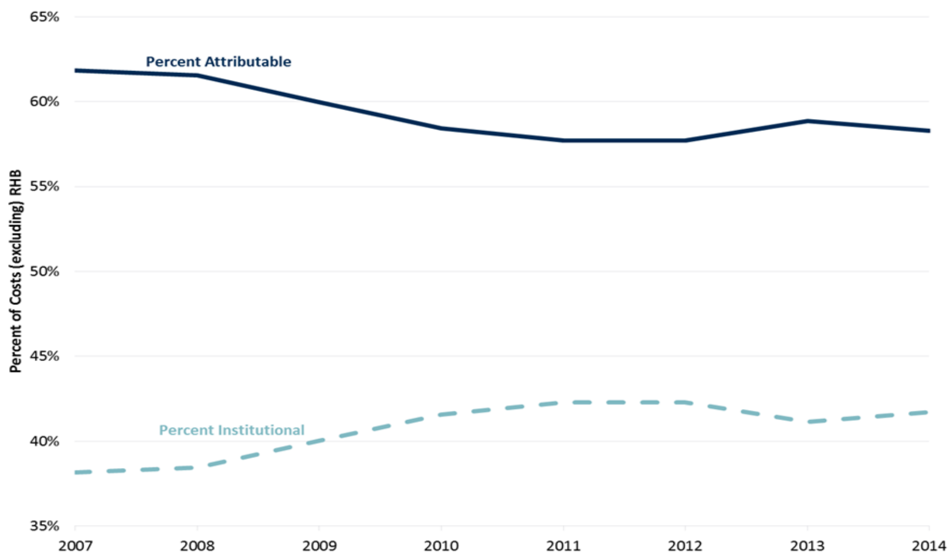

Figure 1: Attributable vs. Institutional Costs[17]

A recent Commission-sponsored study by Richard Cohen and John Waller observed this decline and concluded that attribution levels would likely decrease further "for the foreseeable future."[18] Cohen and Waller suggest that a number of factors may have contributed to this decline, such as decreased market dominant volume, increased productivity, and change in mail mix. *See* Cohen and Waller at 2-3. But another principal factor is that the Postal Service has shown insufficient interest in improving its attribution of costs to products. *Id.* at 12-13 (noting that methodological changes since PAEA "have had small effects" on total attribution rates). In fact, the Postal Service has acknowledged it has devoted less attention to cost attribution since PAEA was passed

[17] The data in this figure comes from Neels Report, Table 4.

[18] Robert Cohen & John Waller, *The Postal Service Variability Ratio and Some Implications* at 9 (2014) ("Cohen and Waller").

than it should have. Dkt. No. ACR2013, Postal Service Reply Comments at 12 (Feb. 14, 2014).

The Postal Service's reluctance to change is consistent with the tendency seen in other regulated industries where a firm occupies a monopoly position in some product markets, while competing against the private sector in others. As Cohen and Waller observe, the Postal Service has an incentive to minimize cost attribution to maximize its own pricing flexibility in competitive markets. Cohen and Waller at 1 (observing that the Postal Service has long preferred lower levels of cost attribution to maximize pricing flexibility). As the late Alfred Kahn (former Chairman of the New York Public Service Commission and Civil Aeronautics Board) explained, as long as prices continue to be set "on the basis of some continuing process of allocation of costs between regulated and unregulated operations, there will always be the danger, in principle, of subsidization of the latter by the former."[19]

It is nearly impossible for a state-run enterprise to ensure its prices are set at profitable levels when such a large amount of costs are treated as "institutional" costs that are untethered to any product or service. Without cost accounting practices that give a more comprehensive 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 temporarily hidden but ultimately borne by the public. It is no wonder that outside analysts are increasingly raising concerns that the Postal Service does not sufficiently understand its costs to make informed decisions. *See* Report of A.T. Kearney, commissioned by the Postal Service Office of Inspector

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[19] Alfred E. Kahn, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS xxxvi (1988).

General, *Greenfield Costing Methodology, An Opportunity to Deliver Transformative Change* at 2 (Jan. 7, 2014) ("[T]oday's more competitive and dynamic environment requires current and granular cost data to support numerous complex product, pricing, and customer decisions.").[20]

The Postal Service's current high levels of unattributed costs are unacceptable from both a regulatory and a business perspective and undermine public confidence in the Postal Service's business practices. The current state of affairs demands bold action, and change is overdue.

UPS understands the complexities required for the Commission to ensure that the goals of the PAEA are being achieved and understands as well that the Commission has a vast undertaking in 2017 to review the rate-making process for market dominant products, as required by PAEA. Such a task will no doubt require a significant effort. As competitive products now constitute over 22% of total revenues and an even higher percentage of costs, the Commission should have a full understanding of the Postal Service's cost drivers for all products, including competitive products, prior to reviewing the market dominant rate-making process.

To facilitate the Commission's review, UPS has limited its request to three proposals, which rely to the extent possible on the cost-accounting machinery already in place, including the existing distribution keys for assigning cost responsibilities among various products. To be clear, these three proposals alone will not solve every issue

[20] The Postal Service apparently anticipates a taxpayer-funded bailout should its ambitious wager on competitive products not go as intended. *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"). This means that the financial consequence of misguided business decisions would ultimately be borne by taxpayers.

with postal costing, and the effectiveness of the distribution keys themselves needs to be continuously analyzed and improved in light of changing conditions. At this time, UPS does not believe that consideration of these proposals will necessarily require additional data collection from the Postal Service. As part of the process, however, it may prove to be advisable for the Commission to require the Postal Service to provide operational data that may have material impacts on cost — such as the weight and the cube of parcels being delivered by the Postal Service.[21]

Finally, while this proceeding is focused upon competitive products, the proposals necessarily implicate letter mail costs as well. Hence, we anticipate that the Commission will invite participation and comments from mailing community stakeholders, and we offer whatever assistance the Commission may request during its evaluation of these proposals.

[21] Weight and cube are primary cost drivers for parcel pick-up, processing, transportation and delivery. It may also be advisable for the Commission to utilize information garnered from the City Carrier Street Time Cost Docket (RM2015-7) to fully understand how many and what types of parcels are being delivered to consignees. In addition, as part of this process, the Commission may need to require the Postal Service to identify what type and how many parcels are being transported into the United States by foreign posts and delivered by the Postal Service.

Respectfully submitted,

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