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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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

VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. INITIAL COMMENTS ON UNITED PARCEL SERVICE, INC.'S PROPOSED CHANGES TO POSTAL SERVICE COSTING METHODOLOGIES
(January 27, 2016)

Order No. 2793, "Notice of Proposed Rulemaking on United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three)," invited comments on UPS Proposals One and Two. Presiding Officer's Ruling No. RM2016-2/2 set January 25, 2016, as the deadline for filing Comments, but due to the significant snowstorm on January 22, 2016, the federal government was closed on January 25 and 26, 2016.

I. Scope of Valpak Comments

UPS Proposal One seeks to require that the Postal Service "attribute all variable costs caused by competitive products to competitive products using existing distribution methods." The attribution methodology proposed by UPS was said to be predicated, in part, on three

PRC-sponsored studies by (i) John Panzar,[1] (ii) Charles McBride,[2] and (iii) Robert Cohen & John Waller.[3]

UPS Proposal Two poses the issue of whether some costs now classified as "institutional" and "fixed" are really so, or instead vary with volume and should be re-classified as volume variable costs and attributed. Proposal Two raises its own set of issues that are distinct from Proposal One. Like Proposal One, this proposal also would increase the level of attributable costs, but by a lesser amount.

UPS Proposal Three has been deferred to a later docket. PRC Order No. 2793 (Oct. 29, 2015) at 6.

Due to time and resource limitations and the greater significance of UPS Proposal One, these Comments address only UPS Proposal One, but Valpak may file Reply Comments which also address other Initial Comments on UPS Proposal Two.

II. Nature of UPS Proposal One

UPS, adopting McBride's methodology, computes incremental cost for each competitive product to include that product's share of so-called "inframarginal" costs.[4] Under

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[1] John C. Panzar, The Role of Costs for Postal Regulation (Sept. 30, 2014), http://www.prc.gov/sites/default/files/reports/J%20Panzar%20Final%20093014.pdf.

[2] Charles McBride, The Calculation of Postal Inframarginal Costs (Sept. 30, 2014), http://www.prc.gov/sites/default/files/reports/McBride%20092814.pdf.

[3] Robert Cohen and John Waller, The Postal Service Variability Ratio and Some Implications (Sept. 30, 2014), http://www.prc.gov/sites/default/files/reports/Cohen-Waller%20Final%20Report%201-100714.pdf.

[4] Inframarginal costs are a subset of variable costs that the current costing system classifies as institutional and does not attribute.

the methodology in UPS Proposal One, it is intended that all volume variable costs would be attributed to Postal Service products, both competitive and market dominant. Total costs attributed to both market dominant and competitive products would increase by more than $13 billion. Under the methodology proposed by UPS, costs attributed to each product would increase by varying degrees, *i.e.*, not uniformly. *See* UPS Response to ChIR No. 1, Q. 5, Table 1.

Even though the proposed principles of cost attribution in UPS Proposal One apply equally to competitive and market dominant products, UPS' analysis is confined to competitive products. UPS notes significant regulatory differences in the way the two categories of products are treated:

> While this basic analysis applies equally to competitive products and market dominant products, there are **differences between how these product categories are regulated.** *First*, the requirement that all "costs attributable" to competitive products be attributed to individual products is **a statutory command that permits no exceptions.** On the other hand, the attributable cost "requirement" for market dominant products is treated more as a "factor," as evidenced by the Commission's conclusion that **the rate cap takes precedence over attributable costs requirements and the fact that some market dominant products have long remained "underwater."** [UPS Response to ChIR No. 1, Q. 3, p. 19 (emphasis added, footnote omitted.)]

A. Competitive Products

Because of the statutory requirement that the price of each competitive product cover its attributable cost, an increase in the attributable cost of competitive products to reflect their incremental costs would establish a higher floor under the price of each product. Attributing incremental costs that include all of each product's inframarginal costs could, in theory, force

the Postal Service to increase sharply the price of some of its competitive products, many of which are in direct competition with UPS. That, of course, would appear to be the result intended by the UPS proposal. UPS characterizes its proposal as an effort to level the playing field. On the other hand, the Postal Service likely would characterize the UPS proposal as threatening Postal Service finances by jeopardizing the contribution to institutional costs earned from reduced volumes of competitive products due to the forced price increases.

B. Market Dominant Products

The UPS filing virtually ignored the existence of market dominant products. Based on a request from Amazon Fulfillment Services, Inc., the Commission quite reasonably ordered UPS to explain how its proposal would affect market dominant products. The UPS response to ChIR No. 1, Q. 5, Table 1, provides a quantitative indication of how its proposed methodology would affect the total cost attributed to each market dominant product. UPS discusses the use of existing distribution keys to attribute incremental costs to competitive products, but is silent as to whether existing distribution keys should be used to attribute incremental costs to market dominant products. However, aside from pointing out that the Commission essentially disregards the statute's attributable cost "requirement" for all market dominant products, UPS does not really discuss how its proposal might affect pricing of market dominant products.

For all mailers which use market dominant products, UPS' failure to address market dominant products in any meaningful way makes it difficult to understand how the proposal would operate to affect cost distribution among products, to say nothing of pricing. The

remainder of these comments focus on the void left by UPS concerning the effect of its Proposal One on market dominant products:

- First, a critique of the existing attribution methodology, which centers on marginal costs (plus, to a small extent, specific fixed costs).
- Second, a discussion of the effects of having cost attribution for market dominant products reflect all costs caused by each product, including inframarginal costs as proposed by UPS (*i.e.*, incremental costs rather than just marginal costs).

III. Current Pricing of Market Dominant Products

A. Introduction

Although the UPS presentation focuses on technical aspects of costing methodology, the underlying concern faced by users of **competitive products** should be how that change in costing would drive pricing because of the clear statutory requirement that the attributable cost of a competitive product sets the price floor for that product.

With respect to **market dominant products**, however, UPS notes appropriately that the Postal Service's pricing and the Commission's regulatory stance has reduced costs to near irrelevance. Although the Commission regularly acknowledges the statutory need for market dominant products to cover their attributable costs as well as make a contribution to institutional costs, it has demonstrated over multiple years its unwillingness to require the Postal Service to price products so that they even cover their attributable cost — so long as price adjustments do not exceed the cap. The Commission has been willing to disregard the pricing mandate imposed by 39 U.S.C. §§ 101(d) and 3622(c)(2), and tolerate significant

losses on underwater products and the cross-subsidies which such losses necessitate, which neglect has contributed mightily to the poor financial condition of the Postal Service.

However, the Postal Service's pricing practices and the Commission's regulatory disregard of the statutory criteria cannot diminish the economic significance of the relationship between the incremental costs which each individual product causes the Postal Service to incur and the revenue earned by that product. Thus, although UPS Proposal One narrowly concerns the methodology for attributing costs, any increase in the level of attribution would highlight the Commission's sanctioning of pricing of market dominant products that it has found to be not in compliance, at least for Standard Flats.

B. Prices Generally Reflect a Markup over Marginal Cost

Under the methodology currently used for market dominant products, unit attributable cost is equal to marginal cost (except for specific fixed costs, which are negligible for most products). Since the Postal Service's production function is subject to increasing returns (*i.e.*, economies of scale), marginal cost will be less than average variable cost, and a price that is equal to (or less than) marginal cost will result in losses. *See* USPS responses to ChIR No. 2, Q. 1 and ChIR No. 6, Q. 1; *see* also UPS response to ChIR No. 4, Q. 1a.

The current Postal Service methodology results in what could be considered the lowest level of cost attribution that, from an economic perspective, is consistent with economic causality. Other things equal, the lower the level of cost attribution, the greater is the Postal Service's ability to exercise arbitrary pricing flexibility, including the ability to set some prices at non-compensatory levels of marginal cost.

Except for those market dominant products that are underwater, the price of postal products reflects a markup over marginal cost, referred to as coverage in excess of 100 percent. However, the fact that prices for most products reflect **some** markup over marginal cost (*i.e.*, cost coverage that exceeds 100 percent) does not mean that the Postal Service sets prices on the basis of what economists generally refer to as marginal cost pricing (see below).

C. Theoretical Advantages of Marginal Cost Pricing

Around the time the Postal Reform Act ("PRA") was enacted in 1971, a number of well-known economists testified that marginal costs should be the basis for pricing decisions by the Postal Service. The standard economic advice was to use **marginal cost** ("MC") and **marginal revenue** ("MR") for pricing. Use of MC and MR in pricing is often referred to as "marginal cost pricing." When properly applied, the result, found in any basic text on micro-economics, is described typically as maximum profits given the cost and demand conditions facing the organization.[5]

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[5] Standard economic theory teaches that the way a firm achieves maximum profitability is by having MR equal MC. Differential calculus is often used to demonstrate that maximum profits are achieved when MR = MC. At the time the economic advice was first given, the price cap did not exist. When operating under a price cap, as now, rather than discuss "maximizing profits" it might be more appropriate to discuss "optimizing contribution subject to the constraint imposed by the price cap." In the last two Annual Compliance Reviews, Valpak has attempted to provide a means for the Postal Service to maximize contribution from Standard Mail, but neither the Postal Service nor the Commission has even given that proposal the courtesy of a hard look. *See* Docket No. ACR2013, Valpak Initial Comments, Appendix A (Jan. 31, 2014); Docket No. ACR2014, Valpak Initial Comments, Appendix A (Feb. 2, 2015). The Postal Service prefers its flawed model which focuses on maintaining gross revenues (including revenues with associated losses) rather than net contribution. The Postal Service seems too concerned about preserving its claim to virtually unfettered "pricing flexibility" and the Commission seems too concerned about being the "partner" of the Postal Service, to the point of abandoning its role as "regulator" of the Postal Service.

In retrospect, it seems inconceivable that any of those distinguished economists who then recommended marginal cost pricing intended to endorse pricing principles that would embrace and justify underwater products with continuing cumulative multibillion dollar losses.

What happened? In its pricing decisions under PAEA, **the Postal Service seemingly has embraced the use of marginal cost while failing to give adequate weight to considerations of marginal revenue**. To paraphrase British economist Alfred Marshall, marginal cost and marginal revenue are like a pair of scissors — it takes both to determine the appropriate price. Simply adding to marginal cost any markup that strikes one's fancy does not determine the appropriate economic price level, nor does it coincide with economists' definition of marginal cost pricing.

Economic theory underlying the original advice to use marginal cost pricing has not changed and remains sound. Prices based on marginal cost **and marginal revenue** — *i.e.*, demand, or elasticity (see below) — would eliminate underwater products and help the Postal Service set prices for market dominant products in a **business-like manner** while also increasing contribution and liquidity.[6] The abandonment of marginal cost pricing by the Postal Service undermines arguments for continuing to use marginal cost as the guiding principle for cost attribution.

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[6] If the Postal Service were to implement demand pricing fully, it could generate substantially more contribution and free cash flow — enough, perhaps, to begin repaying some of its debts and be removed from GAO's "high risk" list. http://www.gao.gov/highrisk/restructuring_postal/why_did_study. However, whoever has been responsible for the Postal Service's pricing decisions has given high priority to subsidizing its favorite mailers, and low priority to enhancing its liquidity, and even lower priority to reducing its $15 billion of outstanding debt.

D. Flawed Implementation

By failing to give adequate consideration to marginal revenue (which reflects elasticity of demand), most especially in the case of underwater products, implementation by the Postal Service has succeeded in distorting the original economic advice concerning pricing. The original advice was applicable to all postal products, which were partitioned in competitive and market dominant products only after enactment of PAEA.

The Postal Service has not submitted — and appears not to possess — any formal pricing model for market dominant products, most especially a model that incorporates elasticity and marginal revenue. For instance, it would appear from a recent Postal Service Office of the Inspector General ("OIG") Report, *Market Dominant Price Adjustment Filings,* Report Number CP-AR-16-003 (Jan. 13, 2016) that the pricing group does not have any model which they update and use on a consistent basis. According to the OIG:

> The Pricing department did not have documented and repeatable processes to guide the preparation of price adjustment proposals filed with the PRC. The Pricing department developed prices based on **institutional knowledge and data and economic analyses**. Based on their **experience** and analyses, they understand which products are at risk of a significant decrease in volume when prices increase.[7] [*Id.,* p. 6 (emphasis added).]

Each January, the Postal Service updates and files with the Commission its estimates of product elasticity, based on the most recent data available. The Postal Service's models for estimating elasticity are highly sophisticated, complex, and broadly inclusive of data on many

[7] Virtually ignoring the Postal Service's highly sophisticated elasticity studies, which are updated annually, allows the Postal Service to set prices on the basis of what is here called "institutional knowledge" and "experience," which, after years of observation, would appear to be little more than a euphemism for arbitrary and capricious pricing.

pertinent variables. They deserve considerable weight in pricing decisions. In price adjustment dockets, however, the Postal Service discussion scarcely mentions the Postal Service's elasticity estimates for various products. For all intents and purposes, the elasticity estimates generated by the Postal Service appear to receive so little weight in pricing decisions as to be effectively ignored.

On more than one occasion the Postal Service has completely jettisoned marginal cost pricing. In its most recent exigent price adjustment, the Postal Service proposed across-the-board percentage price increases, evidencing a disregard of all demand differences. That approach to pricing is almost the antithesis of marginal cost pricing. The Postal Service had complete flexibility to use marginal cost pricing because the price cap did not apply and the Postal Service (i) had more flexibility than ever with respect to pricing, and (ii) its greatest opportunity to incorporate demand considerations into price adjustments. Nor was the recent exigent rate case the only occasion when the Postal Service opted for an across-the-board percentage price increase.

Another example of the Postal Service jettisoning marginal cost pricing is underwater products. For these products, marginal revenue is *negative*, *i.e.*, an additional piece will have *negative* marginal revenue and *increase the cumulative loss*. Deliberately encouraging *negative marginal revenue year after year in no way comports with the economic description of marginal cost pricing*.[8]

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[8] *See* Appendix, *infra*, for further details.

To the extent that the Postal Service has had a consistent pricing "policy" or "strategy" (when not proposing an across-the-board price adjustment), it reflects a large measure of "don't rock the boat any more than necessary." Part of that strategy to minimize opposition is based on the political principle that once a company (or category of companies) receives a large government subsidy, it will go to virtually any length to preserve that subsidy — with its efforts richly funded by the very subsidy they are improperly receiving. Any such strategy leaves little room for marginal cost pricing — *i.e.*, considerations of both marginal revenue and marginal cost. The Postal Service does not appear to believe in application of the fundamental mathematical concept of constrained optimization, which is the essence of (i) developing optimum prices within a price cap, and (ii) use of linear programming techniques to optimize contribution.[9]

E. Results Produced by Current Cost Attribution Methodology

The papers by McBride and Panzar contend that one result of the current attribution methodology is that a sizeable pool of volume variable costs is not attributed. This is to be expected, since the Postal Service is subject to economies of scale and declining unit costs — *i.e.*, marginal cost reflects only the cost of the last piece handled, not all the pieces that preceded it. At the same time, variable costs, by definition vary with and are caused by mail volume.

[9] Linear programming is standard fare in operations research. In lieu of the Postal Service's elasticity estimates, which are a quantitative summary of myriad demand considerations, the Postal Service prefers to rhetorically rationalize what it wants to do.

Having a significant amount of variable costs remain unattributed is not altogether intellectually satisfying to economists. It means some variable costs that obviously are caused by mail volume are not attributed.[10] Those costs therefore must be recovered either through (i) some systematic pricing method, such as using marginal revenue and demand elasticity (*i.e.*, marginal cost pricing) to determine markups over marginal cost, or (ii) across-the-board percentage rate adjustments, or (iii) some unsystematic, arbitrary seat-of-the-pants method for assigning markups.

A second result of the current attribution and pricing methodology is continuing cumulative losses on underwater products.[11] **Based on marginal cost attribution, those recorded losses now exceed $10 billion since FY 2008**. *See*, *e.g.*, Docket No. ACR2015, Annual Compliance Report at 16 (Dec. 29, 2015). It should be remembered that if these losses were to be computed as the shortfall between revenues and **incremental costs**, which are somewhat higher than marginal costs, the losses would be substantially higher than the $10 billion recorded to date. Each year these losses sap Postal Service liquidity and prevent

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[10] Part of the explanation involves the fact that some costs classified as variable are **common or joint** costs that the Postal Service claims it cannot trace causally to any single product and does not attribute for that reason. The UPS proposal to use Shapley values as a basis for attribution offers an interesting solution worthy of consideration. It could be a more rational way to recover such costs than by **arbitrary seat-of-the-pants increases to coverage**.

It often is argued that any attribution of common or joint costs is necessarily arbitrary, and should be avoided. However, when marginal cost pricing is jettisoned (*e.g.*, in favor of an across-the-board percentage price increase, or promoting negative marginal revenue) the resulting markups can be **just as arbitrary as the attribution of common or joint costs**, if not more so.

[11] The papers by Panzar, McBride, and Cohen & Waller notably avoid any mention or defense of non-compensatory pricing for underwater products.

possible debt reduction. The cumulative losses now have grown so large as to make abundantly clear to any fair observer that any claims that these prior losses will be recovered in the future by the Postal Service from underwater products are fictitious. Yet the Postal Service insists that pricing flexibility under PAEA gives it the prerogative to maintain the price of underwater products at non-compensatory levels *ad infinitum*. Prior testimony by Postal Service pricing witnesses to the effect that maintaining the volume of underwater products is worthwhile because they might become a source of future profits is farther from materializing now than it was then. As the aggregate losses on underwater products mount, and in FY 2015 mount at an increasing rate, the truth is almost certainly that **not one dollar** of these prior losses will ever be recovered from future contribution by underwater products.[12]

A third result from the existing attribution and pricing methodology (as implemented) is that under PAEA the Postal Service has failed to eliminate the cross-subsidies required by underwater market dominant products and create a more level playing field among competing mailers that use market dominant products — *i.e.*, it repeatedly has failed to achieve the most fundamental equity requirement contained in the PRA. All Standard Mailers are advertisers, and Postal Service pricing provides unlawful preferences to some advertisers who are competing with other advertisers such as Valpak and other users of saturation mail.

A fourth result from the failure to attribute all costs that might be attributed on an economically causal basis is that the Postal Service (and Commission) could erroneously

[12] Rather than take necessary actions within its control to improve its financial condition, the Postal Service prefers to put all of its financial hopes for relief on Congress.

believe that some market dominant products are marginally profitable when in fact they are not covering all costs which they cause the Postal Service to incur.

In sum, under PAEA marginal cost pricing has ceased to be the *modus operandi* of Postal Service pricing. The existing attribution and (unexplained) pricing methodology has not served the Postal Service well. Low marginal costs that may understate significantly the incremental costs of market dominant products, coupled with the **OIG's finding of no "documented and repeatable processes to guide the preparation of price adjustment proposals filed with the PRC,"** can and has resulted in pricing decisions that undermine the Postal Service's financial health.

UPS may have identified a perverse incentive that could lead to irrational pricing decisions by the Postal Service. In response to ChIR No. 1, Q. 1b & 1c, UPS explains that:

> a state-owned enterprise like the Postal Service may be incentivized to expand its scale **even when expansion would be unprofitable.** That incentive to expand scale can derive from policy objectives, such as **reaching national employment goals**, or from the incentive to increase the enterprise's influence over national policy. Empirical research indicates that government managers may seek to expand the scale of their enterprise to realize the **power and prestige** that often accompanies expanded operations. Notably, the **Postal Service's incentive compensation plan rewards managers with bonuses that are tied to measures of *scale***, including deliveries per hour and total revenue. [*Id.*, p. 3 (emphasis added, footnotes omitted).]

Incentive compensation should be tied directly to net profitability, not gross volume.

IV. Pricing of Market Dominant Products Using Incremental Cost.

A. Introduction

The OIG Report, *supra,* concludes that the Postal Service does not have a consistent thought-out documented pricing strategy. Under the current pricing methodology, attributable costs reflect marginal costs (plus a small amount of specific fixed costs). The price of most market dominant products exceeds marginal (attributable) cost, but as explained previously the Postal Service typically makes no systematic effort to adjust prices in a manner that reflects marginal revenue, elasticity of demand, and changes in elasticity of demand.

At the earliest possible date, the Postal Service should re-think from the ground up its approach to pricing of market dominant products. A determination to replace marginal costs with incremental costs as the basis for cost attribution would offer a major break with the past, and give the Postal Service an opportunity to reappraise completely its pricing strategy. One critical question that needs to be considered is: Would a new system of attribution based on incremental costs make any difference for market dominant products? Could it give a wake-up call to the Postal Service and the Commission? Or, could a new system for attribution, perversely, even make matters worse? At this point, no one could possibly tell what the result would be.

Under PAEA, the Postal Service has somewhat wider latitude with respect to pricing of market dominant products than it does with competitive products, and enjoys almost unlimited Commission deference provided the price cap is not breached. Therefore, the Postal Service, with Commission approval or benign neglect, could implement all of the cost attribution principles advocated in UPS Proposal One, but not change the price of any market dominant

product. Absent any change in the price of market dominant products, no change in volumes and contribution would be expected.

Not surprisingly, it turns out that simply changing the attribution methodology is not sufficient. When it comes to pricing strategy and price adjustments, the Postal Service needs to change its mindset, focus on strengthening the demand for those products which offer the most profit or the best outlook for enhancing contribution, and cease nurturing losses on declining underwater products. If a new attribution methodology were to act as the driving force for such a change, the results could be beneficial. At the same time, however, if the Postal Service were to change its mindset in the manner just described and *fully implement* marginal cost pricing (*i.e.*, with no seat-of-the-pants exceptions), then sticking with the existing attribution methodology might yield equally beneficial results.

The UPS recommended approach to cost attribution relies to a large extent on the use of Shapley values to distribute inframarginal costs (*i.e.*, unattributed variable costs) to individual products. The appropriateness of using the Shapley-Roth approach for attribution may be hotly contested by the Postal Service.[13] For purposes of the analysis here, however, we assume full adoption of the attribution principles as recommended in UPS Proposal One, and discuss potential consequences thereof.

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[13] See footnote 9, *supra*, which points out that the outcome from an "arbitrary" allocation of common costs (*e.g.*, one based on Shapley values), coupled with a rational economic markup procedure, may be no worse than an arbitrary irrational markup over marginal cost.

B. Obvious Effect on Attributable Costs of Market Dominant Products

Under UPS Proposal One, the unit attributable cost for each market dominant product would be somewhat higher than at present (*see* UPS response to ChIR No. 1, Q. 5, Table 1). A number of market dominant products now have adequate coverage, and still would have a "revised" coverage well in excess of 100 percent under UPS Proposal One. Other market dominant products, however, currently are underwater and would be pushed further underwater, *e.g.*, Flats, Periodicals, Media and Library mail. Also, with a higher level of attribution some other market dominant products that currently appear to be marginally profitable might become underwater, *e.g.*, bound printed matter parcels.

The immediate effect of UPS Proposal One is limited to principles used to attribute costs. Nothing in Proposal One requires that prices of market dominant products change in response to a change in cost attribution.

C. Potential Advantages of Basing Attribution on Incremental Costs

One advantage of adopting an incremental cost floor for pricing is that, **if honored in practice**, it will avoid cross-subsidies within each market dominant class of mail and thereby restore to postal pricing a **fundamental principle of equity** promised by, but not heretofore achieved under, PAEA. In that regard, it also would help maintain a more **level playing field** among competing mailers who opt to use different market dominant postal products. Finally, elimination of cross-subsidies within each class of mail would help **honor the letter and the spirit of the original compact** dating back to enactment of the PRA.

A second advantage would be **increased transparency**. All parties, including the Postal Service, could ascertain whether the revenue from each product is covering the total cost

which the Postal Service must incur on behalf of that product — *i.e.*, incremental costs that include a product's share of infra-marginal costs. To the extent that the use of marginal cost for attribution is obscuring insight concerning true profitability of market dominant products, the result could be revelatory and, conceivably, result in price adjustments designed to assure that each market dominant product is at least minimally profitable vis-a-vis its incremental costs.

D. Ambiguity of Outcome

To what extent would the Postal Service consider unit incremental costs to be a floor for pricing? The fact that certain products are hopelessly underwater and the recipient of a significant cross-subsidy obviously has not deterred the Postal Service from non-compensatory pricing — as UPS cogently observed in its response to Response to ChIR No. 1, Q. 3, p. 19. A continuing coverage of Standard Flats in the neighborhood of 80 percent has been no spur to meaningful remedial action. In light of the minuscule upward price adjustments that the Postal Service advocates for underwater products (*e.g.*, CPI plus 5 percent for Standard Flats), it acts as though it prefers to continue losing money rather than raise prices to subsidized mailers.

If changing the cost attribution principles causes coverage to be revised downward to the range of 60 to 70 percent, why should that change anything? Nowhere in its attribution methodology does UPS suggest that the Postal Service should regard incremental unit cost as a price floor for market dominant products. UPS pointedly notes that the provision of PAEA that it has focused on requiring above-cost pricing applies only to competitive products. If the Postal Service wants to continue losing significant sums of money on catalogs, as it does under the existing regulatory regime, it could continue to do so after adoption of Proposal One.

Neither Proposal One nor UPS interpose any objection, because its financial interests are unrelated to Standard Mail. It does not use Standard Mail, hence it is not forced to pay even one cent of the cross-subsidy required to support catalogs.[14]

If the Commission continues to demonstrate almost unlimited tolerance for losses and cross-subsidies on underwater products, that has virtually annulled the statutory factors and objectives contained in sections 3622(b) and (c) of the PAEA, the Postal Service can continue to disregard all considerations of marginal revenue and demand. Instead, it can implement "neutral" across-the-board price adjustments at will, or make other arbitrary pricing decisions. Consequently, using incremental costs rather than marginal costs as the basis for computing losses could amount to nothing more than an accounting adjustment that increases the stated shortfalls of underwater products, but heretofore those shortfalls have left the Postal Service unfazed regardless of any damage to its liquidity or its balance sheet. It thus is possible that the more things change, the more they will remain the same. To conclude, regrettably adoption of UPS Proposal One offers no assurance of meaningful improvement as regards to Postal Service pricing of its market dominant products.

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[14] Moreover, the UPS parcel business may actually benefit from Postal Service below-cost pricing of Standard Flats. Catalogers likely are among UPS' best customers. If they receive wrong pricing signals from the Postal Service, they can be expected to send more catalogs than otherwise, possibly generating more parcel volume for UPS. Hence UPS has little reason to care that below-cost pricing of Standard Flats is paid by overcharging other Standard Mail users, including saturation mailers.

E. Distribution of Institutional Costs among Market Dominant Postal Products

Nowhere in its lengthy presentation does UPS mention the distribution of institutional costs. To the extent that UPS Proposal One would increase total attribution by about $13 billion, the pool of unattributed institutional costs would be reduced by an offsetting amount. Nevertheless, market dominant products share of the remaining pool of institutional costs still could amount to over $10 billion.

If past practices continue, the Postal Service of course would continue to have complete discretion with respect to markups and resulting prices that determine how the pool of institutional costs are distributed among market dominant products. Here again the Postal Service could take into account considerations such as marginal revenue and price elasticity, as well as other demand factors such as underlying trends. Alternatively, it could continue to ignore all such considerations.

V. Conclusion and Recommendation

The existing marginal cost approach to determining attributable costs has been found to meet the requirements of PAEA as well as PRA before it. However, the cost methodology incorporated in UPS Proposal One also appears to meet the economic standard for causality.

Unfortunately, for some years the Postal Service has not faithfully applied marginal cost pricing, charging prices below even marginal cost, leading to creation of cross-subsidies to individual market dominant products, and the creation of an unlevel playing field among competing mailers that use market dominant products. The Commission can and should compel the Postal Service to employ true marginal cost pricing and require all products to at

least cover their attributable costs. If this were done, there would be less of a rationale for proposals such as UPS Proposal One.

Moreover, beginning later in the year, the Commission is expected to conduct its 10-year review of Postal Service pricing as mandated by 39 U.S.C. § 3622(d)(3). Therefore, an argument could be made for delaying UPS Proposal One and rolling it into that Commission docket.

At this point, Valpak looks forward to reviewing the Initial Comments to be filed by other parties, and at this early stage of this docket, takes no position on UPS Proposal One, pending review of those other comments.

Respectfully submitted,

/s/

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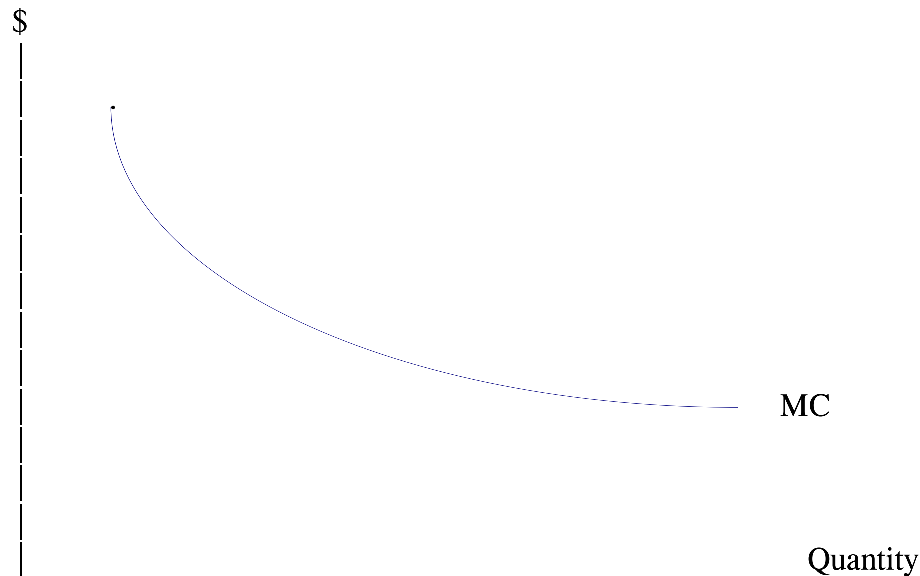
Appendix

Marginal Cost Pricing and Underwater Products

This appendix explains the application of marginal cost pricing to underwater products. The advice to employ marginal cost pricing typically means that price should be set in such a manner that marginal revenue (MR) is equal to marginal cost (MC), *i.e.*, MR = MC, which may help explain how marginal cost came to be the basis for attributable costs.

Figure A-1 depicts a declining marginal cost curve that reflects economies of scale and depicts the situation facing the Postal Service.[15]

Figure A-1



As explained herein, this does not mean that the price is set equal to (or less than) marginal cost. Marginal revenue is derived from and reflects the demand conditions facing the Postal

[15] A similar depiction of the marginal cost curve can be found in UPS Proposal One, pp. 2, 4, 11 and 22 (Figures 1-1, 1-2, 1-5, and 1-6). *See* also UPS Response to CHIR No. 4, Q1a, p. 3. *See* also USPS response to CHIR No. 2, Q1.

Service. Marginal cost of course reflects the supply conditions under which the Postal Service operates.

In theory, demand can take two possible extremes: (1) perfectly elastic demand, and (2) perfectly inelastic demand. As explained below, marginal revenue coincides with the demand curve at those two extremes. Following presentation of these two extreme cases is a discussion of the more realistic situation where demand is more or less elastic, *i.e.*, neither perfectly elastic nor perfectly inelastic.

Perfectly Elastic Demand

Perfectly elastic demand is depicted by the horizontal line MR shown in Figure A-2. This line (sometimes referred to as a "curve") shows that price need not be reduced in order to sell additional units.[16] When demand is perfectly elastic, marginal revenue (MR) also can be depicted by a horizontal line, one that overlays the demand curve. Figure A-2 shows this situation when demand and marginal revenue are substantially below marginal cost.

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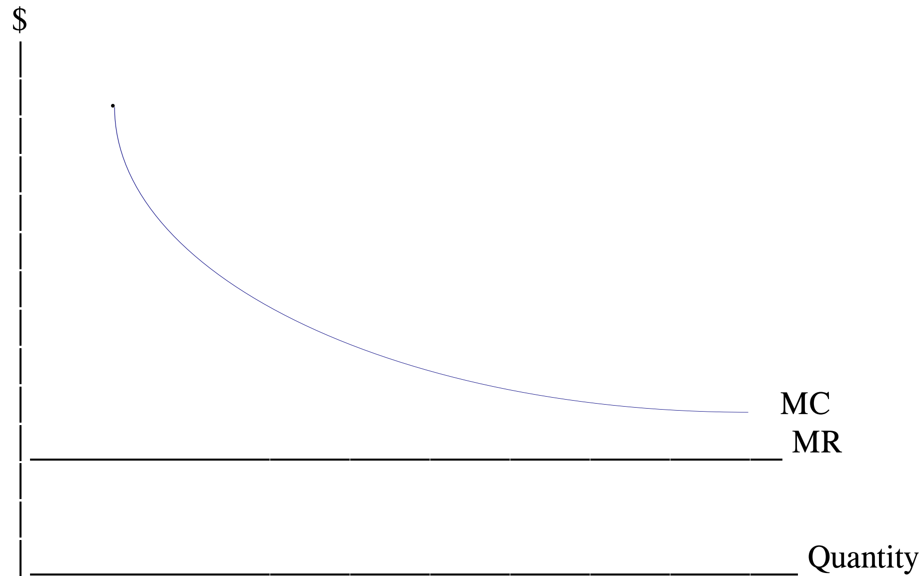
[16] This often is said to be the situation faced by small farmers selling their product in a large commodity market. It obviously does not apply to, or depict the situation of, the Postal Service.

Figure A-2



It can be observed from Figure A-2 that the lines for marginal revenue (MR) and marginal cost (MC) *do not intersect*, *i.e.*, no matter the demand, the cost to supply it everywhere exceeds the price that users are willing to pay. Consequently, under this condition it is not possible to set a price based on MR = MC. If price is set equal to marginal cost, the price will be above the curve for demand and marginal revenue. In general terms, this means that there will be no effective demand, or no transactions. Should this be the case with the Postal Service's underwater products, this means that there would be no volume at a price equal to marginal cost.

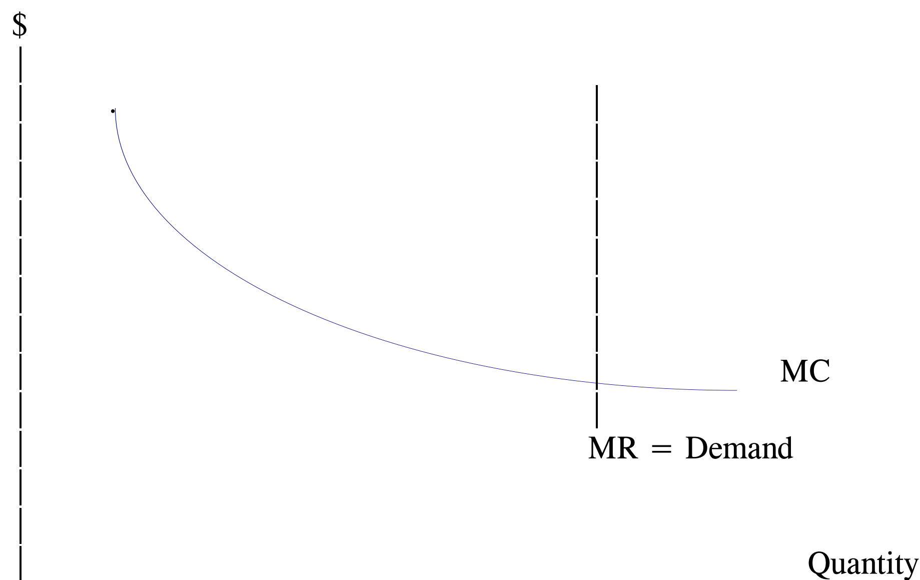
And if price is set equal to marginal revenue, *i.e.*, substantially below marginal cost, there will be unlimited demand and losses *ad infinitum*. This limiting case of perfectly elastic demand is of course unrealistic. It shows that marginal cost pricing is not feasible under the conditions postulated here. What this situation helps demonstrate is that preserving the

demand for underwater products by deliberately pricing them below cost in hopes of trying to turn a future profit can be akin to a fool's errand.

Perfectly Inelastic Demand

Perfectly inelastic demand is depicted in Figure A-3 by a vertical line (just the opposite of perfectly elastic demand). When demand is perfectly inelastic, marginal revenue also can be depicted by a vertical line (or curve), one that overlays the demand curve. Marginal revenue (and demand) are shown in Figure A-3 by the vertical line marked MR. In this extreme case, price need not be reduced in order to sell additional units; *i.e.*, in the range shown the same amount will be demanded regardless of price.

Figure A-3



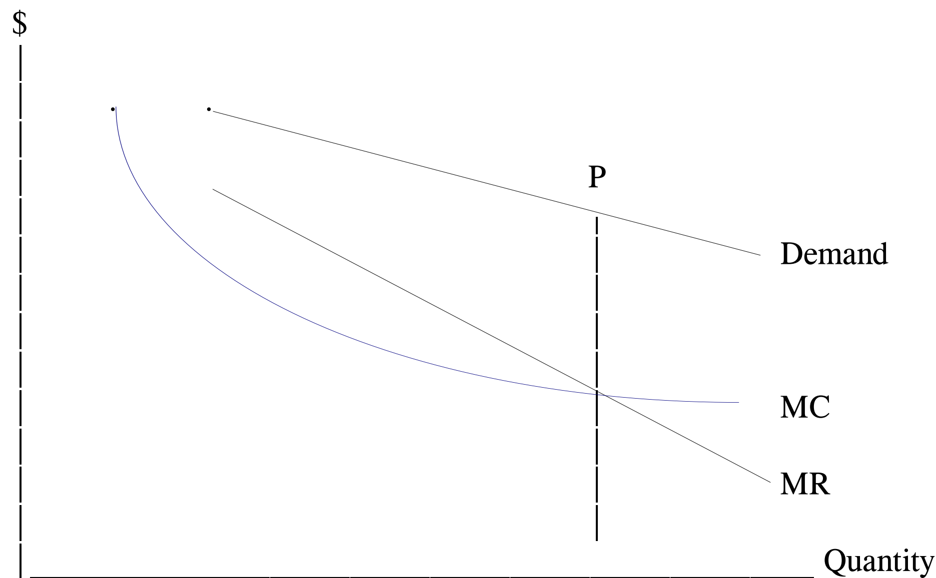
In this case, it obviously is possible to set price somewhere well above the point where marginal revenue equals marginal cost. There is absolutely no economic reason for price to be set equal to or below marginal cost. From an economic perspective, price could and should be

set well above marginal cost because higher prices do not entail loss of volume.[17] Of course this limiting case is also unrealistic. It illustrates, though, that when demand is inelastic (or highly inelastic) setting price below marginal cost makes no economic sense whatsoever because it results in the incurrence of needless losses. In the theory of some discipline (other than economics), it might make sense if the purpose is to lose money, but an assumption of such a purpose does not fall in the realm of economics.

Elastic Demand

We now consider the more realistic case where demand is neither perfectly elastic nor perfectly inelastic, *i.e.*, somewhere in between. This is depicted in Figure A-4 by the declining line labeled "demand."

Figure A-4



[17] A real world situation would be increasing the price of an essential drug for a life-threatening situation from $7.50 to $5,000, as Turing Pharmaceuticals LLC recently did.

A declining demand curve, such as here, generates a marginal revenue curve that declines more sharply, labeled MR in Figure A-4. Under marginal cost pricing, the intersection of marginal revenue and marginal cost should be used to show where on the demand curve (point P) to establish the price. Since the demand curve and the marginal revenue curve are declining, when marginal revenue equals marginal cost, the price P *will always be above the marginal cost*, even if the demand curve has relatively high elasticity.

Under the conditions shown in Figure A-4, it makes no economic sense whatsoever to set the price *equal to* marginal cost, and setting the price *below* marginal cost has even less economic justification. Doing so turns basic economics on its head. Such pricing is highly irrational from an economic perspective.[18] The economic literature contains widely differing opinions on many subjects. In that extensive literature, however, it would be difficult to find articles that advocate setting price of a standard service such as mail delivery below its marginal cost.

It should be noted that these fundamental economic principles are applicable regardless of the existence of any price cap. The Postal Service has complete flexibility to increase the price of one or more products within a class provided such increases are offset by appropriate reductions in the price of other products subject to the same cap. The price cap offers no reason to jettison marginal cost pricing and promote legacy products by using prices that reflect negative marginal revenue.

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[18] Any attempt to show otherwise would re-write the micro-economics section of every economics text ever written.