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BEFORE THE
POSTAL REGULATORY COMMISSION

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

REPLY COMMENTS OF UNITED PARCEL SERVICE, INC. ON NOTICE OF PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS

(March 9, 2017)

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INTRODUCTION

The Postal Service classifies a large portion of its costs as "institutional" costs of the enterprise, conservatively estimated at $30 billion in 2016, or approximately 45% of its total costs.[1] In its opening comments, United Parcel Service, Inc. ("UPS") demonstrated that the overall amount of institutional costs has grown in recent years even as the Postal Service delivers fewer of its flagship mail products. In fact, the Postal Service added at least $1.3 billion in institutional costs in just the last two years.[2]

This growth is occurring because, as the Postal Service increasingly focuses on parcel delivery, competitive products are increasingly driving the costs and investments of the enterprise as a whole. Yet, under current regulations, competitive products have little responsibility to fund these costs and investments. Instead, they ride nearly for free on a network built and largely maintained by proceeds from market-dominant products. Current regulatory requirements thus provide the Postal Service with an artificial advantage over the private sector, which is exactly what Congress sought to prevent by enacting the requirement that competitive products fund an "appropriate share" of institutional costs.

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[1] $30 billion is conservatively derived by taking the institutional cost numbers from the Cost and Revenue Analysis ($36.4 billion in Fiscal Year 2016) and subtracting prefunded annuitant health benefits ("component 203") and workers' compensation calculations from the prior year ("component 205"), whose year-on-year changes are generally not due to operational factors. *See* Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Jan. 23, 2017) ("Initial UPS Comments"), at 30 ("Table 1"). The 45% figure for institutional costs is based on the raw numbers from the Postal Service's 2016 Cost and Revenue analysis, without subtracting prefunded annuitant health benefits and workers' compensation calculations from the prior year. *See* United States Postal Service, Public Cost and Revenue Analysis (Fiscal Year 2016) 3 (2016).

[2] This $1.3 billion is conservatively derived by taking the $2.2 billion difference in institutional cost numbers from Fiscal Year 2016 ($36.4 billion) and Fiscal Year 2014 ($34.2 billion) and excluding the amounts for which components 203 and 205 are responsible.

Under the status quo, the Postal Service must attribute costs to products only when those costs are exclusively caused by individual products. Given that the Postal Service uses its network to deliver many different products, this approach results in a large proportion of costs not being attributed to any products and instead classified as institutional. Current regulations, however, give the Postal Service's competitive products only a negligible responsibility for covering institutional costs. The current requirement that competitive products must cover 5.5% of institutional costs is so low and outdated that it is effectively meaningless today. Indeed, that the current requirement is effectively meaningless is one of the few points upon which virtually all of the parties filing comments in this docket can agree.[3]

No private-sector parcel company has a similar ability to avoid covering the costs and investments associated with selling its products. None of the Postal Service's rivals can avoid responsibility for costs associated with building and maintaining a delivery network, administrative and support functions, and management salaries simply by classifying such costs as "institutional." Only the Postal Service can do this. And its unique ability to avoid responsibility for costs associated with competitive products is having discernible and predictable consequences. Having only recently begun placing a prominent focus on package deliveries, following historic declines in its traditional

[3] *See, e.g.,* Comments of Amazon Fulfillment Services, Inc., Dkt. No. RM2017-1 (Jan. 23, 2017) ("Amazon Comments"), at 54 (describing the current requirement as "economically irrelevant").

letter mail business, the Postal Service already boasts that it delivers more e-commerce packages to American homes "than anyone else in the country."[4]

This Commission has long recognized that Congress intended the "appropriate share" requirement to ensure that the Postal Service competes on a level playing field. But it only meets that objective when the requirement is set at a level that truly ensures that "the Postal Service, like its competitors, must set prices to produce sufficient revenues to cover both variable and fixed costs *in their entirety*."[5] Today, the low 5.5% contribution requirement does not meet that standard. The most reliable benchmarks (such as the degree to which competitive products contribute to overall estimated *attributable* costs) demonstrate that the minimum contribution requirement must be raised to approximately 29% to meet Congress' objectives.

Nevertheless, various commenters in this docket argue that the Commission should keep the minimum contribution requirement at its current low level — or eliminate it entirely. Notably, these commenters do not support their proposals with any meaningful analysis of the degree to which competitive products are responsible for institutional costs. These commenters do not explain, for example, why institutional costs recently grew by over $1.3 billion as mail volumes declined. Nor do they acknowledge the Postal Service's own statements about how higher costs associated

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[4] United States Postal Service (@USPS), TWITTER (Nov. 17, 2016, 6:00 AM), https://twitter.com/USPS/status/799250904151113728 (last visited Mar. 9, 2017) (emphasis added).

[5] Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, Dkt. No. RM2012-3 (Aug. 23, 2012) ("Order No. 1449"), at 15 (emphasis added); *see also id.* ("A primary function of the appropriate share requirement is to ensure a level playing field in the competitive marketplace.").

with competitive products are driving billion-dollar cost increases. They simply disregard these facts.

Instead of acknowledging how competitive products are driving institutional costs today, these commenters typically raise *theoretical* objections to the very idea of a minimum contribution requirement. They assert that the requirement makes no economic sense, effectively questioning Congress' judgment in enacting 39 U.S.C. § 3633(a)(3) a decade ago. They disparage Congress' objectives as "inchoate" or economically irrational. They argue, without citing any legislative history, that Congress somehow intended for the appropriate share requirement to be merely "transitional." As shown herein, none of these objections have merit. Congress had valid reasons for enacting the minimum contribution requirement, and those reasons have only become more valid as the Postal Service's focus shifts toward competitive products and it devotes more of its resources to growing in competitive markets.

With these reply comments, UPS submits the declaration of Prof. Dennis Carlton, who responds to the economic analysis offered by Prof. John Panzar that attempts to justify eliminating the minimum contribution requirement. *See* Declaration of Dennis W. Carlton ("Carlton Declaration"). Prof. Carlton is a professor at the Booth School of Business of The University of Chicago and the former Deputy Assistant Attorney General for Economic Analysis in the Antitrust Division of the U.S. Department of Justice. He is widely recognized as one of the nation's foremost economic experts in the field of industrial organization.

Prof. Carlton explains why Congress' concern with ensuring a level playing field — a concern expressed consistently throughout PAEA's legislative history — is economically sound. As Prof. Carlton explains, Prof. Panzar's dismissal of this concern rests on his mistaken assumption that the Postal Service operates efficiently with the same profit and innovation incentives as private firms. In fact, Prof. Carlton explains that the Postal Service, as a large government enterprise with statutory monopolies, faces weaker incentives than private firms to minimize costs, use capital assets wisely, maximize profits, and innovate. These differing incentives make the Postal Service more likely to make inefficient operational decisions and to maintain excess capacity.

In turn, these incentives create a serious risk that the Postal Service will expand in competitive markets to displace *more* efficient private-sector rivals in the absence of a meaningful contribution requirement. Prof. Carlton explains that setting the minimum contribution requirement too low could, therefore, promote the inefficient expansion of the Postal Service's competitive products business, harming overall innovation, dynamic efficiency, and consumer welfare in the parcel delivery industry.

Prof. Carlton also responds to Prof. Panzar's claim that the existing incremental cost tests fully account for the contribution of competitive products to institutional costs. As Prof. Carlton explains, those tests do not, in fact, fully account for many of the institutional costs that, from an economic perspective, are causally related to competitive products. Causally-related costs that are not accounted for by the existing incremental cost tests include portions of the $23 billion in institutional costs that Postal Service models treat as "fixed," which make up about two-thirds of institutional costs overall. Even though such costs are treated as fixed at current volume levels, many could be reduced if the Postal Service did not sell competitive products. An appropriate contribution requirement is necessary to hold competitive products responsible for *all* of the institutional costs associated with those products as an economic matter.

In short, Prof. Carlton shows that it is necessary for competitive products to be assigned an appropriate share of institutional costs to promote a level playing field and economic efficiency.[6] Consistent with Congress' intent, the minimum contribution requirement should be increased to approximately 29%.

ARGUMENT

I. THE REQUIREMENT THAT COMPETITIVE PRODUCTS MAKE AN APPROPRIATE CONTRIBUTION TO INSTITUTIONAL COSTS IS A CRITICAL ELEMENT OF SECTION 3633

39 U.S.C. § 3633 provides that competitive products must demonstrate that they (i) are not subsidized by market-dominant products, (ii) are recovering their own attributable costs, *and* (iii) are making a meaningful (or "appropriate") contribution to recovering institutional costs. When Congress implemented this "appropriate share" requirement as part of the Postal Accountability and Enhancement Act of 2006 ("PAEA") it was aware that the Postal Service classified a large portion of its costs as "institutional" — a practice that persists today. Congress recognized that, if the Postal Service's competitive products business was not held responsible for an appropriate share of these unattributed "institutional" costs, it would enjoy an artificial advantage over the private sector.

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[6] UPS also asked postal economist J. Gregory Sidak to evaluate the appropriate share requirement. Sidak filed an initial declaration supporting an increase to the appropriate share requirement and explaining that allowing the Postal Service to price competitive products near marginal cost "would stifle dynamic competition." Declaration of J. Gregory Sidak on Behalf of United Parcel Service, Dkt. No. RM2017-1 (Jan. 23, 2017) ("Sidak Declaration"), at 17-18. Sidak will also be filing reply comments responding to the opening set of comments, including Prof. Panzar's report.

The minimum contribution requirement is designed to ensure that competitive products are held responsible for all of the costs, fixed and variable, with which they are associated. By doing so, the requirement will ensure the Postal Service competes on a "level playing field" with the private sector, a concept that Congress mentioned repeatedly in PAEA's legislative history.[7]

UPS demonstrated in its opening comments that the current 5.5% contribution requirement, which the Commission intentionally set as a low starting point in 2007, is not "appropriate" under current conditions and does not fulfill the statutory purpose today. Applying the Commission's own standards, the current requirement does not "reflect the ways in which institutional resources are spent on the competitive enterprise;" nor does it ensure that competitive products produce sufficient revenues to cover all of the "variable and fixed costs" for which they are responsible.[8] No commenter in this docket demonstrates otherwise.

To the contrary, the commenters advocating for a low or zero contribution requirement generally agree that the current 5.5% requirement is "economically irrelevant" and "illusory" in light of current market realities.[9] Rather than proposing to make the contribution requirement relevant, however, these commenters propose that it be eliminated. That proposal is unacceptable. Congress' concerns with ensuring that

[7] *See, e.g.,* H.R. REP. NO. 109-66 at 44, 46 (2005).

[8] Order No. 1449 at 13, 15.

[9] Amazon Comments at 13 (referring to the 5.5% requirement as "a non-binding (and therefore illusory) price constraint"); *id*. at 19 (referring to the 5.5% requirement as "economically irrelevant"); *id.* at 29 (referring to the requirement as "effectively irrelevant as a pricing constraint"); *id.* at 54 (again referring to the requirement as "illusory and non-binding"). *See also* Declaration of John C. Panzar for Amazon Fulfillment Services, Inc., Dkt. No. RM2017-1 (Jan. 23, 2017) ("Panzar Declaration"), at 24 (referring to the 5.5% requirement as "a non-binding (and therefore illusory) price constraint").

the Postal Service competes on a level playing field are even more vital today than they were in 2007, given the Postal Service's increasing focus on growing in parcel markets. To comply with the statutory purpose, the minimum contribution requirement must be increased significantly.

A. Congress' Concern With Ensuring a Level Playing Field is Vital and Economically Valid

The various comments advocating for a low or zero contribution requirement suffer from a common flaw: they fail to acknowledge that Congress has spoken on this issue, and certainly fail to acknowledge that Congress' objectives were valid. As noted, Congress intended that the contribution requirement would promote fair competition by ensuring the Postal Service competes on a level playing field. These commenters, however, dispute the validity of that goal. Prof. Panzar, for example, argues that any requirement that competitive products contribute to institutional costs "makes no economic sense."[10] It makes no sense, in his view, because the only valid economic concern is preventing cross-subsidization, which he asserts is addressed by the incremental cost tests applied under 39 U.S.C. §§ 3633 (a)(1) & (a)(2).

As Prof. Carlton explains, Prof. Panzar fails to consider the role of the "appropriate share" requirement in maintaining adequate incentives for innovation and dynamic efficiency in the postal sector.[11] Prof. Panzar overlooks this role because he relies on several unspoken and unproven assumptions. First, he assumes that the Postal Service has the same incentives as private firms to operate efficiently and to

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[10] Panzar Declaration at 7-8.

[11] Carlton Declaration ¶¶ 10, 32.

innovate. Second, he assumes that the Postal Service's low reported attributable costs for competitive products derive from efficient operations.[12] Consistent with these assumptions, Prof. Panzar sees no legitimate concern with the Postal Service displacing private-sector competition, because he has simply *assumed* that such displacement would reflect economically efficient behavior.

But Prof. Panzar's assumptions are not well founded. As Prof. Carlton explains, the Postal Service faces different incentives from private firms because it is a government agency and a monopoly provider of mail products.[13] Unlike a private enterprise, the Postal Service faces no pressure to earn a return on its capital assets and can expect to remain in operation even if it loses money on a sustained basis.[14] Similarly, its managers generally do not benefit from profits generated by new products or cost-reducing productivity improvements. Nor do they face penalties for failing to improve efficiency. To the contrary, political pressures may inhibit the Postal Service from introducing changes that enhance productivity and lower cost.[15] For these and other reasons, the economic literature recognizes that government enterprises like the

[12] As discussed below, Prof. Panzar also incorrectly assumes that the existing incremental cost tests fully account for all of the institutional costs associated with competitive products. *See* Section I.B *infra*.

[13] *See generally* Carlton Declaration, Sections III.A & B (¶¶ 15-28).

[14] *See, e.g.,* UNITED STATES POSTAL SERVICE, FORM 10-K 32 (2014) (noting "it is unlikely that in the event of a cash shortfall, the Federal Government would allow us to significantly curtail or cease operations").

[15] Prof. Carlton notes, for example, that the Postmaster planned to close 82 mail-processing facilities in 2014, but changed its plans after 50 senators sent a letter asking it do so. Carlton Declaration ¶ 20. This demonstrates how the Postal Service faces incentives that may lead to the inefficient maintenance of excess capacity.

Postal Service are less efficient than private firms and face weaker incentives to innovate.[16]

Nor does the Postal Service have the same incentives as the private sector to make efficient operational decisions. Specifically, Prof. Carlton observes that the Postal Service has an incentive to operate with artificially high fixed costs and artificially low variable costs. For example, the Postal Service may maintain "an inefficiently large number of facilities in the face of a declining volume of letter mail in order to preserve jobs."[17] To the extent it does so, the Postal Service would be able to add competitive products to its network at a low reported incremental cost. Such reported low costs, however, would not genuinely reflect economic efficiency.

If it were acting efficiently and facing the same competitive pressures as a private firm, the Postal Service would have significantly downsized its operations as mail volumes declined, far more than it actually did. Once it had done so, it would be significantly more expensive for the Postal Service to add competitive products and services, since it would no longer have excess capacity that could be leveraged to deliver competitive products. In order to add significant volumes of competitive products and services to a network that was efficiently sized to handle reduced market-dominant mail volumes, the Postal Service would have had to make significant

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16 *See also* J. Gregory Sidak, *Maximizing the U.S. Postal Service's Profits from Competitive Products*, 11 J. COMPETITION L. & ECON. 617, 662 (2015); David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 499-500 (2003); David E.M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. CHI. L. REV. 271, 285-86 (2000).

17 Carlton Declaration ¶ 27.

investments in new facilities and capacity expansion. Overall, this would have raised incremental costs relative to what the Postal Service reports today.

Because the Postal Service does not have the same incentives as private firms to shed excess capacity, however, the Postal Service's reported low incremental costs reflect its high fixed costs rather than genuine economic efficiency.[18] Put differently, the Postal Service's low reported incremental costs do not reflect superior efficiency; they instead reflect, at least in part, the Postal Service's historical inefficiency and maintenance of excess capacity. Prof. Panzar has certainly not shown otherwise.

Accordingly, the Postal Service's displacement of private-sector competition is by no means a necessarily efficient outcome. Such displacement could instead reflect the expansion of the Postal Service's competitive products business in a manner that displaces more efficient and innovative private sector activity — an economically *inefficient* result.

Congress instituted the minimum contribution requirement to prevent the Postal Service from expanding inefficiently in this manner. The legislative history indicates that Congress was attuned to the differences between the Postal Service and the private sector when it enacted § 3633(a)(3).[19] As Prof. Carlton explains, to the extent the Postal Service displaces activities by more efficient rivals, it harms overall innovation and the dynamic efficiency of the parcel industry.[20] Prof. Carlton cites the work of Nobel

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[18] Carlton Declaration ¶¶ 23-29.

[19] The House Report related to PAEA states, for example, that Congress intended for this Commission to apply "*stronger* controls, oversight and limitations" on the Postal Service "*in recognition of its governmental status*." *See* H.R. REP. NO. 109-66 at 44 (2005) (emphasis added).

[20] Carlton Declaration ¶¶ 35-36.

Laureate Robert Solow, which shows that improvements in social welfare are primarily driven by gains in technical and dynamic efficiency.[21] Consistent with the predictions of economic theory, the private sector has historically led the way in innovation in parcel markets. Inefficient expansion of the Postal Service into competitive markets impacts private firms' incentives to invest in research and development that can lead to new services, higher quality services, and cost reductions.

In short, Congress' effort to ensure that the Postal Service competes on a level playing field as it expands into competitive markets is economically justified. A meaningful contribution requirement is necessary to achieve this result.

B. Applying the Incremental Cost Test Alone Would Distort Competition and Harm Dynamic Efficiency

Several commenters, including Prof. Panzar, argue that the only valid rate regulation for competitive products is the use of the incremental cost test to prevent cross-subsidization of the Postal Service's competitive products by its market dominant products. They argue that the minimum contribution requirement should be abandoned because incremental cost tests are already being performed under 39 U.S.C. §§ 3633(a)(1) & (2). This argument, however, is incompatible with PAEA and Congress' objectives.

1. PAEA's Text and Purpose Require More than the Incremental Cost Test

The argument that the incremental cost test is the only test that should be applied to competitive products is not supported by the statutory scheme of rate regulation adopted by Congress. As noted, the Commission interprets 39 U.S.C.

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[21] *Id.* ¶ 37.

§ 3633(a)(1) & (a)(2) to implement an incremental cost test for competitive products at a "group" and "product" level, respectively. Applying only the incremental cost test, as Prof. Panzar proposes, would thus render the separate "appropriate share" requirement embodied in § 3633(a)(3) a nullity. But this result violates basic tenets of statutory construction.[22]

Moreover, the incremental cost test was never intended to ensure that a government enterprise competes with the private sector on a level playing field, which this Commission has recognized is a "primary function of the appropriate share requirement."[23] The incremental cost test was designed instead to prevent cross-subsidization. Indeed, this Commission observed in Order No. 3506 that "the purpose of the incremental cost test is *not* to ensure that the Postal Service is competing fairly in the marketplace."[24] Accordingly, the Commission must do more than impose the incremental cost test to ensure that the Postal Service is competing fairly, as Congress intended.

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[22] *See Setser v. United States,* 566 U.S. 231, 239 (2012) ("[W]e must give effect . . . to every clause and word of the Act.") (alteration in original) (quotation marks omitted); *Alaska Dep't of Envtl. Conservation v. EPA,* 540 U.S. 461, 489 n.13 (2004) ("It is, moreover, a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or otherwise insignificant.") (quotation marks omitted); *Freytag v. C.I.R.*, 501 U.S. 868, 877 (1991) ("Our cases consistently have expressed a deep reluctance to interpret a statutory provision so as to render superfluous other provisions in the same enactment.") (quotation marks omitted); *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985) (holding it is an "elementary canon of construction that a statute should be interpreted so as not to render one part inoperative") (quotation marks and citation omitted); *Donnelly v. F.A.A.*, 411 F.3d 267, 271 (D.C. Cir. 2005) ("We must strive to interpret a statute to give meaning to every clause and word, and certainly not to treat an entire subsection as mere surplusage.").

[23] Order No. 1449 at 13.

[24] Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), Dkt. No. RM2016-2 (Sep. 9, 2016) ("Order No. 3506"), at 58 (emphasis added).

2. A Significant Contribution Requirement is a Necessary Addition to Current Estimates of Incremental Cost to Avoid Inefficient Distortions to Competitive Markets

Arguments by various commenters that the existing incremental cost tests are sufficient to accomplish all of Congress' objectives also overstate the ability of those tests to identify all of the ways in which competitive products contribute to institutional costs. Some commenters, for example, make the conclusory assertion that the existing incremental cost tests already account for *all* of the institutional costs associated with competitive products.[25] They argue that, as a result, any contribution requirement beyond incremental cost would make those products responsible for more than the costs with which they are associated. These arguments are mistaken.

As Prof. Carlton explains, the existing incremental cost tests are limited in their ability to identify the impact of competitive products on institutional costs overall and especially that large portion of institutional costs that are treated as "fixed" (approximately $23 billion or two-thirds of total institutional costs).[26] Only a very small amount of such fixed costs are considered incremental costs of competitive products under the existing methodologies. As an economic matter, however, a significant portion of these costs are causally associated with competitive products.

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[25] *See, e.g.,* Amazon Comments at 31 (arguing, without any demonstration, that "the incremental cost test also ensures that each competitive product will cover 'any costs [that] are uniquely or disproportionately associated with' the product") (quoting 39 U.S.C. § 3633(b)).

[26] By "fixed" costs, UPS refers to cost components modelled as having no "inframarginal" costs and thus excluded from the incremental cost test unless they contain "group-specific" or "product-specific" fixed costs. In RM2016-2, the Postal Service estimated that inframarginal costs in FY 2014 were $10.8 billion out of a total of about $34 billion institutional costs, implying roughly two-thirds of institutional costs (or about $23 billion) are treated as fixed under current models. Analysis of UPS Proposals One and Two, and the Supporting Report of Dr. Kevin Neels, Dkt. No. RM2016-2 (Jan. 27, 2016), at 37.

As Prof. Carlton explains, this limitation of the ability of the existing incremental cost tests to identify how fixed costs would change in the absence of competitive products can be observed across a number of cost pools. For example, with regard to headquarters expenses, the Postal Service incurred roughly $767 million in headquarters expenses that were classified as institutional in 2015, with none attributed to competitive products.[27] Since these costs are considered fixed, the Postal Service's incremental cost framework assumes they would not be reduced if the Postal Service ceased providing competitive services. But if the Postal Service did not provide competitive products (which would reduce its revenues and attributable costs anywhere from a quarter to a third), then it almost certainly would be able to reduce headquarters expenses relating to administration and management.[28]

The same limitations of the existing incremental cost estimates apply to other cost categories as well, including data processing supplies and services, inspection service field support, and building projects expenses.[29] These categories are also treated largely as fixed, and are not generally included within incremental cost

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[27] Specifically, no headquarters expenses were attributed to domestic competitive products and approximately $12 million in headquarters expenses was attributed to "International Mail and Services." Carlton Declaration ¶ 50.

[28] To illustrate the point, assume the Postal Service could have maintained a smaller headquarters for 70% of the cost if the Postal Service were only providing market-dominant products. Since the full cost of the headquarters is already being incurred, and because the ongoing cost of operating the headquarters would not disappear if the Postal Service ceased delivery of competitive products, none of this extra 30% cost would likely be considered incremental to competitive products under the current methodologies. The existing methodologies would thus not hold the competitive products business responsible for the *additional 30% of costs* incurred to maintain the larger headquarters, even though, as an economic matter, that additional 30% of headquarter costs *is* causally associated with competitive products.

[29] *See* Carlton Declaration ¶¶ 50-51.

estimates, even though they also could be reduced if the Postal Service did not deliver any competitive products. This is not to say the Postal Service necessarily *would* reduce these costs in an efficient manner. As discussed above, the Postal Service has incentives and restraints that deter it from shedding excess capacity and reducing fixed costs as efficiently as a private firm would. From an economic perspective, the key point is that, if the Postal Service no longer sold competitive products, it *could* shed many of these fixed institutional costs as part of an efficient reorganization.

As Prof. Carlton explains, the Postal Service's existing estimates of incremental cost do not "fully attempt to evaluate how costs would change if USPS modified the structure of its network in response to dropping the provision of competitive products[.]"[30] As UPS noted in its opening comments, one conceptual reason for this limitation is that the only costs that are treated as incremental under existing methodologies are those costs identified as *exclusively* caused by competitive products.[31] This focus on exclusive causation means that the tests do not account for costs that are largely or disproportionately (but not exclusively) associated with competitive products.

UPS provided a concrete example of this phenomenon in its opening comments. The Postal Service itself described a recent $1.6 billion increase it experienced in labor and transportation costs as one that was "*largely* due to the increase in Shipping and

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[30] *Id*. ¶ 53.

[31] Under the Commission's ruling in Order No. 3506, incremental costs are limited to those costs the Postal Service identifies as *exclusively* (or *uniquely*) caused by single products. *See* Order No. 3506 at 8. Similarly, costs that are not exclusively associated with competitive products as a group are not considered incremental to competitive products as a group under 39 U.S.C. § 3633(a)(1).

Packages volumes, which are more labor-intensive to process and require greater transportation capacity than mail."[32] If the Postal Service was not selling competitive products, there likely would have been no such increase at all. Mail volumes are still declining. Because those increased costs were not *exclusively* driven by competitive products, however, much of the increase that the Postal Service concedes was driven by competitive products was not attributed to competitive products.[33] That type of result, which occurs across many postal costing segments and components, demonstrates that competitive products are not covering their full incremental costs as an economic matter in the absence of a meaningful contribution requirement.

Congress saw the minimum contribution requirement as a means to ensure competitive products are held responsible for all costs with which they are "disproportionately associated," even when competitive products are not *exclusively* responsible for such costs. Indeed, Congress made it mandatory for this Commission, when making *any* determination about the minimum contribution requirement, to consider the "degree to which any costs are . . . disproportionately associated with any competitive products." 39 U.S.C. § 3633(b). This demonstrates that Congress understood the need for competitive products to be responsible for *all* of the costs with which they are causally associated and not just those costs for which they are *exclusively* responsible.

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[32] Initial UPS Comments at 3.

[33] Specifically, only 29% of the $1.2 billion increase in labor costs "largely due" to competitive products was attributed to competitive products. See Responses of the United States Postal Service to Questions 1-12 of Chairman's Information Request No. 11, Dkt. No. ACR2016 (Feb. 3, 2017) at Q.4. Only 42% of the overall increase was attributed to competitive products. *Id.*

Competitive products are indisputably responsible today for a significant portion of institutional costs. If the competitive products business did not exist, the Postal Service's institutional costs would be smaller — and certainly would not be getting larger. Indeed, the Postal Service would likely be able to reduce institutional costs significantly, given the historic declines it has experienced in market-dominant mail volumes. Many of the costs currently treated as fixed under current volume levels could be reduced through a rational downsizing. As Prof. Carlton shows, all of the costs that could eventually be avoided are properly considered incremental costs as defined in the economic literature.[34] Similarly, many common variable (or "inframarginal") costs would disappear as well. As UPS showed in its opening comments,[35] following the Commission's ruling in Order No. 3506, the institutional cost category includes variable costs driven by competitive product volumes. No commenter advocating for the elimination of the minimum contribution requirement accounts for these facts.[36]

The best available way to estimate the portion of institutional costs associated with competitive products is to look at the extent to which competitive products are

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[34] Carlton Declaration ¶ 49.

[35] Initial UPS Comments at 11-13.

[36] Amazon argues that 39 U.S.C. § 3633(a)(3) was "merely a transitional requirement" because § 3633(b) gave the Commission the option to "eliminate" it. Amazon Comments at 42. But nothing indicates that Congress intended § 3633(a)(3) to be "transitional." While Congress did state that the Commission could determine that the requirement should be "eliminated," any such determination must be made with fidelity to the statutory purpose (to ensure a level playing field) and must also be made in terms of the mandated factors, including "the degree to which any costs are uniquely or disproportionately associated with any competitive products." 39 U.S.C. § 3633(a)(3). Given the degree to which institutional costs today are associated with competitive products, there is no basis upon which to eliminate the requirement. *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) ("[A]n agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider [or] entirely failed to consider an important aspect of the problem").

contributing to attributable costs. This approach, which utilizes the extensive processes developed for analyzing cost contribution responsibilities, leads to an "appropriate share" percentage of approximately 29%. No commenter provides any reason to dispute this conclusion.

C. A Meaningful Contribution Requirement is Necessary to Address the Postal Service's Artificial Advantages Arising From the Postal Monopoly

UPS also demonstrated in its opening comments that, without a significant contribution requirement, the Postal Service is able to use revenues generated by the postal monopoly to pay for most of the expenses of building and maintaining its delivery network, while freeing competitive products from much of that burden. Thus, without a significant contribution requirement, the playing field is artificially tilted in the Postal Service's favor. The efforts by various commenters to dispute this conclusion also fail.

1. Congress Did Not Intend for the Postal Service to Fully Exploit its Artificial Advantages Arising from the Postal Monopoly

As UPS showed in its opening papers,[37] the postal monopoly, composed of both the statutory monopoly over letter delivery and the exclusive access to the mailbox, provides the Postal Service with artificial advantages over private-sector competitors in markets for delivering parcels. This advantage principally arises from the large economies of scale and scope generated by the letter monopoly, which private-sector firms are legally barred from replicating. Without a meaningful contribution requirement, the Postal Service can exploit these advantages by setting prices at artificially low levels

[37] *See* Initial UPS Comments at 3-5, 10-14.

that equally efficient rivals could not match, thus displacing the private sector from critical market segments.

No commenter effectively disputes these points. Prof. Panzar does not deny that his preferred approach (*i.e*. incremental cost as the sole basis for rate regulation) could facilitate the Postal Service expanding its letter monopoly into formerly competitive markets. He simply asserts that the Commission "has no duty or responsibility" to offset any of the Postal Service's artificial advantages and should instead allow the Postal Service to exploit whatever advantages it has as a governmental monopolist in full.[38] As discussed above, however, the reason Prof. Panzar is unconcerned about the Postal Service displacing the private sector is that he has mistakenly *assumed* that such displacement is necessarily efficient and failed to consider the adverse impact on innovation and dynamic efficiency of his proposed elimination of the "appropriate share" requirement.

In any event, the Commission must answer to Congress, and Congress expected this Commission to apply "stronger controls, oversight, and limitations" to the Postal Service "in recognition of its governmental status."[39] Rather than permitting the Postal

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[38] Panzar Declaration at 8. Amazon similarly argues the Postal Service should be able fully to exploit the advantages arising from its statutory monopolies, asserting that the Postal Service should be allowed to "discount[] down to incremental costs to the extent needed to compete for competitive business." Amazon Comments at 38. Amazon also states that the Postal Service should have the unlimited ability to "share any resulting cost savings [from its statutory monopolies, tax exemptions, and other benefits] with shippers and consumers." *Id*. at 39. But Amazon's proposed definition of fairness — allowing the Postal Service's competitive products business to exploit the monopoly-driven network to set prices for competitive products at levels the private sector could never replicate — cannot be accepted because it achieves the precise outcome Congress directed this Commission to prevent: a playing field tilted in the Postal Service's favor.

[39] H.R. REP. NO. 109-66 at 44 (2005).

Service fully to exploit its status as a government monopolist to gain artificial advantages over the private sector, Congress expected the Commission to ensure that "the Postal Service will compete on a level playing field."[40]

2. The Postal Service Misconstrues the 2007 FTC Report

The Postal Service acknowledges that "Congress intended to . . . protect[] the public interest against unfair competition in the markets within which competitive products are offered."[41] But it asserts that a 2007 report by the Federal Trade Commission ("FTC") demonstrates that the Postal Service actually operates at a competitive *disadvantage* to the private sector.[42] As UPS showed in its opening comments, however, a closer analysis of the FTC report reveals that it did not actually support such a conclusion in 2007, and certainly does not today.

In fact, the FTC report expressly recognized that the Postal Service enjoyed an artificial advantage over private firms to the extent "it benefitted from economies of scope by producing both market-dominant and competitive products," and the FTC expressly observed that "[t]he consensus appears to be that the postal monopoly provides the Postal Service with some economies of scope in the provision of

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[40] *Id*.

[41] Initial Comments of the United States Postal Service, Dkt. No. RM2017-1 (Jan. 23, 2017) ("Initial USPS Comments"), at 2.

[42] *Id*. at 4. Other commenters make a similar argument. *See* Initial Comments of the American Catalogue Mailers Association, Dkt. No. RM2017-1 (Jan. 23, 2017), at 2; Comment of the National Association of Letter Carriers, AFL-CIO ("Letter Carriers Comment"), Dkt. No. RM2017-1 (Jan. 23, 2017), 4, 6; *See also* Comments of Parcel Shippers Association, Alliance of Nonprofit Mailers, American Catalog Mailers Association, Continuity Shippers Association, Data & Marketing Association, Envelope Manufacturers Association, National Association of Presort Mailers, National Newspaper Association, PSI Systems, and Stamps.com ("Market Dominant Mailers and Competitive Shippers Comments"), Dkt. No. RM2017-1 (Jan. 23, 2017), at 2.

competitive products."[43] Crucially, however, the FTC concluded that the extent of these economies "ultimately is an empirical question" that the FTC was unable to answer.[44]

Similarly, the FTC acknowledged that the Postal Service's exclusive access to mailboxes also generates cost advantages over the private sector that "may be substantial" because of the cost the lack of mailbox access "imposes on private carriers."[45] But the FTC was unable to quantify the magnitude of those cost advantages as well.[46] Accordingly, when the FTC summarized its overall conclusions about the benefits and burdens experienced by the Postal Service as compared to private carriers, the FTC expressly stated that it had made "*no estimate of the benefits [the Postal Service] derives from its postal and mailbox monopolies*," because those benefits fell into the category of those that were "more difficult to quantify."[47]

Because the FTC's analysis was necessarily incomplete, and did not include an estimate of the benefits the Postal Service derives from the its postal and mailbox

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[43] FEDERAL TRADE COMMISSION, ACCOUNTING FOR LAWS THAT APPLY DIFFERENTLY TO THE UNITED STATES POSTAL SERVICE AND ITS PRIVATE COMPETITORS 47-48 (2007) ("FTC Report"). *See also id.* at 47 ("The ability to share the network established to deliver products covered by the postal monopoly may reduce the USPS's cost of providing competitive products."); *id*. at 48 ("If delivering monopoly products lowers the USPS's costs of producing competitive products, then it enjoys an advantage over its private competitors that the [Private Express Statutes] prevent them from duplicating.").

[44] *Id.* at 48.

[45] *Id.* at 52-53. Prof. Carlton agrees that the mailbox monopoly also provides an artificial cost advantage over the private sector, without an apparent efficiency justification. Carlton Declaration ¶¶ 43-44.

[46] *See* FTC Report at 52 (noting that "no commenters provided estimates of the costs of the mailbox monopoly").

[47] *Id.* at 64 (emphasis added) ("Further, there is no estimate of the benefits it derives from its postal and mailbox monopolies. These benefits, if possible to estimate, would further reduce net income for competitive products which in turn would require additional revenue increases or cost reductions.").

monopolies, it is impossible to conclude from the FTC report that the Postal Service operated at a net competitive disadvantage to the private sector in 2007.[48] And it certainly is impossible to rely on that report to reach that conclusion today.

UPS notes, however, that this incorrect view of the FTC report continues to be referenced. Indeed, the Commission recently submitted written comments to the House Committee on Oversight and Government Reform on February 7, 2017, that suggested that the FTC report had "identified *and quantified* the economic burdens and advantages that exist by virtue of the Postal Service's status as a federal government entity *and its postal and mailbox monopolies*."[49] As shown above, the FTC clearly did not quantify the advantages the Postal Service receives from its postal and mailbox monopolies. As noted, it acknowledged that it was unable to do so.

Even though the FTC was unable to quantify the benefits arising from the postal and mailbox monopolies, its analysis supports UPS's proposal in this docket. In particular, the FTC recognized that the institutional cost contribution requirement was a means by which to make competitive products responsible for covering the benefits arising from the postal and mailbox monopolies,[50] which is consistent with UPS's position in this docket. The FTC recognized that, if competitive products can exploit

[48] *See also* Sidak Declaration at 6 (explaining that the FTC report "excluded key Postal Service benefits that the FTC had been unable to quantify" which included benefits flowing from "the postal and mailbox monopolies").

[49] *Accomplishing Postal Reform in the 115th Congress – H.R. 756, The Postal Service Reform Act of 2017 Before the U.S. H. Oversight & Gov't Reform Comm.*, 115th Cong. at 23 (2017) (emphasis added).

[50] *See, e.g.,* FTC Report at 51 (discussing the contribution requirement as a means by which to approximate "any cost advantage that the USPS may enjoy due to scope economies").

those cost advantages for free, they receive an artificial advantage over the private sector.

Moreover, as UPS also noted in its opening comments, the Commission itself estimated in its latest Annual Report to the President and Congress that the value of the postal monopoly was $5.45 billion in 2015 alone.[51] Taken at face value, this estimate significantly outweighs the Commission's estimate of the cost of the universal service obligation of $4.24 billion.[52] As UPS noted in its opening comments,[53] even this recent estimate by the Commission understates the size of the advantage conferred by the postal monopoly.

3. The Ability to Sell Non-Postal Products Does Not Overcome the Advantages Arising from the Postal Monopoly

Some commenters argue that "[t]here is no indication" that the scale and scope economies arising from the postal monopoly provide the Postal Service with "a net advantage overall," because the Postal Service is "barred by 39 U.S.C. § 404(e)" from selling certain non-postal products.[54] But no commenter making this argument attempts to quantify the impact of the private sector's ability to sell non-postal products. There is, in fact, no basis for concluding that private-sector companies enjoy economies of scale and scope from selling non-postal products that compare to those the Postal Service enjoys as a result of the postal monopoly.

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[51] POSTAL REGULATORY COMMISSION, ANNUAL REPORT TO THE PRESIDENT AND CONGRESS (FISCAL YEAR 2016) 48 (2017).

[52] *Id.* at 40.

[53] *See* Initial UPS Comments at 16-18.

[54] Amazon Comments at 40-41.

Economies of scope arise when the same inputs (such as the same delivery network) are used for multiple products and purposes. Because it delivers its competitive and market-dominant products across a single delivery network, the Postal Service enjoys substantial economies of scale and scope from the postal monopoly. In contrast, private firms do not enjoy the same type of "overlap" from their ability to offer non-postal services. For example, UPS's ability to deliver packages in foreign countries does not provide anything approaching the type of economies of scope the Postal Service enjoys from delivering both market-dominant and competitive products over a single network in the United States. When UPS delivered packages to over 220 countries and territories in 2015, for instance, its packages originated in more than 80 different countries, and required the physical presence of employees, vehicles, and networks in those various countries.[55]

UPS's ability to offer a variety of supply chain and freight reporting services similarly provides far fewer opportunities for economies of scale and scope than the Postal Service enjoys from the overlapping use of its network for market-dominant and competitive products.[56] Thus, the private sector's ability to offer non-postal products and services does not come close to outweighing the Postal Service's substantial benefits from its postal monopoly.

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[55] *See* UNITED PARCEL SERVICE, FORM 10-K 7 (2016).

[56] UPS's integrated networks encompass a diverse (and dispersed) set of businesses, including express package delivery, freight forwarding, truckload freight brokerage, logistics and distribution, UPS Freight, customs brokerage, and financial and insurance services. Many of these lines of business involve services related to, but separate from, domestic package delivery.

No commenter, therefore, convincingly disputes that, absent an appropriate contribution requirement, the Postal Service enjoys a significant competitive advantage arising from its statutory monopolies. A meaningful contribution requirement is essential to make competitive products bear an appropriate responsibility for the costs it would incur in the absence of those monopolies.

II. THE STATUTE'S MANDATORY FACTORS SUPPORT UPS'S PROPOSAL

Congress specified two factors the Commission must consider in any "appropriate share" determination: (i) "the prevailing competitive conditions in the market," and (ii) "the degree to which any costs are uniquely or disproportionately associated with any competitive products." 39 U.S.C. 3633(b). UPS has shown that these mandatory factors support its proposal. The analysis of these factors by other commenters, in contrast, is limited and ultimately unpersuasive.

UPS's initial comments make the only meaningful attempt in this docket to estimate institutional costs that are disproportionately associated with competitive products.[57] As UPS noted, institutional costs overall have increased by over $1.3 billion (conservatively estimated) in the last two years even as volumes of the Postal Service's flagship mail products have declined. These and other statistics discussed in UPS's opening comments confirm that competitive products are driving a significant share of institutional costs today, including both fixed and variable (inframarginal) costs.[58] And

[57] FedEx submitted comments in this docket that reached similar conclusions about the inadequacy of the current contribution requirement and the need for a significant increase. FedEx, however, later withdrew those comments without explanation.

[58] *See* Initial UPS Comments at 28-33 ("These facts strongly indicate that the growth of competitive product volumes are driving overall growth of the Postal Service's institutional costs").

these statistics are consistent with anecdotal reports about the attention given to competitive products by Postal Service management. Every available metric indicates that competitive products today are responsible for far more than 5.5% of institutional costs.

UPS's proposal to benchmark the institutional cost requirement to competitive products' share of total attributable costs (using a three-year trailing average) is the best available way to ensure competitive products are covering the institutional costs for which they are responsible. No commenter provides a superior approach. As UPS noted, this approach is supported by how the European Commission chose to regulate postal operators in the European Union, when it faced similar considerations as Congress faced in PAEA.[59] Indeed, the Commission *itself* advocated before Congress in 1999 that "[c]ompetitive postal products should generate at least a proportionate contribution to the institutional costs of the Postal Service."[60] The Commission stated that "[t]here is no valid reason for captive customers to have to pay more toward

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[59] Initial UPS Comments at 37-39.

[60] *H.R. 22, The Postal Modernization Act of 1999: Hearings on H.R. 22 Before the Subcommittee on the Postal Service of the Committee on Government Reform*, 106th Cong., 1st Sess. ("H.R. 22 Hearings"), at 149 (1999) (statement of Edward J. Gleiman, Chairman, Postal Rate Commission) (emphasis added).

overhead than users of competitive services."[61] The Commission's prior reasoning fully supports UPS's proposal in this docket.[62]

No commenter refutes UPS's demonstration that competitive products are driving a much higher share of institutional costs than they were in 2007. Nor does any commenter offer a quantitative analysis demonstrating that competitive products are responsible for less than 29% of institutional costs. Instead, as noted above, other comments typically offer little more than flawed theories for why competitive products should have no responsibility for institutional costs at all.

UPS has also demonstrated that its proposal to increase the minimum contribution requirement to 29% is warranted in light of prevailing conditions in the parcel market. Most notably, over the past few years, the Postal Service has overtaken the private sector in delivering e-commerce packages to American homes. The Postal Service achieved this result because it can set artificially low prices that the private

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[61] *Id*. at 149 (statement of Edward J. Gleiman, Chairman, Postal Rate Commission) (emphasis added). Notably, during this hearing, the Postal Service argued that the only valid regulatory objective with regard to competitive products is preventing cross-subsidization and, as a result, the only valid regulation is one that ensures that competitive products recover their *attributable* costs, with no contribution requirement for institutional costs. *See id*. at 89-90. Congress declined to adopt this position in PAEA.

[62] The Public Representative argues that the legislative history shows that Congress' primary interest was in allowing the Commission "inherent flexibility" when setting the contribution level. *See* Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (Jan. 23, 2017), at 5. The version of the statute which the House Report quoted by the Public Representative accompanied, however, did not contain an analogue to § 3633(b). Any such "inherent flexibility" was necessarily restricted when Congress chose to include § 3633(b) in the legislation and mandated that the Commission consider, among other things, "the degree to which any costs are uniquely or disproportionately associated with any competitive products." The Public Representative's comments are devoid of any analysis of this mandatory factor.

sector, which does not have a monopoly business to fund much of its delivery network, cannot match.[63] This is not what Congress intended.

The Postal Service claims that its "position within the package delivery market has remained virtually unchanged" since the Commission last reviewed the appropriate share requirement in 2012.[64] But it supports this assertion with a "market share" analysis that misleadingly lumps together products and services with different service standards sold at different price points and aimed at different groups of users. As the below table indicates, the products grouped together in the Postal Service's "market share" analysis are very different products.

[63] *See* Initial UPS Comments at 18-21 (citing *WALL STREET JOURNAL* chart showing that Postal Service sets prices below FedEx and UPS for comparable offerings).

[64] Initial USPS Comments at 11.

Table 1: Postal Service Competitive Product Descriptions

Product		Revenue / Piece	Weight (pounds) / Piece	Delivery Time	Description
Priority Mail Express	[A]	$24.50	1.07	Overnight	The "fastest domestic service" offered by USPS; options include Sunday and holiday delivery.
Priority Mail	[B]	$7.75	2.31	1-3 days	"Fast domestic service" that is less costly than Priority Mail Express.
First-Class Package Service	[C]	$2.67	0.39	1-3 days	"Fast, affordable way to send...lightweight packages," "best priced service for mail up to 13 oz."
Retail Ground (Standard Post)	[D]	$17.22	6.01	2-8 days	"Economical ground shipping for less-than-urgent deliveries and oversized packages", retail only.
Parcel Select	[E]	$1.94	2.11	2-8 days	Ground delivery service only available to authorized USPS business partners or PC Postage vendors. Service is used to complete "last mile" delivery.
Parcel Return Service	[F]	$2.63	2.93	Varies	Returns product that serves as "first mile" carrier, meaning another Parcel Consolidator can pick up at postal facility and return to merchant's return facility at a discounted rate.

Notes and Sources:
Revenues, Weights, Pieces from 2016 Fiscal Year Revenue, Pieces, and Weight Report.
Descriptions from https://www.usps.com/ship/mail-shipping-services.htm
[E]: Business days shipping from http://www.stamps.com/usps/parcel-select/
[F]: Description from https://ribbs.usps.gov/shipproductsservices/documents/tech_guides/ReturnsFieldKitw2SOP.pdf

Consider, for example, Priority Mail Express and Parcel Select. Priority Mail Express is, on average, thirteen times as expensive as Parcel Select, with guaranteed overnight delivery. Meanwhile, Parcel Select is a work-shared service that often delivers within 24 hours, but may take up to eight days. Grouping the revenues derived from these six disparate products together, as the Postal Service does in its comments, obscures the rapid growth in recent years of Parcel Select volumes and the Postal Service's share of ground-based and "last-mile" delivery.[65]

The most important e-commerce parcel services are ground based, and ground parcel volumes dwarf those of expedited services. As shown in the following tables, the volume figures for ground-based services reported publicly by UPS, FedEx, and the Postal Service demonstrate that the Postal Service has, in fact, achieved significant gains in ground-based services in recent years.[66]

Table 2: Ground Volume Market Share

	FY2014	FY2015	FY2016
Reported Ground Volume (Thousand Pieces)			
USPS Ground	1,575,596	1,968,761	2,457,488
UPS Ground	3,184,614	3,290,041	3,379,150
FedEx Ground	1,719,176	1,774,801	1,970,295
Implied Piece Based Ground Market Share			
USPS Ground	24%	28%	31%
UPS Ground	49%	47%	43%
FedEx Ground	27%	25%	25%

Sources: USPS Quarterly RPWs FY14-16, UPS Quarterly Historical Income and Operating Data Q4 FY16, FedEx Statistical Books FY16-17.
Notes:
Reported in USPS Fiscal years.
USPS Ground volume is comprised of volume from Parcel Select, Return Parcels, and Total Standard Post. Total Standard Post was renamed Retail Ground in Q2 FY16.

As the table shows, the Postal Service's share of reported ground-based volume grew by 7 percentage points from 2014 to 2016, which is a large gain for a two-year period. Over that same period UPS's share of ground based volumes fell 6 percentage

[65] The Postal Service groups products in this fashion in Table 2 of the non-public filing by the Postal Service dated January 23, 2017.

[66] The file used to calculate Table 2 is provided in Library Reference UPS-RM2017-1/1, accompanying these comments.

points, and FedEx's declined as well. This confirms that the Postal Service has rapidly gained market share in recent years at the expense of the private sector in these critical segments.

In fact, while these figures demonstrate the relevant trend, they understate the magnitude of the Postal Service's gains. Both UPS and FedEx hand a significant portion of their ground volume off to the Postal Service for final delivery. Volume that is "work-shared" in this way is included in the piece counts in Table 2 both for the Postal Service and for the private carrier originating the volume. The Postal Service's market share would be even higher after removing the effects of fact that some piece counts show up twice, such that the statistics counted only the party handling final delivery.

These results demonstrate that, notwithstanding its claims in this docket, the Postal Service is gaining market share at the expense of the private sector, particularly in the crucial areas of e-commerce and last-mile delivery. As noted, the Postal Service boasts in other forums that it delivers "more e-commerce packages to the home than any other shipper" or "than anyone else in the country."[67] In fact, UPS's assessment is that the Postal Service delivers more packages *overall* than any other enterprise in the country today.

Some commenters in this docket claim that "above-inflation" price increases by the Postal Service for certain of its competitive products should be sufficient to eliminate

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[67] United States Postal Service, *U.S. Postal Service Reports Fiscal year 2016 Results*, NATIONAL NEWS (Nov. 15, 2016), https://es-about.usps.com/news/nationalreleases/2016/pr16_092.htm (last visited Mar. 8, 2017) (emphasis added). The figures shown in Table 2 include both deliveries to homes — the segment in which the Postal Service claims to be the market leader — as well as deliveries to businesses and other non-residential locations.

concerns about market distortion.[68] But price increases do not disprove market distortion. To the contrary, they support the conclusion that Postal Service competitive products have historically been underpriced, leaving the Postal Service with ample room to raise prices while still undercutting equally (in fact, *more*) efficient rivals. As the Public Representative concluded in Docket No. CP2016-9, where the Postal Service proposed rate increases: "[T]he most reasonable explanation for why the Postal Service can increase prices by the proposed amounts is that the current prices are set too low, despite meeting the applicable regulatory standards."[69] Neither the Postal Service nor any other commenter has demonstrated that conclusion was erroneous.

Similarly, other commenters argue that the minimum contribution requirement does not need to be increased because the Postal Service has an "incentive" to exceed whatever level is set.[70] But that argument is illogical. The minimum contribution requirement is meant to be an "*appropriate* share," not an artificially low share that can easily be exceeded. The issue of whether the Postal Service has an incentive to profit from its competitive operations is distinct from the policy concerns underlying the minimum contribution requirement. Congress did not intend for the Commission to set an artificially low contribution requirement because the Postal Service would have an incentive to exceed it.

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[68] Amazon Comments at 19.

[69] Public Representative Comments on Postal Service Notice Concerning Changes in Rates of General Applicability for Competitive Products at 5, Dkt. No. CP2016-9 (Nov. 3, 2015), at 5.

[70] *See, e.g.*, Market Dominant Mailers and Competitive Shippers Comments at 2-3; Letter Carriers Comment at 3-4; Comments of Stamps.com, Dkt. No. RM2017-1 (Jan. 23, 2017), at 5.

Finally, some commenters argue the status quo is acceptable because UPS and FedEx remain profitable.[71] But Congress did not intend for its statutory mandates to apply only when private firms suffer overall losses. That UPS and FedEx have maintained positive bottom lines is irrelevant to determining the appropriate share of institutional costs the Postal Service's competitive products must cover. Private firms' profitability (or lack thereof) does not justify the Postal Service competing on a playing field tilted in its favor.[72]

III. NEGATIVE SPECULATION ABOUT THE IMPACT OF A MEANINGFUL APPROPRIATE SHARE REQUIREMENT IS UNSUPPORTED

The Postal Service asserts that the Postal Service and consumers would be harmed if the appropriate share requirement is raised, because "(1) it would lessen the overall price and service competitiveness in the market to the detriment of consumers; and (2) it would harm the ability of the Postal Service to fund the network infrastructure needed to provide universal service through its competitive products."[73] As explained above, however, these arguments are premised on the erroneous assumption that the Postal Service's displacement of private sector competition at low incremental costs is necessarily efficient.

[71] *See* Amazon Comments at 7.

[72] Amazon argues that the Postal Service's practice of "offering destination-entry prices for its competitive services [e.g. last-mile delivery] provides an additional safeguard against the risk that the Postal Service's pricing could injure competition." Amazon Comments at 42. This argument is also mistaken. In fact, the Postal Service's ability to control the price of last-mile delivery provides no "safeguard" at all. To the contrary, the fact that Amazon implicitly acknowledges the Postal Service's power over price for last-mile deliveries confirms the very danger Congress meant to guard against.

[73] Initial USPS Comments at 5.

None of the Postal Service's arguments consider the harm to innovation and dynamic efficiency in parcel markets when the Postal Service inefficiently expands to displace efficient private-sector competition. As noted above, the economic literature demonstrates that these forces of innovation and dynamic efficiency are primarily responsible for driving consumer welfare. In any event, the Postal Service's claim that an increased contribution requirement will hinder its ability to compete in the market is entirely speculative. Neither the Postal Service nor any other commenter actually demonstrates that an increase in the minimum contribution requirement would significantly impact the Postal Service's ability to compete. In fact, Prof. Carlton observes that an appropriate share of 29% may be conservative, given that competitive products are continuing to grow as a share of the Postal Service's overall revenue and cost.[74]

Even assuming the Postal Service had to increase prices for some competitive products, there is no reason to assume it would be unable to compete. Rather, the Postal Service would likely be able to maintain high volumes, especially as e-commerce continues to grow.[75] Even if the Postal Service lost certain volumes in competitive products, any revenue losses may well be smaller than its reduction in costs, leaving

[74] Carlton Declaration ¶ 14.

[75] *See* Initial UPS Comments at 35-36 (observing that "recent history indicates that Postal Service price increases have not resulted in volume decreases. Between FY 2015 and FY 2016 the Postal Service made substantial price increases for a number of its products, with no apparent impact on volume. Moreover, to the extent the e-commerce market continues to expand overall, as expected, the Postal Service will continue to experience overall growth in competitive product volumes. Such growth, when occurring on a level playing field, would align with Congress' intent.")

the Postal Service with greater profit overall. Neither the Postal Service nor Prof. Panzar has addressed these or other possibilities.[76]

The bottom line is that the Postal Service does not have the right to enjoy ever-increasing market shares or guaranteed levels of revenue from competitive products. Rather, PAEA gives the Postal Service the right to compete on a level playing field by recovering revenues that cover all costs, including institutional costs, associated with that business. Once that occurs, market forces will dictate commercial outcomes. The Commission has, for a decade, maintained an appropriate share requirement so low that virtually all interested parties agree it is economically meaningless and irrelevant. The Commission should now set a meaningful appropriate share, as Congress intended, rather than bowing to speculative assertions that doing so might limit the Postal Service's ability to compete.

[76] A commenter cites the railroad industry in the 1950s and 1960s as "a classic illustration of what can go wrong" in agency regulation of industry activity. Amazon Comments at 52. But the comparison is inapt. Unlike the Postal Service, the railroad companies in the 1950s and 1960s were not statutory monopolists that threatened competitive distortions by seeking to expand aggressively into adjacent competitive markets. Rather, they were only leveraging their pre-existing infrastructure to deliver more of their pre-existing products and services. The broader assertion that UPS is trying to "manipulat[e] the regulatory process" by engaging in "rent seeking" is also inaccurate. Amazon Comments at 13 n.6. It is not "rent seeking" for UPS to advocate for Congress' view of how the minimum contribution requirement should function. Moreover, this important issue should be addressed on the merits, in light of the text and purpose of PAEA. *See also* Carlton Declaration ¶ 13 (explaining that the "rent seeking" accusation lacks merit).

CONCLUSION

All relevant factors point unmistakably in one direction: the current 5.5% contribution requirement is out of line with current realities. A significant increase is necessary to ensure that competitive products cover the institutional costs with which they are associated in order to protect the level playing field directed by Congress. Specifically, for the reasons set forth in UPS's comments, the minimum contribution requirement should be increased to approximately 29%.

Respectfully submitted,

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