UPS PROPOSAL THREE

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BEFORE THE
POSTAL REGULATORY COMMISSION

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

PROPOSAL THREE — A PROPOSAL TO ADJUST THE "APPROPRIATE SHARE" OF INSTITUTIONAL COSTS THAT MUST BE COVERED BY COMPETITIVE PRODUCT REVENUE

(October 8, 2015)

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I. SUMMARY OF PROPOSAL

The Commission should modify the “appropriate share” of Postal Service institutional costs that must be covered by its competitive products, a share level the Commission is required to set and revise under 39 U.S.C. § 3633(a)(3). The current minimum 5.5% level, set by the Commission in 2007, is indefensible today, particularly in light of the explosive growth of competitive products in recent years, and it bears no rational relationship to Congress’ goals or directives in PAEA.

UPS proposes that the Commission update the “appropriate share” by using an average of the previous three years of attributable cost shares for competitive products. This approach results in a new “appropriate share” level of 24.6%. Should the Commission so desire, the Postal Service could be given a short grace period to meet this new threshold. In addition, the Commission could direct that this calculation automatically adjust on an annual basis going forward.

II. BACKGROUND: THE CURRENT “APPROPRIATE SHARE” REQUIREMENT

Section 3633(a)(3) requires “that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.” In assessing the appropriate share, the Commission must consider “all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products.” 39 U.S.C. § 3633(b). The Commission has the responsibility to review its determination of the appropriate share every five years, and may consider it more often when “relevant circumstances materialize.” Dkt. No. RM2012-3, Order No. 1449 at 3 (“Order 1449”).

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PAEA's requirement "that all competitive products collectively cover their share of the Postal Service's institutional costs" was "intended to ensure that the Postal Service competes fairly in the provision of competitive products." S. Rep. No. 108-318 at 15 (2004); *see also* Order 1449 at 13 ("A primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace. . . . [T]he appropriate share requirement is an important safeguard to ensure fair competition on the part of the Postal Service."). This requirement also ensures that the Postal Service does not force market dominant mailers to cover those institutional costs of the enterprise that are uniquely or disproportionately associated with competitive products.

Currently, the institutional costs of the Postal Service fall into two categories: inframarginal costs and fixed costs. As discussed in UPS Proposal One, inframarginal costs are *variable* costs that the Postal Service erroneously treats today as overhead costs. Instead of being lumped in as institutional costs of the enterprise, these variable costs should be attributed to products. In other words, inframarginal costs are not institutional costs at all. Institutional costs should instead be limited to those fixed costs that cannot be reliably attributed to any product or groups of products — that is, the fixed and common cost of the enterprise. *See* John Panzar, *The Role of Costs for Postal Regulation* at 8 (2014) (noting that fixed costs measure "the size of jump discontinuities at the origin" and are the "significant levels of costs that must be incurred in order to produce even a vanishingly small level of output").

UPS's Proposal Three focuses on the fixed costs that are not attributed to products — that is, those costs that are properly treated as institutional. As discussed below, to meet Congress' mandates in PAEA, the Postal Service's competitive products business must bear a higher share of these institutional costs than they do today — a share that appropriately reflects the increasingly significant expenditure of Postal Service attention and resources on competitive products.

Before PAEA, the Rate Commission exercised significant discretion in allocating institutional costs according to the non-cost factors in 39 U.S.C. § 3622(b). Under this method, the Rate Commission projected that competitive products would contribute 6.9% of institutional costs in 2008. Dkt. No. RM2007-1, Order 26 at 70-71 ("Order 26") ("Based on the recommended rates, the Commission estimates that in TY 2008 competitive products will contribute . . . approximately 6.9 percent of the total contribution to institutional costs.").

Despite this projected contribution from competitive products, the Commission in 2007 departed sharply downward to set the initial "appropriate share" under PAEA at 5.5%. The Commission offered the following reasons for its decision to set the minimum level significantly below its projected figure:

> (1) the fact that the PAEA 'so thoroughly overhauls the ratemaking process' that the changes in that process should be taken into account; (2) rates for competitive products are no longer predicated on consideration of non-cost factors as they were under the Postal Reorganization Act (PRA), Pub. L. 91-375 (1970); and (3) under the PAEA, the Postal Service may retain earnings, so it has an incentive to exceed the threshold set by the Commission 'including reducing rate pressure on market dominant rates, continuation of universal service, and the possibility of bonuses.'

Order 1449 at 12 (quoting Order 26 at 71-72).

The Commission considered the appropriate share again in 2012 and retained the 5.5% level. *See id.* The Commission's 2012 review occurred in a time of great uncertainty for the Postal Service, with pending postal legislation and network rationalization in its infancy.[1] Some participants, citing this uncertainty, urged the Commission to maintain the 5.5% level, but did so with the "reassurance that the Commission may revisit the appropriate share requirement at any time in the future." Parcel Shippers Association Initial Comments at 4 (Apr. 9, 2012); *see also* Public Representative Initial Comments at 5-6.

The Commission recognized that competitive products' share of total volume had doubled between 2007 and 2012, and noted that an increase in competitive products' share of total volume could influence the Commission to adjust the appropriate share. Order 1449 at 22-23. But, because the Commission determined no party had properly presented that argument in the proceeding, the Commission declined to address it. *Id*.

The Commission has not changed the minimum 5.5% appropriate share level since it was set in 2007. It has, however, repeatedly acknowledged its ability to reevaluate the level at any time in a proceeding like this one. *See, e.g.*, Dkt. No. ACR2014, 2014 Annual Compliance Determination at 86 (Mar. 27, 2015); Dkt. No. ACR2013, 2013 Annual Compliance Determination at 96 (Mar. 27, 2014).

III. RATIONALE FOR UPS PROPOSAL THREE

A. The Current Appropriate Share Level Is Arbitrary and Capricious and Does Not Comply With Congress' Directives.

The 5.5% "appropriate share" level was questionable when it was set in 2007. As noted above, the Commission set this level notwithstanding the fact that it projected that competitive products would contribute 6.9% of institutional costs in 2008. But,

[1] *See generally* Dkt. No. RM2012-3, Public Representative Initial Comments at 4-5 (Apr. 9, 2012); *see also* Parcel Shippers Association Reply Comments at 3-4 (May 7, 2012) ("The main difficulty [with raising the appropriate share] is that it may be awhile before we know the results of the changes that are in process or that may result from legislation now under active consideration by the Congress.").

whatever the merit of a 5.5% level in 2007 or 2008, this level is indefensible today. As explained below, it does not bear any rational relationship to Congress' goals or directives in PAEA, particularly given the explosive growth of competitive products in recent years.

i. The Current Appropriate Share Does Not Ensure Fair Competition.

As the Commission has recognized, a primary goal of 39 U.S.C. § 3633(a)(3) is to "ensure a level playing field in the competitive marketplace" and "to ensure fair competition on the part of the Postal Service." Order 1449 at 13. These goals were made clear in the legislative history of PAEA. *See, e.g.*, S. Rep. No. 108-318 at 15 (the requirement "that all competitive products collectively cover their share of the Postal Service's institutional costs" was intended by Congress "to ensure that the Postal Service competes fairly in the provision of competitive products").

The point is straightforward. Private parcel delivery competitors must set prices that are sufficient to cover *all* of their costs, including their variable costs and fixed costs. If they do not do this, they will go out of business. Congress wanted to make sure the Postal Service would compete on a level playing field. Accordingly, in 39 U.S.C. § 3633(a)(2), Congress directed that the Postal Service's competitive products must recover all of the *variable* costs attributable to those products. In 39 U.S.C. § 3633(a)(3), Congress made sure that the Postal Service's competitive products would also be responsible for their fair share of the *fixed* costs of the enterprise as a whole.

It would be grossly unfair and disruptive, Congress recognized, if the Postal Service were allowed to set its parcel prices without accounting for the same types of fixed costs that private competitors must recover. As the Commission has recognized, "[t]he Postal Service's competitors incur certain fixed operating costs . . . and [i]f the

Postal Service's competitive products were provided by a stand-alone enterprise, it too would incur fixed operating costs." Order 1449 at 13. Accordingly, the "appropriate share requirement could be said to represent the fixed costs of the competitive enterprise and should reflect the ways in which institutional resources are spent on the competitive enterprise." *Id.* at 13.

Measured by this standard, the current 5.5% requirement clearly falls short. The 5.5% minimum level does not bear any rational relationship whatsoever to the proportion of fixed costs that the Postal Service's competitive products business must bear to ensure it is not securing an artificial advantage over its private competitors.

ii. The Current Appropriate Share Does Not Reflect the Time and Effort Spent by the Postal Service on Its Competitive Products Business.

Nor does the 5.5% requirement reflect the significant increase in time and effort devoted by the Postal Service to its competitive products business since 2007. By every measure, there has been a massive shift in the operation of the Postal Service in the eight years since the Commission set the 5.5% appropriate share. Today, the 5.5% requirement does not remotely "reflect the ways in which institutional resources are spent on the competitive enterprise." *Id.* at 13.

Since 2007, mail volumes delivered by the Postal Service have plummeted. Overall market dominant volumes have decreased 28%. *See* Dkt. No. ACR2014, Financial Analysis of United States Postal Service Financial Results and 10-K Statement FY 2014 at 29 (Apr. 1, 2015) ("FY 2014 Financial Analysis"); *see also* Figure 3-1. First-Class Mail averaged an annual 4.7% rate of volume decline. *Id.*

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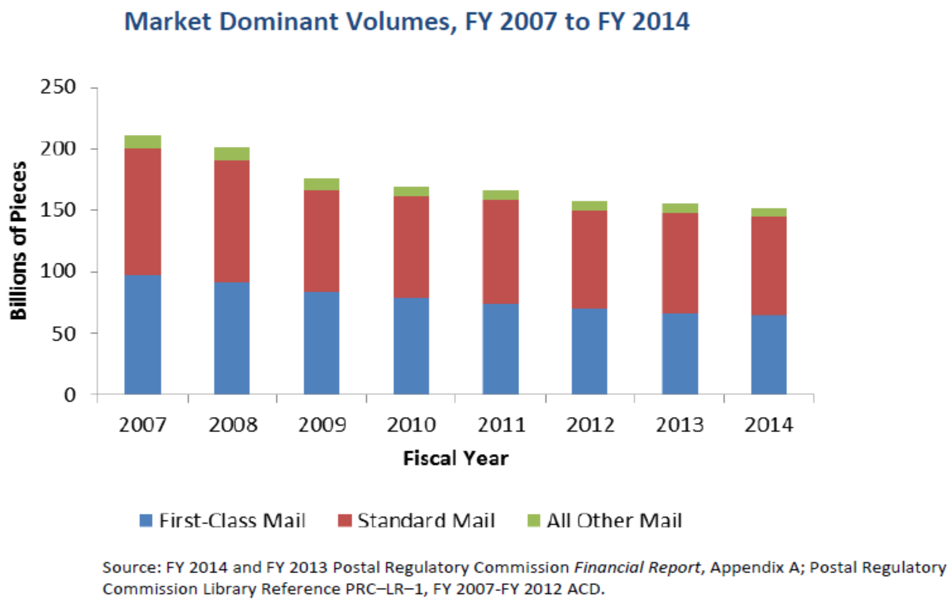

Figure 3-1: Market Dominant Volumes[2]

Market dominant revenues and attributable costs (as calculated by the Postal Service) have also fallen sharply since 2007 — revenues by 18.3% and attributable costs by 24.8%. *Id.* at 30; *see also* Figure 3-2. In FY 2014 alone, market dominant attributable costs fell by 3.7%, or over $1 billion. *Id.* at 28.

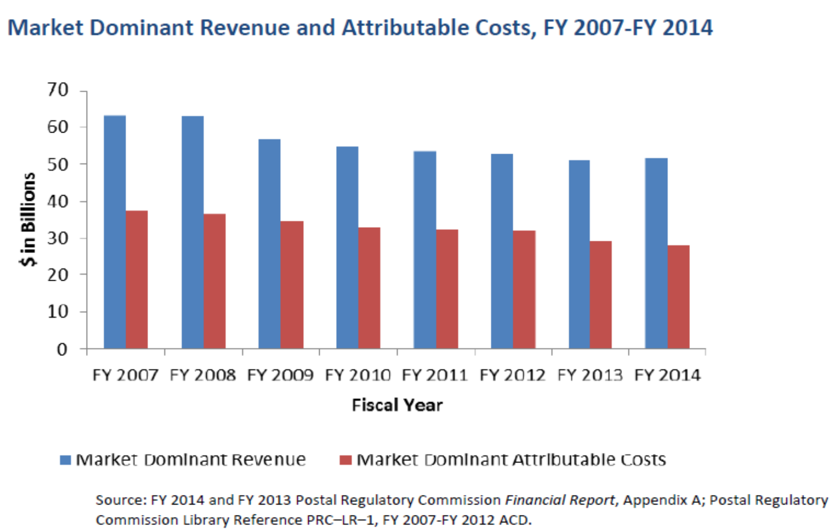

Figure 3-2: Market Dominant Revenue and Attributable Costs[3]

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2 *Id.* at 30.

3 *Id.* at 30.

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In sharp contrast, the Postal Service's competitive products business is growing at a staggering rate. Competitive volumes have a compound annual growth rate of 13.8% since FY 2008.[4] *Compare* Public Cost And Revenue Analysis, FY 2008 at 3, http://about.usps.com/who-we-are/financials/cost-revenue-analysis-reports/fy2008.pdf ("FY 2008 CRA") (1,591,148,000 pieces) *with* Public Cost and Revenue Analysis, FY 2014 at Volume 2, https://about.usps.com/who-we-are/financials/cost-revenue-analysis-reports/fy2014.xls ("FY 2014 CRA") (3,448,005,000 pieces); *see also* Figure 3-3.

Competitive products' share of total volume has nearly *tripled* from 2008 levels. *Compare* FY 2008 CRA at 3 (0.78% of total mail volume) *with* FY 2014 CRA at 3 (2.2% of total mail volume). Total competitive volumes grew nearly 11% in FY 2014. FY 2014 Financial Analysis at 60. The weighted volume of competitive products has also increased from 11.6% in 2008 to 25.0% in 2014. Report of Dr. Kevin Neels Concerning UPS Proposals One, Two, and Three at 8, Table 3 (Oct. 8, 2015) ("Neels Report").

[4] Since the Postal Service did not separate competitive products in its Cost and Revenue Analysis reports in FY 2007, some figures for competitive products are not available until FY 2008.

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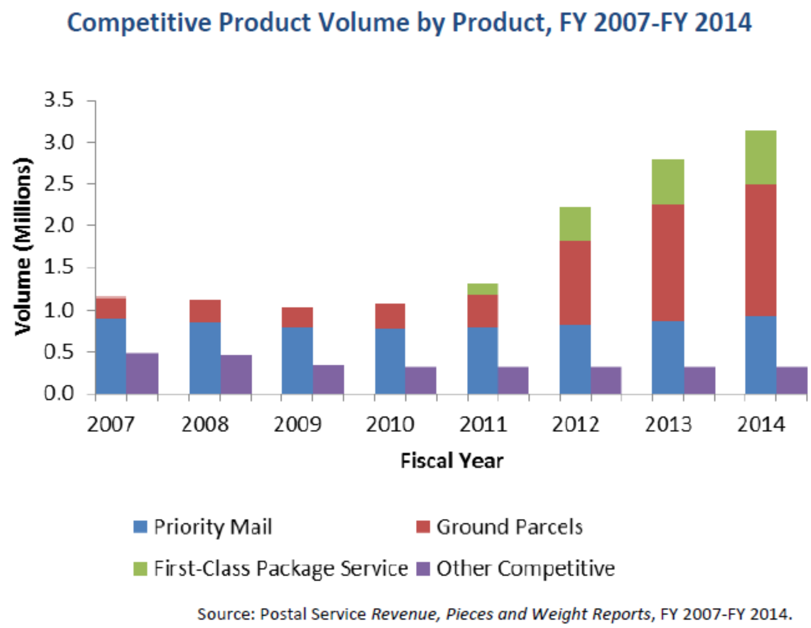

Figure 3-3: Competitive Volume Over Time[5]

As the Commission has noted, "[a]ttributable costs of Competitive products have grown and now comprise 28 percent of total attributable costs, compared with 11.5 percent in FY 2008." FY 2014 Financial Analysis at 61; *see also* Figure 3-4.

Figure 3-4 shows the stark contrast between the clear upward trend of the competitive products business (whether measured by total revenue, weighted volume, or attributable costs) and the 5.5% appropriate share level that has remained unchanged since 2007.

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[5] FY 2014 Financial Analysis at 61.

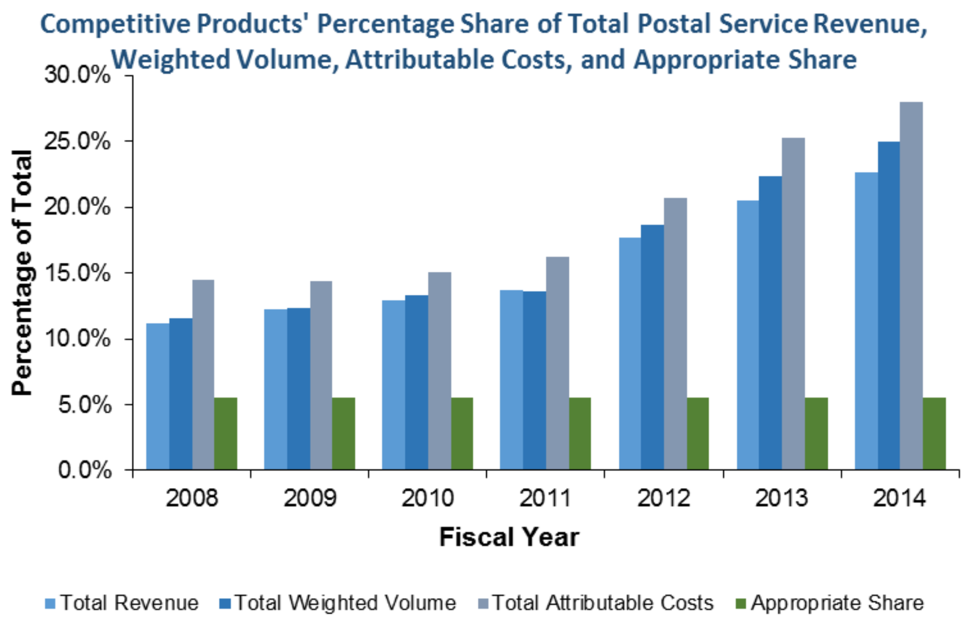

Figure 3-4: Competitive Products vs. the Appropriate Share[6]

A portion of this growth comes from additions to the competitive products list and transfers from the market dominant list to the competitive products list. *See* Neels Report at 35. Initially there were just 11 competitive products, including international competitive products. 39 U.S.C. § 3631; Order 26 at 79. Now there are 22 competitive products — 12 domestic competitive products and 10 international. FY 2014 Financial Analysis at 59. There are also 136 domestic competitive Negotiated Service Agreements (NSAs) and 282 international competitive NSAs, with new NSAs regularly being approved by the Commission.[7] *Id.*

[6] Neels Report at 4, Table 1; 8, Table 3; Cost and Revenue Analyses, 2008-2014, http://about.usps.com/who-we-are/financials/cost-revenue-analysis-reports/.

[7] NSAs are contracts between the Postal Service and individual customers that "provide[] customized pricing incentives or other arrangements." U.S. Postal Service, *Negotiated Service Agreements*, https://www.usps.com/nationalpremieraccounts/nsa/welcome.htm. NSAs may, for example, provide volume discounts to large customers like Amazon.

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In connection with these changes, the Postal Service has made huge investments in the competitive business, spending billions of dollars on various efforts to bolster its ability to deliver parcels. For example, the Postal Service is rolling out new package scanning systems in its Delivery Scanning Systems (DSS), Passive Adaptive Scanning Systems (PASS), and Mobile Delivery Devices (MDD). The Postal Service has apparently spent or plans to spend $1 billion on information technology upgrades in connection with these new scanners in order to compete against private competitors like UPS and FedEx.[8] The Postal Service has recently announced plans to replace its entire fleet of vehicles with "UPS sized and style vehicles"[9] designed primarily with competitive products in mind, at a potential cost of over $6 billion.[10]

At the same time, the Postal Service is cutting its expenditures on market dominant services. *See* U.S. Postal Service 2014 Annual Report to Congress at 46, https://about.usps.com/publications/annual-report-comprehensive-statement-

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[8] Adam Mazmanian, *Mail Carriers Get New Mobile Device*, FCW (Mar. 18, 2014), http://fcw.com/articles/2014/03/18/usps-mobile-device.aspx?m=1 ("The change is part of an IT infrastructure upgrade at the post office fueled by the explosion of e-commerce. The USPS is exploring replacing and upgrading the scanners at its larger processing centers, while bringing more advanced tracking technology to even the smallest post office location. 'We really are making a billion-dollar bet on the future of the shipping business,' Cochran said.").

[9] Mike Colgan, *Familiar White Postal Service Trucks Too Small For Increasing Amount Of Parcels Being Mailed*, CBS (Jan. 19, 2015), http://sanfrancisco.cbslocal.com/2015/01/19/familiar-white-postal-service-trucks-too-small-for-increasing-amount-of-parcels-being-mailed/; Anne Steele, *Postal Service Seeks to Retire the Old Mail Truck*, WALL ST. J. (Feb. 12, 2015), http://www.wsj.com/articles/postal-service-seeks-to-retire-the-old-mail-truck-1423786375 ("'The postal service is experiencing record growth in package delivery, and obtaining vehicles that are designed with the changing mail mix in mind will help improve efficiency of delivery operations,' [USPS spokeswoman] Ms. Ninivaggi said.").

[10] Steele, *Postal Service Seeks to Retire the Old Mail Truck*, WALL ST. J. (Feb. 12, 2015) ("The proposal is for some 180,000 'next-generation delivery vehicles' . . . The service says the trucks would ideally cost between $25,000 and $35,000.").

2014/annual-report-comprehensive-statement-2014.pdf ("The Postal Service is . . . streamlining its mail processing operations so it can invest in new package sorting equipment and other upgrades."); *see also* Commissioner Ruth Goldway, *Postal Service Cuts Ill-Considered*, THE HILL (Jan. 13, 2015), http://thehill.com/blogs/congress-blog/economy-budget/229239-postal-service-cuts-ill-considered (describing the main effect of the "rationalization" of mail processing operations as the degradation of service standards for market dominant mail). The Postal Service projects that these market dominant cuts will save it $2.1 billion per year.[11] The Postal Service does not plan to realize any cost savings from its competitive products business. *See id.* ("Package Services and Priority Mail will not be affected" by this network rationalization).

Consistent with these trends, Postal Service managers, whose salaries are considered institutional costs under the status quo, are increasingly focusing on the competitive products business, which is being touted as the future of the enterprise. "'We've been focusing a lot of efforts on package growth, because that's the biggest opportunity for us,' said [former] Postmaster General Patrick R. Donahoe. . . . The Postal Service is aiming to more than double its package-delivery business within a few years, Mr. Donahoe said."[12] On the market dominant side, "[m]ailers grumble that postal executives talk and think about nothing but packages these days."[13]

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[11] U.S. Postal Service, *Our Future Network: Key Facts on Network Rationalization* (Mar. 23, 2015), https://about.usps.com/news/electronic-press-kits/our-future-network/ofn-usps-key-fact-on-network-rationalization.htm.

[12] 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.

[13] Alliance of Nonprofit Mailers, *USPS: Protecting Flanks and Gaining New Ground* (Sept. 15, 2015), http://www.nonprofitmailers.org/usps-protecting-flanks-and-gaining-new-ground/.

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Attention implies costs. Yet the vast majority of the costs of Postal Service senior management are treated as fixed and common (and thus institutional). *See, e.g.*, FY 2014 Cost Segments and Components Report, http://about.usps.com/who-we-are/financials/cost-segments-components-reports/fy2014.xls (showing that "Headquarters," cost segment 18.1.1, has over $742 million in institutional costs compared with less than $11 million in attributable costs); *see also* Neels Report at 49, Table 14 (showing that this same cost segment tends to have $141 million in variable costs). The dramatically increased attention paid by management to competitive products requires that competitive products bear a higher share of institutional costs.

In light of these dramatic changes since the appropriate share requirement was set at 5.5% in 2007, continued adherence to this level is arbitrary and capricious. The considerable changes in the Postal Service's business are exactly the circumstances that must trigger a significant increase. *See* 39 U.S.C. § 3633(b) (the Commission "shall consider" the "degree to which any costs are uniquely or disproportionately associated with any competitive products.").

Today, the 5.5% requirement is out of line with the current size of the Postal Service's competitive products business, by every objective measure. The D.C. Circuit has regularly struck down agency regulations as arbitrary and capricious when the agency maintains a prior course of action despite a change in relevant circumstances. *See, e.g.*, *Tesoro Alaska Petroleum Co. v. F.E.R.C.*, 234 F.3d 1286, 1294 (D.C. Cir. 2000) ("[Petitioner's] evidence at least suggests changed circumstances . . . The Commission's failure to respond meaningfully to the evidence renders its decisions arbitrary and capricious."); *see also Town of Norwood, Mass. v. F.E.R.C.,* 80 F.3d 526, 535 (D.C. Cir. 1996) ("Because Yankee's circumstances have changed drastically since Opinion No. 285, the Commission's continued adherence to the zone of reasonableness established there is arbitrary and capricious.").

B. The Appropriate Share Should Be Based on Competitive Products' Share of Attributable Costs.

For the reasons discussed below, the appropriate share level should be adjusted to approximate the share of total attributable costs for which competitive products are responsible. This proposal makes use of the extensive processes used to determine product attributable costs, which are the best available indication of "the degree to which any costs are uniquely or disproportionately associated with any competitive products." 39 U.S.C. § 3633(b).

Specifically, the appropriate share should be set at <u>24.6%</u>, which is an *average* of the *previous three years of attributable cost shares*. Competitive products' attributable costs constituted 28.0% of total attributable costs in FY 2014, 25.2% in 2013; and 20.7% in 2012.[14] The average of these numbers is 24.6%. Using a three-year average makes this measure a conservative one for the Postal Service, while still ensuring it reflects current competitive conditions.

Additionally, the Commission could set the "appropriate share" so that it adjusts on an annual basis.[15] When the appropriate share is set at a fixed level in a dynamic environment (such as during a time of substantial growth in the competitive products

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[14] *See* Cost and Revenue Analyses, 2012-2014, http://about.usps.com/who-we-are/financials/# (last visited Oct. 4, 2015).

[15] For example, the FY 2015 appropriate share would be based on an average of attributable cost shares from FYs 2012, 2013, and 2014, while the FY 2016 appropriate share would be based on an average of attributable cost shares from FYs 2013, 2014, and 2015.

business and decline in the market dominant business), it risks becoming outdated not long after it is set. A mechanism where the appropriate share adjusts to current postal realities would comply with the Commission's statutory mandate, *see* 39 U.S.C. § 3633(b) ("the Commission shall consider . . . the prevailing competitive conditions in the market"), and would consistently "reflect the ways in which institutional resources are spent on the competitive enterprise." Order 1449 at 13. UPS is aware of no reason why the Commission could not put in place a mechanism that would adjust on an annual basis.

i. UPS Proposal Three Takes a Significant Step in the Direction of a Level Playing Field in Competitive Product Markets.

To ensure fair competition in compliance with PAEA's instructions, the "appropriate share" must be set at a level that approximates the fixed costs that a private competitor must bear in the parcel delivery market. This is necessary to prevent the Postal Service from securing an artificial advantage in competitive markets by leaving its captive letter customers stuck with the bill for nearly all of the enterprise's fixed costs. Private companies do not have a set of captive customers with which to stick the bill for fixed costs.

Arguably, to put the Postal Service in a position equivalent to private competitors, the competitive products business should be required to cover the fixed costs that are akin to the start up costs of the enterprise — the costs necessary to deliver a single parcel. Private companies must recover all of their own start up costs, and so the Postal Service's competitive products business should do the same to ensure a level playing field. This argument may go too far, however, since the Postal Service's fixed costs likely are higher than they would otherwise be because of the universal service obligation, which requires the Postal Service to build a network that can deliver mail to every address in the nation.[16]

A better approach is to estimate the proportion of the total fixed costs of the enterprise that correspond to the burdens placed on the enterprise by the competitive products business. The best way to estimate this is to use the share of all Postal Service attributable costs that are attributable to competitive products. As noted above, a three-year average of this calculation amounts to 24.6%. Setting the appropriate share at this level would promote fair competition, while giving market dominant customers some much needed relief. This conclusion is reinforced by several additional considerations, discussed below.

ii. UPS Proposal Three Helps Ensure Subsidy-Free Prices.

In addition to promoting fair competition, adopting UPS Proposal Three will help ensure subsidy-free prices. In fact, the Commission has previously recognized that allocating institutional costs "according to attributable cost shares" results in subsidy-free prices. *See* Dkt. No. R94-1, Opinion and Recommended Decision, Appendix F at 9 (Nov. 30, 1994).

Proposal Three would distribute the institutional cost burden between market-dominant products as a group and competitive products as a group based on the attributable cost shares of those groups. As a result, Proposal Three provides an important additional safeguard against the subsidization of competitive products by market-dominant products. Thus, this proposal meets both of the related goals

[16] At the same time, the letter monopoly that goes hand-in-hand with the universal service obligation gives the Postal Service scale economies that allow the Postal Service to have lower average costs than its private competitors.

motivating 39 U.S.C. § 3633 (ensuring fair competition and preventing subsidization) in a way the current practice does not.

iii. UPS Proposal Three is Consistent with the Solution Adopted by the European Commission.

The merits of Proposal Three's solution to the institutional cost problem is also supported by the European Commission's experience with regulating European Union postal operators. The European Commission faced a similar problem, and it adopted a solution that is fully consistent with this proposed solution.

Congress and the European Commission have enacted similar goals and methods of ensuring fair competition despite the presence of a dominant postal operator: Both (1) require extensive monitoring and regulation of the dominant operator to prevent private competition from being impaired or distorted;[17] (2) require cost-based pricing;[18] and (3) mandate separate accounting treatment for "reserved" or market

[17] *Compare* H.R. Rep. No. 109-66 at 44 (2005) "Highlights of the Postal Accountability and Enhancement Act include: . . . Ensuring Fair Competition and Accountability: 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.") *with* Directive of the European Parliament and of the Council amending Directive 97/67/EC, Concerning the Full Accomplishment of the Internal Market of Community Postal Services at 7 (2006) ("European Postal Directive") ("Member States must . . . ensure adequate monitoring of the behaviour of the likely dominant operator in order to safeguard effective competition.").

[18] *Compare* S. Rep. No. 108-318 at 9-10 ("Identifying costs which can reliably be found to have been caused by each specific subclass and service is essential to maintaining economically efficient rates and avoiding inequitable cross-subsidization, which occurs when rates from one product are used to pay costs associated with another.") *with* European Postal Directive at 22 ("[P]rices must be cost-oriented.").

dominant products and competitive products to ensure that competition is not distorted.[19]

The European Commission also follows a cost-allocation procedure very similar to that mandated by 39 U.S.C. § 3633. First, the European Commission attributes costs to particular products according to direct and indirect causal relationships. This is similar to PAEA's mandate regarding attributable costs. Next, the European Commission mandates that the remaining unattributed costs (which it calls "common costs") be allocated according to the share of each product's causally-allocated costs:

> when neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated on the basis of a general allocator computed by using the ratio of all expenses directly or indirectly assigned or allocated, on the one hand, to each of the reserved services and, on the other hand, to the other services.

European Postal Directive, Article 14. Thus, if the reserved products' share of causally-allocated costs were 57%, then reserved products would also be required to cover 57% of common costs. This approach is very similar to the proposal here.

The European Commission mandated this method of allocating common costs because the "level of common costs in the postal sector . . . is significant," which "gives significant leeway for anti-competitive conduct" if the wrong basis for allocating common

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[19] *Compare* S. Rep. No. 108-318 at 50 ("The intent of th[e CPF] 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. Separation of accounts also protects taxpayers and the interests of postal consumers in the market-dominant category."); *with* European Postal Directive at 23 ("The universal service providers shall keep separate accounts within their internal accounting systems to clearly distinguish between services and products which receive or contribute to the financial compensation for the net costs of the universal service and those services and products which do not.").

costs is utilized.[20] The "greatest care needs to be taken" in allocating common costs because of this potential for anti-competitive conduct. *Id.* at 338. "Inappropriate cost allocation rules could lead to higher costs/prices for users of universal services, a larger net cost of universal service obligations, and/or reduced costs/prices for non-universal services." *Id.* at 340. The likelihood of competition-distorting misallocation of common costs explains why the EU Postal Directive is detailed and "very prescriptive" on this point. *Id.*

Postal regulators in the EU and in the U.S. face similar problems in allocating fixed costs between competitive and reserved/market dominant products. The solution to this problem is important on both continents because a large amount of unattributed costs "gives significant leeway for anti-competitive conduct," a result contrary to the purposes of postal law in both places. In light of these similarities, it is significant that the EU resolves this issue in effectively the same way that Proposal Three does: allocating institutional costs on the basis of the proportional share of attributable cost. The European Commission has shown that this solution is both logical and feasible.

UPS Proposal Three, like the EU's Postal Directive, enables fair competition, discourages subsidization, and fairly estimates how "institutional resources are spent on the competitive enterprise." Order 1449 at 13.

iv. <u>UPS Proposal Three is Consistent with Private Sector Practice</u>.

UPS Proposal Three is also consistent with private sector practice. In the private sector, overhead costs are generally allocated to individual products on a proportional

[20] John Hearn, *The Accounting Implications of the EU's Third Postal Directive*, in COMPETITION AND REGULATION IN THE POSTAL AND DELIVERY SECTOR 336, 339 (Michael A. Crew & Paul R. Kleindorfer eds., 2008).

basis. Dr. Neels explains that this practice is so widespread in the private sector it is nearly universal. Neels Report at 54. It is common for private businesses to talk about "assigning" fixed or overhead cost to products, or about "building fixed or overhead costs into rates and prices." *Id.* Such language reflects an intention to assign to each product or business line some proportionate degree of responsibility for generating enough contribution to assure that adequate revenues will be available to cover these costs. *Id.*

One reason for the widespread private sector practice of allocating fixed or overhead costs to individual products on a proportional basis stems from recognition of the importance of "soft" cost causation. *Id.* at 55. Private businesses recognize that, while they may attempt to isolate overhead costs, many of the costs classified as "overhead" are variable costs related to volume. Private businesses typically realize, for example, that if they were to double their sales, they would probably have to expand their headquarters and support functions to some significant degree. Allocating overhead costs on a relatively neutral proportional basis provides a way of accounting for the fact that these costs are likely to expand as a result of growth in sales.

The private sector practice of assigning overhead costs to products on a proportional basis is consistent with UPS Proposal Three, which would assign Postal Service overhead costs to the competitive products basis in proportion to those products contribution to attributable costs.

v. <u>UPS Proposal Three Provides an Important Safeguard Against the Postal Service's Systematic Bias Towards Fixed Costs</u>.

Dr. Neels' discovery of a systematic tendency by the Postal Service to overstate fixed costs presents additional support for UPS Proposal Three. As discussed in UPS

Proposal Two, Dr. Neels has shown that the Postal Service consistently over-classifies its costs as fixed (and thus institutional) to a significant degree. While some of this can be addressed now, by adopting UPS Proposal Two, it is impracticable at this time to revisit every cost component with hidden fixed costs to solve the problem entirely. Even if Proposal Two is adopted, Dr. Neels' work shows that hidden variable costs will remain in the system.

In addition to its other virtues, UPS Proposal Three provides an important safeguard to ensure that the Postal Service is not benefiting from the hidden variable costs that remain (mis)classified as fixed in cost pools scattered across the system. UPS Proposal Three will ensure that, even while those hidden variable costs remain hidden, competitive products must still bear their average proportion of any misclassified costs. For example, if competitive products bear 24.6% of attributable costs on average, they would bear 24.6% of a cost that is erroneously considered fixed when in fact the cost is and should be treated as attributable. Setting the appropriate share in this way thus limits the potentially distortionary effect of outdated or erroneous costing models that produce these overestimations. *Id.* at 37-38; *see also* Charles McBride, *Calculation of Postal Inframarginal Costs* at 8 (2014) ("[W]e have serious reservations about the lack of a consistent approach as well as documentation for the criteria used by the Postal Service to decide which components would be designated as constant elasticity components and which would not.").

One possibility for why the Postal Service demonstrates a systematic tendency to overstate fixed costs is that it obtains a competitive advantage by doing so. Competitive products must today only cover 5.5% of any institutional cost, while they must bear their full “fair share” of attributable costs. The more costs that are classified as institutional, the less the Postal Service is accountable for its competitive product pricing practices, and the more the Postal Service can choose whatever prices it wants in competitive product markets.

UPS Proposal Three avoids these accounting shortcomings and skewed incentives by preventing the Postal Service from artificially benefitting as a result of the “hidden” variable costs in the system. This provides yet another reason why the proposal should be adopted.

C. Other Factors Previously Considered by the Commission Do Not Support Maintaining the Current Appropriate Share Level of 5.5%.

In previous decisions regarding the appropriate share, the Commission has occasionally relied upon factors that should not, in this instance, be considered.

For example, in setting the initial minimum contribution rate at 5.5% in 2007, the Commission relied upon the Postal Service’s perceived “incentive” to “generate contributions in excess of the floor.” Order 26 at 71-73. This factor was apparently one of the Commission’s primary justifications for setting the appropriate share at such a low number. *See* Order 1449 at 12 (“[U]nder the PAEA, the Postal Service may retain earnings, so it has an incentive to exceed the threshold set by the Commission ‘including reducing rate pressure on market dominant rates, continuation of universal service, and the possibility of bonuses.”).

Whether or not this perceived incentive was appropriate to consider back in 2007, it is not appropriate to consider today. Justifying maintaining a low appropriate share requirement on the basis that the Postal Service can choose to exceed it is effectively the same as allowing the Postal Service to determine for itself the share of institutional costs to be covered by its competitive products business. Such an approach is inconsistent with 39 U.S.C. § 3633(a), which obliges *the Commission* to set the "appropriate share" at a level sufficient to meet Congress' objectives of ensuring fair competition and preventing subsidization. The current approach essentially outsources to the Postal Service the Commission's statutory responsibility. It does not protect fair competition or ensure that the competitive products business is covering a proportion of fixed costs fairly attributable to that business.

That the Postal Service cannot be left to set its own appropriate share is evident in its actual contributions to institutional costs. In FY 2014, competitive products comprised 28.0% of attributable costs, 22.6% of revenue, and 25.0% of weighted volume – but the business contributed only 12.6% of total institutional costs.[21] This gross disparity demonstrates that, whatever incentive the Postal Service has to contribute more than the minimum appropriate share, that incentive is inadequate to ensure that competitive products bear a fair share of institutional costs.

Additionally, in declining to modify the appropriate share percentage in 2012, the Commission was influenced by uncertainties that surrounded the Postal Service, including pending postal legislation and the beginning of network rationalization. *See* Order 1449 at 23 ("[T]he Commission recognizes that resolution of these uncertainties has the potential to alter the relationship of attributable costs to institutional costs."); *see also* Dkt. No. RM2012-3, Initial Comments of the Public Representative at 4-5 (Apr. 9, 2012). These uncertainties — to the extent they were appropriate to consider at all, which UPS does not concede — are no longer relevant.

[21] *See* FY 2014 CRA; Neels Report at 8, Table 3; 59, Table 17.

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Legislative postal reform appears no closer than it has been for a number of years. "As 2015 wears on, legislative relief for the Postal Service is about as likely to occur as an upturn in First-Class Mail volume."[22] The faint prospect of legislative change cannot indefinitely delay making meaningful change to the appropriate share level. Moreover, the Postal Service's network rationalization is well underway and would be nearly complete had the Postal Service not temporarily delayed the closing of some facilities until 2016.[23] The Postal Service has projected that it will save $2.1 billion annually when the network rationalization is complete.[24] As this process will soon be completed, the Postal Service's path forward is largely set and little uncertainty remains.

In sum, there is no reason to delay compliance with Congress' directive that competitive products be required to cover an appropriate share of institutional costs. For the reasons discussed above, that share should be set at 24.6%.

IV. IMPACT

Table 3-1 reports the hypothetical cost impact of this rule for 2014 ACR, based on the three-year average prevailing at that time (*i.e.*, 20.7%).[25] The actual impact for

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[22] Al Urbanski, *PRC Chief Tells What Will Keep the Postal Service Going*, Direct Marketing News (May 1, 2015), http://www.dmnews.com/postal/prc-chief-tells-what-will-keep-the-postal-service-going/article/410676/.

[23] U.S. Postal Service, USPS Network Consolidations on Hold (May 27, 2015), http://about.usps.com/news/recent-statements.htm.

[24] U.S. Postal Service, Our Future Network: Key Facts on Network Rationalization (Mar. 23, 2015), https://about.usps.com/news/electronic-press-kits/our-future-network/ofn-usps-key-fact-on-network-rationalization.htm.

[25] Under Proposal Three a three-year trailing average for FY 2014 is 20.7%, based on attributable cost shares for FYs 2011, 2012, and 2013, which were 16.2%, 20.7%, and 25.2%, respectively. *See* Cost and Revenue Analyses, 2011-2013, http://about.usps.com/who-we-are/financials/# (last visited Oct. 4, 2015). The table also provides as the baseline the amount competitive products contributed to institutional costs in FY 2014 (12.6%).

using 24.6% in FY 2015 cannot presently be calculated because FY 2015 financial results will not be released until December 2015. Furthermore, the impact of Proposal Three depends on whether Proposals One and Two are also adopted.

		Current Competitive Contribution		Proposal Three	
		Share	Cost	Share	Cost
		[1]	[2]	[3]	[4]
Total Market Dominant Attributable Costs	[A]		28,205		28,205
Total Competitive Attributable Costs	[B]		10,970		10,970
TOTAL ATTRIBUTABLE COSTS	[C]		39,175		39,175
Market Dominant Share	[D]	87.4%	29,877	79.3%	27,110
Competitive Share	[E]	12.6%	4,310	20.7%	7,077
OTHER COSTS	[F]		34,187		34,187
TOTAL COSTS	[G]		73,362		73,362
Total Market Dominant Costs	[H]		**58,082**		**55,315**
Total Competitive Costs	[I]		**15,280**		**18,047**

Table 3-1: Impact of Proposal Three (Neels Report, Table 17)[26]

[26] Notes and Sources:

[1]: Appropriate share currently used in USPS costing.

[2]: Costs as reported in the FY14 Public Cost and Revenue Analysis (PCRA) applied to appropriate share in [1].

[3]: Appropriate share during the phase-In period under Proposal Three.

[4]: Costs as reported in the FY14 PCRA applied to appropriate share in [3].

[5]: Ultimate appropriate share under Proposal Three.

[6]: Costs as reported in the FY14 PCRA applied to appropriate share in [5].

[A],[B]: Attributable costs as reported in FY14 PCRA.

[C]: [A] + [B].

[D][2]: [F][2] x [D][1].

[D][4]: [F][4] x [E][3].

[D][6]: [F][6] x [D][5].

[E][2]: [F][2] x [E][1].

[E][4]: [F][4] x [F][3].

[E][6]: [F][6] x [E][5].

[F]: Other costs as reported in FY14 PCRA.

[G]: Total costs as reported in the FY14 PCRA.

[H]: [A] + [D].

[I]: [B] + [E].