**Postal Regulatory Commission**
**Submitted 1/25/2016 11:09:00 AM**
**Filing ID: 94802**
**Accepted 1/27/2016**

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

| | |
|---|---|
| Periodic Reporting<br>(UPS Proposals One, Two, and Three) | Docket No. RM2016-2 |

**COMMENTS OF THE NATIONAL POSTAL POLICY COUNCIL**
(January 25, 2016)

The National Postal Policy Council ("NPPC")[1] respectfully submits these comments in response to Order No. 2793.[2] In that Order, the Commission invited comment on two proposals relating to costing submitted by the United Parcel Service (""UPS"), and deferred consideration of a third UPS proposal regarding the appropriate minimum share of the Postal Service's institutional costs that Competitive products should bear.

UPS contends that the Postal Service "is failing to ensure that its competitive products business is recovering all costs fairly attributable to that business." *UPS Petition* at 9. Although it is not entirely clear, the *UPS Petition* can be read as asserting either that the Postal Service is (1) cross-subsidizing

---

1 The National Postal Policy Council is an association of large business users of letter mail, primarily Bulk First-Class Mail using the Automation rate category, with member companies from the telecommunications, banking and financial services, insurance, and mail services industries. Comprised of 39 of the largest customers of the Postal Service with aggregated mailings of nearly 30 billion pieces and pivotal suppliers, NPPC supports a robust postal system as a key to its members' business success and to the health of the economy generally.

2 Order No. 2793 (October 29, 2015) (Notice of Proposed Rulemaking On United Parcel Service, Inc.'s Proposed Changes To Postal Service Costing Methodologies (UPS Proposals One, Two, and Three)). UPS filed its petition ("UPS Petition") raising these issues on October 8, 2015, supported by a statement by Dr. Roger Neels ("*Neels Statement*").

Competitive products with revenues from Market-Dominant products, or (2) that it simply does not understand its costs sufficiently well to price its Competitive products properly or to assure that such products are not being subsidized by Market-Dominant mail.[3] UPS proposes to address this perceived problem by advocating in its Proposal One that the Postal Service include in attributable costs "inframarginal costs" that vary with volume in cost components displaying economies of scale or scope. UPS provides a calculation suggesting that doing so would reclassify $13.4 billion of institutional costs as attributable. In Proposal Two, UPS asserts that the Service erroneously classifies some volume variable costs as fixed, and estimates that more than $3.4 billion in costs currently are misclassified in that way.

NPPC's interest in this proceeding arises from the fact that First-Class Presort Mail currently pays, and for many years has paid, the largest contribution to institutional costs of any mail in the postal system whether measured on an aggregated, per-unit, or cost coverage basis. Looking at only the most recent data, in Fiscal Year 2015 First-Class Presort mail paid $10.445 billion in contribution alone, more than twice the amount paid by either Single-Piece mail or Standard Mail Letters, the next largest contributors. *United States Postal Service FY2014 Annual Compliance Report*, at 7, Table 1 & 17, Table 2.[4] Put simply, First-Class Presort mail pays close to 40 cents of every dollar of

---

3 *UPS Petition* at 8: "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."

4 *See Comments of National Postal Policy Council*, Docket No. ACR2014 at 3 (February 2, 2015) (presenting table showing unit contribution and cost coverages for past seven years).

institutional cost contribution. No other mail category bears anything close to so large a burden.

Accordingly, if a cross-subsidy is occurring anywhere in the postal system due to a misclassification of attributable or incremental costs as institutional – either of Competitive products by market-dominant products, or within market-dominant products – it is First-Class Presort mailers that are paying the largest share of the subsidy. For this reason, NPPC members believe that costs should be charged to products accurately and that cross-subsidization should be confined to instances that can be justified by statute or public policy.

As to Proposal One, NPPC believes that inframarginal costs are part of a product's incremental costs and should be included when testing for cross-subsidy, but takes no position on the merits of UPS's suggestion that Shapley Values be used to distribute such costs. As to Proposal Two, NPPC sees no harm in revisiting the validity of past assumptions regarding whether costs are properly classified as fixed. As with Proposal One, however, NPPC takes no position on the specific recommendations that UPS is urging the Commission to adopt in Proposal Two.

## I. THE UPS PROPOSALS

Section 3652(e)(2) authorizes the Commission to review costing methodologies if they can be significantly improved. 39 U.S.C. §3652(e)(2). In Proposal One, UPS suggests that the Commission distribute inframarginal costs among postal products, resulting in a reclassification of some $13.4 billion in costs. In Proposal Two, UPS suggests that certain costs currently treated as fixed may, in fact, be variable. The Commission should explore these matters, but NPPC takes no position on the specific recommendations that UPS offers.

### A. Proposal One: The Incremental Cost Test Is The Appropriate Test For Cross-Subsidy

Proposal One raises important issues pertaining incremental costs and cross-subsidization. As relevant to this proceeding, only one provision of the Postal Enhancement and Accountability Act specifically addresses cross-subsidization. That is Section 3633(a)(1), which directs the Commission to adopt and revise as needed regulations to "prohibit the subsidization of competitive products by market-dominant products." 39 U.S.C. §3633(a)(1).

The Commission enforces the prohibition against cross-subsidy by applying an incremental cost test. *See* Order No. 399 (January 27, 2010); *Annual Compliance Determination Report Fiscal Year 2014* at 72 (March 27, 2015). At theoretical level, both the Postal Service[5] and economists[6] support using incremental costs as the test for the presence of a cross-subsidy. However, there is considerable disagreement as to how incremental costs should be measured in practice.[7]

---

5 *United States Postal Service Response To Chairman's Information Request No. 2, Q3* (December 10, 2015) ("The Postal Service has already put forward, and the Commission has already accepted, the correct test for cross-subsidy: the incremental cost test" citing Order No. 399).

6 *See* John C. Panzar, *The Role of Costs for Postal Regulation* (September 30, 2014) ("*Panzar*").

7 For a summary of how the Postal Service has calculated incremental cost over the years, *see* Dr. Charles McBride, *The Calculation of Postal Inframarginal Costs* (September 30, 2014) ("*McBride*"). In addition, for years the Postal Rate Commission used a hybrid of volume variable and incremental (single subclass) costs in determining the attributable portion of city carrier time. *E.g.,* Docket No. R87-1 at 271 (March 4, 1988) (Opinion and Recommended Decision).

The PAEA also uses the term "attributable cost." Section 3633(a)(2) directs the Commission to "ensure that each competitive product covers its costs attributable." Similarly, for market-dominant products, Section 3622(c)(2) directs the Commission to factor into account "the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service."[8] "Attributable cost" is not a term used in economics. In postal ratemaking, attributable costs are an imperfect proxy for marginal costs.[9] The Commission implements these requirements by comparing rates to the costs presented in the Cost and Revenue Analysis and International Cost and Revenue Analysis.

The attributable costs presented in the CRA do not meet an economic definition of incremental costs (which are currently calculated consistent with Order No. 399, and which, in any event, are calculated only for Competitive products as a whole).[10] In particular, UPS's Proposal One highlights that the current definition of attributable costs does not include inframarginal costs. For this reason, Professor Panzar has concluded, "attributable cost is not an appropriate substitute for *incremental* cost." *Panzar* at 21. That is because "the CRA's volume variability approach takes the product's economic marginal cost – which is, indeed, the avoided cost of the *last* unit of output – and applies that

---

8 The Commission has held that this language is "broad enough to include an individual product" but is not confined to an individual product. Order No. 536 at 26.

9 Attributable costs include specific fixed costs, and thus do not equate to the economic concept of marginal cost, although in most instances the difference is not large.

10 The Postal Service has never calculated incremental costs for individual Competitive products since enactment of the PAEA. *United States Postal Service Response To Chairman's Information Request No. 6, Q1* (January 8, 2016).

amount to *all* the units of the product provided. But, these infra-marginal units will not have the same amount of avoided costs associated with them unless marginal costs are constant." *Panzar* at 15-16. That condition does not apply in the postal system, however, because marginal postal costs generally decline due to economies of scale and scope.

Given the difference between attributable costs (which currently omit inframarginal costs) and incremental costs (which should include inframarginal costs), UPS's Proposal One (1) implicitly asks the Commission to redefine attributable costs to mean economic incremental costs (although it does not explicitly say so), and (2) explicitly asks it to adopt a new way of distributing such costs. On the first point, although there is agreement that incremental costs are the appropriate test for cross-subsidy, whether the term "attributable costs" should be redefined has received little debate. Professor Panzar has said: "statutory attributable costs should be interpreted as economic incremental costs" when implementing Sections 3622(c)(2) and 3633(a). *Panzar* at 2. But that has not been the Commission and Postal Service's practice to date, and NPPC expresses no opinion on whether the Commission should redefine attributable costs to be incremental costs. However, incremental costs are the correct test for cross-subsidy.

As to the second point, despite agreement that inframarginal costs are incremental costs, there is substantial disagreement regarding how to distribute such costs among postal products.[11] The Postal Service prefers the existing incremental cost methodology that the Commission approved in Order No. 399.[12] UPS suggests distributing inframarginal costs using Shapley Values. And Dr. McBride, whose work was presented alongside Professor Panzar's, has proposed a methodology based on CRA data, with modifications. The differences seem to arise from what ordering assumption is made -- which product is considered the "last" – when the calculation is made.

Inframarginal costs are part of a product's incremental costs. However, as stated above, NPPC takes no position at this time on whether the Order No. 399 approach, Shapley Values, Dr. McBride's analysis, or in some other approach is the most appropriate way to distribute those costs.

### B. Proposal Two: Are Fixed Costs Truly Fixed?

In Proposal Two, UPS contends that a number of cost components currently regarded as fixed are, in fact, volume variable and thus attributable to products. UPS proposes to reclassify some $2.8 billion in this manner.

NPPC does not have the resources to address the merits of UPS's proposal or the correctness of the particular analyses that Dr. Neels has

---

[11] UPS uses the method of *calculating* the amount of inframarginal costs used by Dr. Charles McBride in his 2014 paper. *McBride* at 5-9. NPPC is unaware of any Postal Service statements regarding Dr. McBride's estimate of inframarginal costs.

[12] In doing so, the Postal Service has acknowledged that inframarginal costs are incremental costs, stating that it charges "inframarginal costs to products in the only instance in which there is a reliably identified causal relationship between those inframarginal costs and the products that caused them. This occurs in the calculation of incremental costs." *United States Postal Service Response to Chairman's Information Request No. 2* (December 10, 2015) (also indicating where a description of the methodology used can be found).

employed on behalf of UPS to determine whether certain fixed costs are, in fact, variable. However, the PAEA does not justify a continued mischaracterization of volume variable (or marginal) costs as fixed. Accordingly, it is appropriate to reconsider, from time to time, whether purportedly fixed costs are, in fact, truly fixed, just as it is appropriate to review whether the volume variability of cost components can be measured more accurately, as the Commission has tried to do in Docket No. RM2015-7 (city carrier costs).

Thus, if the Commission concludes that UPS and Dr. Neels have advanced sufficient grounds for revisiting whether the particular costs at issue in Proposal Two are, in fact, fixed, the appropriate course would be to proceed to review and, if appropriate, improve the costing methodology. *See* 39 U.S.C. §3652(e)(2).

## II. IF PROPOSALS ONE OR TWO ARE ADOPTED, THE COMMISSION SHOULD APPLY AN INCREMENTAL COST TEST TO MARKET-DOMINANT RATES

If Commission were to adopt Proposals One and Two in part or in whole, the costs charged to nearly all postal products and services, including First-Class Presort Letters and Cards, would increase, possibly substantially. *United Parcel Service, Inc.'s Response To Chairman's Information Request No. 1, Q5 Table 1 and Q12(c) Table 4* (December 15, 2015). Because every dollar newly charged to a product under the two proposals would be a dollar currently considered institutional, products would also see large decreases in their institutional cost contributions. However, the decrease in institutional costs for any product would not exactly offset the increases in attributed cost, so absolute and relative cost coverages would change.

Consequently, it would be appropriate for the Commission to conduct an incremental cost test not only for Competitive products, but also for market-dominant products. Checking for the existence of cross-subsidies within market-dominant products could prove useful. Doing so could help achieve the objective of a "just and reasonable rate schedule," a term that implies that rates are compensatory and that cross-subsidies are not present unless justified by law or public policy. 39 U.S.C. 3622(b)(8).

An incremental cost test would also comport with the Commission's previous rulings regarding market-dominant rates. In 2011, the Commission determined that Section 3622(c)(2), in conjunction with the Section 101(d) directive that postal rates "be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis," authorizes it to hold that a particular product's persistent cost coverage of less than 100 percent could, under certain circumstances, be unlawful. *Annual Compliance Determination Fiscal Year 2010* at 106 (March 29, 2011). The Court of Appeals affirmed this interpretation. *United States Postal Service v. Postal Regulatory Commission*, 676 F.3d 1105 (D.C. Cir. 2012) (affirming in part and remanding in part); *see also* Order No. 1427, Docket No. ACR2010-R (August 9, 2012) (Order On Remand). That holding confirms that market-dominant products should cover costs and contribute to institutional costs, subject to constraints driven by the existence of the price cap and to any exceptions required by public policy.[13] Products that fail to recover incremental costs do neither.

If cross-subsidies exist in market-dominant rates, they should be clearly identified, not hidden in a maze of costs. Once identified, the Commission could determine whether an cross-subsidy can be justified on legal or policy grounds.

In addition, in December the Commission will embark upon a statutorily mandated 10-year review of the market-dominant rate regulatory regime. The Commission should consider applying an incremental cost test even if it does not adopt Proposals One or Two in any respect, because it has never applied an incremental cost test to market-dominant products in the decade since enactment of the PAEA.[14] Understanding the incremental costs incurred by individual market-dominant products would provide the Commission with potentially valuable information regarding the performance of the current ratemaking system, and would help to fulfill the Section 3622(b)(8) objective of a just and reasonable rate schedule for market-dominant products.

---

[13] The Commission has interpreted the price cap provision of the PAEA to trump the factor 2 requirement that rates for each class cover that class's costs. *See ACD FY2010* at 19 (discussing how price cap under Section 3622(d)(1) takes primacy over the objectives and factors set forth in Sections 3622(b) and (c)). That Order also explained why the price cap prevented above-cap rates for Periodicals mail, where the class as a whole had, and has continued to have, a cost coverage below 100.

[14] Nor has the Postal Service submitted incremental cost data for market-dominant products.

## III. CONCLUSION

For these reasons, the National Postal Policy Council urges the Commission to take these comments into consideration, and to consider applying an incremental cost test to market-dominant products.

Respectfully submitted,

By: /s/ William B. Baker

Arthur B. Sackler
Executive Director
NATIONAL POSTAL POLICY COUNCIL
1150 Connecticut Avenue, N.W.
Suite 900
Washington, D.C. 20036
(202) 955-0097

POTOMAC LAW GROUP, PLLC
1300 Pennsylvania Avenue, N.W.
Suite 700
Washington, D.C. 20004
(571) 317-1922