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BEFORE THE
POSTAL REGULATORY COMMISSION

Institutional Cost Contribution Requirement for Competitive Products	: : :	Docket No. RM2017-1

INITIAL COMMENTS OF UNITED PARCEL SERVICE, INC. ON NOTICE OF PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS
(January 23, 2017)

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United Parcel Service, Inc. ("UPS") respectfully submits these comments in response to the Postal Regulatory Commission's Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Order No. 3624, Dkt. No RM2017-1 (Nov. 22, 2016).

INTRODUCTION

In enacting the Postal Accountability and Enhancement Act ("PAEA"), Congress recognized the inherent danger of allowing the Postal Service, a large government entity with statutory monopolies over letter mail delivery and access to mailboxes, to expand aggressively into the adjacent competitive market for parcel delivery. Congress recognized that, if left unchecked, it would be all too easy for the Postal Service to use its status as a government monopolist to displace private-sector competitors in parcel delivery. Congress was determined to prevent this outcome because it recognized that private-sector competition is (and long has been) the primary engine of growth, productivity, and innovation for the nation's economy.

Accordingly, Congress enacted 39 U.S.C. § 3633, directing this Commission to establish and maintain appropriate safeguards, controls, and oversight to ensure that the Postal Service competes on a level playing field against private-sector rivals. In doing so, Congress expressed a clear preference for the continued existence of a robust, competitive market for parcel delivery over the creation of another government monopoly.

Although this Commission has recognized that "[a] primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace,"[1] the current 5.5% contribution requirement does not protect that interest today. The current level of required contribution fails to account for the significant growth of the Postal Service's competitive products business since PAEA was passed and bears no rational relationship to current market conditions.

The Commission originally set the 5.5% contribution level in 2007 as a "fitting starting point" to give the Postal Service "some flexibility" to compete in light of its "relatively small" market share.[2] Today, a decade later, the Postal Service proclaims that it delivers "*more e-commerce packages to the home than any other shipper*"[3] or "*than anyone else in the country*,"[4] and is responsible for delivering "*one-third* of all domestic packages in the United States."[5] The overall volume of Postal Service competitive products has grown by over 175% since 2007,[6] in significant part because of the Postal Service's advantages as a government entity with a protected monopoly.

Competitive products are also increasingly responsible for more of the Postal Service's costs. In a recent press release, for example, the Postal Service

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[1] Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, Dkt. No. RM2012-3 (Aug. 23, 2012) ("Order No. 1449"), at 13.

[2] Order Proposing Regulations to Establish a System of Ratemaking, Dkt. No. RM2007-1 (Aug. 15, 2007) ("Order No. 26"), at 70.

[3] United States Postal Service, *U.S. Postal Service Reports Fiscal Year 2016 Results*, NATIONAL NEWS (Nov. 15, 2016), https://es-about.usps.com/news/national-releases/2016/pr16_092.htm (last visited Jan. 22, 2017) (emphasis added).

[4] *See, e.g.*, United States Postal Service (@USPS), TWITTER (Nov. 17, 2016, 6:00 AM), https://twitter.com/USPS/status/799250904151113728 (last visited Jan. 22, 2017) (emphasis added).

[5] *Reforming the Postal Service: Finding a Viable Solution: Hearing Before the House Oversight and Government Reform Committee*, 114th Cong. 10 (May 11, 2016) (statement of Megan J. Brennan, CEO of United States Postal Service) (emphasis added).

[6] *Compare* POSTAL REGULATORY COMMISSION, ANNUAL COMPLIANCE DETERMINATION: U.S. POSTAL SERVICE PERFORMANCE (FISCAL YEAR 2007) 24 (2007) ("Total Competitive Mail"), *with* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2016) 5 (2016) ("Total Competitive Mail").

acknowledged that an over $1.6 billion year-over-year increase in its labor and transportation costs was "*largely due to the increase in Shipping and Packages volumes*, *which are more labor-intensive to process and require greater transportation capacity than mail*."[7] Competitive products are driving overall increases in the Postal Service's institutional costs, which have risen by $1.3 billion in just the last two years, even as volumes of market-dominant products continue to decline significantly.[8] In 2015 and 2016, competitive products were responsible for approximately 30% of the Postal Service's total attributable cost, which the Commission has observed is "double the percentage of total Competitive attributable cost in FY 2008."[9]

The current 5.5% contribution requirement, coupled with the Commission's recent ruling in RM2016-2 that individual competitive products must cover only their incremental costs,[10] effectively allows competitive products to "piggyback[] onto the existing transportation, processing, and delivery network designed around letters and flats."[11] The status quo, in other words, allows the Postal Service to fund the costs of delivering competitive products with revenues derived from its postal monopoly.

As the Federal Trade Commission ("FTC") recognized in 2007, this practice represents an "artificial" advantage for the Postal Service — one that private-sector

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[7] United States Postal Service, *U.S. Postal Service Reports Fiscal Year 2016 Results*, NATIONAL NEWS (Nov. 15, 2016), https://es-about.usps.com/news/national-releases/2016/pr16_092.htm (last visited Jan. 22, 2017) (emphasis added).

[8] *See infra* Section V.

[9] POSTAL REGULATORY COMMISSION, FINANCIAL ANALYSIS OF UNITED STATES POSTAL SERVICE FINANCIAL RESULTS AND 10-K STATEMENT (FISCAL YEAR 2015) 73 (2016).

[10] Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), Dkt. No. RM2016-2 (Sep. 9, 2016) ("Order No. 3506").

[11] UNITED STATES POSTAL SERVICE OFFICE OF INSPECTOR GENERAL, PACKAGE SERVICES GET READY, SET, GROW!, WHITE PAPER (REPORT NO. RARC-WP-14-012) 10 (Jul. 21, 2014).

competitors are legally barred "from duplicating" because the postal monopoly is reserved by law for the Postal Service alone.[12] As *The Wall Street Journal* has observed, if the Postal Service "misjudges its capacity or financial strength, it could end up with too many packages to deliver, *compromising mail service*."[13] And, to the extent the Postal Service succeeds in displacing efficient private-sector rivals, consumers will suffer from the diminished competition and loss of innovation that inevitably results.

In short, even as the low 5.5% contribution level has remained frozen for a decade, competitive products have steadily grown to comprise a much larger portion of the Postal Service's business. They are the subject of greater attention by Postal Service management, impose more demands on its network, and are responsible for a greater proportion of its costs and investments. As a result, the 5.5% contribution level should be significantly increased to meet PAEA's objectives.[14] Specifically, for the reasons set forth below, the appropriate share of institutional costs that should be borne by competitive products under current conditions is approximately 29%.

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[12] FEDERAL TRADE COMMISSION, ACCOUNTING FOR LAWS THAT APPLY DIFFERENTLY TO THE UNITED STATES POSTAL SERVICE AND ITS PRIVATE COMPETITORS 27-28 (2007) ("FTC Report").

[13] Laura Stevens, *For FedEx and UPS, a Cheaper Route: the Post Office*, WALL ST. J. (Aug. 4, 2014), www.wsj.com/articles/u-s-mail-does-the-trick-for-fedex-ups-1407182247 (last visited Jan. 22, 2017) (emphasis added).

[14] The D.C. Circuit has 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.").

ARGUMENT

I. THE APPROPRIATE SHARE REQUIREMENT MUST ENSURE THE POSTAL SERVICE COMPETES FAIRLY IN THE PROVISION OF COMPETITIVE PRODUCTS

In PAEA, Congress gave the Postal Service greater flexibility to sell competitive products while restraining its ability to exploit the postal monopoly, and the advantages that come with it, to enjoy an artificial competitive advantage over private-sector rivals. As this Commission has recognized, "section 3633 and its required regulations are 'intended to ensure that the Postal Service competes fairly in the provision of competitive products.'"[15] Congress intended that, under the Act, "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." H.R. REP. NO. 109-66 at 44 (2005).[16]

Congress tasked this Commission with implementing these "stronger controls, oversight, and limitations"[17] because it recognized that the nation's economy relies on private-sector innovation as the primary engine for economic growth.[18] Congress stated that it "strongly believes that the Postal Service should operate more like a private

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[15] Order No. 3506 at 121 (quoting S. REP. NO. 108-318, at 19 (2004)).

[16] *See also id.* at 46 ("Once the Commission has issued its regulations, the Postal Service is given pricing flexibility somewhat comparable to that exercised by private competitors. The changes regarding competitive products will be complemented by title III, which provides for a level playing field for such products in several important respects.").

[17] *Id.*

[18] In economic terms, Congress was concerned with "dynamic" efficiency in competitive markets. Dynamic efficiency is concerned with the development of better technology and innovations that lead to greater efficiency of production. In contrast, static efficiency focuses upon the most efficient combination of resources at a fixed point in time.

business," and that it "believe[s] just as strongly that the advantages the Postal Service has as a government entity should be blunted."[19]

Accordingly, the Postal Service cannot avoid meaningful regulation simply by asserting that such regulation would impact its business. Indeed, Congress *meant* for the regulations enacted under 39 U.S.C. § 3633 to have an impact — the "appropriate share" requirement of § 3633(a)(3) was specifically intended to limit "the advantages the Postal Service has as a government entity."[20] And Congress imposed this requirement in addition to the separate prohibition on cross-subsidization.[21] The current contribution requirement of 5.5%, however, has virtually no impact at all.

Congress enacted the "appropriate share" requirement because it recognized that it would hurt competition if the Postal Service could charge prices for competitive products that were insufficient to cover the same types of underlying costs that private competitors must cover. Private-sector companies bear costs identical to those the Postal Service classifies as "institutional" — including management salaries, costs of maintaining a delivery network, real estate maintenance costs, and variable "common" costs that are driven by more than one product (which, under Order No. 3506, are now classified as institutional). Private-sector competitors must generate revenues sufficient to cover *all* of those costs in order to break even.

To the extent the Postal Service's competitive products business is not required to recover the same types of costs as the private sector, that business enjoys an

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[19] S. REP. NO. 108-318 at 27-28 (2004).

[20] *Id.*

[21] *See* 39 U.S.C. § 3633(a)(1). The incremental cost test has long been the conventional test for preventing cross-subsidization. That Congress separately imposed an "appropriate share" requirement is powerful evidence that Congress did not believe the incremental cost test alone was sufficient to fulfill its objectives.

artificial competitive advantage. 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."[22] 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."[23]

As shown below, the appropriate share requirement does not meet either Congress's or the Commission's standard today. The 5.5% contribution requirement does not nearly reflect the ways in which the Postal Service's resources are spent on the competitive enterprise and thus allows the Postal Service to exploit the very competitive advantage that Congress intended the requirement to prevent.

II. IN 2007, THE COMMISSION SET 5.5% AS A LOW, TRANSITIONAL MEASURE

When the Commission set the appropriate share level at 5.5% in 2007, it noted that, since PAEA "thoroughly overhauls the ratemaking process," the Commission was "mindful of the risks of setting [the rate] too high, particularly at the outset of the new system of regulation."[24] When the Postal Service itself advocated for the 5.5% share, it acknowledged it was a "relatively low institutional cost contribution," but argued that a higher rate would be "an unreasonable constraint at this early stage in the life of the Postal Service under PAEA."[25]

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[22] Order No. 1449 at 13.

[23] *Id*.

[24] Order No. 26 at 71-73.

[25] Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking, Dkt. No. RM2007-1 (Jun. 18, 2007), at 25.

The Commission agreed to set a low rate to give the Postal Service "some flexibility to compete" given that "the Postal Service's market share is relatively small."[26] But the Commission stressed that 5.5% was intended to be an "initial" rate and a "starting point."[27] The Commission emphasized "that its initial quantification of appropriate share is not written in stone," and it "anticipate[d] that [the] need [to modify the appropriate share] may arise for any number of reasons."[28] That "starting point," however, has now been in place for a decade.

III. <u>IN 2012, THE COMMISSION RETAINED THE 5.5% LEVEL BECAUSE IT FOUND THAT FACTS ABOUT MARKET CONDITIONS WERE LACKING</u>

When the Commission last revisited the appropriate share requirement in 2012, it recognized that "[a] primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace."[29] As the Commission explained:

> Competitors must produce revenues that cover both variable and fixed costs. In effect, the appropriate share assigns a portion of the Postal Service's fixed costs to competitive products collectively, *so that the Postal Service, like its competitors, must set prices to produce sufficient revenues to cover both variable and fixed costs in their entirety*. Thus, the appropriate share provides another way of leveling the playing field for competitive products.[30]

Nevertheless, the Commission chose to maintain the 5.5% contribution level because it concluded that UPS and other interested parties had failed to demonstrate that the Postal Service was enjoying a competitive advantage.[31] The Commission cited data suggesting, for example, that the Postal Service's market share (2007-11) was

[26] Order No. 26 at 73.

[27] *Id*. at 70.

[28] *Id*. at 74.

[29] Order 1449 at 13-15 (emphasis added).

[30] *Id*. at 15 (emphasis added).

[31] *Id*. at 24.

relatively stable for domestic overnight air packages and for domestic 2-3 day air and ground packages.[32] And it stated that the "lack of a significant increase in market share minimizes concerns that the Postal Service may have an artificial advantage over its competitors."[33] The Commission noted that it would consider modifying the appropriate share requirement "if competitive volumes substantially increase relative to market-dominant volume," but found "this issue was not raised by the parties."[34]

As shown below, the key facts the Commission believed were missing in 2012 are overwhelmingly present today. The Postal Service has experienced significant growth in market share since 2007 and even since 2012. Similarly, the Postal Service's competitive volumes have substantially increased relative to market-dominant volumes. And those increased competitive volumes are driving a larger share of the Postal Service's overall costs.

In declining to change the 5.5% contribution level in 2012, the Commission also relied upon the findings of a 2007 report by the Federal Trade Commission,[35] which the Commission believed found that:

> in spite of any implicit subsidies afforded to competitive products from the Postal Service's status as a Federal government entity, Federally-imposed restraints on the Postal Service's operations increase its costs to provide competitive products and leave the Postal Service at a *net competitive disadvantage*.[36]

The conclusion the Commission drew from the FTC Report was, however, erroneous in 2012 and is even more so today. Although the FTC Report contains a

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[32] *Id*. at 16-18.

[33] *Id*. at 18.

[34] *Id*. at 23.

[35] FTC Report at 27.

[36] Order No. 1449 at 14-15 (emphasis added) (citing FTC Report at 64-67).

useful discussion of many issues, such as the implicit subsidies that the Postal Service enjoys by virtue of its status as a government entity, it does *not* support the conclusion that the Postal Service operates at a net competitive disadvantage to the private sector. In fact, the FTC expressly acknowledged that it was working from "limited data" that did not ultimately allow it to quantify or even estimate the value of the postal monopoly.[37] Since the postal monopoly provides the Postal Service with a unique and widely recognized advantage over the private sector, the FTC's inability to estimate its value means it is impossible to conclude from the FTC Report that the Postal Service operates at a net competitive disadvantage to the private sector.

Critically, the FTC Report recognized that the postal monopoly had the potential to create an advantage for the Postal Service over the private sector. Specifically, it observed: "If delivering monopoly products lowers the USPS's costs of producing competitive products, then it enjoys an advantage over its private competitors that the [postal monopoly] prevent[s] them from duplicating."[38] The FTC also recognized that the Postal Service's competitors cannot generate "similar scope economies because they are legally prohibited from delivering products that are covered by the postal monopoly."[39] But the FTC Report ultimately determined that the "extent of these economies . . . is an empirical question" that it was unable to answer, at least in part because of the "limited data" it received for the study.[40]

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[37] FTC Report at 14, 64. The postal monopoly includes both the letter monopoly, which is the Postal Service's exclusive statutory right to carry and deliver certain types of mail, and the mailbox monopoly, which is the Postal Service's exclusive right to deposit mail into mailboxes. *See id.* at 39.

[38] *Id*. at 48.

[39] *Id.* at 10.

[40] *Id*. at 48, 1.

As discussed below, recent analyses of the postal monopoly demonstrate that it does provide the Postal Service with a significant competitive advantage over the private sector — an advantage that Congress recognized when it enacted 39 U.S.C. § 3633 and that the Commission itself confirmed in a recent analysis finding that the Postal Service's monopoly-based benefits exceed its costs of complying with the universal service obligation ("USO").[41]

IV. ORDER NO. 3506 MAKES THE APPROPRIATE SHARE REQUIREMENT EVEN MORE VITAL

The Commission's recent ruling on UPS Proposal One in Order No. 3506, in Docket No. RM2016-2, makes it even more vital for the Commission to increase the 5.5% contribution requirement significantly.[42]

UPS Proposal One addressed whether the Postal Service should attribute all variable costs to competitive products, rather than the Postal Service's practice at the time of attributing only marginal (or so-called "volume variable") costs. UPS demonstrated that, under the status quo, a large portion of variable costs called "inframarginal" costs were not being attributed to products and were instead treated as institutional costs of the Postal Service. Inframarginal costs are those variable costs other than marginal costs that exist where the Postal Service enjoys economies of scale.

UPS calculated, and the Postal Service confirmed, that there are over $5 billion in inframarginal costs associated with the "Delivery Activities" component of "City

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41 *See* POSTAL REGULATORY COMMISSION, ANNUAL REPORT TO THE PRESIDENT AND CONGRESS (FISCAL YEAR 2016) 40, 48 (2016); *see also infra* Section V.

42 UPS disagrees with the ruling in Order No. 3506 and has filed an appeal in the D.C. Circuit Court of Appeals challenging the rejection of UPS Proposal One. *See United Parcel Service, Inc. v. Postal Regulatory Comm'n*, No. 16-1354 (D.C. Cir. filed Oct. 7, 2016).

Carrier Street Time" alone, meaning that over $5 billion in variable costs in just that one component were not attributed to any products (and were instead treated as "institutional").[43] UPS proposed an "order neutral" approach by which such variable costs could be attributed to individual products — moving them from the "institutional" to the "attributable" category — and argued that doing so is necessary to ensure that the Postal Service is competing fairly in the provision of competitive products.[44]

In rejecting UPS Proposal One, however, the Commission stated that 39 U.S.C. §§ 3633 (a)(1) & (a)(2) made "no mention" of fair competition.[45] And in adopting incremental cost as the appropriate measure for compliance with those provisions, the Commission acknowledged that "the purpose of the incremental cost test is *not* to ensure that the Postal Service is competing fairly in the marketplace."[46] Thus, following the rationale in Order No. 3506, the "appropriate share" requirement of § 3633(a)(3) is the *only* vehicle within § 3633 that the Commission recognizes as protecting Congress's interest in ensuring that the Postal Service competes on a level playing field with the private sector in a competitive parcel market.

Significantly, the Commission's ruling also for the first time expressly approved the Postal Service's practice of including within "institutional" costs both fixed *and variable* common costs.[47] In its prior rulings on the appropriate share requirement, the

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[43] *See* Proposal One – A Proposal to Attribute All Variable Costs Caused By Competitive Products to Competitive Products Using Existing Distribution Methods, Dkt. No. RM2016-2 (Oct. 8, 2015), at 7.

[44] *Id*. at 21-25.

[45] Order No. 3506 at 58.

[46] *Id*. (emphasis added).

[47] *Id.* at 85 ("The Postal Service also confirms that institutional costs are a mix of fixed and variable costs.").

Commission had characterized "institutional" costs as being the "fixed" costs of the enterprise,[48] and framed the issue as what percentage of those "fixed" costs was appropriate for competitive products to bear.[49]

The Commission's ruling that the Postal Service can treat most inframarginal costs as institutional costs of the enterprise means that, going forward, the institutional cost category will indisputably include *variable* costs that are driven by competitive product volumes. This ruling thus makes it even more essential that competitive products bear their proportional share of institutional costs.

V. THE APPROPRIATE SHARE REQUIREMENT MUST SIGNIFICANTLY INCREASE TO SATISFY THE CONGRESSIONAL PURPOSE

Much has changed since the Commission set the contribution requirement at 5.5% in 2007. While Congress directed the Commission to consider "all relevant circumstances" in evaluating changes to the appropriate share requirement, it specifically instructed the Commission to consider "the prevailing competitive conditions in the market" and "the degree to which any costs are uniquely or disproportionately associated with any competitive products."[50] An analysis of these factors establishes that a significant increase in the appropriate share requirement is long overdue.

A. The Postal Service's Status as a Governmental Monopolist Confers a Significant Artificial Competitive Advantage

Analyses conducted by UPS in connection with Commission dockets have demonstrated that the postal monopoly provides the Postal Service a sizeable advantage over private-sector competitors in the market for delivering parcels. This

[48] In 2012, for example, the Commission observed that institutional costs are those Postal Service costs that "do not vary with volume." *See* Order No. 1449 at 23.

[49] *See, e.g.,* Order No. 1449 at 25.

[50] *See* 39 U.S.C. § 3633(b).

advantage principally arises from the large economies of scale and scope generated by the postal monopoly, which the private sector are legally barred from duplicating. The Postal Service delivered 149.8 billion pieces of market-dominant mail in 2016, which amounts to about 410.5 million pieces of market-dominant mail per calendar day.[51] It delivered that market-dominant mail to approximately 156 million delivery points.[52] Given its vast assets funded largely by revenues from its postal monopoly, the Postal Service derives a tremendous advantage when it is able to piggyback competitive products and services on that infrastructure at a very low marginal and incremental cost, which the accepted cost methodologies allow it to do today.

The "constant elasticity" cost function used by the Commission to calculate incremental cost in many of the largest cost components demonstrates this principle. This cost function illustrates that current costing practices allow the Postal Service to leverage its market-dominant products and services to drive the marginal costs for competitive products (rightward on the curve) to very low values:

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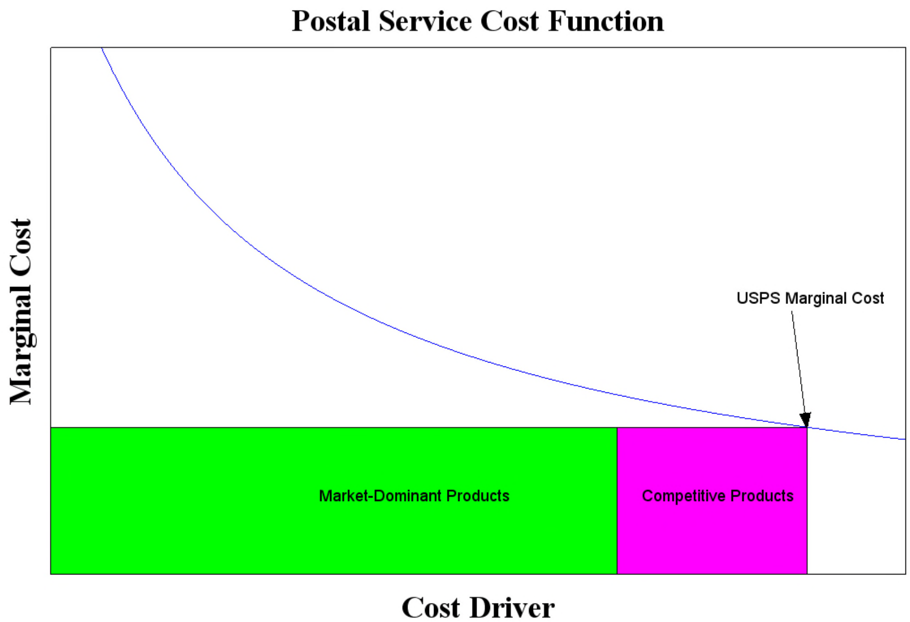
[51] *See* United States Postal Service, Public Cost and Revenue Analysis (Fiscal Year 2016) 4 (2016).

[52] *See* United States Postal Service, Form 10-K 2 (2016).



The private sector cannot duplicate these low marginal costs. Private sector competitors necessarily handle lower volumes and face higher marginal costs for their competitive products because they are legally barred from securing the scale and scope advantages of providing the products reserved exclusively for the Postal Service by the postal monopoly. As the FTC Report recognized, this advantage for the Postal Service arising from the postal monopoly is properly characterized as "artificial."[53]

A recent analysis by the Commission supports this conclusion that the postal monopoly confers an advantage on the Postal Service, while taking a somewhat different approach to the question. In its 2016 Annual Report, the Commission estimated that the value of the postal and mailbox monopolies were $5.45 billion and $1.03 billion respectively in 2015 alone.[54] These estimates far outweigh the

[53] FTC Report at 50.

[54] POSTAL REGULATORY COMMISSION, ANNUAL REPORT TO THE PRESIDENT AND CONGRESS (FISCAL YEAR 2016) 48 (2016).

Commission's estimate of the total cost of the USO of $4.24 billion.[55] Taking the Commission's estimates at face value, the Postal Service enjoys a sizeable net competitive *advantage* over the private sector because of the value of the postal monopoly.[56]

For a number of reasons, however, the Commission's estimates significantly understate the size of that advantage. *First*, the Commission did not account for the value of the scale and scope economies arising from the postal monopoly as demonstrated above. The Commission's report instead focused more narrowly on how much profit the Postal Service would lose if private competitors were able to contest and win a portion of market-dominant mail from the Postal Service.[57] By focusing only on sales of market-dominant mail lost to potential rivals in the absence of the postal monopoly, the analysis overlooks the cost advantages the Postal Service already has in competitive product markets as a result of the monopoly.

If new rivals were to begin delivering market-dominant products in the absence of the postal monopoly, overall Postal Service delivery volume would decrease, driving the Postal Service's marginal cost of delivery upwards. Existing rivals in competitive products could also horizontally expand into market-dominant products, realizing additional economies of scale and scope that are currently off-limits to them. The net effect would be higher incremental costs for the Postal Service and lower incremental

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[55] *Id.*

[56] This is especially true in light of Dr. Panzar's observation that, in the absence of the USO, market forces may dictate a higher service quality than the Postal Service could maintain as a monopoly holder. *See See* John C. Panzar, *Methodologies for Costing the USO and Valuating the Letter and Mailbox Monopolies*, STUDY ON UNIVERSAL POSTAL SERVICE AND THE POSTAL MONOPOLY (APPENDIX F, SECTION 2) (2008), at 9 n.8.

[57] *See id.* at 48.

costs for its rivals. These changes would reduce the Postal Service's sales of competitive products in addition to the lost sales of market-dominant products considered by the Commission.

Second, the Commission's model fails to account for all of the advantages arising from the mailbox monopoly. Most notably, postal carriers can leave small packages in the mailbox, such as e-commerce packages, whereas UPS and FedEx drivers may need to return to the same address repeatedly to find someone at home, thus increasing delivery costs. The Commission's analysis does not include the extensive cost savings the Postal Service enjoys because of exclusive mailbox access.

Third, the Commission overstates the net burden of complying with the USO by failing to account for incremental revenue the Postal Service receives from USO expenditures. As the FTC Report found, the Postal Service's compliance with the USO "likely leads to increased demand for its competitive products by reducing consumer costs of using the USPS."[58] The Commission's analysis, for example, does not account for all of the incremental revenue derived from the "small post offices" the Postal Service maintains to satisfy the USO. Similarly, while the Commission estimates that the Postal Service incurs a loss of roughly $2.074 billion by being forced to deliver mail six days a week,[59] that estimate does not account for additional revenues earned by the Postal Service *because* it delivers six days a week instead of five.

Fourth, some of the costs the Commission treats as resulting from the USO may instead reflect inefficiencies in the enterprise. The data shows, for example, a

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[58] FTC Report at 51.

[59] POSTAL REGULATORY COMMISSION, ANNUAL REPORT TO THE PRESIDENT AND CONGRESS (FISCAL YEAR 2016) 46-47 (2016).

downward trend in the costs associated with the Postal Service maintaining small post offices.[60] This trend reflects the results of belt-tightening at the Postal Service involving the closure of facilities it does not truly need to meet its USO. Such inefficiencies are likely also present elsewhere in the Postal Service.

In short, while the Commission's analysis confirms that the Postal Service enjoys a competitive advantage because of the postal monopoly, that analysis significantly understates the size of the advantage.[61] As shown below, market trends increasingly demonstrate that the Postal Service is exploiting this advantage.

B. Market Conditions Have Changed Dramatically Since PAEA Was Enacted

As noted, the market conditions that the Commission found absent in 2012 are overwhelmingly present today. The Postal Service acknowledges that it has overtaken its private-sector rivals, especially in the important segment of e-commerce package delivery. A year-end 2016 press release, for example, stated: "The Postal Service continues to win e-commerce customers and grow our package delivery business. *We*

[60] In 2011, these costs were $673 million while in 2015 these costs were $209 million. POSTAL REGULATORY COMMISSION, ANNUAL REPORT TO THE PRESIDENT AND CONGRESS (FISCAL YEAR 2016) 42 (2016).

[61] Section 703 of PAEA requires the Commission when revising regulations promulgated under § 3633 to "take into account" the initial recommendations of the FTC concerning explicit and implicit legal advantages enjoyed by the Postal Service over private competitors and "subsequent events that affect the continuing validity of the estimate of the net economic effect" of the Postal Service's legal status. Postal Accountability and Enhancement Act of 2006, Pub. L. No. 109-435, § 703(d) (2006). To the extent the Commission believes it would be helpful, UPS would welcome the Commission overseeing an updated study of these issues.

deliver more e-commerce packages to the home than any other shipper because of our predictable service, enhanced visibility and competitive pricing."[62]

Similarly, the Postal Service advertises that: "We deliver more online purchases to homes than anyone else in the country."[63] Postal Service management has also stated that the Postal Service "delivered one-third of all domestic packages in the United States" in 2015.[64] These statements stem in part from the fact that the Postal Service has captured more than 40% of the shipping business of one of the world's largest retailers.[65]

Thus, the Postal Service has gone from having a relatively low market share when PAEA was passed to now delivering more packages to American homes than any company and at least one-third of all domestic packages today. Indeed, UPS and FedEx "frequently deposit their lightweight packages into the Postal Service's network for final delivery," and, as of July 2014, "the Postal Service makes final delivery for about *two-thirds* of the nation's lightweight packages."[66] This is a remarkable fact, unparalleled elsewhere in the U.S. economy: within a decade of PAEA's passage, a

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[62] United States Postal Service, *U.S. Postal Service Reports Fiscal Year 2016 Results*, NATIONAL NEWS (Nov. 15, 2016), https://es-about.usps.com/news/national-releases/2016/pr16_092.htm (last visited Jan. 22, 2017) (emphasis added).

[63] *See, e.g.*, United States Postal Service (@USPS), TWITTER (Nov. 17, 2016, 6:00 AM), https://twitter.com/USPS/status/799250904151113728.

[64] *Reforming the Postal Service: Finding a Viable Solution: Hearing Before the House Oversight and Government Reform Committee*, 114th Cong. 10 (May 11, 2016) (statement of Megan J. Brennan, CEO of United States Postal Service).

[65] PAUL WALTER ODOMIROK, AFFORDABILITY: INTEGRATING VALUE, CUSTOMER, AND COST FOR CONTINUOUS IMPROVEMENT (2016) at 65-66.

[66] UNITED STATES POSTAL SERVICE OFFICE OF INSPECTOR GENERAL, PACKAGE SERVICES GET READY, SET, GROW!, WHITE PAPER (REPORT NO. RARC-WP-14-012) 10 (Jul. 21, 2014) (emphasis added).

government entity has captured two-thirds of a delivery segment with private-sector rivals finding it rational to purchase the government entity's services.

These changes did not occur on a level playing field. Since 1976, UPS has been a leader in innovation in the logistics industry, with over 400 assigned patents.[67] To address the challenges arising from the explosion in e-commerce UPS, among other things, invested in a high-level corporate organization focused on operations research which works to optimize sorting, dispatch planning, and delivery. One recent innovation is UPS's ORION ("On-Road Integrated Optimization and Navigation") system that optimizes drivers' routes. This system not only reduces costs and environmental impact, it allows personalized delivery options. ORION involved a tremendous investment over the course of many years: it was conceived in 2000, tested in 2008, and has had 500 staff working towards full deployment in 2017.[68]

In contrast, the Postal Service classifies its own research and development activities as "not material" to its financial statements,[69] a practice that would be inconceivable for private-sector companies. Indeed, as economic literature predicts, the private sector has consistently led in introducing important delivery innovations to the market.[70]

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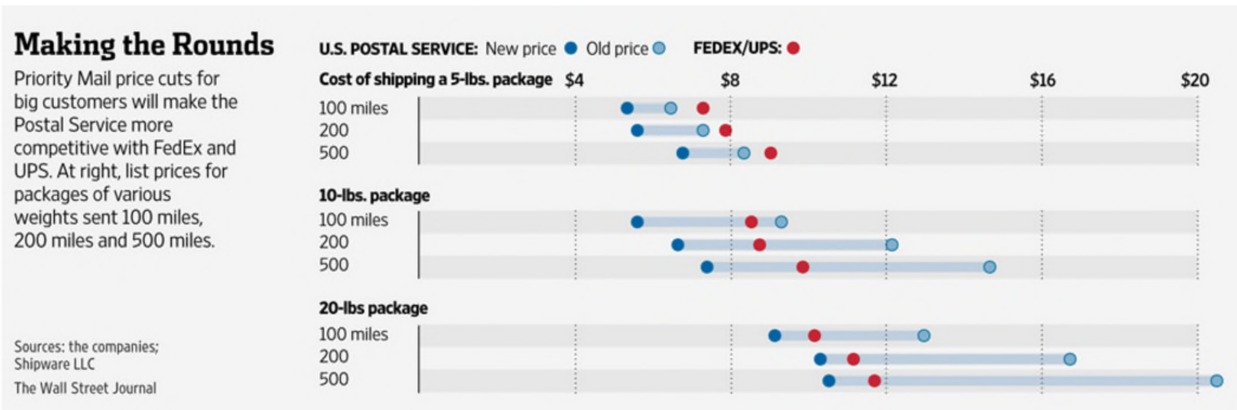
[67] Information taken from U.S. Patents and Trademark Office website. *See* USPTO PATENT FULL-TEXT AND IMAGE DATABASE, http://patft.uspto.gov/netahtml/PTO/search-adv.htm (last visited Jan. 22, 2017).

[68] *See* Alex Konrad, *Meet ORION, Software That Will Save UPS Millions By Improving Drivers' Routes*, FORBES MAGAZINE (Nov. 1, 2013), www.forbes.com/sites/alexkonrad/2013/11/01/meet-orion-software-that-will-save-ups-millions-by-improving-drivers-routes/#139e8045383e (last visited Jan. 22, 2017).

[69] UNITED STATES POSTAL SERVICE, FORM 10-K 4 (2016).

[70] For instance, the Postal Service adopted mobile data collection devices and a delivery confirmation system around 1997 (about six years after UPS) and adopted dynamic route optimization software only around 2014 (about four years after UPS). *See* U.S. Postal

The Postal Service's dramatic growth should in no way arise from its ability to shift a large proportion of the fixed and variable costs associated with competitive products to the market-dominant side of its ledger. The Postal Service's competitive product business, however, continues to achieve rapid growth by harnessing its ability to disregard costs that private-sector companies must bear. A 2014 Wall Street Journal article, for example, analyzed the Postal Service's delivery prices and found the Postal Service changed list prices to undercut its rivals *across the board* for 5, 10, and 20 pound packages:[71]



Service to Deploy 300,000 + Mobile Data Collection Units From Hand Held Products, PR NEWSWIRE ASSOCIATION LLC (Aug. 28, 1997), www.thefreelibrary.com/U.S.+Postal+Service+to+Deploy+300,000%2B+Mobile+Data+Collection+Units...-a019709351 (last accessed Jan. 22, 2017); Mallis, Laurie, *Birth of DIAD*, THE UPS BLOG (Dec. 7, 2009), https://web.archive.org/web/20100221043817/http://blog.ups.com/2009/12/07/birth-of-the-diad/ (last accessed Jan. 22, 2017); United States Postal Service, *Toward dynamic routing*, LINK (Mar. 28, 2014), https://liteblue.usps.gov/news/link/2014/03mar/news31s1.htm (last accessed Jan. 22, 2017); United Parcel Service, *ORION Backgrounder*, UPS PRESSROOM, www.pressroom.ups.com/pressroom/ContentDetailsViewer.page?ConceptType=Factsheets&id=1426321616277-282 (last accessed Jan. 22, 2017).

[71] Laura Stevens, *U.S. Mail Cuts Prices, Chafing UPS and FedEx*, WALL ST. J. (Sep. 4, 2014), www.wsj.com/articles/u-s-mail-cutting-rates-to-win-e-commerce-business-1409850185.

Competitive products' share of total Postal Service volume more than tripled from 2007 to 2016,[72] with competitive mail volumes experiencing an 11.9% compound annual growth rate since 2007.[73] Postal Service competitive volumes grew 14.8% in FY 2015 alone.[74]

The unprecedented growth of the Postal Service's competitive products business is illustrated below in Figure 1.[75]

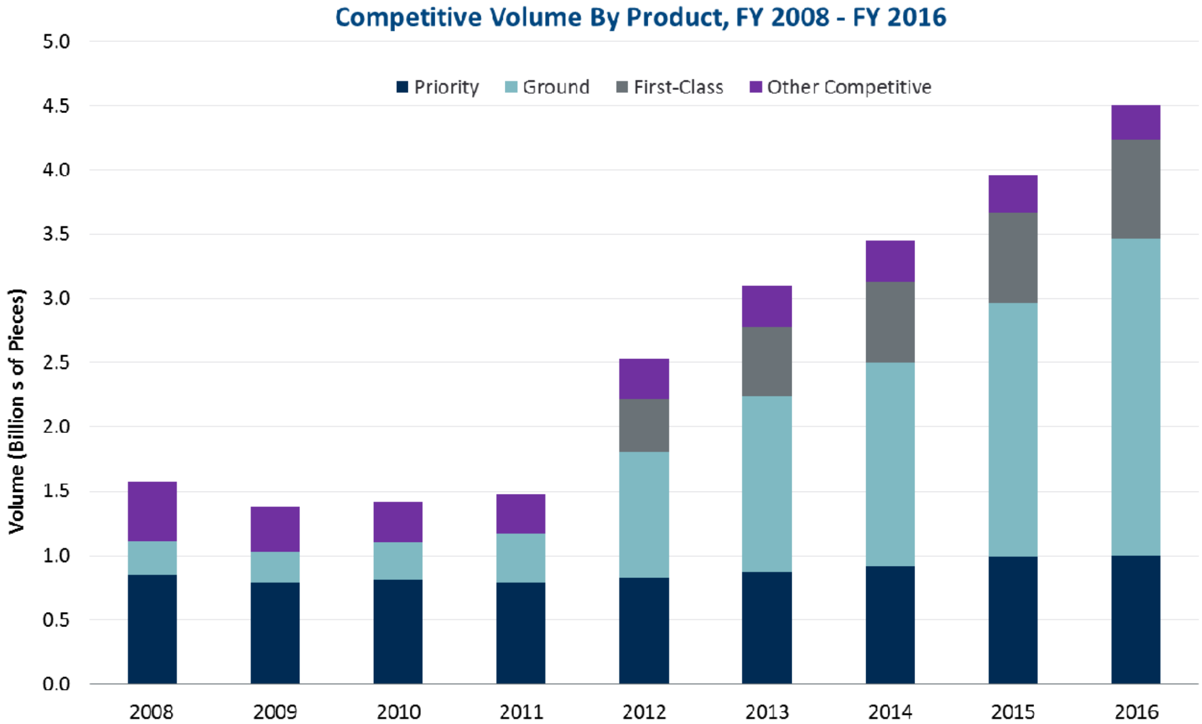
[72] *Compare* POSTAL REGULATORY COMMISSION, ANNUAL COMPLIANCE DETERMINATION: U.S. POSTAL SERVICE PERFORMANCE (FISCAL YEAR 2007) 24 (2007) (see "Total Competitive Mail" and "Total Mail & Services", 0.77% of total mail volume), *with* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2016) 2 (2016) (see "Total Competitive Mail" and "TOTAL ALL MAIL", 2.9% of total mail volume).

[73] *Compare* POSTAL REGULATORY COMMISSION, ANNUAL COMPLIANCE DETERMINATION: U.S. POSTAL SERVICE PERFORMANCE (FISCAL YEAR 2007) 24 (2007) (see "Total Competitive Mail"), *with* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2016) 2 (2016) (see "Total Competitive Mail").

[74] POSTAL REGULATORY COMMISSION, FINANCIAL ANALYSIS OF UNITED STATES POSTAL SERVICE FINANCIAL RESULTS AND 10-K STATEMENT (FISCAL YEAR 2015) 70-71 (2016).

[75] Some of the growth reflected in this figure comes from additions to the competitive products list or transfers from the market-dominant list to the competitive products list. In 2007, there were only 11 competitive products, including international competitive products. *See* 39 U.S.C. § 3631; Order No. 26 at 79. Today, there are 22 competitive products — 12 domestic and 10 international. *See* POSTAL REGULATORY COMMISSION, FINANCIAL ANALYSIS OF UNITED STATES POSTAL SERVICE FINANCIAL RESULTS AND 10-K STATEMENT (FISCAL YEAR 2015) 70 (2016). There are also 200 domestic competitive Negotiated Service Agreements (NSAs) and 269 international competitive NSAs, with new NSAs constantly being approved by the Commission. *See id*. The Commission has previously stated that "[w]hether an expansion of the Postal Service's competitive products comes from competitive product transfers or volume growth is not by itself related to the appropriate share requirement." Order No. 1449 at 22-23.

Figure 1



Sources: Revenue, Pieces and Weight (RPW) reports as filed in ACR proceedings, FY09-FY16.
Notes: 2008 values taken from 2009 RPW as product-specific volumes for competitive products were not available in the public reports until 2009. "Ground" is comprised of Standard Post, Parcel Select Mail , and Parcel Return Service Mail. "Other Competitive" is comprised of Competitive International Mail and Priority Mail Express Mail.

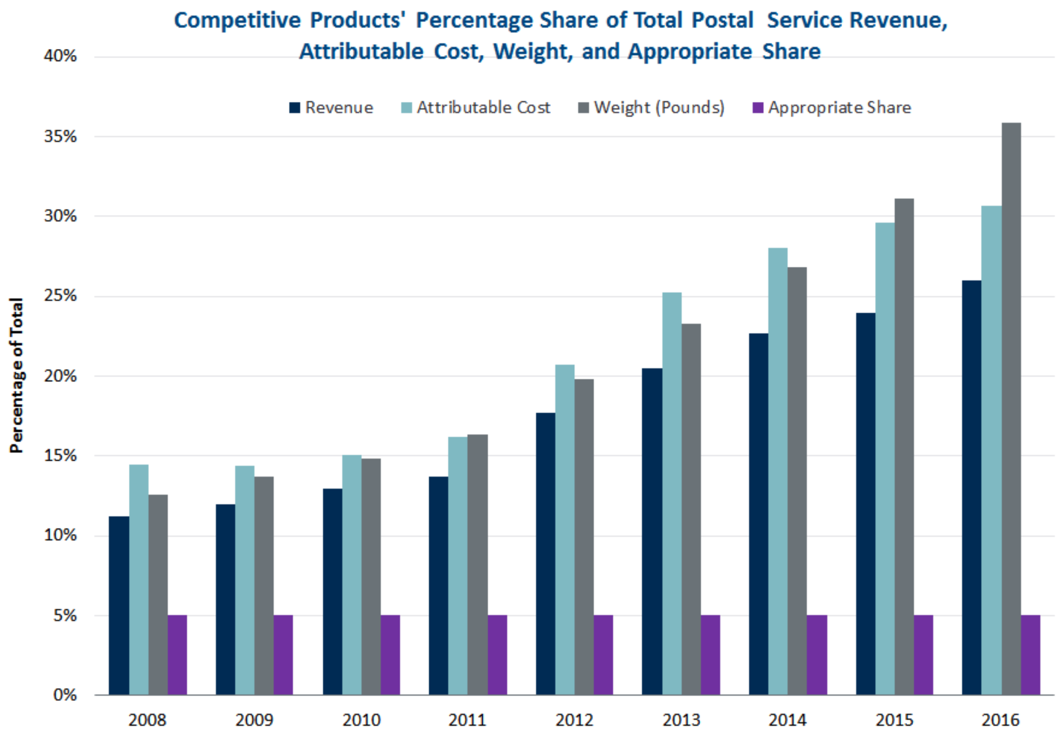
Postal Service revenues from competitive products have grown significantly as well. Revenue from competitive products and services increased from 11.4% of total revenue in 2008 to 26.6% in 2016.[76] Between 2015 and 2016, Postal Service raw revenues skyrocketed for competitive products like Parcel Select Mail (+39.7%), First-

[76] *Compare* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2008) 2 (2008) (see "Total Competitive Mail and Services" and "Total Mail and Services") *with* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEAR 2016) 3 (see "Total Competitive Mail and Services" and "Total All Mail and Services"). Figures from 2008 are used instead of 2007 because some figures for competitive services are not available until 2008, since the Postal Service did not separate competitive services in its 2007 Annual Compliance Determination Report.

Class Package Service (+19.1%), and competitive products and services overall (+13.3%).[77]

Figure 2 below shows the stark contrast between the Postal Service's rapidly growing competitive products (whether measured by total revenue or attributable costs) and the 5.5% appropriate share that has remained unchanged since 2007.[78]

Figure 2



Sources: Cost and Revenue Analysis reports as filed in ACR proceedings, FY08-FY16.

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[77] *See* UNITED STATES POSTAL SERVICE, REVENUE, PIECES, AND WEIGHT BY CLASSES OF MAIL AND SPECIAL SERVICES FOR FISCAL YEAR 3-4 (2016). This growth was not, or only minimally, affected by changes in product classification. The last major shift in competitive product definitions occurred in FY 2013. The only change since then, taking effect in Q1 2015, was the shift in Inbound International Surface Post (at UPU rates) from market dominant to competitive. The revenues for this product in FY 2014 (its last year as a market dominant product) were equal to 0.1% of total competitive revenues in that year.

[78] *See* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEARS 2008-16) (2008-16). As noted, some of the growth in competitive products' share of revenue and volume comes from additions to the competitive products list and transfers from the market-dominant list to the competitive products list. *See* note 75 *supra*.

C. Market Trends Impact Competition And Private-Sector Investment In Innovation

If these trends continue, the Postal Service will take an ever-increasing share of the market while denying rivals economies of scale and scope necessary to grow and thrive. These trends necessarily affect investment decisions by the private sector and have the potential to dissuade entry or expansion by firms and to disincentivize the major investments necessary for the future of the industry overall and for e-commerce delivery innovations specifically. The absence of these innovations would have negative ripple effects throughout the economy.

Even economists who typically defend Postal Service pricing practices acknowledge that the economic forces underlying the trends documented above could eventually allow the Postal Service to dominate some or all of the parcel market. In RM2016-2, for example, Professor John Panzar explained how the Postal Service's ability to exploit the cost advantages arising from the postal monopoly could naturally lead to a "monopoly industry configuration" where the Postal Service becomes the sole provider of competitive products and services.[79]

Congress enacted § 3633 to prevent this outcome. Congress's instruction that the Commission consider "the prevailing competitive conditions in the market,"[80] presupposes the continued existence of vibrant private-sector competition within the parcel industry. Under a "monopoly industry configuration," any short-term benefits to consumers in the form of lower prices would be greatly outweighed by the longer-term harms to competition. For example, the Postal Service would lose whatever incentive it

[79] Declaration of John C. Panzar on Behalf of Amazon Fulfillment Services, Inc., Dkt. No. RM2016-2 (Jan. 29, 2016), at 27-28.

[80] *See* 39 U.S.C. § 3633(b).

has to innovate in order to improve the delivery of packages. And it would be free to raise prices, with potential entrants deterred by their knowledge that the Postal Service could respond with temporary price decreases no entrant could match.[81]

Such an outcome would also thwart the innovation and competition driven by the private sector. Economic literature recognizes that government enterprises are inherently less efficient than private-sector companies due to the absence of strong incentives to maximize profits or minimize costs, and other factors. As Harvard economist Andrei Shleifer summarizes in a comparison of state and private ownership, "state firms are inefficient . . . because their managers have weak incentives to reduce costs," among other reasons, and "*[a] large body of observation and research is consistent with this view of public production*."[82]

Unlike a private company, the Postal Service is not constrained by the need to answer to active shareholders, grow dividends, eliminate overhead, or maximize profit. Rather, it has an incentive to prioritize scale over profit due to statutory mandates and

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[81] If Congress had been indifferent to the expansion of the Postal Service's monopoly, there would be no reason why the Postal Service could not expand to dominate still more industries. Given its thousands of Post Offices across the country, the Postal Service could theoretically use its network of retail locations to engage in financial services or retail or pharmaceutical sales. Given the modest share of its costs that are "attributed" instead of "institutional," it would be easy to show the Postal Service could enter those markets at rock-bottom prices that were above its incremental cost but far lower than what the private-sector incumbents could match. The Postal Service could displace the private sector in many other fields as well (while still making a "contribution" to the enterprise's overall revenues).

[82] Andrei Shleifer, *State Versus Private Ownership*, J. OF ECON. PERSPECTIVES (VOL. 12 NO. 4) 148 (1998) (emphasis added). *See also id.* at 135 (explaining that "private ownership is the crucial source of incentives to innovate and become efficient, which accounts for what Samuelson (1948) called the 'tremendous vitality' of the free enterprise system."); *id*. at 138 (noting the "weak incentives of government employees with respect to both cost reduction and quality innovation").

policy goals that diverge from profit maximization.[83] Managers of state-owned enterprises "often have a considerable interest in expanding the scale or scope of their activities, in part, because a manager's abilities may be inferred from the size of the operations that he or she oversees."[84]

The Postal Service can also be more confident than any private-sector company that, if it were to encounter severe enough financial problems, it will receive legislative relief, including authorization to impose permanent increases in the rates charged to market-dominant mailers, relief from obligations to retirees, or potentially even outright subsidies.[85] The potential for that relief may also contribute to an incentive for the Postal Service to maximize growth over other objectives.

The Postal Service has consistently argued that, so long as its competitive products generate revenues exceeding their marginal or incremental costs, those products are contributing to the Postal Service's bottom line, and there is no need for regulation. But Congress rejected this argument when it enacted 39 U.S.C. § 3633. Congress imposed the appropriate share requirement to provide meaningful limits on the Postal Service above and beyond the requirements of §§ 3633(a)(1) & (2). It is the

[83] J. Gregory Sidak, *Maximizing the U.S. Postal Service's Profits from Competitive Products*, 11 J. COMPETITION L. & ECON. 617, 662 (2015); *see also* David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 500 (2003); David E.M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. CHI. L. REV. 271, 285-86 (2000) (explaining why a public enterprise has a greater incentive than a private firm to engage in predatory pricing).

[84] David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 500 (2003).

[85] *Statement Of Megan J. Brennan Postmaster General And Chief Executive Officer United States Postal Service Before The Senate Homeland Security And Governmental Affairs Committee*, 114th Cong. 3-5 (January 21, 2016) (statement of Megan J. Brennan, CEO of United States Postal Service, requesting "fundamental legislative reform" to improve the Postal Service's financial position).

Commission's responsibility to further the policy goals of PAEA even if the Postal Service would prefer otherwise.

D. Many Institutional Costs are Uniquely or Disproportionately Associated with Competitive Products

Many costs currently classified as "institutional" are "uniquely or disproportionately associated with" competitive products.[86] As demonstrated below, these include both the fixed costs the Commission has traditionally treated as the essence of institutional costs and the variable common costs the Commission more recently ruled are properly included within the institutional cost bucket.[87]

In connection with PAEA, Congress considered such things as "salaries for management and other overhead costs" to be paradigmatic examples of institutional costs.[88] The Postal Service indeed treats the vast majority of management costs as institutional.[89] Yet its management is clearly focused today on growing the competitive products business, stating that it is transforming into "a delivery service for the e-commerce era" in which it will haul "fewer letters and more packages."[90] As former Postmaster General Patrick Donahoe stated in 2014: "'We've been focusing a lot of

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[86] 39 U.S.C. § 3633(b).

[87] As noted above, UPS disagrees with this decision and is appealing it to the D.C. Circuit Court of Appeals. *See United Parcel Service, Inc. v. Postal Regulatory Comm'n*, No. 16-1354 (D.C. Cir. filed Oct. 7, 2016).

[88] SEN. REP. NO. 108-318, at 9 (2004).

[89] *See, e.g.*, UNITED STATES POSTAL SERVICE, PUBLIC COST SEGMENTS AND COMPONENTS (FISCAL YEAR 2016) (2016) (spreadsheet showing that "Headquarters," cost segment 18.1.1, has over $786 million in institutional costs compared with less than $15 million in attributable costs); *see also* Report of Dr. Kevin Neels Concerning UPS Proposals One, Two, and Three, Dkt. No. RM2016-2 (Oct. 8, 2015), at 49 (showing that this same cost segment appears to have over $140 million in variable costs in FY 2014).

[90] Devin Leonard, *It's Amazon's World. The USPS Just Delivers in It*, BLOOMBERG BUSINESSWEEK (Jul. 30, 2015), www.bloomberg.com/news/articles/2015-07-30/it-s-amazon-s-world-the-usps-just-delivers-in-it (last visited Jan. 22, 2017).

efforts on package growth, because that's the biggest opportunity for us,'. . . . The Postal Service is aiming to more than double its package-delivery business within a few years."[91] Meanwhile, "[m]ailers grumble that postal executives talk and think about nothing but packages these days[.]"[92]

Given the very low 5.5% contribution requirement, the Postal Service's competitive products business has only a nominal obligation to fund the cost of this human capital. This ability to shift most of the cost of management to the market-dominant side of the ledger provides a clear competitive advantage to the Postal Service. The Postal Service alone is free to have its management focus on package growth, without the business benefiting from attention having to pay for it.

As reflected in the following table, even as market-dominant volumes and revenues have drastically *decreased*, and even as the Postal Service engages in cost-cutting programs, institutional costs overall have *increased*, especially in the past couple of years.

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[91] Laura Stevens, *For FedEx and UPS, a Cheaper Route: the Post Office*, WALL ST. J. (Aug. 4, 2014), www.wsj.com/articles/u-s-mail-does-the-trick-for-fedex-ups-1407182247 (last visited Jan. 22, 2017).

[92] Alliance of Nonprofit Mailers, *USPS: Protecting Flanks and Gaining New Ground*, ALLIANCE REPORT (Sept. 15, 2015), www.nonprofitmailers.org/usps-protecting-flanks-and-gaining-new-ground/ (last visited Jan. 22, 2017).

Table 1

Fiscal Year		2008	2009	2010	2011	2012	2013	2014	2015	2016
		USD (millions)								
Attributable Cost										
Market Dominant Products	[a]	39,035	36,830	35,319	34,572	32,145	29,288	28,205	28,283	28,261
Competitive Products	[b]	6,602	6,175	6,257	6,680	8,383	9,881	10,970	11,913	12,496
Total Attributable Cost	[c]	45,638	43,005	41,576	41,252	40,528	39,169	39,175	40,196	40,758
Other (Institutional) Costs	[d]	29,211	28,398	27,968	28,711	28,461	28,630	28,124	28,350	29,459
Total Costs	[e]	74,848	71,403	69,544	69,962	68,989	67,800	67,299	68,546	70,216

Sources and Notes:
(a], [b]: FY08-FY16 CRA Reports
[c] = [a] + [b]. Minor differences may occur due to rounding.
[d]: "All Other" costs from the Public CRA reports, after subtracting (1) component 203, Annuitant Health Benefits - Pre-Funded (Prior), and (2) component 205, Workers' Comp Prior Year from Cost Segments and Components Report. Those values were obtained from the Public B Cost files in library reference 31 for each fiscal year's ACR. The subtracted components are large cost pools with significant year-to-year variation that is not generally driven by operations.
[e] = [c] + [d]. Minor differences may occur due to rounding.

As Table 1 shows, the FY 2008 to FY 2014 period was characterized by steady decreases in the attributable costs of market-dominant mail, which declined by 28% over that six-year period. Institutional costs were also generally decreasing and were $1.1 billion lower in FY 2014 than in FY 2008.[93] Of course, this was also a period of steady decline in mail volumes which was only partially offset by growth in competitive products.[94] The six-year decline in institutional costs also occurred despite modest growth of approximately 0.5% per year in the number of delivery points.[95]

Since FY 2014, the story has reversed. Institutional costs have risen by $1.3 billion in just two years. The growth in competitive products has continued unabated,

[93] As described in Table 1, the displayed totals for institutional costs exclude costs related to the Pre-Funded portion of Annuitant Health Benefits and Workers' Comp claims from prior years, which are sources of variation in institutional costs that are not driven by operational factors.

[94] See, *e.g.*, United States Postal Service, *A Decade of Facts and Figures*, ABOUT USPS, https://about.usps.com/who-we-are/postal-facts/decade-of-facts-and-figures.htm (last visited Jan. 22, 2017) (documenting the general decline in total mail volume, including first class mail volume, standard mail volume, and various subsets thereof).

[95] *Id*.

while first class mail volumes have continued to decline and standard mail volumes have remained stagnant. These facts strongly indicate that the growth of competitive product volumes are driving overall growth of the Postal Service's institutional costs.

Notably, these trends were not apparent the last time the Commission reviewed the appropriate share requirement in 2012. The Commission issued Order No. 1449 before FY 2012 was even completed. Institutional costs had declined by half a billion dollars between FY 2008 and FY 2011, and the competitive products business was not immune from the effects of the global financial crisis. The situation is very different today.

The increasing role that competitive products are playing in driving overall institutional costs is confirmed by statements by the Postal Service about its investments. Postal Service executives have acknowledged in multiple public statements that many significant investments and other costly initiatives have been driven by competitive products. As noted above, for example, the Postal Service recently acknowledged that an over $1.6 billion increase in its labor and transportation costs in 2016 was "*largely due to the increase in Shipping and Packages volumes*, which are more labor-intensive to process and require greater transportation capacity than mail."[96] From 2013 to 2016 the Postal Service on net hired over 20,000 new employees. Half of this increase consisted of new hires in the category of "City Carrier Assistant," further suggesting that, despite the continuing decline in overall mail

[96] United States Postal Service, *U.S. Postal Service Reports Fiscal Year 2016 Results*, NATIONAL NEWS (Nov. 15, 2016), https://es-about.usps.com/news/national-releases/2016/pr16_092.htm (last visited Jan. 22, 2017) (emphasis added).

volumes, growth in package volume is placing new demands on the Postal Service's delivery network.[97]

The Postal Service has spent billions of dollars in recent years on efforts to bolster its ability to deliver parcels and to catch up with the innovations introduced by the private sector. It has been rolling out new package scanning systems in its delivery scanning systems, passive adaptive scanning systems, and mobile delivery devices. 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 in the "shipping business."[98]

The Postal Service also plans to replace its entire fleet of vehicles with "UPS sized and style vehicles"[99] designed primarily with competitive products in mind, at a potential cost of over $6 billion.[100] Capital commitments for vehicles rose from $13

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[97] Information taken from United States Postal Service 10-K statements. *See, generally* UNITED STATES POSTAL SERVICE, FORM 10-K (2004-16).

[98] Adam Mazmanian, *Mail Carriers Get New Mobile Device*, FED. COMPUT. WEEK (Mar. 18, 2014), http://fcw.com/articles/2014/03/18/usps-mobile-device.aspx?m=1 (last visited Jan. 22, 2017) ("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.").

[99] Mike Colgan, *Familiar White Postal Service Trucks Too Small For Increasing Amount Of Parcels Being Mailed*, CBS SF BAY AREA (Jan. 19, 2015), http://sanfrancisco.cbslocal.com/2015/01/19/familiar-white-postal-service-trucks-too-small-for-increasing-amount-of-parcels-being-mailed/ (last visited Jan. 22, 2017); Anne Steele, *Postal Service Seeks to Retire the Old Mail Truck*, WALL ST. J. (Feb. 12, 2015), www.wsj.com/articles/postal-service-seeks-to-retire-the-old-mail-truck-1423786375 (last visited Jan. 22, 2017) ("'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.").

[100] Anne Steele, *Postal Service Seeks to Retire the Old Mail Truck*, WALL ST. J. (Feb. 12, 2015), www.wsj.com/articles/postal-service-seeks-to-retire-the-old-mail-truck-1423786375 (last visited Jan. 22, 2017) ("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.").

million in 2013 to $561 million in 2015.[101] These costs have begun to appear in the Postal Service's financial statements, with a large proportion treated as "institutional."

Private-sector competitors must fund *all* investments in their network, labor, and transportation with revenues from competitive products. The Postal Service's competitive products business should be held to the same standard.

VI. **<u>THE MINIMUM CONTRIBUTION RATE SHOULD BE RAISED TO APPROXIMATELY 29%</u>**

As noted, Congress intended that the Commission would ensure that the Postal Service covers the costs of its competitive products business in a manner analogous to the private sector, where companies must set prices to cover *all* of their costs, both variable and fixed. As the Commission has recognized: "Competitors must produce revenues that cover both variable and fixed costs. In effect, the appropriate share assigns a portion of the Postal Service's fixed costs to competitive products directly, so that the Postal Service, like its competitors, must set prices to produce sufficient revenues to cover both variable and fixed costs in their entirety."[102]

In setting the appropriate share, the Commission must therefore theoretically consider the "stand-alone" institutional costs of the competitive enterprise.[103] In a simple example, UPS is responsible for the *full* cost of its management salaries (and not

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[101] Information taken from United States Postal Service 10-K statements. *See, generally* UNITED STATES POSTAL SERVICE, FORM 10-K (2013-16).

[102] Order No. 1449 at 15. Although the Commission spoke in terms of "fixed" costs alone, it is now clear following Order No. 3506 that the Postal Service's institutional costs also include a significant amount of *variable* costs as well, including those that are driven by competitive products. *See* Order No. 3506 at 85 ("The Postal Service also confirms that institutional costs are a mix of fixed and variable costs.").

[103] Order No. 1449 at 13.

just a share of them). Arguably, the Postal Service's competitive products business should have the same responsibility.

Short of the "stand-alone" accounting approach, however, the best proxy for estimating "the degree to which any costs are uniquely or disproportionately associated with any competitive products" pursuant to the PAEA,[104] is to use the share of total attributable costs for which competitive products are responsible. This approach utilizes the most robust processes that exist today for estimating the cost impact of competitive products on the Postal Service's business.

A. The Commission Should Set the Appropriate Share Percentage as a Three-year Average of Attributable Cost Shares

1. Attributable Costs

Attributable cost shares are the best available proxy for the "appropriate share" of institutional costs that should be borne by competitive products, because they provide the best available estimates of the relative contribution of competitive and market-dominant products to the various categories of institutional costs. The overhead costs that make up the predominant share of institutional costs — administration, supervision, human resources, facilities and the like — tend to be driven by the overall size of the Postal Service's business and operations. Attributable costs provide a precise and direct measure of the extent to which these two sets of products contribute to the overall scale of postal operations.[105]

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[104] 39 U.S.C. § 3633(b).

[105] In 2007, the Postal Service itself advocated that the minimum institutional contribution rate be "calculated as a mark-up on the sum of the competitive products' attributable cost." *See* Initial Comments of the United States Postal Service on the Second Advance Notice of Proposed Rulemaking, Dkt. No. RM2007-1 (Jun. 18, 2007), at 23-24.

It is reasonable to assume that institutional costs are incurred roughly in proportion to the importance of each product to the enterprise, as measured by the costs associated with each product. If 95% of attributable costs were allocated to a single product, for example, it is likely the enterprise would also invest its institutional resources in optimizing the development of that single product as well, and the vast majority of institutional costs also should be covered by that single product. Accordingly, competitive products' share of institutional costs for these categories should correlate with their share of attributable costs.

Competitive products' share of attributable costs were 28.0% in 2014, 29.6% in 2015, and 30.7% in 2016.[106] The average of the previous three years of attributable cost shares is 29.4% — a number that accords with current competitive conditions and serves as a reasonable proxy for an "appropriate share" of institutional costs for which competitive products should be responsible. Using a three-year average allows this measure to reflect current market conditions, which fits the requirement of § 3633 that the appropriate share requirement reflect "prevailing competitive conditions in the market[.]"[107]

While the Postal Service may argue that this change in the contribution percentage would cripple its competitive products business, recent history indicates that Postal Service price increases have not resulted in volume decreases. Between FY 2015 and FY 2016 the Postal Service made substantial price increases for a number of

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[106] *See* UNITED STATES POSTAL SERVICE, PUBLIC COST AND REVENUE ANALYSIS (FISCAL YEARS 2014-16) 3 (2014-16) (Competitive products' share of attributable costs is derived by dividing "Total Competitive Mail and Services" by "Total All Mail and Services.").

[107] 39 U.S.C. § 3633(b).

its products, with no apparent impact on volume.[108] Moreover, to the extent the e-commerce market continues to expand overall, as expected, the Postal Service will continue to experience overall growth in competitive product volumes. Such growth, when occurring on a level playing field, would align with Congress's intent.

Moreover, increasing the "appropriate share" to reflect attributable cost shares will encourage the Postal Service to be more disciplined and rational when making future investment decisions. Increasing the contribution percentage does not in any way increase the *total costs* the Postal Service must recover. These costs already exist today; but they are disproportionately placed on the market-dominant side of the ledger. In the last decade, much of the Postal Service's growth in package delivery was made possible by exploiting excess capacity. But the Postal Service is at or near an inflection point where future growth will require major investments. These investments are going to be geared toward competitive products, and they should be paid for by competitive products.[109]

Finally, if it is deemed necessary, the Commission could phase-in the increase of the appropriate share percentage. If the Commission chooses this approach, the Commission could adopt a rule that would set a new requirement for the next fiscal year

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[108] *See, e.g.,* Reply Comments of United Parcel Service, Inc. Regarding UPS Proposals One and Two, Dkt. No. RM2016-2 (March 25, 2016), at 38 (quoting Public Representative's statement that "[t]he most reasonable explanation for why the Postal Service can increase prices by the proposed amounts is that *the current prices are set too low*, despite meeting the applicable regulatory standards.") (emphasis added).

[109] In the absence of a robust appropriate share requirement, the Postal Service has an incentive to structure its investments (and costs) to be more institutional than attributable. For instance, the Postal Service might prioritize investments that would be easier to classify as fixed or "common" costs, as opposed to investments that are more likely to be traceable to specific products. If left unchecked, this incentive will lead to an inefficient cost structure that is weighted towards fixed costs and excess capacity. A significant appropriate share requirement also serves as a check on potential cross-subsidization of competitive products by market-dominant products. *See* 39 U.S.C. § 3633(a)(1).

that is a weighted average of (i) the newly calculated three year moving average of attributable cost shares and (ii) the current appropriate share level. For example, with the current 5.5% requirement and a three-year moving average attributable cost share for 2014-2016 at 29.4%, the Commission could set the 2018 requirement at 17.5% (*i.e.*, 5.5 + 29.4)/2.[110]

2. European Commission Practice

Raising the minimum contribution rate to correlate with attributable cost is strongly supported by the European Commission's regulation of postal operators in the European Union. Both Congress and the European Commission enacted similar goals and methods of ensuring fair competition despite the presence of a dominant postal operator: (1) both require extensive monitoring and regulation of the dominant operator to prevent private competition from being impaired or distorted;[111] (2) both require cost-based pricing;[112] and (3) both mandate separate accounting treatment for "reserved" or

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[110] For purposes of illustration, assume then that the FY 2017 share of attributable cost for competitive products comes in at 33%. The 2015-2017 average of attributable cost shares would then be equal to 31.1%. The 2019 appropriate share requirement would then be (17.5 + 31.1)/2 = 24.3%.

[111] *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* COMMISSION OF THE EUROPEAN COMMUNITIES, 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 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.").

[112] *Compare* S. REP. NO. 108-318 at 9-10 (2004) ("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[.]").

market-dominant products and competitive products to ensure that competition is not distorted.[113]

The European Commission follows a cost-allocation procedure 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, which resembles PAEA's mandate regarding attributable costs. Second, the European Commission mandates that the remaining unattributed costs (which it calls "common costs"), which resemble institutional 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.[114]

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.

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 the large amount of unattributed costs "gives significant leeway for anti-competitive conduct," a result contrary to the

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[113] *Compare* S. Rep. No. 108-318 (2004) at 50 ("The intent of [the Competitive Products Fund] 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.").

[114] European Postal Directive at 23.

purposes of postal law in both places.[115] In light of these similarities, it is significant that the EU resolves this issue by using attributable cost share as a proxy to allocate institutional costs.

3. Revenue as an Alternative Benchmark

If the Commission declines to use attributable cost as the relevant metric, the appropriate share requirement should be set to equal the revenues from competitive products as a percentage of total revenues. Like attributable cost shares, this measure reflects the growing importance of competitive products to Postal Service income. On a product-by-product basis, revenues generally equal or exceed attributable costs, and so revenue shares are correlated to some degree with competitive products' increasing role as a driver of growth in institutional costs. Because revenues reflect markups over attributable cost, they reflect to some degree differences across products in willingness to pay.

Competitive product revenues as a percentage of total revenues have grown steadily over the years. This share was 22.6% in 2014, 24.0% in 2015, and 25.9% in 2016.[116] The average of these numbers is 24.2%.

B. The Commission Should Set a Formula That Reflects the Changes Taking Place in the Postal Service's Competitive Products Business

Finally, UPS urges the Commission to establish a rule for setting the "appropriate share" requirement so it adjusts on an annual basis. For example, if the Commission

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[115] 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).

[116] UNITED STATES POSTAL SERVICE, REVENUE, PIECES, AND WEIGHT BY CLASSES OF MAIL AND SPECIAL SERVICES FOR FISCAL YEAR 4-5 (2014-16) ("Total Competitive Revenue" divided by "Total All Revenue").

decides to use attributable costs as a proxy, the FY 2017 appropriate share would be based on an average of attributable cost shares from FYs 2014, 2015 and 2016, while the 2018 appropriate share would be based on attributable cost shares from FYs 2015, 2016, and 2017.

When an appropriate share is set at a fixed level in a dynamic environment, such as during a time of substantial growth in the competitive products business and decline in the market-dominant business, it risks becoming outdated shortly after it is set. A mechanism where the appropriate share has the ability to adjust to changing postal realities would comply with Congress's intent that the figure reflect "the prevailing competitive conditions in the market"[117] and would also consistently "reflect the ways in which institutional resources are spent on the competitive enterprise."[118]

CONCLUSION

The Commission should modify the "appropriate share" of Postal Service institutional costs that must be covered by its competitive products. The low contribution requirement set by the Commission in 2007 is obsolete and indefensible today, particularly in light of the 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 minimum contribution rate,[119] by using an average of the previous three years of attributable cost for competitive products as a fraction of total attributable costs. This approach yields a new "appropriate share" level of roughly 29.4%.

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[117] 39 U.S.C. § 3633(b).

[118] Order No. 1449 at 13.

[119] *See* 39 C.F.R. § 3015.7(c).

Respectfully submitted,

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