

BEFORE THE
POSTAL REGULATORY COMMISSION

Annual Compliance Report, 2016

:
: Docket No. ACR2016
:

REPLY COMMENTS OF UNITED PARCEL SERVICE, INC.
ON POSTAL SERVICE'S ANNUAL COMPLIANCE REPORT
FOR FISCAL YEAR 2016
(February 13, 2017)

The ACR is an opportunity to evaluate whether the Postal Service's cost attribution practices are working as they should. As United Parcel Service, Inc. ("UPS") has shown in this docket, current practices are falling far short in several areas. The percentage of costs attributed to competitive products is often facially unreasonable in light of the growth of that business in recent years. Far too many costs driven by competitive products are either being shifted to the market dominant side of the ledger or mistakenly treated as "institutional" costs of the enterprise as a whole. Changes must be made. Specifically:

- **City Carrier Street Time.** The Postal Service's ACR filings confirm that, out of a total of \$12.385 billion in city delivery costs, the Postal Service attributes just \$565 million, or *less than 4.6%*, to competitive products.¹ That result is facially unreasonable, especially as the Postal Service states that it delivers more packages to American homes than any private company.² UPS put forward a model in the City Carrier Street Time docket that can use actual operational data collected by the Postal Service in the ordinary course of business to dramatically improve cost attribution, but the Postal Service has failed to collect the data needed for the model to work. This situation should not be allowed to continue given the large costs at

¹ See Public Cost Segments and Components Report, Library Reference USPS-FY16-2, Dkt. No. ACR2016 (Dec. 29, 2016).

² See, e.g., United States Postal Service (@USPS), TWITTER (Nov. 17, 2016, 6:00 AM), <https://twitter.com/USPS/status/799250904151113728> (last visited Feb. 13, 2017).

stake. The Commission should convene a technical conference to consider the availability of Postal Service data for use in the proposed UPS model.³

- **Vehicle Costs.** The Postal Service confirms that just 5.2% of Vehicle Depreciation costs are attributed to competitive products, even as it plans to buy Next Generation Delivery Vehicles designed *specifically to deliver parcels*.⁴ This facially unreasonable practice largely occurs because Vehicle Depreciation cost attribution is allowed to mimic the same cost attribution models used in city carrier delivery. The costing distortions caused by this practice will only grow in the years to come, as the Postal Service spends millions of dollars on these vehicles. Reexamination of how vehicle costs are attributed is necessary now.
- **Compensation and Expenses.** The Postal Service's answers in this docket have shown that, out of the \$1.2 billion increase in labor and transportation costs that the Postal Service itself acknowledges were "*largely due* to the increase in Shipping and Packages volumes," just 29% were attributed to competitive products.⁵ Since these costs were "*largely*" incurred to handle larger volumes of competitive products, simple logic indicates they should be attributed to competitive products at a level far above 29%. The Commission should conduct proceedings to investigate how to properly attribute labor and transportation costs.
- **Seasonal Increases in Cost.** This docket has also established that the Postal Service is failing to account for its increased costs during peak season. These costs include (1) the growing volume of "Christmas Route" highway transportation costs, (2) the spike in Special Purpose Routes during peak season, and (3) the hiring of *thousands* of additional temporary employees during peak season. Those costs are incremental costs that should be attributed in whole or in large part to competitive products. But that is, inexplicably, not happening today. The Commission needs to conduct proceedings to address these peak season costs. Further, UPS has urged the Commission to require *quarterly* USPS cost segment and component reporting.
- **Special Purpose Routes.** The Postal Service has acknowledged that Parcel Post Routes are responsible for a growing share of Special Purpose Route costs, and these costs also increase during peak season. As the Postal Service incurs these additional costs to handle a growing volume of competitive products, those costs should be attributed (as incremental costs) to parcels. But that is not happening today. The Commission should conduct appropriate proceedings to address this error.

³ See Initial Comments of United Parcel Service, Inc. on United States Postal Service's Annual Compliance Report for Fiscal Year 2016, Dkt. No. ACR2016 (February 2, 2017) at 9 ("UPS's Initial ACR2016 Comments").

⁴ See Responses of the United States Postal Service to Questions 1-12 of Chairman's Information Request No. 11, Dkt. No. ACR2016 (Feb. 3, 2017) at Q.5 ("Responses to CHIR No. 11").

⁵ See *id.* at Q.4 (emphasis added).

- **Attributing Incremental Cost to Individual Products.** The Postal Service has also admitted in this docket that it has not complied with the Commission's directive, in Order No. 3506, that "attributable costs" for individual products must include product incremental costs.⁶ The Commission should convene a technical conference to explore and resolve issues identified by the Postal Service, so the Commission's directive will be implemented without further delay.
- **Increased Cost Transparency.** Similarly, in Order No. 3506, the Commission ordered the Postal Service to provide "more specific and detailed information with its annual Summary Description of USPS Development of Costs by Segment and Components report."⁷ To the extent there are any issues or difficulties related to producing this new data, the Commission should conduct appropriate proceedings to see that the required reports are published on schedule in July of this year. UPS further requests that these reports break down cost data into separate columns for competitive products and market dominant products.

UPS requested two sets of Chairman's Information Requests in this docket, seeking clarity regarding a number of questions raised by the Postal Service's costing methodology. See United Parcel Service, Inc.'s Motion for Issuance of Information Request to the United States Postal Service, Dkt. No. ACR2016 (Jan. 19, 2017); Second Motion of United Parcel Service, Inc. for Issuance of Information Request to the United States Postal Service, Dkt. No. ACR2016 (Jan. 26, 2017).⁸ The Postal Service's responses to these Information Requests raise a number of important questions about how the Postal Service is attributing its costs to products.

⁶ Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), Order No. 3506, Dkt. No. RM2016-2 (September 9, 2016) at 105 ("Order No. 3506").

⁷ *Id.* at 106.

⁸ The Commission issued UPS's first information request in full, and the second in part. See Chairman's Information Request No. 11 and Notice of Filing Under Seal, Dkt. No. ACR2016 (Jan. 27, 2017) ("CHIR No. 11") at Q.3-10; Chairman's Information Request No. 13 and Notice of Filing Under Seal, Dkt. No. ACR2016 (Feb. 3, 2017) ("CHIR No. 13") at Q.4-11. The Postal Service responded to these requests between the deadline for initial comments and the deadline for these reply comments in this docket. See Responses to CHIR No. 11; Responses of the United States Postal Service to Questions 1-15 of Chairman's Information Request No. 13, Dkt. No. ACR2016 (Feb. 10, 2017) ("Responses to CHIR No. 13").

I. INFORMATION REQUEST NO. 11

In response to CHIR No. 11, the Postal Service acknowledged that, of the \$1.2 billion increase in compensation and benefits expenses in FY 2016 compared to FY 2015, only \$350 million was traceable to competitive products.⁹ The Postal Service press release that spurred this question, however, stated that “[t]he growth in labor and transportation costs *is largely due* to the increase in Shipping and Packages volumes, which are more labor intensive to process and require greater transportation capacity than mail.”¹⁰ The Commission should investigate how the very activities that “largely” drove this \$1.2 billion increase only account for \$350 million of the costs.

The Postal Service also stated that it does not have “data to directly relate total staff headcount to individual products.”¹¹ But that is not an acceptable explanation. The large number of new hires is because the competitive products business is growing. Accordingly, those costs should be properly attributed to competitive products. If the Postal Service lacks a method to do so today, the Commission should initiate appropriate proceedings to resolve this issue.

The Postal Service also confirmed that it only attributes 5.2% of vehicle depreciation costs to competitive products.¹² If the Postal Service’s current approach to

⁹ Responses to CHIR No. 11 at Q.4(b).

¹⁰ “U.S. Postal Service Reports Fiscal Year 2016 Results,” UNITED STATES POSTAL SERVICE (Nov. 15, 2016) *available at* http://about.usps.com/news/national-releases/2016/pr16_092.htm (emphasis added).

¹¹ Responses to CHIR No. 11 at Q.4(c).

¹² *See id.* at Q.5(c). The Postal Service has not shed much light on the \$1.4 billion invested in “much-needed building improvements, vehicles, equipment and other capital projects.” *See id.* at Q.5. In its response, the Postal Service clarified that none of these \$1.4 billion in costs related to the new next-gen vehicles. *See id.* at Q.5(a). The Postal Service did not, however, explain what this \$1.4 billion investment covered nor the extent to which and the manner in which these costs will be attributed to products.

vehicle costs is not corrected, the Postal Service will be spending millions of dollars on a new fleet of vehicles in the coming years designed specifically to deliver parcels, while attributing only a tiny fraction of those costs to competitive products.¹³

That unacceptably low level of cost attribution occurs because the City Delivery Vehicle Depreciation cost model is illogically tied to the city carrier street time cost model.¹⁴ As UPS has previously explained, vehicle depreciation costs and city carrier costs are driven by different causes and factors, so the labor-based cost distribution for city carriers should not apply to vehicle depreciation costs, as usage of vehicle space is more plausibly tied to cubic footage of mail.¹⁵ The Commission should initiate appropriate proceedings to properly attribute vehicle depreciation costs to products, before these cost distortions escalate.

Until vehicle cost models are updated, it is critical that city carrier street time models are themselves updated, otherwise any errors in city carrier street time models will distort other cost component models. UPS offered an alternative model for city carrier street time, which would more accurately model the Postal Service's costs by directly using robust Postal Service operational data, an approach the Commission

¹³ See "*Postal Service's next-gen van carriers a \$6 billion prize*," AUTOMOTIVE NEWS (Feb. 14, 2015) available at [http://www.autonews.com/article/20150214/OEM/302169967/postal-services-next-gen-van-carries-a-\\$6-billion-prize](http://www.autonews.com/article/20150214/OEM/302169967/postal-services-next-gen-van-carries-a-$6-billion-prize) ("It could be one of the largest fleet purchases ever. According to specifications released to potential bidders Jan. 20, the Postal Service would buy 180,000 vehicles at \$25,000 to \$35,000 apiece, valuing the contract at \$4.5 billion to \$6.3 billion.").

¹⁴ See "CS20-15.docx," Summary Description of USPS Development of Costs by Segments and Components, Fiscal Year 2015 (2016) at 3 ("Depreciation costs for vehicles assigned to city carrier routes are classified as variable to the same degree as city carrier personnel on their respective street functions.").

¹⁵ See Comments of United Parcel Service on Rulemaking on Analytical Principles Used in Periodic Reporting (Proposal Twelve), Dkt. No. RM2016-3 (December 4, 2015) at 2-5.

thought promising.¹⁶ To date, the Postal Service has not implemented the new model because it claims it does not collect the right data to do so. But that explanation should not be accepted. UPS reiterates its request for the Commission to convene a technical conference to explore the availability of Postal Service data for use in the proposed UPS model.

II. INFORMATION REQUEST NO. 13

The Postal Service's second set of responses highlighted current infirmities in how the Postal Service handles peak season costs and seasonality issues in its cost models. The Postal Service confirmed that mail volume was 13% higher and mail weight was 22% higher in Q1 FY2016 than in Q4 FY2015.¹⁷ The Postal Service also confirmed that these increases were primarily due to seasonality. *Id.* And the Postal Service confirmed that 60% of the quarter-to-quarter weight variation was driven by competitive products.¹⁸

But the Postal Service also stated that, under current practices, "the costing principles used to attribute costs do not differ by quarter."¹⁹ On the one hand, then, the Postal Service acknowledges there is substantial variation in its operational demands. On the other hand, the Postal Service does not modify its models throughout the year.

The quarterly data presented by the Postal Service also shows a strong quarterly variation for "Parcel Post" special purpose routes but little to no variation for other types

¹⁶ See UPS's Initial ACR2016 Comments at 17.

¹⁷ See Responses to CHIR No. 13 at Q.4.

¹⁸ See *id.* at Q.4(d).

¹⁹ *Id.*

of special purpose routes.²⁰ Despite this key difference, the Postal Service confirmed that its cost modeling for special purpose routes “aggregates the SPR street costs across route types prior to the attribution and distribution treatment of these costs.”²¹ This costing methodology has also remained largely unchanged even as the importance of “Parcel Post” routes has grown in the past few years.²²

Finally, the Postal Service has confirmed it employed “40,436 City Carrier Assistants.”²³ The Postal Service explained that “the direct and indirect costs incurred by City Carrier Assistants are treated in the same fashion as all City Carriers.”²⁴ It is likely, however, that these temporary workers are used to handle overflow or excess volume that cannot be handled by the Postal Service’s permanent employees. If so, the costs associated with these City Carrier Assistants should be examined closely, as any excess volume at the Postal Service is likely due to parcel growth.

The Postal Service’s second set of responses highlighted problems with the treatment of special purpose routes generally. The Postal Service explained that SPR Parcel Post routes are managed locally to address local issues.²⁵ Accordingly, it appears that SPR Parcel Post routes are overflow routes — accommodating delivery needs that the regular letter carrier cannot handle. The costs of these routes have grown steadily in recent years as parcel volumes have increased.²⁶ Furthermore, unlike

²⁰ *Id.* at Q.6(c).

²¹ *Id.* at Q.6(d).

²² *See id.* at Q.7.

²³ *See id.* at Q.8.

²⁴ *Id.*

²⁵ *See id.* at Q.6-7.

²⁶ Responses to CHIR No. 13 at Q.7(c)-(f); CRA “B” Workpapers (Public Version), Library Reference USPS-FY16-32, Dkt. No. ACR2016 (Dec. 29, 2016).

other kinds of SPRs, their costs surge markedly in the first Postal quarter, along with the spike in competitive product volume.²⁷

All of these facts demonstrate that the costs of these routes vary with volume. Nonetheless, large portions of the costs of these routes are treated as *fixed*. In particular more than 40% of SPR costs for all route types are being treated as “Network Travel,”²⁸ a fixed cost component, which is not consistent with the Postal Service’s description that Parcel Post special purpose routes “do not typically service the same set of delivery points nor have the same line of travel on a daily basis.”²⁹ Further, the parameters and assumptions upon which the cost attribution of these routes is based appear to derive primarily from a special study conducted in 1995 and adopted for costing purposes in R97, in a time when parcels were a far smaller fraction of the Postal Service’s business than they are currently, and when the operating environment was vastly different, despite the Postal Service’s contention that the findings in R97 “generally reflect the operating environment in FY 2016.”³⁰

The Postal Service responses regarding seasonality and special purpose routes discussed above provide additional support for UPS’s request for appropriate

²⁷ Responses to CHIR No. 13 at Q.4(c)-(e), Q.6(c).

²⁸ See UPS’s Initial ACR2016 Comments at 6.

²⁹ The Postal Service also explained that “combination/other” routes, which represent the largest share of costs among the three SPR route types “do not service the same set of delivery points daily and they often include ad hoc trips to other postal facilities or firms for pickups.” Responses to CHIR No. 13 at Q.6(a).

³⁰ See FY2016 Roadmap Document, Library Reference USPS-FY16-9, Dkt. No. ACR2016 (Dec. 29, 2016) at 132.

proceedings to “analyze the costing of Special Purpose Routes, Christmas Routes, and other peak season costs.”³¹

CONCLUSION

UPS reiterates the need for follow-up action by the Commission with respect to the issues raised herein and in UPS’s Initial ACR2016 Comments.³² To the extent the Commission will rely on UPS to initiate appropriate proceedings on these topics, UPS welcomes the Commission’s guidance as to how it would prefer to resolve these issues beyond the technical conferences, investigations, and other appropriate proceedings UPS has recommended.

Respectfully submitted,

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³¹ See UPS’s Initial ACR2016 Comments at 9.

³² UPS notes that the issues raised by Valpak’s Initial Comments, in conjunction with UPS’ initial comments, paint a concerning picture of the Postal Service’s ability and motivation to follow through with past commitments. See Valpak Direct Marketing Systems, Inc. and the Valpak Franchise Association, Inc. Initial Comments on the United States Postal Service FY 2015 Annual Compliance Report, Dkt. No. ACR2016 (Feb. 2, 2017). In its comments, Valpak details a half-decade of noncompliance of the Standard Mail Flats product. See *id.* at 5-8. The Commission first determined that Standard Mail Flats were not in compliance in FY 2010, and issued a remedial order. *Id.* The product has not been brought into compliance in the intervening years. UPS’ initial comments, likewise, highlighted several examples of the Postal Service taking unreasonable amounts of time to comply with Commission Orders. See UPS’s Initial ACR2016 Comments at 14-18. These outstanding issues raise concerns about the Postal Service’s efforts to comply with relevant regulatory and statutory mandates.