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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 THE UNITED STATES POSTAL SERVICE
(March 9, 2017)

On November 22, 2016, the Commission initiated this proceeding with the issuance of an advance notice of proposed rulemaking in Order No. 3624.[1] The Order sought initial comments by January 23, 2017, and reply comments by March 9, 2017. On January 23, 2017 the Postal Service and ten other parties filed comments.[2] The Postal Service hereby provides its reply comments.

I. THERE IS BROAD CONSENSUS THAT THE APPROPRIATE SHARE REQUIREMENT SHOULD BE ELIMINATED OR MAINTAINED AT ITS CURRENT LEVEL

As the Postal Service amply demonstrated in its Initial Comments, the current state of the competitive delivery market provides no basis for an appropriate share

[1] Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Nov. 22, 2016).

[2] Comments of Amazon Fulfillment Services, Inc., PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *AFSI Comments*]; Initial Comments of the American Catalog Mailers Association (ACMA), PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *ACMA Comments*]; Comments of the Association for Postal Commerce, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *PostCom Comments*]; Comments of Former Utility Regulators, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *FUR Comments*]; Initial Comments of the Greeting Card Association, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *GCA Comments*]; Comment of the National Association of Letter Carriers, AFL-CIO, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *NALC Comments*]; Comments of Parcel Shippers Association et al., PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *MDMCS Comments*]; Public Representative Comments in Response to Advance Notice of Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *PR Comments*]; Comments of Stamps.com, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *Stamps.com Comments*] Initial Comments of United Parcel Service, Inc., PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *UPS Comments*]; Initial Comments of the United States Postal Service, PRC Docket No. RM2017-1 (Jan. 23, 2017) [hereinafter *Postal Service Comments*].

requirement at this time, and certainly not one higher than the current 5.5 percent level. Consequently, the current appropriate share requirement could be set at zero, or at the very least, reduced. The current circumstances do not justify raising the appropriate share requirement above its current level.

A majority of the parties submitting comments on January 23rd reached similar conclusions. The comments of Amazon Fulfillment Services (AFSI) took this view:

> For the reasons explained in these comments, the Commission should exercise its discretion under 39 U.S.C. § 3633(b) to eliminate the minimum "appropriate share" contribution requirement for competitive products under § 3633(a)(3).[3]

A broad coalition of Market Dominant Mailers and Competitive Shippers (MDMCS) stated the following:

> Some of us represent mailers that rely mainly on market dominant products. Others represent shippers that mainly use competitive Postal Service products. Still others represent substantial users of both kinds of Postal Service products. All of us urge the Commission to eliminate the minimum contribution requirement.[4]

Filing separately (in addition to joining the MDMCS comments), the American Catalog Mailers Association (ACMA) reiterated that conclusion:

> The purpose of the instant docket is to "determine whether" the minimum proportion "should be retained in its current form, modified, or eliminated. *See* 39 CFR 3015.7(c)." Order No. 3624 at 2. ACMA believes it should be eliminated.[5]

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[3] AFSI Comments, *supra* note 2, at 5.

[4] MDMCS Comments, *supra* note 2, at 1. The parties endorsing these comments were the Parcel Shippers Association, the Alliance of Nonprofit Mailers, the American Catalog Mailers Association, the Continuity Shippers Association, the Data and Marketing Association, the Envelope Manufacturers Association, the National Association of Presort Mailers, the National Newspaper Association, PSI Systems, and Stamps.com.

[5] ACMA Comments, *supra* note 2, at 3.

Similarly, Stamps.com filed separate comments as well:

> In our business, we have seen tremendous growth in e-commerce shipping volume with the Postal Service, and we believe forcing the Postal Service to artificially raise its prices would be harmful. In this situation, the minimum contribution should be left alone or eliminated. It has no role to play.[6]

Lastly, the National Association of Letter Carriers (NALC) joined the chorus of parties leaning towards elimination of the requirement:

> For the reasons set forth below, NALC believes that the current minimum is unnecessary and should be eliminated. In any event, the Commission should certainly not raise the minimum.[7]

The Public Representative's comments were also broadly consistent with the Postal Service's recommendations because, while not going so far as to embrace any reduction in the appropriate share requirement, they did state a belief that "the Commission should retain the current 5.5 percent requirement."[8] Similarly, while PostCom perceived continued relevance for an appropriate share requirement, it also observed that the existing provisions seem to be working to the benefit of market dominant and competitive mailers, and it cautioned the Commission "against taking radical action that could serve to unfairly hamstring the Postal Service's pricing flexibility and endanger its ability to compete in the competitive marketplace."[9] PostCom believed it appropriate to seek to ensure that "the stable structure that has allowed the USPS to

[6] Stamps.com Comments, supra note 2, at 5.

[7] NALC Comments, supra note 2, at 1.

[8] PR Comments, supra note 2, at 2.

[9] PostCom Comments, supra note 2, at 1, 6.

prosper is not unduly disrupted," and indicated that a "sudden large change in [the appropriate share] requirement could prove disruptive."[10]

One major feature of the comments summarized above should not be overlooked. Collectively, they cover the expression of views in this docket by <u>all consumers of shipping services</u> who profess to use the products covered by the appropriate share requirement (as well as by the Public Representative, who presumably offers comments on behalf of the individual members of the general public who also use those products).[11] Moreover, they cover the views of several other mailers who use market dominant products (or both competitive and market dominant products). While it is certainly true that parcel shippers have a short term interest in avoiding any action by the Commission likely to raise the rates they pay for postal delivery of their packages, it is equally true that those same shippers have a longer-run objective to sustain competition in the package delivery market. If their educated views were that ongoing competition in package delivery would benefit from an increase in the current appropriate share requirement, they would likely be the first to advocate for that resolution of this docket. Instead, their nearly unanimous consensus is the opposite – the appropriate share requirement should be eliminated, reduced, or at most maintained at the current level. The majority of these parties, in fact, favor its elimination.

Moreover, comments filed on behalf of market dominant mailers are also entitled to significant weight. For mailers concerned exclusively with market dominant products

[10] *Id*. at 2, 6.

[11] Of course, entities like United Parcel Service, Inc. (UPS) also enter sizable numbers of packages for postal delivery, but they are not ultimate consumers of shipping services (i.e., those owning or purchasing items to be moved from origin to destination), as opposed to suppliers of alternative shipping products.

(and thus with no direct interest in rate levels for competitive products), it might seem that having a higher appropriate share requirement, and thus potentially higher aggregate net contribution from competitive products, would lead to a healthier Postal Service. Even under a market dominant price cap regime, market dominant mailers cannot ignore the overall financial health of the Postal Service. Nevertheless, these commenters appear to realize that, if the appropriate share requirement were to suddenly increase, then both the Postal Service and the market dominant mailers stand to lose, especially if the upward pressure placed on competitive rates significantly reduces competitive volumes, and thus their net contribution. The analysis on page 6 of the comments of PostCom manifests a practical example of this awareness.

II. SEVERAL COMMENTERS MISCONSTRUE THE PURPOSE OF THE APPROPRIATE SHARE REQUIREMENT

United Parcel Service, Inc. (UPS), Greeting Card Association (GCA), and the Former Utility Regulators (FUR) advance a variety of arguments in support of their position that the appropriate share requirement should be increased. For example, UPS contends that the recent growth in the Postal Service's institutional costs is disproportionately caused by competitive products.[12] FURFUR claims that the current allocation of 5.5 percent of institutional costs to competitive products "seems facially improbable" and "implausible" in light of the increasing growth in revenues generated by the Postal Service's competitive products.[13] What each of these arguments ignores, however, is the fact that the purpose of Section 3633(a)(3) is to determine the

[12] UPS Comments, *supra* note 2, at 28-33.

[13] FUR Comments, *supra* note 2, at 9-10.

appropriate "*minimum* contribution," not the recommended contribution level.[14] In other words, the appropriate share requirement is a floor, not a target or a ceiling.

As the Commission explained in Docket No. RM2007-1, the PAEA's appropriate share requirement "is a floor for all competitive products, but the hope (and expectation) is that competitive products will generate contributions in excess of the floor."[15] In fact, this "expectation" has been realized consistently since the last time the Commission considered the appropriate share requirement, as the Postal Service's competitive products have contributed more than 5.5 percent to institutional costs over each of the past five years.[16] The consensus of the commenters representing consumers of shipping services, moreover, is that the market for package services is competitive and thriving.[17] Accordingly, there simply is no need to raise the floor. Rather, for the reasons set forth in the Postal Service's initial comments, the appropriate share requirement should be reduced to zero, or at a minimum decreased.

III. THE COMMENTS OF UPS CONTAIN NUMEROUS MISLEADING AND/OR INCORRECT ARGUMENTS

a. UPS's Proposal to set the Appropriate Share Requirement Equal to Competitive Products' Attributable Cost Share Contradicts Legislative Intent and is Impracticable.

UPS proposes setting the appropriate share requirement equal to the three-year average of the attributable cost share for competitive products,[18] implying equalized

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[14] 39 U.S.C. § 3633(b) (emphasis added).

[15] Order No. 26 – Order Proposing Regulations to Establish a System of Ratemaking, Docket No. RM2007-1, at 72 (Aug. 15, 2007) [hereinafter *Order No. 26*].

[16] *See* Postal Service Comments, *supra* note 2, at 18. For a full discussion of the mechanism by which these contributions have been processed over the last several years, see the Postal Service's response to Question 10 of Chairman's Information Request No. 11, PRC Docket No. ACR2017 (Feb. 3, 2017).

[17] *See, e.g.,* AFSI Comments, *supra* note 2, at 6-9; Stamps.com Comments, *supra* note 2, at 1-3.

[18] UPS Comments, *supra* note 2, at 34-35.

percentage markups over attributable costs and equalized cost coverages for market dominant and competitive products. Under certain scenarios, the proposal could result in a greater than equal markup for competitive products. UPS is simply attempting to resurrect, or even go beyond, an equal markup requirement rejected by Congress during its consideration of postal reform leading to the enactment of the Postal Accountability and Enhancement Act (PAEA). While the legislative history alone refutes the use of an equal markup requirement, a closer examination of the proposal reveals shortcomings that render it impracticable.

i. Setting the Appropriate Share Requirement Equal to the Attributable Cost Share Contradicts Legislative Intent.

The UPS proposal contradicts the underlying purpose of the appropriate share provision. At best, the proposal is an equal markup requirement, which was considered and expressly rejected by Congress. At worst, the proposal would require a greater than equal markup, which diverges even further from congressional intent. Instead, legislative history buttresses what is evident from the language of the statute: the appropriate share provision must be interpreted in light of prevailing market conditions.

Early postal reform bills included specific provisions governing competitive products' contribution to institutional costs. Specifically, H.R. 22, introduced during the 106th Congress (1999-2000), required that competitive products have a collective markup equal to the collective markup of all products as a means of preventing cross-subsidy between categories.[19]

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[19] *See* H.R. 22, 106th Cong. § 3744 (1999); *H.R. 22, The Postal Service Modernization Act of 1999 Before the H. Subcomm. on the Postal Serv. of the H. Comm. On Govt. Reform*, 106th Cong. 88 (1999) (hereinafter "H.R. 22 Hearing")(Question by Chairman McHugh explaining that one of the issues that H.R.

The Postal Service strongly opposed a permanent equal markup rule. In its responses to questions for the record, the Postal Service made it clear that the equal markup rule was arbitrary and would be ineffective.[20] The Postal Service argued that the artificial requirements of equal cost coverage would provide an "unprecedented degree of price protection to the Postal Service's competitors, at the ultimate expense of consumers."[21] The absence of an equivalent rule in the market reinforced the Postal Service's claim that the equal markup rule was arbitrary.[22] The Postal Service maintained that although all businesses must cover their fixed and common costs, an equal markup requirement ignored the realities of the marketplace.[23] Christensen Associates also provided a paper, as part of the Postal Service's response for the record, discussing the economic and policy problems with the equal markup rule and explaining that the rule was "not necessary to prevent cross-subsidization."[24] The paper concluded that the equal markup rule was not good public policy, would not serve the goals of H.R. 22, and would have a deleterious effect on the public.[25] Additionally, Christensen explained:

> The equal-markup requirement is based on the erroneous notion that application of equal percentage markups on products is the only way to ensure that the

22 tried to address was preventing cross-subsidies); *see also* H.R. 22 Hearing at 112 (posing a question to Postmaster General Henderson about the other safeguards in the bill that prevent cross-subsidization).

[20] *See* H.R. 22 Hearing at 111-15 (Questions Submitted to Postmaster General William J. Henderson in Follow-up to the Hearing on H.R. 22, the Postal Modernization Act of 1999).

[21] *Id*. at 114; *See also, Id*. at 113 (The Postal Service explained that "[t]he equal markup rule would pile another layer of pricing restriction on top of the attributable cost standard, which itself is more restrictive than the antitrust standard." The Postal Service went on to say that while this would provide a "luxurious degree of price insulation to the Postal Service's competitors, it would do nothing to benefit consumers.").

[22] *Id*. at 111-12.

[23] *Id.* at 111.

[24] *Id*. at 126.

[25] *Id*. at 126-28.

> Postal Service recovers its fixed costs. Many firms in the private sector also have fixed costs, and they must price their products to recover these costs. But these firms do not recover these costs by applying an equal percentage markup to the different products. Rather, markups for the different products are determined by market conditions.[26]

Indeed, if a firm were required to impose an equal percentage markup on all its products, it may not remain competitive in some markets.[27] The paper went on to say that in markets with strong competition, a firm must generally set its prices closer to incremental cost.[28] Furthermore, Christensen opined that:

> The equal-markup requirement is not necessary to prevent cross-subsidization. Cross-subsidization occurs when the revenue generated from a product does not cover its incremental cost. Similarly, the courts have generally interpreted prices above unit incremental cost as not being predatory. Consequently, a price floor based on incremental cost, and not some arbitrary multiple of incremental cost, will provide the necessary protection against cross-subsidization and predatory pricing.[29]

Although the Postal Service was against the equal markup rule, it did support transparency in the costs and financing of competitive products. Specifically, the Postal Service believed its competitive products should make a “reasonable contribution to institutional costs” and should “provide public reassurance that [competitive service offerings] will avoid cross-subsidies..”[30] The Postal Service reiterated its commitment to transparency in its responses to questions for the record, but asserted that market

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[26] *Id*. at 128.

[27] *Id*. at 128

[28] *Id*.

[29] *Id*. at 126.

[30] *Id*. at 73 (Written Statement of Postmaster General William J. Henderson).

conditions, and not pricing relationships imposed by regulation, should be the primary influence on competitive products.[31]

Others, however, were strongly in support of the equal cost coverage requirement. For example, the then-Chairman of the Postal Rate Commission believed it was an important firewall to avoid cross-subsidization[32] and a necessary way to "solve the problem associated with declining first class volume."[33] FedEx went even further, stating that it would not support any revision to H.R. 22 that failed to maintain the equal cost coverage rule,[34] believing it to be necessary to prevent cross-subsidization.[35]

However, Congress rejected these arguments: the equal markup requirement was never again included in a House (or Senate) bill. In fact, in the next iteration of postal reform legislation, alternative institutional cost contribution language was adopted. In lieu of the equal cost coverage rule, the House bill required that competitive products make a "reasonable contribution" to institutional costs.[36] Every postal reform

[31] *Id*. at 112.

[32] *Id*. at 147, 149 (Written Statement of Edward J. Gleiman, Postal Rate Chairman on behalf of the Postal Rate Commission).

[33] *Id*. at 181 (Statement of Edward J. Gleiman). Chairman Gleiman believed that the equal markup rule was necessary to cover the "substantial fixed, overhead costs" in light of the declining volume, and therefore declining institutional cost contribution, of first class mail. *Id*. Declining first class volume obviously remains a strong motivation for the Postal Service to seek whatever contribution it can from competitive products and it has done so.

[34] *Id*. at 368 (Answers of Frederick W. Smith to Questions from the House Postal Service Subcommittee on H.R. 22).

[35] *Id*. at 341-42 (Written Statement of Frederick W. Smith, Chairman, President, and Chief Executive Officer FDX Corporation).

[36] H.R. 4970, 107th Cong. § 3633 (2002); H.R. 4341, 108th Cong. § 3633 (2004); H.R. 22 109th Cong. § 3633 (2005).

bill in the Senate also included its own institutional cost coverage language, which required competitive products to "collectively cover their share of institutional costs.."[37]

With all postal reform bills from the previous five years including some version of institutional cost coverage for competitive products, it was no surprise that the PAEA included an appropriate share provision. The "appropriate share" language first emerged in the compromise bill (H.R. 6407) reconciling H.R. 22 and S. 662 in the 109th Congress. Significantly, an equally important safeguard, Section 3633(b)'s five-year review taking into account prevailing competitive conditions in the market, also reemerged at this time.[38] The language in Section 3633(b) reflects suggestions from the Postal Service and a growing sentiment from Congress that the Postal Service needed to be responsive to market conditions.[39] The prevailing market conditions provision was reintroduced as guidance to the Commission in determining the "appropriate share.." Congress determined that the final provisions in the PAEA struck the right balance on competitive issues.[40] Therefore, the appropriate share provision must be interpreted in light of prevailing market conditions.

In short, the UPS proposal is nothing more than a misguided and ill-conceived attempt to resurrect an equal markup requirement that was considered and rejected by

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[37] S. 2468, 108th Cong. § 3633 (2004); S. 1285, 108th Cong. § 3633 (2004); S. 662, 109th Cong. § 3633 (2005).

[38] The prevailing market conditions language was included in S. 622 (109th Congress) when the bill was first introduced, but was removed when the bill was reported out of committee. S. 622, § 3633(b).

[39] S. REP. NO. 108-318, at 14 (2004) ("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."); H.R. REP. NO. 109-66, at 43 (2005) ("The objective of the bill is to position the Postal Service to operate in a more business-like manner. To achieve this goal, the system must be responsive to market considerations….").

[40] 135 CONG. REC. S11675, (daily ed. Dec. 8, 2006) (statement of Sen. Collins "I note that we looked at competitive issues with UPS and FedEx, and I think we have come up with the right balance here.").

Congress. Adopting such a requirement would defy legislative intent regarding the proper balance of competitive protections. The appropriate share provision is one of many tools designed to correct a tilt in the playing field, should one exist. Congress never intended for appropriate share to be an arbitrary markup, benefiting only the Postal Service's competitors and harming consumers. Consequently, UPS's proposal should be rejected.

ii. The Logical and Functional Failings of the UPS Proposal Render it Impracticable.

UPS's proposal to set the appropriate share requirement equal to the attributable cost share for competitive products (29.4 percent) is illogical and unworkable.[41]

First, it is unclear whether UPS's proposal would also set the contribution share for market dominant products equal to their attributable cost share (70.6 percent). If so, the sum of the contribution shares is 100 percent. This implies that institutional costs are fully covered, and that the Postal Service is breaking even.[42] However, the Postal Service is not breaking even. In fact, in FY 2016, the contribution shares summed to only 78.7 percent (62.2 percent for market dominant products, 16.5 percent for

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[41] The implied competitive products price increase for a 29.4 percent competitive products contribution share, before volume effects, is [(29.4% x $36.363 billion) - $5.999 billion] ÷ $18.495 billion = 25.4 percent, where $36.363 billion is the FY 2016 institutional cost, $5.999 billion is competitive products' actual contribution in FY 2016, and $18.495 billion is competitive products' actual revenue in FY 2016. The implied competitive products cost coverage is 148.0% x (1 + 25.4%) = 185.6 percent, where 148.0 percent is competitive products' actual cost coverage in FY 2016.

[42] UPS seems to suggest this framework in two ways. First, in Docket No. RM2016-2 Proposal Three, Table 3-1, the market dominant products contribution share is indeed set equal to the attributable cost share. Petition of United Parcel Service, Inc. for the Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies, Proposal Three—A Proposal to Adjust the "Appropriate Share" of Institutional Costs that Must be Covered by Competitive Product Revenue, PRC Docket No. RM2016-2, 24-25 (Oct. 8, 2015). The result is forced break-even in columns [2] and [4]. So, for example, the $29.877 billion specified for the contribution made by market dominant products in FY 2014 (column [2]) misses the mark by $6.5 billion; actual contribution that year was $23.385 billion. Second, in the instant docket, UPS approvingly cites the European Commission's use of the attributable cost share (57 percent) to set the contribution share for market dominant ("reserved") products. UPS Initial Comments at 38.

competitive products). Moreover, for market dominant products to achieve a 70.6 percent contribution share, a significant price increase (one almost certain to exceed the PAEA price cap) would be necessary. Thus, if UPS intended for the contribution share of market dominant products to be 70.6 percent, this solution is clearly not tenable under current law.

UPS's proposal is equally untenable if market dominant products are intended to achieve a contribution share less than 70.6 percent. Such an outcome cannot be obtained – while keeping the competitive products contribution share at 29.4 percent – without violating UPS's core argument for proportional institutional cost allocations to competitive and market dominant products.[43]

Moreover, under any interpretation,[44] UPS's proposal would fail to take account of the asymmetric distribution of worksharing, which has had the natural effect of pushing the overall cost coverage for (more highly-workshared) market dominant products above the overall cost coverage for (less highly-workshared) competitive products.[45] All else being equal, the market dominant products' markup and cost coverage should be expected to exceed, not be equal to or less than, those for

[43] The competitive products' contribution share would be equal to the attributable cost share (29.4 percent) but the market dominant products' contribution share would be less than the attributable cost share (70.6 percent).

[44] If the market dominant products' contribution share is equal to 70.6 percent, the competitive products and market dominant products markups and cost coverages will be forced to equalization. If the market dominant products' contribution share is less than 70.6 percent, the competitive products' markup and cost coverage will actually exceed those for market dominant products.

[45]This is because workshare discounts are set with reference to unit avoided costs. As a result, workshare-induced numerator and denominator adjustments to the cost coverage calculation tend to be offsetting. Consider a mail piece with a price of 40 cents and an attributable cost of 25 cents. The cost coverage is 40 cents ÷ 25 cents = 160 percent. If the piece then becomes workshared, and is discounted by 5 cents in accordance with an avoided cost also equal to 5 cents, the cost coverage increases to (40 cents - 5 cents) ÷ (25 cents - 5 cents) = 175 percent.

competitive products. Additionally, the UPS proposal undermines the Postal Service's ability to price competitive products as they should be priced: with respect to demand and supply conditions in the package delivery market, and with contribution maximization as a goal (e.g., to help support the provision of universal service). Instead, under UPS's proposal, competitive product pricing would be directly tied to contingencies on the market dominant side of the ledger.[46] On top of this, the required 25.4 percent price increase (first-stage, before volume effects)[47] for the contribution share to reach 29.4 percent could very well cause such a loss of volume that total contribution from competitive products would decrease.

Finally, it is arbitrary to use attributable costs as a cost-allocation basis for institutional costs. 39 U.S.C. § 3633(b) recognizes that attributable costs can have unique aspects, and consequently requires the Postal Regulatory Commission to consider "the degree to which any costs are uniquely or disproportionately associated with any competitive products" during its "appropriate share" determination every five years. From a cost standpoint, what arguably distinguishes competitive products most from market dominant products is a reliance on purchased transportation (Cost

[46] For example, if Single-Piece First-Class Mail volume continues to decline, this will leave competitive products holding a larger share of total attributable costs, and therefore with a greater responsibility for institutional costs. Irrationally, this would occur even if competitive products volume has not increased, and competitive products are not making more demands on the Postal Service's network. Such a condition could easily undermine the Postal Service's competitive position in the package delivery market, for completely artificial reasons.

[47] The after-volume effects could be complex and difficult for the Postal Service to predict, greatly complicating attempts to achieve compliance. Volume losses would affect both the contribution competitive products would be able to generate, and the proportion of total attributable costs coming from competitive products that would drive the target share. Without very precise forecasting models able to predict volume and cost responses from price increases perhaps outside the range of current market conditions, hitting such a moving target would be difficult, if not impossible.

Segment 14).[48] This has much to do with the effects of three key cost drivers: cubic volume, distance shipped, and the use of air versus surface transportation. UPS offers no argument for why the effects of those cost drivers on attributable costs should be extended to the allocation of institutional costs.[49]

b. Competitive Product Volume/Revenue Trends, in Isolation, do not Support UPS's Claims About the Postal Service's Market Share

On ppages 20 through 23 of its comments, UPS discusses the growth of the Postal Service's competitive volume and revenue since 2008. Employing subjective terms such as "significant," "skyrocketed," and "unprecedented," UPS attempts to describe an alternative universe in which the Postal Service enjoys an "ever increasing share of the market."[50] However, the Postal Service's competitive volumes/revenues, in isolation, do not yield a meaningful analysis of the market or each competitor's position within it. To be sure, UPS's presentation of the Postal Service's competitive product volumes/revenues does not even attempt to isolate for growth related to product transfers or growth related to the organic expansion of the market. Contrary to UPS's hypothesis, and as shown in the Postal Service's publically sourced market analysis spreadsheet, submitted with its initial comments on January 23, 2017, the Postal Service's market share has not significantly changed since 2012.[51]

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[48] In FY 2016, Cost Segment 14 accounted for 29 percent of all costs that were attributed to competitive products but only 7 percent of all costs that were attributed to market dominant products. Clearly, transportation costs are "uniquely or disproportionately associated with" competitive products.

[49] For example, the cost drivers are tied to services provided mainly under contract by third-party carriers. It is unclear why those cost drivers should also be used, effectively, as a distribution key for internal network (i.e., institutional) costs.

[50] UPS Comments, *supra* note 2, at 22-25.

[51] *See* RM2017-1 Analysis-public.xlsx, filed concurrently with Postal Service Comments, *supra* note 2.

Further, to support the notion that the Postal Service's competitive volumes/revenues have grown due to a competitive advantage, UPS resurrects a previously discredited Wall Street Journal (WSJ) article.[52] As discussed in more detail in the Postal Service's initial comments in Docket No. RM2016-2, the WSJ article suffers from a number of flaws.[53] In particular, the article: 1) misleadingly focuses on decreases to a small subset of Priority Mail's 2,000-plus price cells; 2) ignores the fact that those price decreases were accompanied by other Priority Mail price increases (which resulted in a weighted-average price increase of 0 percent for all Priority Mail); and 3) uses UPS, FedEx, and Postal Service list prices, even though, unlike the Postal Service, the majority of UPS customers pay undisclosed discounted rates.[54] Moreover, just as it did in its petition in Docket No. RM2016-2, UPS again fails to mention the subsequent implementation of substantial Priority Mail price increases, including 9.8 percent in January of 2016 and 3.8 percent in January of 2017. At base, the impact of a more than 2-year-old pricing decision, which was limited to select price cells within a single product, does not support UPS's assertion.

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[52] UPS Comments, supra note 2, at 21 (citing Laura Stevens, U.S. Mail Cuts Prices, Chafing UPS and FedEx, WALL ST.J. (Sept. 4, 2014), http://www.wsj.com/articles/u-s-mail-cutting-rates-to-win-ecommerce-business-1409850185).

[53] Initial Comments of the United States Postal Service on UPS Proposals One and Two, PRC Docket No. RM2016-2, at 36-37 (Jan. 25, 2016).

[54] *See* Rob Martinez, 2015 Parcel Pricing & Benchmarking Survey: Live Parcel Forum Results Unveiled, PARCEL (Nov.-Dec. 2015), at 5, http://www.parcelindustry.com/file-224-Survey2015.pdf (showing how a majority of the survey respondents, most of whom used UPS and/or FedEx, had negotiated their rates over the past two years).

c. The Postal Monopoly does not Give the Postal Service an Artificial Advantage in the Marketplace

UPS attempts to justify an extremely high appropriate share floor, in part, by arguing that the Postal Service's monopoly somehow confers a "significant artificial" competitive advantage in its ability to provide competitive products.[55] These claims contain serious factual and conceptual errors.

i. The Postal Service does not have an Artificial Competitive Advantage due to the Postal Monopoly

UPS argues that the Postal Service's alleged competitive advantage "principally arises from the large economies of scale and scope generated by the postal monopoly."[56] UPS then cites the 149.8 billion pieces of market dominant mail that the Postal Service delivered in 2016 and attempts to illustrate its point by presenting a marginal cost graph reflecting the shape of delivery costs.[57] In its marginal cost graph, UPS presents the market dominant volumes first and the competitive volumes second, attempting to show that the existence of market dominant volumes create economies of scale advantages for competitive products. However, this presentation is flawed because UPS makes the same mistake here as it did throughout Docket No. RM2016-2, in which it erroneously treated the Postal Service like a single product firm.

In presenting its graph, UPS is assuming that there is a single cost driver in delivery, when in fact, there are multiple cost drivers, some for letter shaped pieces,

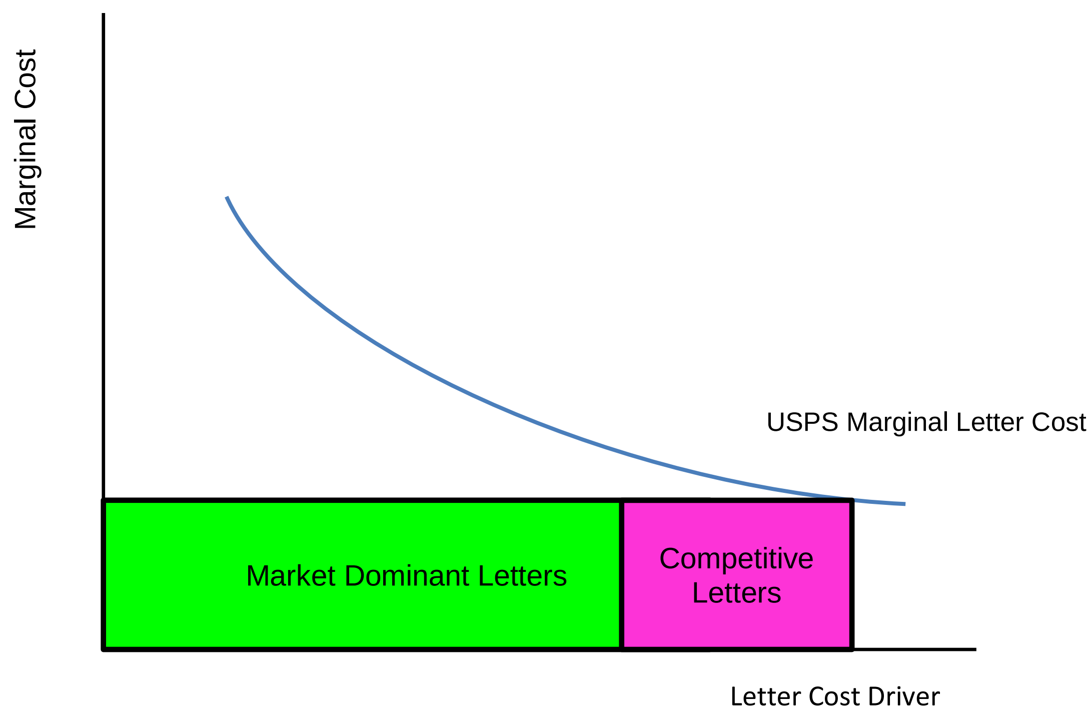
[55] UPS Comments, *supra* note 2, at 13-15.

[56] *Id.* at 14.

[57] In presenting this graph, UPS mistakenly appears to suggest that the graph is a result of a constant elasticity cost function. UPS Comments, *supra* note 2, at 14. In reality, a downward sloping marginal cost curve does not require a constant elasticity cost function.

some for flat shaped pieces, and some for parcels. The existence of multiple cost drivers reflects the fact that there are separate economies of scale in delivery for differently shaped pieces. Assuming that the Postal Service is a single product firm caused UPS to present a single marginal cost graph for all shapes, when in fact there are separate marginal cost graphs for each cost driver.[58]

For example, the next two graphs present the corrected version of UPS's graph for delivery of letters and delivery of parcels. These graphs immediately highlight the mistaken assumption in UPS's assertion about scale economies. The first graph shows the marginal cost curve for letter delivery, and reflects that, in letter delivery, UPS's assertion that nearly all of the economies of scale come from market dominant letters is appropriate.



[58] UPS Comments, *supra* note 2, at 15.

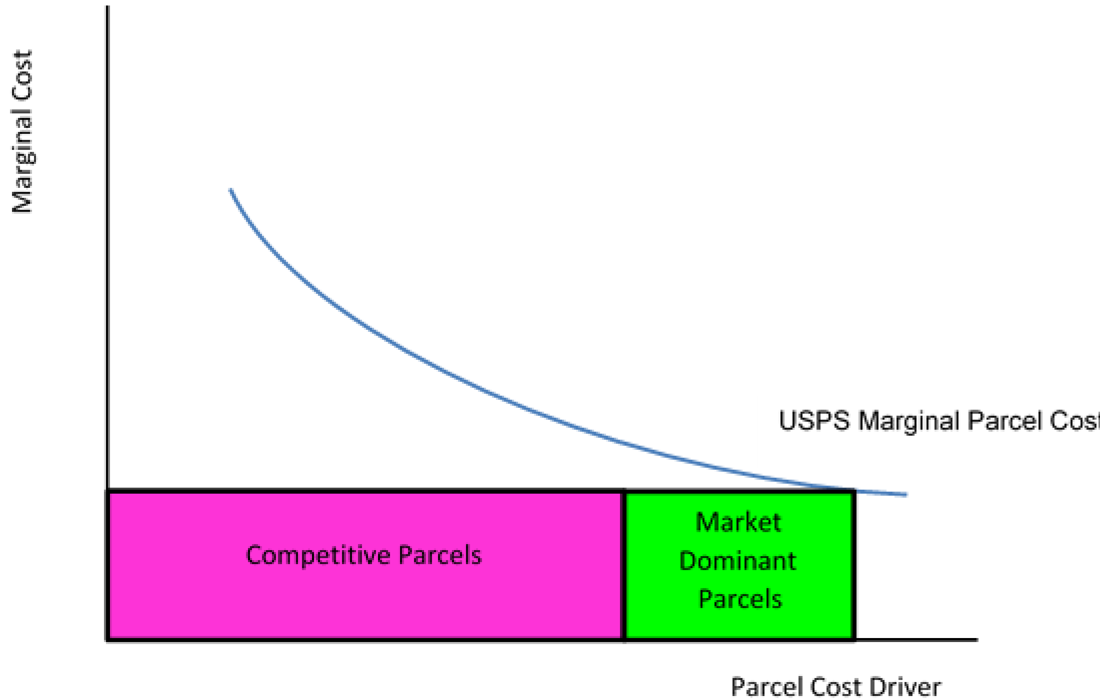
Things are quite different for parcels, however. There, the volume of competitive parcels is many times larger than the volume for market dominant parcels. For example, Table 1 shows that the FY 2016 volume for Ground parcels, by itself, was many times larger than volumes for market dominant Package Services parcels.

Table 1

Product	**Pieces (Thousands)**
Package Services	326,238
First Class Parcels	253,945
Standard Parcels	45,017
Ground Parcels	2,457,488

Note: Ground Parcels includes Parcel Select, Retail Ground (formerly Standard Post), and Parcel Return Service.

This means that the nature of the original UPS graph is reversed, with market dominant parcels benefiting from the economies of scale generated from the relatively large volume of competitive parcels. In other words, the economies of scale in parcel delivery can be traced to relatively large volume of competitive parcels. The parcel marginal cost graph also illustrates the fact that the monopoly on market dominant mail does not provide economies of scale in the delivery of competitive parcels.



UPS also confounds the concepts of economies of scale and economies of scope. Economies of scale arise when a product's unit cost falls as the product's volume increases, while economies of scope arise when it is cheaper to provide two products together than it is to provide them separately. The Postal Service does enjoy natural, not artificial, economies of scope in delivery. Such economies reflect the true resource cost of providing parcel delivery, and society as a whole should benefit from any natural efficiencies that arise.[59] Moreover any scope economies between competitive and market dominant products depend upon market dominant volume. As

[59] Broadly speaking, American consumers are the ones who, directly or indirectly, have historically financed the universal delivery network, and it would thus be patently unreasonable to deny them the opportunity to benefit from potentially lower competitive product rates facilitated by the economies of scope that network generates.

market dominant volumes have fallen, so have the scope economies with competitive products, putting upward pressure on the marginal costs of those competitive products.

ii. The Postal Service does not have an Artificial Competitive Advantage even though the PRC's Valuation of the Postal Monopoly exceeds its Valuation of the cost of the USO.

UPS attempts to buttress its appropriate share proposal by arguing that, in some unspecified way, the fact that the Commission's estimate of the value of the postal monopoly exceeded the Commission's estimate of the cost of the universal service obligation (USO) in FY2016, confers an artificial advantage to the Postal Service in providing competitive products.[60] There are a number of serious problems with this claim. First, UPS fails to provide any linkage between the calculated value for the monopoly and the Postal Service's ability to provide competitive products. Estimating the value of the monopoly is a counterfactual estimate of what might happen to Postal Service profit if it lost some of its market dominant volume to competitors. This estimate has no impact on the actual costs of the Postal Service in providing competitive services. Moreover, the Commission's estimates of the USO and the postal monopoly are not directly comparable. They are based upon different models and very different scenarios.

To calculate the value of the monopoly, the Commission's methodology assumes that the postal monopoly no longer exists. But if the Postal Service did not have a monopoly on market dominant products, its USO would be considerably higher because many more routes across the country would not have sufficient volume (and thus lack

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[60] UPS Comments, *supra* note 2, at 15-16.

sufficient revenue) to be profitable. In contrast, the current Commission estimate of the cost of the USO is made under the assumption that the monopoly remains in place, and thus this estimate is not comparable to its postal monopoly estimate. The fact that the value of the postal monopoly, made under one set of assumptions, exceeds the cost of the USO, under a different set of assumptions, does not in any way inform how the Postal Service provides competitive services.

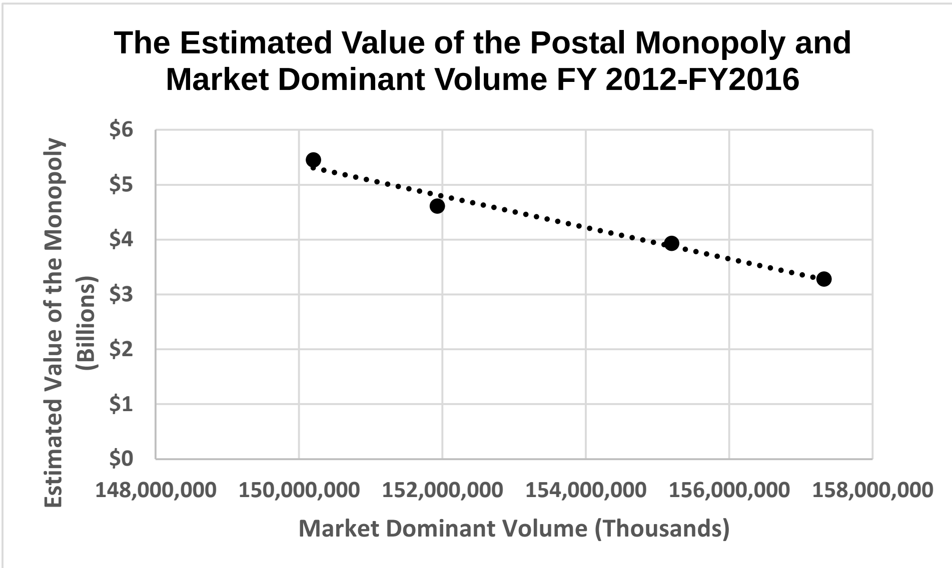
The Commission's estimate of the value of the postal monopoly also produces counterintuitive results, and thus, may have methodological drawbacks. The Commission defines the value of the postal monopoly as follows:

> The value of the postal monopoly is an estimate of the profit that the Postal Service would lose if both the mailbox and letter monopolies were lifted, and the Postal Service were subject to competition for mail currently covered by the postal monopoly.[61]

As the volume of mail covered by the monopoly falls, the value of the monopoly should also fall, as the ability of the Postal Service to earn a profit on its market dominant mail is reduced. If, for example, the Postal Service delivered only a few pieces of market dominant volume per year, the value of the postal monopoly would be near zero. Surprisingly, the Commission's estimates of the value of the postal monopoly exhibit exactly the opposite pattern -- as the volume of market dominant mail has fallen, the calculated value of the postal monopoly has sharply increased. Between FY 2012 and FY 2015, the volume of market dominant mail fell by 4.5 percent, but the Commission's calculated value of the postal monopoly increased by 66.1 percent. Such

[61] Postal Regulatory Commission, Annual Report to the President and Congress (Fiscal Year 2016), at 48 (Jan. 12, 2017).

a result is difficult to understand. It is highly unlikely that the value of the postal monopoly has actually increased by a double-digit amount in any one year, let alone in three consecutive years. (In the following graph, note that the data points appear in reverse chronological order, with the first data point – associated with the lowest volume and the highest estimated value – relating to FY 2016.)



UPS also argues that the Commission's estimate of the cost of the USO is overstated because it does not include the additional revenue that the Postal Service gains from having Saturday delivery, and because some of the costs that the Commission includes in the USO are actually due to "inefficiency."[62] But it is just as likely that the Commission's estimate of the USO is understated, because it omits important costs.

For example, the Commission includes only the USO cost of Saturday delivery, but ignores the fact that many places in the country receive insufficient volume to justify

[62] UPS Comments, *supra* note 2, at 17.

even five-day delivery, let alone six-day delivery. Without the USO, the Postal Service might seek to reduce the frequency of delivery to these areas to four days, three days, or perhaps even two days a week. Such a reduction would save cost in a number of ways.

Some activities undertaken by city and rural carriers are not driven by volume, but by the need to cover the network. These costs are incurred whenever a carrier affects delivery across the network. Reducing the number of delivery days reduces these costs. Also, a reduction in delivery days increases the number of pieces delivered per delivery point. Economies of density in delivery imply that this will lead to some savings of attributable costs. Finally, not only will carrier direct labor costs be saved, but also the indirect costs (e.g. carrier supervisors, vehicle maintenance) required to support carriers. The cost savings from not having to deliver everywhere five days a week are likely to be material. One analysis of this issue estimated that in 2010 27.5 percent of households would likely receive less than five days of delivery.[63] With the declines in volume that have taken place since 2010, this proportion has likely increased.

Similarly, the Commission's estimate of the cost of the USO examines the impact of the uniform geographic rates for First-Class Mail, Media Mail, and Library Mail, but does not include the cost of uniform geographic rates for Standard Mail. Research has shown that this latter cost could be in the billions of dollars.[64]

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[63] *See* Bradley, Michael D., Colvin, Jeff, Nieto, Norma and Houck, Adam C., "Analyzing the Impact of Differential Delivery-Day Frequency," 18th Conference on Postal and Delivery Economics, at 19 (June 2010).

[64] *See* Bradley, Michael D., Colvin, Jeff, Nieto, Norma and Tobias, Daniel, "Estimating the Impact of a Uniform Price Rule in a Liberalized Postal Environment: the Case of the United States Postal Service," in

iii. The Estimate of the Mailbox Monopoly on Which UPS Relies is Deeply Flawed.

The Declaration of J. Gregory Sidak, submitted on UPS's behalf, relies on an estimate of the value of the mailbox monopoly provided by Robert J. Shapiro.[65] Specifically, Mr. Sidak claims that, even under "extremely conservative assumptions" about the relative proportion of the value of the monopoly that accrues to competitive products, "the value of the mailbox monopoly *alone* exceeds the net disadvantages that the [Federal Trade Commission] identified in 2007."[66] Far from being "conservative," this estimate grossly overstates the value of the mailbox monopoly, as the Postal Service has previously demonstrated.[67]

For example, the "subsidy" figure incorporated into Dr. Shapiro's analysis relates only to the Postal Service as a whole, without allocating competitive products separately. Additionally, his estimate of the value of the mailbox monopoly is based on the cost of delivering to mailboxes, even though the USOUSO would require the Postal Service to deliver to these mailboxes even in the absence of a monopoly. Finally, Dr. Shapiro also fails to adjust his analysis to account for: 1) those packages that do not fit into the mailbox and therefore would not be delivered to it; or 2) the fact that many of the competitive packages the Postal Service delivers are actually Parcel Select items,

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Heightening Competition in the Postal and Delivery Sector, Michael Crew and Paul Kleindorfer (eds.), 2010, at 215.

[65] Declaration of J. Gregory Sidak on Behalf of United Parcel Service, PRC Docket No. RM2017-1, (Jan. 23, 2017), at 6, n.11-12 ("Sidak Declaration") (citing Robert J. Shapiro, *The Basis and Extent of the Monopoly Rights and Subsidies Claimed by the United States Postal Service*, at 16 (March 2015), *available at* http://www.sonecon.com/docs/studies/) [hereinafter *Sidak Declaration*].

[66] *Id.* at 6.

[67] Initial Comments of the United States Postal Service on UPS Proposals One and Two, PRC Docket No. RM2016-2, at 49 (Jan. 25, 2016).

for which the Postal Service effectively shares the benefits of the monopoly with private carrier-customers like UPS.[68]

iv. UPS's Arguments Concerning Rivals Realizing Economies of Scale and Scope from Delivering Market Dominant Products is Unpersuasive.

UPS argues that the Commission's estimate of the value of the postal monopoly is too low, because it "overlooks the cost advantages" UPS claims the monopoly creates for the Postal Service in competitive product markets.[69] It asserts, for example, that if new rivals were to begin delivering market dominant products in the absence of the postal monopoly, overall Postal Service volume would decrease, driving the marginal cost of delivery upwards, while the new rivals could expand and realize economies of scale and scope that are currently unavailable to them.[70] UPS contends, further, that the Commission's model does not account for the advantages associated with the mailbox monopoly, including postal carriers' ability to leave lightweight packages (such as e-commerce packages) in the mailbox while private carriers may not.[71] Implicit in this line of argument is UPS's true purpose in advocating for a higher appropriate share requirement:to drive up Postal Service prices in order to improve its own network economies and bottom line.

Of course, UPS and other private carriers, along with consumers, actually <u>benefit</u> from the nationwide universal service network that facilitates the Postal Service's ability

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[68] *Id.* at 49, n. 40.

[69] UPS Comments, *supra* note 2, at 16.

[70] *Id.*

[71] *Id.* at 17.

to provide last-mile delivery of lightweight packages at reasonable rates.[72] With the explosion in e-commerce, an increasing percentage of the Postal Service's growth in competitive products has come via the Parcel Select product.[73] Even if competitors did not benefit from the Postal Service's last-mile delivery capabilities, however, the appropriate share requirement would be an improper way to address their alleged disadvantages. The purpose of the appropriate share requirement is to protect the package services market and consumers as a whole, not UPS or other individual competitors. The USO would compel the Postal Service to deliver to virtually every mailbox even if the postal monopoly were eliminated or if the appropriate share requirement were raised. If the Postal Service were forced to raise prices for last-mile delivery as the result of an increased appropriate share requirement, both consumers and the market as a whole would suffer.[74] New entrants (or existing competitors) might expand further to improve their capabilities to provide last-mile delivery, but because the USO would remain, the Postal Service would also need to maintain its delivery network despite decreasing volumes, while any new entrants seeking to match the scale of the

[72] *See, e.g.*, Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors, FED. TRADE COMM'N (2008), at 50 (noting that competitors' access to the Postal Service's networks through Parcel Select mitigates any concerns that the Postal Service's economies of scope create an artificial advantage versus its competitors); AFSI Comments, *supra* note 2, at 42 (noting that the Postal Service shares its economies of scale, scope, and density with competitors "by unbundling last-mile delivery from upstream functions, and offering last-mile delivery to competitors at reasonable rates"); Reply Comments of the United States Postal Service on Proposals One and Two, PRC Docket No. RM2016-2, at 6 n.5 (March 25, 2016).

[73] Postal Service Comments, *supra* note 2, at 12-14.

[74] *See, e.g.*, AFSI Comments, supra note 2, at 9-12 (describing the likely harm to mailers, shippers, consumers, and the Postal Service if the appropriate share requirement were raised high enough to constrain the Postal Service's downward pricing flexibility).

Postal Service's natural monopoly would need to invest heavily to build it out. The result would be that consumers would pay more for less market efficiency.

Finally, the recent financial performance of the Postal Service's principal competitors undermines UPS's position that the postal monopoly creates a market imbalance that needs to be corrected via the appropriate share requirement. UPS is not only thriving,[75] but has even announced that it will soon start making Saturday deliveries and testing drones.[76] Clearly, UPS does not need the Commission to increase the appropriate share level as an incentive to innovate and develop its service offerings. The continuing growth in e-commerce, increasing logistics and delivery capabilities of e-commerce retailers, and recent technological innovations have resulted in a shifting competitive landscape in which participants in the e-commerce economy have more choices for last-mile delivery than ever before.[77]

v. Assertions Concerning the Profit Maximization and Postal Costing are Unfounded.

UPS also attempts to justify an extreme appropriate share by arguing, based upon the declaration of J. Gregory Sidak, that Postal Service managers have "incentive to prioritize scale over profit due to statutory mandates and policy goals that diverge from profit maximization."[78] Specifically, Mr. Sidak hypothesizes that Postal Service managers have incentive to sacrifice profit in order to expand its scale of operations

[75] *Id.* at 7-8 (summarizing the recent financial performance of UPS and FedEx).

[76] *See* Paul Ziobro, *UPS to Start Ground Deliveries on Saturdays*, WALL ST. J. (Feb. 21, 2017), *available at* https://www.wsj.com/articles/ups-to-start-ground-deliveries-on-saturdays-1487701384?mod=djemlogistics.

[77] Postal Service Comments, *supra* note 2, at 14-16.

[78] UPS Comments, *supra* note 2, at 26-27.

because their goals deviate from the goal of profit maximization.[79] But, this "empire building" hypothesis is exactly that – just a hypothesis – and not one grounded in facts.

Moreover, any attempted application of the empire building hypothesis to the Postal Service must consider some relevant facts. First, if increasing the scale of operations is truly an important goal for Postal Service managers, then competitive products is hardly the place for it to start. Even in FY 2016, the scale of market dominant operations dwarfed the scale of competitive operations. Market dominant volume was nearly 150 billion pieces, whereas competitive volume was just under 4.5 billion pieces. A doubling, tripling or even quadrupling of the scale of competitive operations would still leave those operations tiny relative to market dominant operations.

In addition, it is important to recognize that the Postal Service does not set the prices for its competitive products in a vacuum. Competitive product prices are reviewed annually by the Commission to ensure that they are above competitive products' costs. This annual review precludes the Postal Service from setting the prices for its competitive products below their cost. In order to try to circumvent this inconvenient fact, Mr. Sidak must resort to alleging that, despite the fact that its costs are reviewed in great detail each year by the Commission and UPS, somehow the Postal Service is surreptitiously understating the costs for its competitive products. He attempts to buttress this claim with two arguments, first, the Postal Service costing system is "opaque" and, second, "the costs that the Postal Service attributes to its competitive products are not publically available in sufficient detail to enable scrutiny of

[79] Sidak Declaration, *supra* note 65, at 11.

the Postal Service's costing procedures."[80] Both of these arguments are demonstrably false.

Contrary to Mr. Sidak's assertion, the Postal Service's costing system has been, and continues to be, developed in public, adversarial, proceedings in which the Postal Service's competitors have, and do, review and critique the methodology. Moreover, the final methodology is determined by the Commission, not the Postal Service. Thus, to make his point, Mr. Sidak must actually argue that the Commission has incentives to under-attribute costs to competitive products. Given that the Commission is concerned with the welfare of Postal Service customers and competition, this is unlikely.[81] The transparency of the Postal Service costing methodology is apparent from the fact the UPS could not only reproduce the Postal Service's costing model, but also could suggest extensive and detailed modifications to its algorithms.[82]

Mr. Sidak's claim that the attributable costs are not available to those who wish to review them is also false. Not only are these costs provided annually to the Commission, but they are also provided, under appropriate protective conditions, to other parties, like UPS, who desire to review the Postal Service's costing. And the access to these materials is not fleeting, as UPS recently received permission from the

[80] *Id*. at 12.

[81] *See* Bradley, Michael D., Colvin, Jeff and Perkins, Mary, "Testing for Anti-Competitive Behavior in Public Enterprises," in *Competitive Transformation of the Postal and Delivery Sector*, Michael Crew and Paul Kleindorfer, (eds.), 2004, at 179.

[82] *See generally*, Proposal One and Proposal Two submitted by UPS in PRC Docket No. RM2016-2, October 8, 2015.

Commission to have continued access to competitive costs not only for FY 2016, but also for FY2014 and FY2015.[83]

Mr. Sidak goes on to argue that “even without deliberate manipulation of accounting data, the Postal Service’s cost attribution methodologies are likely to understate the cost of providing competitive products.”[84] He argues that the Postal Service will shift resources to the provision of competitive products “in ways that the Postal Service’s accounting procedures are unlikely to capture.”[85]

Giventhe alleged opacity of the Postal Service’s costing methodology, it is an open question how Mr. Sidak would know this. In any event, the assertion is erroneous. To the extent resources are increased for competitive products, the Postal Service’s costing methodology is designed to capture them. For example, the Postal Service deployed the Passive Adaptive Scanning System (PASS) and the Delivery Sortation System (DSS) to allow post offices and other delivery units to capture arrival-at-unit scans on packages. Because the cost of this capital equipment was incurred specifically for packages, the Postal Service costing system distributes its cost to packages:

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[83] Order No. 2797, Granting Motion for Continued Access to Non-Public Materials, PRC Docket No. RM2017-1 (Feb. 17, 2017) (listing the many times UPS has obtained access to competitive product costs); Order No. 2756 – Order Granting Unopposed Request for Continued Access to Non-Public Materials Filed Under Seal, PRC Docket No. RM2016-2 (Oct. 15, 2015) (granting UPS continued access to materials filed under seal in Docket Nos. ACR2014 and RM2015-7); Order No. 3033 – Order Granting First Motion for Access, PRC Docket No. ACR2015 (Jan. 15, 2016); Order No. 3044 – Order Granting Revised Second Motion for Access, PRC Docket No. ACR2015 (January 22, 2016); *See also*, Order No 2321 – Order Granting Request for Access, PRC Docket No. ACR2014 (Jan. 15, 2015); Order No. 2363 – Order Granting Motion for Access to Non-Public Material, PRC Docket No. RM2015-7 (Feb. 24, 2015).

[84] Sidak Declaration, *supra* note 65, at 12.

[85] *Id*. at 13.

> PASS/DSS depreciation costs are distributed using RPW parcel volumes by product. [86]

Contrary to what Mr. Sidak implies, if the Postal Service were to incur additional cost to increase the capacity of its delivery vehicles to accommodate parcels, that additional cost could be distributed to parcels in the Postal Service costing system.

Finally, Mr. Sidak argues that the Postal Service will make investments to support its competitive products that have large "fixed" costs and low "variable" costs so that relatively small amounts of cost would be attributed to competitive products. Mr. Sidak does not provide an example of such an investment, but presumably he means an investment in capital, like machines or vehicles, that could be used in place of labor. But a capital-intensive investment will not have the cost attribution effect that Mr. Sidak anticipates, because the Postal Service does not treat capital costs as fixed:

> The impact of moving costs from labor to capital is less than one might expect. In the Postal Service product costing system, capital costs are treated as variable to the same degree as (and distributed to products in proportion to) labor costs. [87]

d. UPS Incorrectly Attributes the Rise of Institutional Costs to the Growth of Competitive Product Volumes.

In its comments, UPS notes that since 2012 "[i]nstitutional costs have risen by $1.3 billion," and that "[t]he growth in competitive products has continued unabated."[88] Using this information, in combination with carefully chosen statements made by Postal

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[86] United States Postal Service, Summary Description of USPS Development of Costs by Segments and Components – Fiscal Year 2015, at 20-22 (July 6, 2016).

[87] *See* Bradley, Michael D., Colvin, Jeff and Perkins, Mary, "Testing for Anti-Competitive Behavior in Public Enterprises," in *Competitive Transformation of the Postal and Delivery Sector*, Michael Crew and Paul Kleindorfer, (eds.), 2004, at 176.

[88] UPS Comments, supra note 2, at 30.

Service management, UPS concludes that "the growth of competitive product volumes are driving overall growth of the Postal Service's institutional costs."[89] However, this ignores some important sources of growth in institutional costs. Rather, institutional costs have risen primarily due to an acceleration in the growth rate of delivery points,[90] an increase in the Federal Employees Retirement System (FERS) supplemental liability payment,[91] and methodology change for city carriers.[92] Moreover, UPS's argument appears to be contradicted by Table 1 in its comments. Indeed, the overall trend between 2008 and 2016 has been for institutional costs to remain essentially constant, reflecting the largely fixed nature of the universal service network, while (volume-variable) attributable costs have reflected m dcmarket dominant/competitive volume trends. Even if institutional costs' proportion of total costs has grown, this says less about cost allocation and more about the m dmarket dominant driven decline in attributable costs.

[89] *Id*. at 31.

[90] As shown in PRC Docket No. ACR2017, USPS-FY16-17, page 28, delivery points have grown by 2.2 million between FY 2014 and FY 2016.

[91] The FERS Supplemental Liability grew by about $240 million between FY2014 and FY2016. The Office of Personnel Management (OPM) assesses these charges if the cumulative value of past payments for FERS is deemed insufficient (or are less than the FERS actuarial liability). Thus, these charges by OPM relate to the Postal Service's past history of payments with OPM rather than any changes in mail/package volumes between FY2014 and FY2016. *See* U.S. Postal Service's 2016 Report on Form 10-K, page 23. *See also* USPS-FY16-31, FY16Public.CRpt.xls, 18.3.7 and USPS-FY16-5, Cost Segment 18, Component 71.

[92] The new city carrier methodology was expected to slightly lower the variability of street time, raising institutional costs by approximately $242 million..*See* Docket No. RM2015-7 (Proposal Thirteen), Cost_Impacts_Proposal_13.xlsx (December 11, 2014).

IV. THE GREETING CARD ASSOCIATION'S PROPOSAL FOR AVERAGING COMPETITIVE PRODUCT CONTRIBUTION IGNORES RELEVANT CIRCUMSTANCES THAT THE COMMISSION MUST CONSIDER WHEN REVIEWING THE APPROPRIATE SHARE REQUIREMENT

The Greeting Card Association (GCA) makes two basic recommendations in this docket: (1) that the Commission increase the current 5.5 percent appropriate share requirement; and (2) that it set the new appropriate share requirement equal to the Postal Service's average competitive product contribution over the past seven years.[93] GCA would have the Commission rely on historical contributions to justify moving the appropriate share requirement upward. In attempting to support its position, however, GCA ignores the "relevant circumstances" that section 3633(b) requires the Commission to consider, and most of the factors that the Commission found to be relevant in the last appropriate share review.[94]

GCA bases its call to increase the current 5.5 percent appropriate share requirement exclusively on the Postal Service's competitive contributions to institutional costs since FY 2010, which have trended upward;[95] however, because it ignores other "relevant circumstances" that the Commission must consider when determining the appropriate share, this analysis is not consistent with the statute and does not square with Commission precedent.[96] GCA states that "the Commission relied on the trend in contribution level" in Docket No. RM2012-3,[97] but to the extent the Postal Service's

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[93] GCA Comments, *supra* note 2, at 1, 6-7.

[94] Order No. 1449 – Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, Docket No. RM2012-3, at 13-26 (Aug. 23, 2012) [hereinafter *Order No. 1449*].

[95] GCA Comments, *supra* note 2, at 4-5.

[96] 39 U.S.C. § 3633(b).

[97] GCA Initial Comments, *supra* note 2, at 4.

historical contributions in excess of the required 5.5 percent minimum factored into the Commission's appropriate share analysis, they did not lead the Commission to conclude that the minimum level should be increased.[98]

Moreover, there is nothing in the Commission's final order in Docket No. RM2012-3 to warrant weighing historical contributions as heavily as GCA suggests in its initial comments. Quite the opposite, in Order No. 1449, the Commission deployed an analysis of "'all relevant circumstances' that could affect its decision to retain, modify, or eliminate the current appropriate share contribution level under 3633(b)," including those specifically required by statute.[99] GCA nonetheless fails to take into consideration whether there is evidence that the Postal Service has a competitive advantage, changes to the Postal Service's market share, changes to the market and competitors, or market uncertainties. Although GCA acknowledges that these and other factors the Commission considered in previous appropriate share reviews "could be useful, in varying degrees, in the present review,"[100] it makes no attempt to analyze whether they support its recommendation.

As the Postal Service noted in its initial comments, historical contribution levels, standing alone, do not support increasing the appropriate share requirement.[101] That competitive products have contributed more than the appropriate share requirement is

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[98] Order No. 1449, supra note 94, at 15, 19, 21 (looking at historical contributions to conclude that: the appropriate share requirement "provided another level of protection against unfair or anti-competitive pricing"; changes to the market would not provide the PPostal Service with an unfair competitive advantage; and the appropriate share level "ha[d] not hampered the Postal Service in pricing its competitive products").

[99] *Id*. at 13.

[100] GCA Comments, supra note 2, at 4.

[101] Postal Service Comments, *supra* note 2, at 18.

entirely consistent with the requirement's nature as a floor, rather than a ceiling or target, and is not on its own an indicator that the requirement should be increased.[102] To the contrary, competitive products' historical contributions are evidence of the strong incentives that the Postal Service has to generate contribution from the competitive side, and, absent evidence of unfair competitive advantage, weigh in favor of resetting the appropriate share to zero.[103]

The second component of GCA's recommendation is likewise unsupported by the statute or Commission precedent. Specifically, GCA proposes that the Commission set the appropriate share requirement equal to the Postal Service's average competitive contribution "in recent years."[104] GCA averages the Postal Service's contribution over the past seven years to arrive at a recommended floor of between 10.5 and 11.0 percent.[105] This method of setting the appropriate share requirement continues to ignore the relevant factors that the Commission must consider under the statute.

GCA states that its proposed approach would "continu[e] the Commission's previous historically-based approach,"[106] presumably adopted by the Commission in its initial appropriate share rulemaking proceeding. But in Docket No. RM2007-1, the Commission used historical contributions to set the appropriate share level as an "initial effort to implement the competitive products' regulations" under a new and untested statutory pricing regime, declaring that "the Postal Service should perform at least as

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[102] Order No. 26, *supra* note 15, at 72.

[103] Postal Service Comments, *supra* note 2, at 5 n.11.

[104] GCA Comments, *supra* note 2, at 6.

[105] *Id*.

[106] *Id*.

well as it has historically."[107] The Commission moved away from a historical averaging approach in Docket No. RM2012-3, choosing instead to apply a "totality of the relevant considerations" approach when reviewing the appropriate share requirement.[108] GCA simply does not present sufficient analysis to support its recommendations.

V. CONCLUSION

For the foregoing reasons, the Postal Service reiterates its request that the Commission eliminate the current 5.5 percent appropriate share requirement, or at a minimum, reduce it. No commenter has provided a basis for raising the appropriate share requirement at this time, while many have persuasively articulated why it is currently unnecessary.

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[107] Order No. 26, *supra* note 15, at 74.

[108] Order No. 1449, *supra* note 94, at 24.

Respectfully submitted,

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