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

INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS	))	Docket No. RM2017-1

REPLY COMMENTS OF
AMAZON FULFILLMENT SERVICES, INC.

(March 9, 2017)

Amazon Fulfillment Services, Inc. ("AFSI") respectfully submits these reply comments pursuant to Order No. 3624. These comments are supported by the reply declaration of Dr. John C. Panzar, Louis W. Menk Professor of Economics, Emeritus, at Northwestern University and Professor of Economics at the Business School of the University of Auckland.

I. INTRODUCTION AND SUMMARY

The initial comments filed by other parties in this docket provide no legitimate case for keeping—let alone increasing—the minimum contribution requirement. The overwhelming majority of mailers and shippers[1] support its elimination. These parties, in addition to AFSI, include the Alliance of Nonprofit Mailers, American Catalog Mailers Association, Continuity Shippers Association, Data & Marketing Association (formerly Direct Marketing Association), Envelope Manufacturers Association, National Association

[1] In these comments, "mailers" refers to users of market-dominant postal products; "shippers" refers to users of competitive postal products offered by the Postal Service and substitutes for those products offered by private carriers.

of Presort Mailers, National Newspaper Association, Parcel Shippers Association, PSI Systems, and Stamps.com. Other ratepayers propose eliminating or at least freezing the minimum contribution requirement (Stamps.com) or setting it at a level too low to be binding (Association for Postal Commerce and Greeting Card Association). The Public Representative also opposes any increase in the required minimum contribution.

As in Docket No. RM2016-2, the only party to offer extensive argument in support of a large increase in the regulatory price floor is United Parcel Service, Inc. ("UPS"). The comments of UPS and its advocates in this docket (J. Gregory Sidak and the Former Utility Regulators[2]) confirm that the inflated price floor sought by UPS would provide no benefits to mailers, shippers or consumers, and that UPS is simply rent seeking at their expense.[3] First, UPS's arguments for a higher price floor ignore the most important competitive condition today: the rapid rise in the prices, coverage ratios, and contribution of competitive products since the Commission last reviewed the minimum contribution requirement five years ago.

Second, UPS has made no showing that a minimum contribution requirement is necessary to prevent the Postal Service from pricing competitive products below cost or

[2] The comments of the Former Utility Regulators appear to have been underwritten by UPS. The signers of the comments include four partners in the law firm of Wilkinson Barker Knauer LLP: Bryan Tramont, Raymond Gifford, Gregory Sopkin, and Tony Clark. *See id.* at 2 n. 5; http://www.wbklaw.com/Our_Team. Mr. Tramont and the Wilkinson firm also appear as counsel of record for Mr. Sidak in his February 10 brief to the D.C. Circuit as *amicus curiae* in defense of UPS's current petition for review of the Commission's final decisions in RM2016-2 and RM2016-13. *UPS v. PRC*, No. 16-1354. Mr. Sidak's comments in this case are sponsored by UPS, and he has served repeatedly as a witness for UPS during the past quarter century. UPS is entitled to retain lawyers and consultants to advocate for its interests at the Commission. But the Commission should be aware of these individuals' relationship to UPS.

[3] "Rent seeking" is the "socially costly pursuit of wealth transfers," often by manipulating the regulatory process to exclude rival suppliers or drive up their prices or costs. AFSI at 13 n. 6 (citing economic literature); Panzar Decl. at 3 n. 2.

sacrificing potential contribution from competitive products to gain added volume or "scale." Nor is such a requirement necessary to "level the playing field" between the Postal Service and private carriers.

Third, the alternative price floor proposed by UPS is fully allocated cost, the most discredited standard in postal rate regulation.[4] Congress, the Commission, and the Supreme Court, supported by the overwhelming consensus of economists, have all repudiated the use of fully allocated costs to set postal rates since the enactment of the Postal Reorganization Act of 1970. UPS has provided no good reason to resurrect this approach. As Mr. Sidak has acknowledged in his scholarly work, fully allocated cost pricing relies on cost allocations that are "admittedly arbitrary," "generally discredited," "essentially random," without "economic content," incapable of "pretend[ing] to constitute approximations to anything," and lacking "any relation to the prices required for economic efficiency" except "by very unlikely happenstance." *See* pp. 19, 37-39 and 44, *infra*. Moreover, imposing a fully allocated cost floor under competitive product prices would cause a catastrophic loss of revenue for the Postal Service, or massive price increases by the Postal Service and competitive private carriers through the regulatory cartelization of the package delivery and express industries, or both. UPS and its advocates almost completely ignore these facts.

II. 39 U.S.C. § 3633 ALLOWS THE COMMISSION TO ELIMINATE THE MINIMUM CONTRIBUTION REQUIREMENT.

As AFSI explained in its initial comments, the Postal Accountability and Enhancement Act of 2006 ("PAEA") imposed three floors under the prices of competitive

[4] The terms "fully allocated cost" and "fully distributed cost" are synonyms, and we use them interchangeably in these comments. Panzar Reply Decl. at 2.

products: (1) a prohibition against cross-subsidy of competitive products by market-dominant products; (2) a requirement that each competitive product cover its attributable costs; and (3) a requirement that rates also cover an appropriate share of institutional costs (the "appropriate share" or "minimum contribution" requirement). The first two requirements are permanent. The minimum contribution requirement, by contrast, was temporary: the Commission was free to eliminate it after five years. AFSI at 14-15 (discussing 39 U.S.C. § 3633).

UPS does not dispute that 39 U.S.C. § 3633(b) authorizes the Commission to eliminate the minimum contribution requirement. UPS asserts, however, that the structure and legislative history of Section 3633 nonetheless imply a permanent policy preference in favor of a competitive price floor well above attributable or incremental cost. UPS at 5-6, 25, 27-28; Sidak Decl. at 8 ¶ 16 ("the appropriate share is intended to be a contribution above and beyond the attributable-cost requirement and cross-subsidy test"). This claim founders on several grounds.

(1) The text of Section 3633(b), which expressly authorizes the Commission to eliminate the minimum contribution requirement after five years, is controlling. UPS asserts that "Congress *meant* for the regulations enacted under 39 U.S.C. § 3633 to have an impact" and divines that Congress intended for Section (a)(3)'s "impact" to be at least co-extensive with that of Sections (a)(1) and (a)(2). UPS at 6 (emphasis in original), 27 ("Congress imposed the appropriate share requirement to provide meaningful limits on the Postal Service above and beyond the requirements of §§ 3633(a)(1) & (2)."). But the source of what Congress "meant" is the unambiguous text of the PAEA. The inquiry into the meaning of a statute ceases "if the statutory language is unambiguous and 'the statutory scheme is coherent and consistent.'" *Barnhart v. Sigmon Coal Co., Inc.*, 534 U.S. 438, 450 (2002) (citations omitted).

Section 3633(b) unambiguously directed the Commission to review the minimum contribution requirement every five years, and unambiguously authorized the Commission to eliminate the requirement after the first five-year period. If Congress had intended to make the minimum contribution requirement permanent rather than transitory, Congress knew how to say so. *See Wallaesa v. FAA*, 824 F.3d 1071, 1083 (D.C. Cir. 2016); *accord Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253–54 (1992) ("a legislature says in a statute what it means and means in a statute what it says there.").

(2) The notion that Section 3633 was intended to require (or encourage) a permanent minimum contribution requirement is also refuted by the evolution of the draft language that ultimately became Section 3633. Section 201 of H.R. 22, a postal reform bill introduced in the House by Cong. John McHugh and others on January 6, 1999, included a provision that would have required rates on competitive products in the aggregate to have the same cost-coverage ratio as all competitive and non-competitive products combined—*i.e.*, would have imposed a fully-allocated cost rate floor on competitive products. H.R. 22, 106th Cong., 1st Sess. (introduced Jan. 6, 1999) at 35-36 (proposing new 39 U.S.C. § 3644).

The proposed fully-allocated cost floor was later deleted, however. The bills that passed the House and Senate in 2004 and 2005 merely required a minimum contribution of unspecified magnitude. The 2004 Senate bill required only that the Commission "(1) prohibit the subsidization of competitive products by market-dominant products; (2) ensure that each competitive product covers its costs attributable; and (3) ensure that all competitive products collectively cover their share of institutional costs of the Postal Service." Report of the Sen. Comm. on Govt. Affairs on S. 2468, S. Rep. No. 108-318, 108th Cong., 2nd Sess. 107 (text of proposed 39 U.S.C. § 3633). The 2004 House bill was identical, except that its version of the third provision required the Commission to "ensure that all competitive products collectively make a reasonable contribution to the institutional costs of the Postal Service." Report of the House Comm. on Govt. Reform on H.R. 4341, H.R. Rep. No. 108-672, 108th Cong., 2nd Sess. 86 (text of proposed 39 U.S.C. § 3633(3)).

The version of PAEA ultimately enacted into law in 2006 further softened the minimum contribution provision by adding the subsection now codified at 39 U.S.C. § 3633(b), which authorizes the Commission to eliminate the minimum contribution requirement after five years. Pub. L. No. 109-435, § 202, 120 Stat. 3206-07 (Dec. 20, 2006).

The replacement of the fully allocated cost floor in favor of a looser minimum contribution requirement, followed by the further amendment authorizing the Commission to eliminate the minimum contribution requirement outright, refutes UPS's claim that Section 3633 should be construed to require a permanent minimum contribution requirement of any kind, let alone a fully allocated cost (or "proportional" allocation) cost floor under competitive prices. *See Natural Resources Defense Council, Inc. v. E.P.A.*, 824 F.2d 1146, 1153-54 (D.C. Cir. 1987) (the omission of a provision from the final version of an act constitutes Congress's rejection of that provision); *United States v. Gilliland*, 312 U.S. 86, 93-95 (1941) (the scope of the False Claims Act was not limited to those cases in which the government had been defrauded because the bill's final amendment had eliminated such limiting language).[5]

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[5] *See also Atwell v. Merit Systems Protection Bd.*, 670 F.2d 272, 284-85 (D.C. Cir. 1981) (holding that "the draftsmen of what is now section 5366(b) [of the Civil Service Reform Act] intended to eliminate individual appeals of downward reassignments and that they succeeded in their aim with the language they adopted" after noting that such preclusive language was included in House version of bill that was ultimately codified); *Wagner v. PennWest Farm Credit, ACA*, 109 F.3d 909, 912 (3d Cir. 1997) (noting that a "most persuasive indication of legislative intent is Congress's decision to delete a proposed private right of action provision from the final version of the Act").

(3) UPS's reliance on language in the House and Senate committee reports on the 2004 and 2005 bills that were predecessors of PAEA (UPS at 5-6, 25, 27-28) is likewise misplaced. Because the 2004 and 2005 committee reports predated the amendment that added Section 3633(b), which reduced the minimum contribution requirement to a transitional requirement, the committee reports shed no light on the meaning and effect of that provision. Committee reports supporting draft legislative proposals that were not enacted merit little or no weight in determining a legislation's meaning. *See Ratzlaf v. United States*, 510 U.S. 135, 147 (1994) ("We do not find that Report, commenting on a bill that did not pass, a secure indicator of congressional intent at any time"); *see also NLRB v. Drivers Local Union No. 639*, 362 U.S. 274, 288-290 (1960) (counseling "wariness" in finding a legislative policy when, "from the words of the statute itself, it is clear that those interested in just such a [policy] were unable to secure its embodiment in enacted law.") (internal quotation omitted).[6]

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[6] In any event, even if Congress had not added the language now codified at 39 U.S.C. § 3633(b) in 2006, the 2004 and 2005 committee reports still would provide no support for the notion that the minimum contribution requirement was intended to require a large minimum markup over incremental cost, let alone a price floor rigidly set at fully allocated costs. UPS, while quoting a reference in the 2004 Senate report to "appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete," S. Rep. No. 108-318 at 14, omits the immediately preceding sentence: "This bill establishes a *flexible* system of pricing the Postal Service's competitive products which reduces regulatory burdens and permits more *customer- and market-responsive pricing*." *Id*. (emphasis added).

Likewise, UPS quotes a reference on page 44 of the 2005 House report to the drafters' intent to preserve a "level playing field," but omits the immediately following sentence, which makes clear that the primary safeguard contemplated by the House was the prohibition against cross-subsidy: "The Postal Service will be given flexibility to price competitive products, but competitive products and services will have to pay their own costs without subsidy from market-dominant mail revenues." H. Rep. No. 109-66 at 44.

UPS likewise quotes another reference in the 2005 House report to the general goal of a "level playing field," (UPS at 5 n. 18 (quoting 2005 House report at 46), but omits the clarification of the minimum contribution requirement in the section-by-section portion of the

(4) Statements by members of Congress during oversight hearings *after* the enactment of PAEA also cannot alter the meaning of Section 3633. Indeed, "ordinarily even the contemporaneous remarks of a single legislator who sponsors a bill are not controlling in analyzing legislative history." *CPSC v. GTE Sylvania, Inc.*, 447 U.S. 102, 118 (1980) (citing *Chrysler Corp. v. Brown*, 441 U.S. 281, 311 (1979)); *accord Mujica v. Occidental Petroleum Corp.*, 381 F. Supp. 2d 1164, 1176 n.9 (C.D. Cal. 2005) ("In general, statements offered by individual members of Congress are not entitled to great weight."). And a statement by a member of Congress who was not seated until *after* the legislation was enacted merits no consideration at all. This is because "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *GTE Sylvania*, 447 U.S. at 117-18 (citing *United States v. Price*, 361 U.S. 304, 313 (1960)); *see also United States v. United Mine Workers of Am.*, 330 U.S. 258, 281–82 (1947) (holding that statements of senators debating a 1943 amendment to a 1932 act "cannot [be] accept[ed] ... as authoritative guides to the construction of" the 1932 act; "some of [the senators] were not members of the Senate in 1932," and "[w]e fail to see how the remarks of these Senators in 1943 can serve to change the legislative intent of Congress expressed in 1932").

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committee report: "With respect to the requirement that competitive products collectively make a reasonable contribution to overhead, it should be noted that the broad standard contains inherent flexibility. It is not intended to dictate a particular approach that the Postal Regulatory Commission should follow. … The committee expects that the Commission, like the courts, will take into account the inherent differences between market dominant and competitive markets." H.R. Rep. No. 109-66 at 49.

Similarly, UPS also ignores a similar clarification in the September 2004 House report: "With respect to the specific requirement that competitive products collectively make a reasonable contribution to overhead, it should be noted that the broad standard contains inherent flexibility. It is not intended to dictate a particular approach that the Postal Regulatory Commission should follow." H.R. Rep. No. 108-672 (Sept. 4, 2004) at 8.

(5) Finally, UPS once again fails to reconcile its proposed construction of Section 3633 with the overarching policy of minimum price regulation under Title 39—"to protect competition, not particular competitors." AFSI at 43 (citing judicial and Commission precedent).

III. THE "PREVAILING COMPETITIVE CONDITIONS IN THE MARKET" SINCE 2011 CONFIRM THAT A MINIMUM CONTRIBUTION REQUIREMENT IS UNNECESSARY.

AFSI and other mailers and shippers also showed in their initial comments that the "prevailing competitive conditions in the market," 39 U.S.C. § 3633(b), confirm that a minimum contribution requirement is unnecessary. The rapid rise in the inflation-adjusted prices of competitive products since 2011, the gains in both the contribution from and cost coverage of competitive products during the same period, and the robust financial health of the Postal Service's private competitors all show that the minimum contribution requirement has become irrelevant at its present level, and the goals of 39 U.S.C. § 3633(a)(3) do not warrant raising the required minimum enough to make it binding or potentially binding. Moreover, the traditional arguments for imposing binding regulatory price floors above incremental cost would be conceptually unsound even if the contribution from competitive postal products had not risen so much. AFSI at 19-43.

Other stakeholders overwhelmingly agree. Most mailers of market-dominant mail products, shippers of competitive products, and other postal stakeholders also support eliminating the minimum contribution requirement or at least leaving it at its current, nonbinding level. *See* comments of Parcel Shippers Ass'n *et al.* ("Market Dominant Mailers and Competitive Shippers" or "MDMCS"); American Catalog Mailers Ass'n; Association for Postal Commerce; National Association of Letter Carriers, AFL-CIO; Public Representative; Stamps.com. The only mailer to support a sizeable increase in the minimum contribution requirement is the Greeting Card Association ("GCA"); and even GCA does not support requiring competitive products to cover more than 10.5 to 11 percent of institutional costs, an amount still well below the actual recent performance of competitive products.

The only party to support raising the minimum contribution requirement high enough to make it binding is UPS. UPS and its advocates (Gregory Sidak and Former Utility Regulators) argue, in essence, that a higher minimum contribution requirement is necessary to (1) ensure that competitive products cover the costs they cause; (2) prevent the Postal Service from sacrificing contribution from competitive products for the sake of maximizing competitive product volume; and (3) "level the playing field" by offsetting the legal advantages supposedly enjoyed by the Postal Service. We respond in turn to each argument. First, however, we discuss the central fact bearing on the "prevailing competitive conditions" issue: the massive growth in prices, coverage ratios and contribution of competitive products since 2011.

A. UPS largely ignores the most important competitive condition today: the rapid rise in the prices, coverage ratios, and contribution of competitive products since 2011.

As both AFSI and MDMCS showed in their initial comments, the Postal Service has been aggressively raising the prices of its competitive products since 2011, the last fiscal year for which financial information was available when the Commission performed its previous review of the minimum contribution requirement. These increases have far outstripped inflation, raising the share of institutional costs covered by competitive products from 7.8

percent in Fiscal Year 2011 to 16.5 percent in Fiscal Year 2016 and a projected 20.2 percent—or $6.8 billion—in Fiscal Year 2017. AFSI at 19-23; MDMCS at 3-6. The trend undermines the central theory of UPS's case: that the Postal Service, left to its own devices, will set competitive prices at levels low enough to cause competitive harms. The Postal Service's aggressive steps to raise the markups on and contribution from competitive products make the minimum contribution requirement irrelevant. *Id.*

UPS offers no cogent response to these facts. The Former Utility Regulators make no mention of the above-inflation increases in competitive product prices since 2011. Mr. Sidak, while devoting much of his declaration to theoretical speculation about why the Postal Service might want to keep its competitive prices down, does not acknowledge that the Postal Service has actually been aggressively raising them. UPS, while admitting that the Postal Service "made substantial price increases for a number of its products" between Fiscal Year 2015 and Fiscal Year 2016, ignores the increases that occurred before then; the increases that have occurred since then; and the cumulative effect of all competitive price changes over the full period from Fiscal Year 2011 to Fiscal Year 2017. *Compare* UPS 35-36 with AFSI at 19-23 and MDMCS at 4-6.[7]

UPS's discussion of the *contribution* from competitive products is equally without merit. UPS implies, without saying so explicitly, that the 5.5 percent minimum contribution

[7] UPS also repeats its claim in RM2016-2 that Postal Service reduced prices for Priority Mail in 2014 to undercut the prices charged by UPS and FedEx for competing products, but does not answer AFSI's responses in that docket: (1) the overall effect of the Priority Mail rate changes was revenue neutral; (2) the Postal Service indisputably has raised competitive product prices by substantially more than inflation over past decade; and (3) most of the recent growth in Postal Service competitive product volume has involved Parcel Select products, not Priority Mail. *Compare* UPS at 21 with Docket No. RM2016-2, AFSI Comments filed Jan. 25, 2016, at 69-74

requirement also operates as a ceiling on the contribution from competitive products. See UPS at 3 (claiming that the 5.5 percent requirement "effectively allows competitive products to piggyback[]" onto the network "designed around letters and flats"); *id*. at 4 ("the low 5.5% contribution level has remained frozen for a decade"). UPS's advocates go even further. Mr. Sidak states that, even today, competitive products contribute only 5.5 percent of institutional costs plus an imputed income tax, and "have not contributed any additional revenue to institutional costs in excess of those two statutorily mandated contributions." Sidak at 20 n. 22. Hence, "if the Postal Service is to break even in any given year, revenues from market-dominant mailers must cover almost the entire remaining 94.5 percent of institutional costs." *Id*. at 9, 14-15. The Former Utility Regulators likewise suggest that the actual contribution from competitive products is frozen at the 5.5 percent floor prescribed by the Commission in that year. *See* Former Utility Regulators at 1-2 ("We understand that … the competitive products 'appropriate share' allocation of this large pool of institutional costs has remain [sic] frozen at just 5.5% for more than a decade.").

The reality, however, is clear. The large and growing contribution made by competitive products to the Postal Service's institutional costs has far outstripped the 5.5 percent minimum contribution requirement. Every penny of this actual contribution goes to the Postal Service Fund established under 39 U.S.C. § 2003. Although the Commission ruled in 2015 that the Postal Service may not denominate amounts paid in excess of the minimum contribution requirement as prepayments of the appropriate share requirement for future fiscal years,[8] it is immaterial whether transfers of the contribution in excess of the 5.5 percent threshold are considered prepayments of future years' institutional costs or merely "a

[8] Order No. 2329 in Docket No. PI2013-1, *Inquiry Concerning Competitive Products Fund* (Jan. 23, 2015) at 5-6.

voluntary payment in excess of the minimum 5.5 percent requirement." USPS response in Docket No. ACR2016 to Chairman's Information Request No. 11, Question 10 (filed February 3, 2017). The "tangible effect is the same": the entire amount of the net contribution from competitive products is transferred to the Postal Service Fund. *Id.*

B. A minimum contribution requirement is unnecessary to ensure that competitive products cover the costs they cause.

For the reasons explained by AFSI in its initial comments, a minimum contribution requirement is unnecessary to ensure that the revenue from competitive products covers the costs that they cause. AFSI comments at 30-34; Panzar Decl. 5-7. UPS and its advocates offer several arguments to the contrary. Both UPS and Mr. Sidak assert that existing cost attribution methodologies are likely to understate the cost of providing competitive products. UPS 29-33; Sidak Decl. 1-2, 12-14. The Former Utility Regulators contend that the Postal Service's competitive products are in fact priced below "cost," and therefore are being "subsidized" by market-dominant products. Former Utility Regulators at 3-14. These arguments are without merit.

(1) Neither UPS nor Mr. Sidak offers any evidence that the Postal Service's revenue from competitive products falls short of the actual incremental or attributable costs of those products. Indeed, Mr. Sidak admits that a firm with the competitive advantages that he imputes to the Postal Service could "undercut its competitors' prices without engaging in below-cost pricing." Sidak at 7.[9]

[9] Mr. Sidak also concedes that the Postal Service is unlikely to engage in predatory pricing. *Id*. at 7 n. 14.

(2) UPS has made no showing that its criticisms of existing cost attribution methods, even if entirely valid, would materially reduce the $6 billion annual contribution to institutional costs that competitive products are now reported to make. *Cf.* AFSI at 21 (table showing annual contribution of competitive products since Fiscal Year 2011). As long as competitive products cover their incremental costs, they are not being subsidized. Order No. 3506 in RM2016-2 at 10, 13- 17-18, 57-58, and App. A at 17-22; Order No. 3641 in RM2016-13 at 6-7, 11-12; Panzar Decl. at 5-6; AFSI at 30 & n. 24 (citing precedent and economic literature); *see also* UPS at 6 n. 21 (acknowledging that the "incremental cost test has long been the conventional test for preventing cross-subsidization.").

(3) The Commission has given the accuracy of its cost attribution methodology thorough scrutiny in costing rulemakings over the last decade. UPS identifies no significant errors in the Commission-approved costing methods.[10] Postal Service disclosure of its costs is far more detailed and transparent than the highly aggregated disclosures made by even the publicly traded private carriers in their Form 10-K and other SEC filings.

(4) The Commission has repeatedly invited postal stakeholders who believe that existing cost attribution methods can be improved to propose specific changes via petition for rulemaking. *2011 Annual Compliance Determination* at 119; *2014 Annual Compliance Determination* at 48; *2015 Annual Compliance Determination* at 93. UPS is free to pursue the rulemaking remedy, just as it did in Docket No. RM2016-2, *Periodic Reporting (UPS Proposals One, Two, and Three)*. *See id.*, Order No. 3506 (September 9, 2016), petition for review pending *sub nom. United Parcel Service, Inc. v. PRC*, No. 16-1354 (D.C. Cir.). UPS is also entitled to ask the

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[10] *See* Docket No. ACR2016, USPS responses to Chairman's Information Request No. 11 (Feb. 3, 2017) (responding to various costing anomalies alleged by UPS); *id.*, USPS response to Chairman's Information Request No. 13 (Feb. 10, 2017) (same).

Commission to reopen a previous rulemaking if it believes that the Postal Service has not complied adequately with the Commission's orders in that rulemaking. These remedies—which allow the Commission to resolve cost attribution issues on the basis of a fully developed record—are a far better way to deal with alleged cost attribution errors than the alternative of inflating the price floor by adding a large and arbitrary markup over attributable cost.

(5) The attribution of motor vehicle costs illustrates these facts. UPS asserts that existing cost attribution methods ignore the role of the Postal Service's parcel volume in causing the imminent replacement of the Postal Service's existing delivery vehicle fleet. UPS at 32; Sidak at 13. But the purchasing of next-generation delivery vehicles has not yet begun, and will not begin in significant numbers until 2018. Docket No. ACR2016, USPS Response to CHIR No. 11, Q 5a-b. That leaves plenty of time, if necessary, to review the Postal Service's attribution of the vehicle costs before the expenditures occur. Second, and in any event, the main reason for replacing the vehicles is their age and the high breakdown rates and maintenance costs that result. This is true of the Postal Service's foreign counterparts as well as the Postal Service.[11] While package volumes are one of many design considerations, the purchase of new vehicles benefits all Postal Service products.[12] Further, UPS has made no showing that this is a significant issue. The entire annual depreciation costs of the new vehicles, even when fully deployed several years from now, will be a small fraction of the $6 billion contribution to institutional costs that competitive products now make, and a small

[11] See OIG Report DR-MA-15-002, *Benchmarking of Delivery Fleet Replacement Strategies* 25 (Aug. 18, 2015).

[12] Hearings before the House Committee on Oversight & Government Reform, prefiled testimony of Chairman Taub (February 7, 2017) at 8; USPS Form 10-K report for Fiscal Year 2016 (Nov. 15, 2016) at 30, 32, 48; Docket No. RM2015-7, PSA Reply Comments 6-7 (May 13, 2015).

fraction of the extra contribution that UPS would require competitive products to make.[13] Finally, the annual depreciation costs of the new vehicles will be largely offset by the reduction in maintenance costs that the new vehicles will allow. During an oversight hearing on February 7, 2017, PMG Brennan testified that the Postal Service's vehicle fleet is at end of its useful life, and annual maintenance costs exceed $1 billion.[14]

(6) UPS argues that the change in institutional costs reported from Fiscal Year 2014 to Fiscal Year 2016 shows that some costs now classified as institutional are in fact caused by competitive products. UPS at 29-30. The data suggest no such thing. As evidence of cost causation, the change is as irrelevant as the time series comparisons of mail volume and costs in UPS Proposal 2, which the Commission rejected in Docket No. RM2016-2. *See* Order No. 3506 (Sept. 9, 2016) at 62-105. Indeed, UPS does not claim in the present case to have performed any analysis to attempt to determine causality or even adjusted its institutional cost figures for inflation. This is unsurprising. In Docket No. RM2016-2, UPS admitted that it had been unable to identify any statistical relationship between volume changes and institutional costs through regression analyses other than those submitted to the Commission in that docket, which included a weighted volume measure related to *total* mail volume, not competitive product mail volume, as an independent variable. Docket No. RM2016-2, UPS response to ChIR No. 1, Question 9(e) (filed December 10, 2015).

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[13] *See* OIG Report DR-MA-14-005, *Delivery Vehicle Fleet Replacement* (June 10, 2014); OIG Report DR-MA-15-002, *Benchmarking of Delivery Fleet Replacement Strategies* (Aug. 18, 2015); and OIG Report DA-AR-10-005, *Delivery Vehicle Replacement Strategy* (June 16, 2010).

[14] *See* https://oversight.house.gov/hearing/accomplishing-postal-reform-115th-congress-h-r-756-postal-service-reform-act-2017/, Chairman Chaffetz video at 5:31 to 5:35 (colloquy with PMG Brennan); OIG Report DR-MA-14-005 at 1 n. 5 (annual vehicle maintenance costs in Fiscal Year 2012 were more than $906 million).

(7) The Postal Service's statements attributing a share of recent increases in labor and transportation costs to competitive products also fail to establish that costs caused by competitive products are being misclassified as institutional. *Cf.* UPS at 31-32. None of the quoted statements or data indicate that the referenced cost increases involved costs that were classified by the Postal Service as institutional costs. Furthermore, the costs attributed to competitive products increased from $11.9 billion in Fiscal Year 2015 to $12.5 billion in Fiscal Year 2016. Fiscal Year 2015 and Fiscal Year 2016 Public Cost and Revenue Analysis Reports.

(8) UPS's claim that the Commission's decision in RM2016-2 makes a large minimum contribution requirement "even more essential" because the decision expanded the definition of "institutional" costs to include "variable costs that are driven by competitive product volumes," not just fixed costs (UPS 12-13), is baseless. The Commission and the Postal Service have defined institutional costs for decades as the residual of total costs minus the sum of attributable costs for all outputs. The costs attributed to individual classes or products—or all competitive products together—have never included all costs that vary with volume in the aggregate. Before Docket Nos. RM2016-2 and RM2016-13, attributable costs excluded costs that varied with volume in the aggregate but did not vary with the marginal unit of output (so-called "inframarginal" costs). Since Docket Nos. RM2016-2 and RM2016-13, attributable costs have been defined to exclude costs that vary with volume in the aggregate, but do not vary with the *incremental* unit of output being studied because they are incurred jointly or in common with other increments of output. Order No. 3506 in Docket No. RM2016-2 at 123-24, 125 (ordering paragraph 2); Order No. 3641 in Docket No.

RM2016-13 (Dec. 1, 2016) at 2, 11; Panzar Reply Decl. at 4.[15] The Commission's final decision in Docket No. RM2016-2 and RM2016-13, by substituting incremental cost for volume variable cost as the main component of attributable cost, actually *decreased* the share of total costs treated as institutional. *Id*.

UPS is aware that some variable costs were classified as institutional costs before RM2016-2; indeed, one of the main goals of UPS Proposal 1 in Docket No. RM2016-2 was to change that. *See* Docket No. RM2016-12, Neels report (Oct. 8, 2015) at 11 (figure depicting "inframarginal" variable costs that were classified as institutional); *id*. at 13 (claiming that "nearly half of so-called 'institutional' costs are actually variable"; "inframarginal costs … are 'institutional' under postal parlance, but these are decidedly not fixed costs and should not be thought of as such")); *see generally id*. at 9-13.

(9) The Former Utility Regulators' claim that the Postal Service is pricing competitive products below costs is premised on the assumption that the relevant measure of cost is *fully allocated cost*. *Id*. The Commission and its reviewing courts repudiated fully allocated cost as a method of cost attribution or rate regulation decades ago, a position that the Commission reaffirmed most recently in Docket No. RM2016-2. *See* Order No. 3506 in Docket No. RM2016-2 at 104 (first full paragraph) (rejecting allocation of volume-variable costs "based on the respective shares of overall attributable costs"); AFSI comments in RM2016-2 (Jan. 25, 2016) at 30, 39-49, 53-56 (citing earlier precedents); *see also* pp. 41-43, *infra*. Even Mr. Sidak has recognized in his prior professional work that outputs whose rates

[15] The annual reports filed by the Postal Service in compliance with 39 C.F.R. § 3050 provide more details about the volume variable costs that are customarily classified as institutional. *See*, *e.g.*, Summary Description of USPS Development of Costs by Segments and Components, Fiscal Year 2015, at Appendix H (filed July 6, 2016).

cover incremental cost are not being subsidized.[16] He has also recognized that fully allocated costs "have no economic content. They cannot pretend to constitute approximations to anything."[17] "There just can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators."[18]

C. UPS has made no showing that the Postal Service is sacrificing contribution from competitive products to maximize competitive product volume.

UPS witness Sidak asserts that the Postal Service, left to its own devices, has a "strong incentive" to (a) hold down competitive product prices to increase competitive product volume or "scale" at the expense of profits, and (b) at least partially recoup any contribution foregone from doing so by reducing the quality of service provided to market-dominant products. To "protect market-dominant consumers" and "improve the Postal Service's financial condition," Mr. Sidak urges the Commission to "increase the proportion of institutional costs that competitive products must cover." Sidak 1 (¶ 2), 10-16. This argument fails on several grounds.

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[16] See, e.g., Sidak, J. Gregory, and Daniel F. Spulber, *Protecting Competition from the Postal Monopoly* 108 (1996); Baumol, William J., and J. Gregory Sidak, *Toward Competition in Local Telephony* 57, 81-83 (1994).

[17] Sidak, J. Gregory, and Daniel F. Spulber, *Deregulatory Takings and the Regulatory Contract* 42 (1997) (quoting Baumol, William J., and J. Gregory Sidak, *Transmission Pricing and Stranded Costs in the Electric Power Industry* 64 (1995)).

[18] *Deregulatory Takings* at 42 (quoting Baumol, William J., Michael F. Koehn & Robert D. Willig, *How Arbitrary is "Arbitrary"?—or, Towards the Deserved Demise of Full Cost Allocation*, 21 Pub. Util. Fortnightly, Sept. 3, 1987, at 16).

First, it is refuted by the Postal Service's actual behavior. As noted above, the Postal Service has been aggressively raising the prices of its competitive products since 2011. These increases have far outstripped inflation, raising the share of institutional costs covered by competitive products from 7.8 percent in Fiscal Year 2011 to 16.5 percent in Fiscal Year 2016 and a projected 20.2 percent in Fiscal Year 2017. AFSI at 19-23. Mr. Sidak makes no attempt to reconcile his scale-maximization theory with these trends.

Mr. Sidak's scale-maximization hypothesis is also unsound even in theory. Price cap ("incentive") regulation replaced cost-of-service regulation for market-dominant mail products in 2007. As Prof. Panzar has explained, the incremental cost floor established by the Commission under 39 U.S.C. § 3633 and the CPI cap mandated by 39 U.S.C. § 3622(d) preclude recoupment of the kind hypothesized by Mr. Sidak by severing the link between the profitability of competitive products and the maximum allowable prices for market-dominant products. Accordingly, the historical regulatory concern about the pricing of competitive products is irrelevant here. AFSI at 31; Panzar Decl. at 5-6; Panzar Reply Decl. at 8-9.

Mr. Sidak has acknowledged in his prior work that price cap regulation, by breaking the link between competitive cost recovery and the regulatory ceiling on market-dominant rates, can attenuate the incentive to sacrifice competitive contribution for competitive volume or scale that traditional cost-of-service rate regulation was thought to create:

> Administrative cost allocation rules [inherent in price regulation based on fully allocated costs] create an incumbent burden for the [telephone local exchange carriers]. A preferable way to reduce the incentive and opportunity for anticompetitive cross-subsidization is to replace cost-of service regulation with price caps.

Deregulatory Takings, supra, at 44; *accord*, Sidak, J. Gregory, and Daniel F. Spulber, *Monopoly and the Mandate of Canada Post*, 14 Yale J. on Reg. 1, 53 (1997) ("Price caps do more than induce the private firm to minimize its cost of production. They also reduce the incentive for the firm to cross-subsidize new lines of business through the misallocation of costs, for the firm may charge up to its maximum price whether or not its accounting costs for the regulated service change."); Sidak, J. Gregory, and Daniel F. Spulber, *Protecting Competition from the Postal Monopoly* 101-104 (1996) (recognizing that price cap regulation would have this effect, but asserting that price cap regulation could never be imposed on the USPS).[19] UPS and Mr. Sidak do not mention these prior writings.

Mr. Sidak asserts that the Postal Service can evade the CPI cap by underinvesting in the quality of service for market-dominant products, or giving priority treatment to competitive products, thereby raising the "quality-adjusted prices" of market-dominant products. Sidak at 10, 15-16. The flaw in this reasoning is that, if the Postal Service could reduce the quality of service for market-dominant products in these ways without detection

[19] The possibility that legislation or Docket No. RM2017-3, the Commission's 10-year review proceeding, might lead to changes in the system of maximum price regulation for competitive products does not alter the above analysis. No one, not even the Postal Service, has proposed a return to traditional cost-of-service rate regulation, a prerequisite for the scale-maximization hypothesis to regain any plausibility. In any event, an agency must decide a case based on the existing law, not on speculation about future legislative changes. "[A]llowing agencies to ignore statutory mandates and prohibitions based on agency speculation about future congressional action … would gravely upset the balance of powers between the Branches and represent a major and unwarranted expansion of the Executive's power at the expense of Congress." *In re Aiken County*, 725 F.3d 255, 259-260 (D.C. Cir. 2013). The "Commission and participants must act in accordance with the law as it is currently written, not speculate upon possible Congressional intervention into that process." Presiding Officer's Ruling No. R2005-1/84 (Sept. 21, 2005) at 4. Consistent with this principle, the Commission declined in Docket No. R2005-1 to adjust the Postal Service's revenue requirement to reflect the anticipated effect of legislation that would modify the Postal Service's funding obligations for retiree health benefits, PRC Op. & Rec. Decis. (Nov. 1, 2005) at ¶ 3035), or even to allow discovery on the subject. Presiding Officer's Ruling No. R2005-1/84 at 4 (sustaining USPS objections to OCA interrogatories concerning the financial effect of proposed legislation concerning the funding of the Postal Service's Retiree Health Benefits Fund).

or effective oversight by the Commission, simultaneously underpricing competitive products would not make these operational strategies more profitable than following the same strategies but raising prices to capture the greater value that the preferred treatment conferred on competitive products. Accordingly, the hypothesis that quality reductions for market-dominant products might be profitable for the Postal Service does not reestablish an incentive for underpricing competitive products under incentive price regulation of market-dominant products. It is telling that Mr. Sidak did not assert his operational-preference hypothesis in his discussion of the incentive effects of price cap regulation in the peer-reviewed works cited above.

Finally, UPS's profession of concern about "improving" the Postal Service's "financial condition" and "financial stability" (Sidak at 10 & 16) rings hollow in light of the specific "improvements" that UPS asks the Commission to impose. As explained in Section IV, *infra*, what UPS proposes is a regulatory floor under competitive product prices equal to fully allocated cost or even stand-alone cost. Imposing either floor would make the Postal Service or its customers (or both) much worse off, and could very well drive the Postal Service into insolvency. The only interests that would profit from these anticompetitive price umbrellas would be the Postal Service's private competitors and their shareholders.

D. The minimum contribution requirement is unnecessary to "level the playing field" between the Postal Service and private carriers.

The initial comments also confirm the unsoundness of UPS's appeals to "fair competition" and a "level playing field." AFSI comments at 34-36; Panzar 7-8. UPS's arguments may be summarized as follows: Private competitors must incur the same kinds of fixed and common costs as the Postal Service, but lack monopoly services from which to recover these costs. Hence, a price floor that allows the Postal Service to reduce its competitive prices down to incremental cost is unfair because it allows Postal Service to "piggyback" competitive products onto an existing network "designed around letters and flats," an option unavailable to UPS and other private competitors. UPS 3-4, 6-7, and 10. "The private sector cannot duplicate [the] low marginal costs" that the Postal Service enjoys because of the letter and mailbox monopolies, as well as various other advantages that the Postal Service allegedly enjoys because of its unique status as an establishment of the federal government. UPS 13-15; Sidak at 1 (¶ 2), 5-9, 16-17. Moreover, UPS argues, the importance of maintaining a "level playing field" by restricting the Postal Service's freedom to compete on price is heightened by the recent surge in the Postal Service's competitive product volume. UPS 2-4, 9, 18-20, 22-24; Sidak 9-10. The urgency of requiring that competitive product prices include a substantial markup over incremental cost under 39 U.S.C. § 3633(a)(3) is also heightened, UPS adds, by the Commission's recent holding in Docket No. RM2016-2 that the promotion of fair competition is irrelevant to Sections 3633(a)(1) and (2). UPS 12.

The factual premises of these arguments are false, and would not justify establishing a minimum price floor above incremental cost even if true.

1. The record contains no evidence that the unique legal status of the Postal Service give it a significant competitive advantage over private carriers.

The flaws in UPS's level playing field argument begin with its factual premises. UPS offers no evidence that the Postal Service in fact enjoys a significant cost advantage over its private competitors as a result of the Postal Service's unique legal benefits and burdens.

(A)

In Docket No. RM2012-3, the Commission found that the record provided "no evidence of a Postal Service competitive advantage" over UPS and other private carriers. Order No. 1449 at 24. UPS asserts that two more recent analyses have refuted this finding: (1) a 2016 Commission study purportedly finding that the letter and mailbox monopolies gave the Postal Service $6.5 billion or more in competitive benefits in Fiscal Year 2015; and (2) a white paper, commissioned by UPS from an economist, Robert Shapiro, in 2015, which purported to show that the Postal Service's net competitive advantage is even higher. UPS 15-16 (citing PRC Fiscal Year 2016 Annual Report 48-49 (Jan. 13, 2017)); Sidak at 6 (citing Robert J. Shapiro, *the Basis and Extent of the Monopoly Rights and Subsidies Claimed by the United States Postal Service* (March 2015) ("Shapiro")).[20] Neither study supports UPS's level playing field claims.

The Commission's 2016 analysis of the value of the postal monopoly does not even purport to estimate the cost advantages enjoyed by the Postal Service over private carriers for competitive products. The analysis is an estimate of the contribution that the Postal Service would lose from three mail products—two of them market-dominant—if the letter and mailbox monopolies were repealed and private competitors captured some of the Postal Service's existing volume of those products as a result. PRC Fiscal Year 2016 Annual Report 48-49 (Jan. 13, 2017). The study does not claim to quantify the scope economies that the Postal Service would lose for any product. *Id.*

The Shapiro paper claims that the Postal Service received about $17 billion per year in implicit subsidies under federal law, approximately $14.5 billion of which were from the

[20] Dr. Shapiro's 2015 paper was funded by UPS. Shapiro at 2 n. 1.

mailbox monopoly. The Shapiro paper has never been subjected to academic peer review or discovery in litigation, and much of its analysis is unverified. Nevertheless, several major flaws in the paper are apparent. First, Dr. Shapiro derived the $14.5 billion figure from cost estimates that are nearly a quarter-century old, and which have been heavily criticized by the Government Accountability Office. *Compare* Shapiro at 16 with GAO Report No. GAO-14-444, *U.S. Postal Service: Delivery Mode Conversions Could Yield Large Savings, but More Current Data Are Needed* (May 2014) at 8-11.

Second, Dr. Shapiro's analysis did not estimate what portion of the "implicit subsidies" from the mailbox monopoly inure to competitive products, rather than to market-dominant and competitive products combined. His paper made no attempt to separate the two; he simply lumped competitive and market-dominant products together. *Compare* March 2015 paper at 15-16 with FTC, *Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors* (2007) ("FTC Report") at 57 (Table 3). This omission makes his analysis useless. Market-dominant mail, not competitive products, still represents the majority of the pieces that the Postal Service delivers.[21] Further, many packages, unlike

[21] In October 2015, UPS sponsored a follow-up report by Dr. Shapiro purporting to calculate the subsidies received by competitive products alone. Robert J. Shapiro, *How the U.S. Postal Service Uses Its Monopoly Revenues and Special Privileges to Subsidize its Competitive Operations* 17-20 (October 2015). All of these calculations, however, relied on arbitrary allocations of systemwide revenues and costs. One set of his calculations defined the subsidy for competitive products as the amount by which the revenue generated by competitive products fell short of their *fully allocated costs* (with institutional costs allocated to competitive products in proportion to their share of total Postal Service revenue or attributable costs). *Id*. at 17-18. Alternatively, Dr. Shapiro multiplied his $17 billion systemwide subsidy estimate by 28 percent, the share of attributable costs caused by competitive products in Fiscal Year 2014. *Id.* at 20. As discussed below, "cost" estimates based on non-causal allocations of systemwide costs provide neither a valid test for cross-subsidy nor an appropriate floor under prices. *See* pp. 19, *supra*; pp. 36-41, 44, *infra*.

letters, are too big to fit in standard mailboxes; for these packages, mailbox access offers the Postal Service no savings. Finally, and in any event, Dr. Shapiro's estimate is implausible on its face: if the annual operational savings resulting from access to a network of mailboxes for package delivery were remotely as large as he claims, private carriers (individually or collectively) would have built their own mailbox network years ago.

Third, Dr. Shapiro's analysis ignores the massive disadvantage that the Postal Service suffers from being compelled to invest hundreds of billions of dollars of pension and retiree health benefit assets in low-yielding Treasury bonds rather than a diversified investment portfolio of equities, corporate bonds, and real estate. The present value of this financial drag exceeds $140 billion. See Appendix A, *infra*.

Fourth, Dr. Shapiro himself estimates that the Postal Service incurs labor compensation costs that exceed by approximately $20.5 billion per year the costs that private carriers incur for comparable work. Shapiro at 14. This competitive disadvantage by itself exceeds Dr. Shapiro's estimate of the value of the letter and mailbox monopolies to the Postal Service.

Mr. Sidak's estimate of the economic value of the Postal Service's supposed legal advantages relies largely on Dr. Shapiro's paper, and thus shares its flaws. Sidak at 6. Mr. Sidak asserts that competitive products receive six percent, or $780 million, of total "benefit" calculated by Dr. Shapiro. Mr. Sidak offers no basis for the six percent ratio, however, and he appears to have derived it simply by rounding up the 5.5 percent minimum contribution requirement to the next integer. Sidak at 6 n. 12. There is no economic basis, however, for using the 5.5 percent factor (which was derived from estimates of the share of *institutional costs* covered by competitive products before the enactment of the PAEA in 2006) to calculate the reduction in the *attributable costs* of competitive products caused by the extra volume of market-dominant products generated by the letter and mailbox monopolies.

Further, Mr. Sidak fails to deduct from the $780 million figure the costs of the regulatory burdens imposed uniquely on the USPS. This is a serious omission: Mr. Sidak himself has recognized elsewhere that asymmetric regulation can impose major competitive burdens on incumbent carriers vis-à-vis their unregulated competitors. Sidak, J. Gregory, and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 Yale J. on Regulation 128, 133-34 (1998).

Finally, the $780 million figure, like the $743 million upper bound of the FTC's 2007 estimate of the value of the Postal Service's legal competitive advantages, is just a tiny fraction of the minimum contribution burden proposed by UPS. *See* p. 35, *infra*. And the *net* benefit to the Postal Service, after deducting the competitive burdens resulting from its unique legal status, is an even smaller fraction of the regulatory burden that UPS would impose on the Postal Service's competitive prices.

(B)

As AFSI noted in its initial comments, economies of scale and scope cut in both directions. The Postal Service is hardly the only provider of package delivery services that enjoys economies of scale, scope and integration. So do UPS and FedEx. Moreover, many of their economies of scale and scope result from the provision of services that the Postal Service is barred by law from offering, and which are growing faster than the market-dominant products that are reserved to the Postal Service. AFSI comments at 40-41.

UPS does not discuss this issue in its initial comments. Its Form 10-K annual report for 2016, however, does:

> We offer differentiated value propositions in several segments, including aerospace, automotive, industrial manufacturing, retail, professional and consumer services, healthcare and high-tech.
>
> * * *
>
> Rapid technology innovation and growing worldwide demand for electronics are driving change in the already-dynamic high-tech industry. UPS's global transportation network and integrated technology solutions enable high-tech customers to get their products to market faster, improve customer service and increase revenue. We offer global sourcing and a significant amount of repair space to leverage one of the largest networks of post-sales facilities in the world. With more than 950 field stocking locations in over 110 countries, we help high-tech companies identify better ways to manage inventories and meet their crucial logistics needs.
>
> * * *
>
> Our global small-package operations provide time-definite delivery services for express letters, documents, small packages and palletized freight via air and ground services. We service more than 220 countries and territories around the world along with domestic delivery service within 50 countries. We handle packages that weigh up to 150 pounds and are up to 165 inches in combined length and girth as well as palletized shipments weighing more than 150 pounds. All of our package services are supported by numerous shipping, visibility and billing technologies.
>
> *We handle all levels of service (air, ground, domestic, international, commercial, residential) through one global integrated pick-up and delivery network. All packages are commingled within our network, except when necessary to meet their specific service commitments. This enables one UPS driver to pick up customers' shipments for any of our services at the same scheduled time each day. Compared to companies with single service network designs, our integrated network uniquely provides operational and capital efficiencies while being more environmentally-friendly.*

USPS Form 10-K for 2016 at 3-5 (emphasis added). FedEx has similar economies of scale and scope. *See* FedEx Annual Report for Fiscal Year 2016 at 1 (Chairman's letter) ("Our dense, ubiquitous networks create fundamental scale and scope advantages that aren't easily replicated.").

(C)

UPS's "level playing field" claims are also undermined by the lack of any evidence that the supposedly unfair cost advantages of the Postal Service have impaired the competitive performance of UPS and other private carriers against the Postal Service.

First, the Postal Service's share of competitive product volume, properly measured, remains modest. While the total volume of *pieces* handled by the Postal Service has grown rapidly, the share of total parcel delivery *revenue* captured by the Postal Service has not. The recent growth in domestic competitive piece volume has consisted largely of last-mile delivery of packages originated by other carriers. Those other carriers keep the long haul and the lion's share of the revenue. USPS at 11-13; *compare* UPS 2-4, 9, 18-20, 22-24; Sidak 9-10. Mr. Sidak insists that volume share trends are not "directly relevant." Sidak 8-9.

Second, UPS and other private carriers are financially robust. AFSI at 23-28 (quoting public statements by UPS, FedEx, and others). Statements by UPS to its investors since the filing of AFSI's initial comments have underscored this reality. Consider a press release issued by UPS on February 21, 2017, to accompany the release of its Form 10-K report for 2016. "The strong financial hallmarks of UPS remain unchanged," said UPS CFO Richard Peretz. UPS News Release, *UPS Accelerates Transformation of its Smart Logistics Network* (February 21, 2017). "We are great stewards of capital, generate strong cash from operations and have a generous shareholder distribution policy. We continue to deliver the highest operating margins in the industry … This legacy combined with our future growth prospects makes UPS a high-quality investment today, and for years to come as we build the smart logistics network." *Id*.

UPS expanded on these points in its Form 10-K annual report for 2016 (issued February 21, 2017):

> E-commerce continues to drive significant growth in package delivery volume. Our integrated network puts us in an ideal position to capitalize on the shift towards residential deliveries. We continue to create new services, supported by our technology, that complement traditional UPS premium home delivery services and address the needs of e-commerce shippers and consignees. We offer cost-effective solutions such as UPS SurePost, for U.S. domestic shipments, and UPS i-parcel, for a low-cost deferred cross border solution, where economy takes precedence over speed.

Id. at 2. "We operate one of the largest airlines in the world, with global operations centered at our Worldport hub in Louisville, Kentucky. Worldport sort capacity, currently at 416,000 packages per hour, has expanded over the years due to volume growth and a centralization effort." *Id*. at 5. UPS mentions none of these facts in their initial comments.[22]

Third, UPS, FedEx and smaller private carriers continue to invest heavily in growing their businesses and deploying new technology. AFSI at 24-28 (citing statements to investors). UPS's February 21 press release emphasized this point too:

> "Over the next several years, you will see the most sweeping transformation of our network in its history," said David Abney, UPS chairman and CEO. "We are adding more flexible capacity, more technology, more capabilities and

[22] UPS falsely attributes to Prof. Panzar a belief that the Postal Service's "ability to exploit the cost advantages arising from the postal monopoly could … lead to a 'monopoly industry configuration' where the Postal Service becomes the sole provider of competitive products and services." UPS 25 & n. 79. This is a clear mischaracterization of Prof. Panzar's actual statement, which was that the Postal Service would (and should) become the sole supplier of a service in a hypothetical case in which the Postal Service was *assumed* to be the most efficient supplier. Panzar Reply Decl. at 13-14.

> becoming more efficient, ultimately to improve customer and shareholder value."

UPS News Release (Feb. 21, 2017) at 1; *accord*, UPS Form 10-K for 2016 (Feb. 21, 2017) at 4, 10-11 (noting UPS's "financial strength," "leading-edge technology," and "expanded investment in new automated facilities"). Capital investments also have been growing for the industry as a whole:

> Industry capital expenditure has grown more than 40% from 2013 to 2015 as post and parcel organizations make significant investments in increased capacity, new capabilities and diversification to keep up with eCommerce-driven change and demand.
>
> Some are spending as much as one-third of their revenues on major internal or external projects. Almost all are investing in additional capacity to accommodate eCommerce growth, especially for peak periods.
>
> Merger and acquisition activity is also high … Acquisitions are being made around logistics and transportation, parcels and express, technology and software, financial services, and mail.

Accenture Consulting, *The New Delivery Reality: Achieving High Performance in the Post and Parcel Industry 2016* (Jan. 24, 2017) at slide 10 (https://www.slideshare.net/accenture/the-new-delivery-reality-achieving-high-performance-in-the-post-and-parcel-industry-2016).

Investment in innovative methods of parcel delivery has not been limited to the three largest carriers. "Drawn by the allure of surging e-commerce sales, venture capitalists have spent billions of dollars funding startup firms in the last two years in search of a stake in the home-delivery post and parcel segment … Venture capital funding of supply chain and logistics startups performing delivery services has increased from $266 million in 2013 to $2.78 billion in 2016, according to the consulting firm Accenture." DC Velocity (Jan. 31, 2007) (http://www.dcvelocity.com/articles/20170131-report-investors-spending-billions-in-parcel-delivery-sector/). This investment has led to a "proliferation of new technologies" and "tremendous innovation in how last-mile delivery to customers takes place." OIG report RARC-WP-16-012, *Technological Disruption and Innovation in Last Mile Delivery* (June 6, 2016). These are not the hallmarks of an industry whose returns have been beaten down to unattractive levels by unfair competition from the government. Panzar Reply Decl. at 9-10.

2. A minimum contribution requirement would be unwarranted even if (contrary to fact) the legal status of the Postal Service gave it a significant competitive advantage over private carriers.

UPS's "level playing field" arguments are also wrong even in theory. The statutory monopolies and other legal preferences possessed by the Postal Service today, whether considered "artificial" or not, reflect deliberate policy choices made and repeatedly reaffirmed by the American people through their elected representatives for more than two centuries, most recently in 2006. *See* Docket No. PI2008-3, *Report on Universal Postal Service and the Postal Monopoly* 15-85 (2008); see also 2007 FTC Report at 49 ("if the provision of universal service in its current form requires the maintenance of a monopoly provider, then the postal monopoly should be viewed as a marketplace distortion that Congress has chosen to assure that the United States has a postal network that offers ubiquitous coverage at uniform prices and service levels"). The merits of continuing those legal preferences are beyond the scope of this proceeding. As AFSI explained in its initial comments, the sole question here is who should gain the benefit of the resulting economies of scale and scope: ratepayers and consumers, or the highly profitable private competitors of the Postal Service. AFSI at 41-42; Panzar Decl. at 8; Panzar Reply Decl. at 5-6.[23]

[23] UPS argues that, if PAEA were indifferent about the Postal Service's expansion into other product lines, the Postal Service logically could offer any good or service at its retail post offices. UPS 26 n. 8. The argument ignores the distinction between package service and other competitive services, on the one hand, and non-postal goods and services that are only

UPS's notion of "fairness" to private competitors—*i.e.*, the suppression of price competition from the Postal Service—is deeply unfair to mailers, shippers and ultimately consumers. Fairness to *those* stakeholders requires that integrated enterprises like the Postal Service be allowed to price down to incremental cost when needed to attract business. AFSI comments at 38-40 (quoting economic literature). Raising the regulatory price floor significantly above incremental cost would not eliminate those economies, but merely transfer their benefits from shippers and consumers to already-profitable private competitors like UPS. AFSI comments at 38-40; Panzar Decl. at 8; Panzar Reply Decl. at 6; *accord*, Ronald R. Braeutigam, *Optimal Policies for Natural Monopolies*, *in* 2 *Handbook of Industrial Organization* 1337-41 (R. Schmalensee & R. Willig, eds., 1989)); 1 Alfred E. Kahn, *The Economics of Regulation* 141, 172-73 n. 25 (1970); Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* 22-29, 32-33 (1998).

Moreover, the resulting playing field, far from level, would be tilted severely against the Postal Service. No private carrier, including UPS, is required to recover from its competitive product prices an arbitrary allocation of the private firm's fixed, joint or common costs. Mr. Sidak has acknowledged this in his peer-reviewed work:

> Regulators should not constrain the incumbent [local exchange carriers'] price responses to entry beyond what the antitrust laws already provided … Entrants are free to set prices as market conditions change and to negotiate contractual agreements with individual customers. … In addition, regulators typically do not require entrants to provide cost studies to support their proposed rates, even though the incumbent LEC must provide such studies.

"tangentially related to the delivery of mail." *USPS v. PRC*, 599 F.3d 705, 706 (D.C. Cir. 2010). The former have major economies of scope with market-dominant products; the latter do not. This distinction is the reason that the PAEA restricted the Postal Service's ability to offer non-postal products and services, but imposed no restriction on continuing to offer competitive postal products. *See* 39 U.S.C. § 404(e).

Sidak, J. Gregory, and Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 Yale J. on Regulation 128, 133-34 (1998).

UPS, apparently recognizing that the interests of mailers, shippers and ultimate consumers matter, asserts that a high regulatory floor under the competitive product prices would be good for ratepayers and consumers in the long run because aggressive Postal Service price competition is chilling investment by competing private carriers, which are inherently more innovative than the Postal Service. UPS at 20, 25-27; Sidak at 16-17. As noted above, however, the premise of this "dynamic competition" theory—that private competitors are being deterred from investing in innovation and expansion—is unsupported. The major package carriers are vigorously innovating, as are a swarm of new entrants. *See* pp. 30-32, *supra*.

As AFSI noted in its initial comments, the Postal Service's destination entry prices allow UPS and other private carriers to benefit from the Postal Service's economies of scale and scope by keeping the long-haul revenue for themselves while using the Postal Service for the last-mile delivery. AFSI at 42. The 2007 FTC report, which UPS cites against the Postal Service (*e.g.*, UPS at 19), notes this fact as well:

> Even if economies of scope are an artificial advantage … they may no longer provide a substantial benefit to the USPS. The USPS's competitors regularly purchase access to the USPS's networks through workshare rates. Currently, UPS, Federal Express, and DHL account for the majority of Parcel Select workshare volume.
>
> * * *
>
> The USPS … could use its postal monopoly to affect competition in the competitive products market if it denied competitors reasonable access to its networks. Currently, this does not appear to be an issue.

FTC, *Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors* 50, 52 (2007). UPS has acknowledged elsewhere that it has built much of its business on the use of "final delivery often provided by the U.S. Postal Service" or its foreign counterparts. UPS Form 10-K for 2016 at 6, 7. UPS, Mr. Sidak and the Former Regulatory Commissioners acknowledge none of these facts in their initial comments.

IV. THE MINIMUM PRICE STANDARD PROPOSED BY UPS IS FULLY ALLOCATED COST RATEMAKING, A REGULATORY APPROACH THAT THE COMMISSION AND REPUTABLE ECONOMISTS HAVE REJECTED FOR HALF A CENTURY.

The alternative minimum contribution requirements that UPS proposes confirm the anticompetitive character of the company's position. UPS would have the Commission require that competitive products cover approximately 29 percent of the Postal Service's total institutional costs—a five-fold increase in the current minimum contribution requirement, an increase of nearly 100 percent over the contribution made by competitive products in Fiscal Year 2016, and an increase of nearly 50 percent (or about $3.1 billion annually) over the contribution that competitive products make today. UPS at 33.

UPS justifies the 29 percent figure on the ground that competitive products caused approximately 29 percent of the Postal Service's *attributable costs* in Fiscal Years 2014 through 2016 (*id*. at 34-39). Alternatively, UPS proposes that the competitive products be required to cover 24.2 percent of the Postal Service's institutional costs, a fraction equal to the average share of total Postal Service *revenue* generated by competitive products in Fiscal Years 2014 through 2016. *Id*. at 39.

There is a term for this approach, although UPS and its advocates do not mention it. The term is fully allocated cost ratemaking: *i.e.*, pricing by allocating joint and common costs to particular services (or groups of services) in proportion to relative volume or incremental cost.[24] UPS's failure to use the customary name for its proposed price floor is telling. No approach to the recovery of institutional costs has been more extensively studied in postal rate regulation—and more thoroughly repudiated—than fully allocated cost pricing. We discuss in turn the economic and legal flaws in it.

A. Fully allocated cost pricing is junk economics.

AFSI has explained in this case and RM2016-2 the basic economic defects of fully allocated cost pricing. To summarize: Fully allocated cost pricing is inherently arbitrary because it assigns costs to individual services (or groups of services) without any basis in causation. For services that have relatively intense competition (and thus have relatively elastic demand), a fully allocated cost floor will either operate as cartelizing device, harming ratepayers and ultimate consumers, or cause devastating losses to the regulated carrier, or both. In the present case, the biggest losers are likely to be rural shippers and consumers because of the surcharges that private carriers (but not the Postal Service) typically impose in rural areas. The flaws of fully allocated cost pricing are vividly illustrated by the regulation of minimum railroad rates by the Interstate Commerce Commission in the 1950s and 1960s. The fully allocated cost floor under railroad freight rates imposed by the ICC, ostensibly to level the playing field for competition between railroads and other modes of transportation,

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[24] Panzar Reply Decl. at 10-13; Ronald R. Braeutigam, *Optimal Policies for Natural Monopolies*, *in* 2 *Handbook of Industrial Organization* 1313 (R. Schmalensee & R. Willig, eds., 1989); 1 Alfred E. Kahn, *The Economics of Regulation* 150-58, 198-99 (1970); *accord*, Baumol, William J., and J. Gregory Sidak, *Toward Competition in Local Telephony* 56 (1994).

played a major role in the bankruptcy of most major freight-carrying railroads. In response, Congress amended the law in 1976 to allow railroads to price competitive services down to short-run marginal cost, and in 1995 to eliminate minimum rate regulation for competitive railroad services entirely. AFSI comments at 43-53; Panzar Decl. at 11-15; AFSI comments in RM2016-2 at 4-5, 9-12, 29-33, 43-53 (citing economic literature); Panzar Decl. in RM2016-2 at 3, 20-30.

Even Mr. Sidak has emphatically rejected fully allocated cost pricing in his peer-reviewed work. In 1994, he wrote that this "traditional tool of price regulation" is an "admittedly arbitrary rule of thumb" that "is now generally discredited and is increasingly being abandoned in regulatory practice." Baumol, William J., and J. Gregory Sidak, *Toward Competition in Local Telephony* 56 (1994). "[S]ince the FDC figures are arbitrary, only by very unlikely happenstance will the numbers that emerge from any particular FDC calculation have any relation to the prices required for economic efficiency." *Id*. The "legalistic and near-theological battles over the proper methods for full distribution of costs . . . made [rate of return] regulation most damaging to the public interest." *Id*. at 91. Fully allocated cost pricing, he added in 1998, "is noted for its ease of application without any economically meaningful criterion." Sidak, J. Gregory, and Daniel F. Spulber, *Deregulatory Takings and the Regulatory Contract* 42 (1998). "The 'reasonableness' of the basis of allocation selected makes absolutely no difference except to the success of the advocates of the figures in deluding others (and perhaps themselves) about the defensibility of the numbers. There can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators." *Id*. (quoting with approval Baumol, William J., Michael F. Koehn & Robert D. Willig, *How Arbitrary is "Arbitrary"?—or, Towards the Deserved Demise of Full Cost Allocation*, 21 Pub. Util. Fortnightly, Sept. 3, 1987, at 16)).

"Fully allocated cost figures … have no economic content. They cannot pretend to constitute approximations to anything." Sidak and Spulber, *Deregulatory Takings* at 42 (quoting Baumol, William J., and J. Gregory Sidak, *Transmission Pricing and Stranded Costs in the Electric Power Industry* 64 (1995)).[25] The "distinguishing feature of FDC pricing is that the allocation of common costs is done without reference to any economically meaningful criterion." *Deregulatory Takings* at 386.

"There are other problems with FDC pricing as well. As Ronald R. Braeutigam has observed, 'FDC pricing will lead to prices which are in general economically inefficient, which is not surprising given the fact that the practice focuses heavily on cost and little on conditions of demand (including demand elasticities) which are important in determining the size of the deadweight losses from any pricing policy.'" *Id.* at 42 (quoting Ronald R. Braeutigam, "Optimal Policies for Natural Monopolies," in 2 Schmalensee, Richard & Robert D. Willig, eds., *Handbook of Industrial Organization* 1289, 1314 (1989)). "A preferable way to reduce the incentive and opportunity for anticompetitive cross-subsidization is to replace cost-of-service regulation with price caps." Sidak and Spulber, *Deregulatory Takings* at 44 & n. 49 (citations omitted).

Mr. Sidak has also recognized the anticompetitive effect of fully allocated cost and similar price floors when applied asymmetrically to the competitive services offered by a regulated carrier but not to the services offered by its unregulated rivals:

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[25] These facts dispose of UPS's claim that the "allocation of institutional costs" to particular products or services is "indispensable to accurate and effective regulatory cost accounting." Former Utility Regulators at 7. Basing prices on accounting conventions that are "admittedly arbitrary," "generally discredited," "essentially random," without "economic content," and which "cannot pretend to constitute approximations to anything" is inimical, not indispensable, to economically sound price regulation.

> When companies compete to provide local telecommunications services, prices are driven down toward costs. Regulators, however, will not achieve the full benefit of competition if they continue price controls on the incumbent LEC [local exchange carrier]. The maintenance of price controls—*not only price caps, but also price floors*—prevents the incumbent LEC from responding competitively to the price offers of entrants. *This minimum-price constraint can prevent the incumbent's participation in important market segments, for it provides an umbrella under which entrants can price without fear of retaliation from the incumbent*.

Sidak, J. Gregory, and Daniel F. Spulber, "Deregulation and Managed Competition in Network Industries," 15 *Yale J. on Regulation* 117, 127 (1998) (emphasis added).

UPS does not distinguish Mr. Sidak's prior inconsistent statements, or even acknowledge their existence. In arguing for a fully allocated cost floor under competitive postal prices, UPS has left Mr. Sidak's prior scholarship at the courthouse door.

The handful of economic arguments that UPS does make in defense of a fully allocated cost price floor border are without merit. First, UPS speculates that, because the increases in Postal Service competitive prices between Fiscal Years 2015 and 2016 had "no apparent impact on volume," further price increases should not prevent the Postal Service from sharing in the "overall growth in competitive product volumes." UPS at 36. This is an obvious *non sequitur*. The fully allocated cost floor proposed by UPS would require the Postal Service to raise its competitive prices high enough to net an additional $3.1 billion a year in contribution from competitive products. That is substantially greater than the revenue increases that the Postal Service has applied to competitive products in recent years. UPS offers no elasticity data—or any other evidence—showing that the Postal Service could squeeze this much extra contribution—or any extra contribution at all—from competitive products. Two alternative outcomes are more likely. Private competitors of the Postal Service could exploit the resulting price umbrella by undercutting the Postal Service's prices for either end-to-end service or last-mile delivery, inducing shippers to bypass both the long-haul and last-mile offerings of the

Postal Service, with devastating financial consequences to it. Or the private carriers could match the Postal Service's price increases, ultimately harming mailers, shippers and consumers. AFSI comments at 9-12, 43-53; Panzar Decl. at 11-23.[26]

UPS's appeal to stand-alone cost principles (UPS 6-7, 33-34) is backwards. Stand-alone costs define regulatory price ceilings, not price floors. AFSI comments at 37-38; Panzar Decl. 8-10; Panzar Reply Decl. at 6. Mr. Sidak himself has noted this distinction:

> Under the competitive-market standard for regulations, marginal costs and average-incremental costs are the figures relevant for price floors, while *stand-alone costs are the figures relevant for price ceilings*.

Baumol, William J., and J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 Yale J. on Regulation 171, 177-78 (1994) (emphasis added); *accord*, Sidak and Spulber, *Monopoly and the Mandate of Canada Post*, *supra*, 14 Yale J. on Regulation at 55 (explaining that the stand-alone cost is the price ceiling above which a service subsidize others, while the incremental cost test is a price floor below which a service is subsidized by others).

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[26] That the UPS proposal would allocate institutional costs between market-dominant and competitive products in the aggregate, rather than to individual products or classes, would not avoid these problems. Panzar Reply Decl. at 11. As Alfred Kahn explained, the "basic defect of full cost distributions as the basis for pricing" is their disregard for "the pervasive discrepancies between marginal and average cost" and the need for prices to "take into account not just the costs but also the elasticities of demand of the various categories of service if the company is to recover its total costs." 1 Alfred E. Kahn, *The Economics of Regulation* 155 (1970). The Postal Service's competitive products on average face significantly greater competition and more inelastic demand than do the Postal Service's market-dominant products on average. Hence, contribution-maximizing markups over attributable cost for competitive products on average are by necessity significantly lower for competitive products than for market-dominant products. *See* AFSI at 23 (showing average cost coverage for competitive products). Even at the aggregate level of competitive products as a whole and market-dominant products as a whole, a price floor equal to fully allocated costs would require the Postal Service to price competitive products above the level warranted by competition and demand, or price market-dominant products below the level warranted by competition and demand, or both. Panzar Reply Decl. at 10-13.

Finally, UPS, apparently aware that the Commission may find the economic consequences of a fully allocated cost price floor unacceptable, proposes in the alternative that the Commission "phase-in the increase of the appropriate share percentage." UPS at 36-37. Phasing does not eliminate these harms, however. By the third year of the fully allocated cost regime, its destructive effects would be fully phased in.

B. Congress, the Commission and the courts have rejected fully allocated cost pricing of postal services.

UPS's fully allocated cost pricing proposal is in any event foreclosed by decades of Commission and judicial precedent under the Postal Reorganization Act of 1970 and the Postal Accountability and Enhancement Act of 2006. As AFSI has previously explained, postal pricing before 1971 relied heavily on fully allocated costs. AFSI comments in RM2016-2 (Jan. 25, 2016) at 39. The Kappel Commission Report and other independent observers urged Congress to end this practice. *Id*. at 39-40 (citing Toward Postal Excellence: The Report of the President's Commission on Postal Organization 133 (1968)); *accord* PRC Docket No. R74-1 Op. and Rec. Decis. (Aug. 28, 1975) at 82-83 (discussing reports of Kappel Commission and Touche, Ross, Bailey and Smart). During the drafting of the Postal Reorganization Act, UPS nonetheless argued for the enactment of a fully allocated cost price floor, but Congress declined to include one. AFSI comments in RM2016-2 at 39-42.

The first dozen years after the enactment of the Postal Reorganization Act witnessed protracted litigation at the Commission and the Courts of Appeals between the supporters and opponents of fully allocated cost pricing. This litigation culminated in the repudiation of fully allocated cost ratemaking by the Supreme Court in *Nat'l Ass'n of Greeting Card Publishers v. USPS*, 462 U.S. 810 (1983). AFSI comments in RM2016-2 at 42-49 (discussing *Greeting*

Card Publishers and its background). During the 13 years between the Supreme Court decision in *Greeting Card Publishers* and the enactment of PAEA in 2006, the Commission repeatedly reaffirmed its rejection of fully allocated cost ratemaking. AFSI comments in RM2016-2 at 30 (citing precedents).

As explained above, the Postal Service's competitors again urged adoption of a fully allocated cost floor during the legislative deliberations that led to the enactment of PAEA in 2006. Congress ultimately rejected this approach, however: PAEA, as enacted into law in 2006, contained no such requirement. *See* pp. 5-6, *supra*; AFSI comments in RM2016-2 at 53-56. The committee reports on the proposed legislation confirm that the elimination of any proportionality requirement was intentional:

> "The current analysis has been guided by a Supreme Court decision, *National Assoc. of Greeting Card Publishers v. USPS*, 462 U.S. 810, 829-34 (1982), that carefully analyzed how the term attributable should be interpreted. This definition has been further refined by U.S. Courts of Appeals and is well understood in the industry. The NAGCP Court rejected a contention that it was appropriate to make classes responsible for the recovery of costs for which an extended inference of causation was claimed. It emphasized the need for reliable indicators of causality without specifying any specific method for identifying causality. Governed by this ruling since 1982, the Postal Rate Commission must have reasonable assurance that any costs attributed to a class of mail are incurred as a result of providing that class of mail. *The Committee finds no reason for changing this standard.*

S. Rep. No. 108-318 at 9-10 (emphasis added); *see also* pp. 7-8 n.6, *supra* (quoting other committee report language).

The Commission against considered and rejected a fully allocated cost price floor in Docket No. R2007-1, the first Commission rulemaking to implement the minimum contribution requirement. In that case, UPS proposed that the Commission "base competitive products' share of institutional costs on the percentage of total postal revenue earned by competitive products as a whole … Alternatively, the competitive products' share of institutional costs could track the competitive products' share of the Postal Service's total attributable costs." UPS comments in RM2017-1 (June 18, 2007) at 13 (citing European postal precedent). The Commission considered and rejected these proposals. Order No. 26 (Aug. 15, 2007) at 69-70 ¶¶ 3049-50.

UPS's most recent attempt to resurrect fully allocated cost pricing occurred, as the Commission knows, in RM2016-2. The Commission again rejected the allocation of volume-variable costs "based on the respective shares of overall attributable costs." Order No. 3506 at 104 (first full paragraph) (rejecting UPS proposal).

As in Docket No. RM2016-2, UPS does not respond to—or even acknowledge—these controlling legal authorities. Instead, UPS again invites the Commission to follow the lead of certain foreign postal regulators and domestic non-postal regulators that, according to UPS, still use fully allocated cost ratemaking. UPS at 37-38 (citing European Commission regulations); Former Utility Regulators (citing decisions of the Federal Communications Commission, Federal Energy Regulatory Commission, and state public utility commissions). The Commission should decline this invitation.

First, postal ratemaking in the United States is governed by a different set of laws. Whether the European Commission, the FCC, the FERC, and state regulatory commissioners still attribute joint and common costs to individual services "to the maximum extent practicable," Former Utility Regulators at 6 & n. 14, postal rate regulation in the United States has taken a different course. As the Supreme Court explained in upholding the Commission's rejection of "extended cost attribution," the Commission "acted consistently with the statutory mandate and Congress' policy objectives in refusing to use distribution keys or other accounting principles lacking an established causal basis." *National Ass'n of Greeting Card Publishers*, 462 U.S. at 826-29. The Commission's attribution methods must "provide reasonable assurance that costs are the result of providing one class of service." *Id*. at 833. When "causal analysis is limited by insufficient data, the statute envisions that the Rate Commission will press for . . . better data, rather than construct an 'attribution,' based on unsupported inferences of causation" (internal punctuation omitted). *Id*. at 827.

Second, the foreign and nonpostal precedents cited by the Former Utility Regulators would be poor economic guidance for the Commission even if the precedents were on point. Mr. Sidak's views on the FCC's "Part 64" cost allocation rules, which the Former Utility Regulators endorse as a model for the Commission (*id*. at 6 n.14, 7 n.16, 8 n.19), are instructive:

> The cost allocation procedures of [47 C.F.R.] Part 64 also invite strategic abuse of the regulatory process to impede the [local exchange carriers'] competitive entry into other markets. The proponents of any given cost allocation formula will predictably justify their recommendation on the grounds that it will advance 'the public interest.' Yet elementary price theory will usually reveal the contrary—that the recommendation has the practical effect of reducing consumer welfare. In the FCC's 1996 cost allocation proceeding, for example, the cable television industry's principal proposal—that 75 percent or more of common costs be allocated to the LEC's video services and 25 percent to its telephony services—had no economic substance. With as much intellectual weight the industry could have proposed that the FCC allocate the LEC's common costs between video and telephony on the basis of the ratio of the total offensive yardage of the Washington Redskins to that of the Dallas Cowboys. *Such cost allocation procedures erect regulatory barriers to competitive entry by telephone companies.*

Sidak and Spulber, *Deregulatory Takings* at 46 (emphasis added).

Third, and in any event, UPS has overstated the actual role of fully allocated costs in the foreign and nonpostal regulatory regimes that UPS would have the Commission emulate.

Consider first the European Commission. It is true that an EU directive requires European postal operators to maintain accounting systems that differentiate between the costs of fulfilling universal service obligations and the costs of other services. But the directive has no binding effect unless implemented by enabling legislation in a particular EU member country. Many observers have criticized the fully-allocated cost price floor provisions of the European rules on grounds akin to those discussed in these comments, and the fully-allocated cost pricing provisions appear to be honored more in the breach than the observance. The Office of Inspector General of the Postal Service noted this in 2013:

> Three foreign postal operators reported using FDC to establish a floor for pricing. One used FDC as a cross-subsidy test while three reported no testing for cross-subsidy. Another used it for calculating Universal Service Obligations (USO) and a third used it to report to their regulatory authority. Only one made the number public. All postal operators recognized that setting all prices close to FDC ensured that all costs were covered and that a profit was generated but *many claimed that it was not a tenable or sustainable position for all products due to the impact on customer usage. One postal operator explicitly stated that an attempt to use FDC as a price floor resulted in prices so high that customers abandoned the mail to such an extent that net revenue decreased. Therefore, most postal operators and all nonpostal businesses recognized that it could not be a universal price floor and that it was necessary to price below FDC for many products*.
>
> Economists have asserted that distributing nonvolume variable costs by using arbitrary allocation rules could be counterproductive. While the European Union Postal Directives are often cited as requiring FDC as a cost floor, many of those interviewed in this benchmark study claimed their prices merely needed to have a cost-based orientation. That is, their prices needed to be related to product cost. They asserted that there was some flexibility in the type of cost used and that it was not required to be FDC in all cases. The nonuniversal use of FDC as a basis for pricing demonstrates this more flexible interpretation.

OIG Report No. MS-MA-13-004, *Benchmarking of Costing Methodologies* at 16 (Aug. 14, 2013) (emphasis added).

The Former Utility Regulators have similarly overstated the role of fully allocated costing in rate regulation by the FCC and FERC. Cost allocation rules, although still on the regulators' books, have played a diminishing role in setting rates since the late 1980s. In the early 1990s, the FCC replaced rate of return regulation with price cap regulation for the market-dominant services of carriers such as AT&T and Verizon. *Verizon and AT&T, Inc. v. FCC*, 770 F.3d 961, 963 (D.C. Cir. 2014). "Under the new regime, the Commission sets a maximum price and the firm selects rates at or below the cap." *Id*. Within the past decade, the FCC has exempted price-cap carriers from most of the cost allocation rules. *In re Petition of USTelecom for Forbearance Under 47 U.S.C. § 160(c) from Enforcement of Certain Legacy Telecommunications Regulations*, 28 FCC Rcd. 7627, 7646-53 (2013), *aff'd*, *Verizon and AT&T*, *supra*.[27] Since the early 1990s, the FERC similarly has adopted rules (1) allowing oil pipelines to opt for price cap regulation of their market-dominant services, 18 C.F.R. § 342.3, and (2) generally exempting competitive services from both cost-of-service *and* price cap regulation. 18 C.F.R. §§ 342.4, 348.1, 348.2.[28] And natural gas pipelines are permitted to compete by discounting their rates down to average variable cost. 18 C.F.R. § 284.10(c)(4)(ii). Significantly, the Former Utility Regulators fail to cite any recent FCC or FERC decision

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[27] In *Petition of USTelecom*, the FCC declined to exempt the price-cap carriers from their obligation to continue maintaining records in compliance with the FCC's Uniform System of Accounts. But in *Comprehensive Review of the Part 32 Uniform System of Accounts*, 2017 WL 751378 (Feb. 24, 2017), the FCC has proposed to relax this requirement as well.

[28] *See also Williams Pipe Line Co.*, 71 FERC ¶ 61,291 (1995) at 62,146 ("discounts to customers with other shipping alternatives are recognized as benefitting captive customers, so long as non-captive customers contribute something to common costs"); *Texas Eastern Products Pipeline Co.*, 50 FERC ¶ 61,218 (1990) at *61704 (terminating investigation of an unregulated competitor's allegation that the rate discounts offered by Texas Eastern were predatory or unlawful; to prevail, the competitor would need to show that "TEPPCO can price below marginal or variable costs to drive competitors from its market and above those costs to recover lost profits").

finding that a rate charged by a telecommunications or pipeline carrier for a competitive service was unlawfully low because the rate failed to cover fully allocated costs.[29]

V. THE GCA PROPOSAL ILLUSTRATES WHY THE COMMISSION SHOULD ZERO OUT THE MINIMUM CONTRIBUTION REQUIREMENT, NOT JUST FREEZE IT AT ITS CURRENT LEVEL.

The only mailer or shipper interest to propose a significant increase in the minimum contribution requirement, GCA, proposes that the Commission set the required minimum contribution equal to the average minimum share of institutional costs covered by competitive products "in recent years." GCA at 6. As "one suitable approach," GCA suggests that the Commission set the average minimum between 10.5 and 11 percent, the average of the minimum share actually covered by competitive products in Fiscal Years 2010 through 2016. *Id*. at 6-7. This minimum would still be below the actual contribution from competitive products in any year since Fiscal Year 2013, and would be approximately half the projected contribution in Fiscal Year 2017. Hence, the proposed minimum would be nonbinding for the foreseeable future absent an unanticipated collapse in the Postal Service's competitive product business.

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[29] Neither *In the Matter of Connect America Fund; Allband Communications Cooperative Petition for Waiver of Certain High-Cost Universal Service Rules*, 31 FCC Rcd 8454 (2016), nor *SFPP, L.P.*, 137 FERC ¶ 61,120 (2011), was a minimum rate case. *Allband* was an investigation into whether a rural telecommunications carrier had inflated the subsidies which it had claimed from the universal service fund by seeking reimbursement of labor and other costs that were caused by non-USO services and even personal spending by company managers for their spouses. *SFPP* was a maximum rate case.

The GCA proposal illustrates why the Commission should zero out the minimum contribution requirement, not just keep it low enough to be nonbinding. A minimum requirement, as long as it remains too low to be binding, is pointless and benefits no one. AFSI comments at 28. Even UPS agrees: "The current contribution requirement of 5.5% … has virtually no impact at all." UPS at 6. Moreover, even a nonbinding contribution requirement has costs. The "administrative costs borne by" the Postal Service, its customers and the Commission from any minimum price rule "include the expense of lawyers, accountants, and the cost reporting systems necessary to comply with the rule." Sidak and Spulber, *Deregulatory Takings* at 43; *accord*, AFSI comments 54; Panzar 24.

Conversely, if circumstances ever made the minimum contribution requirement proposed by GCA proposal binding, then the competitive harms described in section IV.A above and in AFSI's initial comments would materialize. This could happen, for example, if the growth in contribution from competitive products eventually flattened out (which would cause the trailing historical average proposed by GCA to approach and eventually equal the current contribution), and unanticipated developments then caused the current contribution to shrink. If that happened, any downturn in the contribution from competitive products, by forcing the Postal Service to raise its prices in a futile attempt to squeeze more contribution from its competitive customers, could send the USPS into a financial tailspin.

Apart from this potential death spiral, the approach of the minimum required contribution to the Postal Service's actual current contribution would, by reducing the Postal Service's downward pricing flexibility, weaken the Postal Service's ability to act as a competitive constraint on the major private carriers. The minimum contribution constraint would become, in the words of Mr. Sidak, "an umbrella under which" the private carriers "can price without fear of retaliation from the" Postal Service. Sidak and Spulber, 15 *Yale J. on Regulation* at 127.

CONCLUSION

For the above reasons, the Commission should exercise its authority under 39 U.S.C. § 3633(b) to eliminate the minimum required contribution.

Respectfully submitted,

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APPENDIX A

Approximate Effect of Prudent Investing on Present Value of Retirement Benefits (Billions of Dollars)
(Treating Liability as Perpetuity)

Obligation	**Fiscal Year 2016 10-K**		**PV at 7.5% Discount Rate**	**Difference in Present Value**	**Fiscal Year 2015 Fund Balance**	**New Surplus/ Liability**
	Present Value	**Discount Rate**				
	[1]	**[2]**	**[3]=[1]*[2]/7.5%**	**[4]=[3]-[1]**	**[5]**	**[6]=[5]-[3]**
Retiree Health Benefits	$104.0	3.9%	$54.1	-$49.9	$51.9	-$2.2
Pension Benefits	$307.8	5.25%	$215.5	-$92.3	$286.5	$71.0
Total	**$411.8**		**$269.5**	**-$142.3**	**$338.4**	**$68.8**

[1],[2] USPS Fiscal Year 2016 10-K at 25, 27

[3] 7.5% Median Investment Return Assumption from NASRA ISSUE BRIEF: Public Pension Plan Investment Return Assumptions. February 2017

[5] USPS Fiscal Year 2016 10-K at 24, 27

These calculations update an analysis originally presented in Attachment B to the June 14, 2016, comments of MPA-Association of Magazine Media and Alliance of Nonprofit Mailers in Docket No. PI2016-3, *Section 701 Report*.