

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Statutory Review of the System
for Regulating Rates and Classes
for Market Dominant Products

Docket No. RM2017-3

COMMENTS OF THE PUBLIC REPRESENTATIVE

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I. INTRODUCTION

On December 20, 2016, the Commission established this docket to initiate the review of the regulatory system governing market dominant products.¹ That review presents a broad spectrum of issues for the Commission to consider. Pursuant to Order No. 3673, the Public Representative hereby files his comments.² Submitted with these comments are the sworn declarations of Dr. John Kwoka,³ Dr. Timothy J. Brennan,⁴ and Lyudmila Bzhilyanskaya.⁵

These comments focus on a select list of issues that have emerged over the past 10 years. The Public Representative believes that those issues are of fundamental

¹ Order No. 3673, Advance Notice of Proposed Rulemaking on the Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products, December 20, 2016 (ANOPR). In its notice, the Commission designated the undersigned to serve as Public Representative. ANOPR at 12.

² Assisting the Public Representative are Kenneth E. Richardson and Samuel M. Poole from the Office of General Counsel and Dr. Lyudmila Bzhilyanskaya from the Office of Accountability and Compliance.

³ Declaration of John Kwoka, March 20, 2017 (Kwoka Decl.). Dr. Kwoka is currently the Neal F. Finnegan Distinguished Professor of Economics at Northeastern University.

⁴ Declaration of Timothy J. Brennan for the Public Representative, March 20, 2017 (Brennan Decl.). Dr. Brennan is currently Professor of Public Policy and Economics in the School of Public Policy at the University of Maryland, Baltimore County.

⁵ Declaration of Lyudmila Bzhilyanskaya, March 20, 2017 (Bzhilyanskaya Decl.). Dr. Bzhilyanskaya is a Senior Econometrician in the Commission's Office of Accountability and Finance.

importance to the Postal Service's continued ability to meet its obligation to provide postal services to the nation.

For the reasons given below, the Public Representative submits that the current regulatory system is not achieving some of the objectives established by the Postal Accountability and Enhancement Act (PAEA) for market dominant products. This failure relates to the core considerations of financial viability and service performance. Whatever other changes the Commission decides are needed, it must come to grips with the serious deficiencies in those two areas.

The Public Representative recommends several changes to the existing system. Several of these recommendations require further exploration in further Commission proceedings, particularly with respect to issues of implementation.

II. EXECUTIVE SUMMARY

The Public Representative's comments are organized into the following four basic sections:

Section III. provides a brief background to the PAEA's modern system of regulation beginning with the enactment of the Postal Reorganization Act in 1970. This background is drawn upon in later sections to provide context to the comments that follow.

Section IV. discusses the procedural framework established by the Commission for its 10-year review.

Section V. identifies and discusses the statutory objectives in 39 U.S.C. § 3622(a) that the Public Representative submits are not being achieved. Those objectives are:

- Objective (5) To assure adequate revenues, including retained earnings, to maintain financial stability.
- Objective (4) To allow the Postal Service pricing flexibility.
- Objective (3) To maintain high quality service standards established under section 3691.

Because of the seriousness of these shortcomings, the Public Representative submits that the modern system of ratemaking is not achieving

the objectives in subsection 3622(b), taking into account the factors in subsection 3622(c) and that modifications to the system are necessary to achieve the statutory objectives.

In addition, the Public Representative submits that it cannot be determined whether Objective (1), the objective of maximizing incentives to reduce costs and increase efficiency, is being achieved because of uncertainties regarding the reliability of the Total Factor Productivity (TFP) Standard used by the Postal Service and the Commission to calculate changes in the efficiency of Postal Service operations.

Section VI. sets forth the Public Representatives recommended changes to the current regulatory system. Briefly summarized, those changes are:

- Include an exogenous factor adjustment (an adjustment for a factor beyond the Postal Service's control) in the price cap formula which permits recovery of the unfunded amortization payments that the Postal Service will be required to make into the Retiree Health Benefits Fund (RHBF).
- Include a second exogenous factor adjustment in the price cap formula to reflect declining demand.
- In addition to the inclusion of exogenous factor adjustments in the price cap formula for RHBF payments and declining demand, adjust the price cap applicable to the Periodicals Class to permit the recovery of total costs.
- As an alternative to exogenous factor adjustments in the price cap formula and the class specific price cap adjustment for periodicals, make a one-time generally applicable price cap reset for all mail classes.
- Begin development of an additional price cap adjustment factor to incentivize/penalize the Postal Service for failure to meet service performance standards.

In addition to these changes to the market dominant regulatory system, the Commission should provide for a further price cap review not later than four years from the date its revisions to the current system go into effect.

III. THE MODERN SYSTEM OF REGULATION ADOPTED BY THE PAEA

A. Background to the PAEA

In 1970, Congress enacted the Postal Reorganization Act (PRA), P.L. No. 91-375. The PRA transformed the Department of the Post Office into an independent establishment within the executive branch of the United States government. 39 U.S.C § 201. From 1971 to 2006, the Postal Service's rates and services were subject to regulatory oversight by the Postal Rate Commission. Postal Service rates were reviewed by the Commission using regulatory principles commonly referred to as "cost-of-service regulation." Kwoka Decl. at 5. Under those principles, the Postal Service's rates were designed to recover demonstrated costs on a break-even basis.

During 1995, a series of oversight hearings began before the House Subcommittee on the Postal Service of the House Committee on Government Operation and Oversight.⁶ Beginning in 2003, the Senate began conducting its own consideration of postal legislation.⁷

The House and Senate hearings investigated a wide range of issues. One of the central issues considered by the committees in both Houses was the issue of whether cost-of-service regulation should be replaced by a relatively new regulatory approach called "price-cap regulation."⁸ The interest in price-cap regulation was driven in part by the Federal Communications Commission's (FCC) adoption in 1989 of price-cap

⁶ The House Sub-committee was under the Chairmanship of Congressman John M. McHugh. The hearings conducted by Congressman McHugh are referred to herein as the McHugh Oversight Hearings. Those hearings began on February 23, 1995, and continued periodically through March of 2000. During the course of the hearings, the Committee considered several postal bills. The first bill to be considered was H.R. 3717, the Postal Reform Act of 1996 (introduced June 25, 1996). In 2001, the full oversight committee took over conduct of the hearings and proceeded to consider several additional postal bills, including the bill that was ultimately enacted as the PAEA.

⁷ S. 1285, the Postal Accountability and Enhancement Act (introduced June 18, 2003).

⁸ Among the earliest price-cap systems was the system introduced in Great Britain in 1984. The theory underlying the adoption of that system was articulated in a paper by Stephen C. Littlechild. Littlechild, S.C. Regulation of British telecommunications' profitability: report to the Secretary of State for Trade and Industry, 1983.

regulation for American Telephone & Telegraph (AT&T) as a replacement for cost-of-service regulation.⁹ During one of the McHugh Oversight Hearings, six witnesses provided testimony on the theory of price-cap regulation, as well as related policy issues and practical considerations presented in the context of Postal Service regulation.¹⁰

While the House and Senate hearings were still underway, a 2003 Presidential Commission presented its report with a series of recommendations for changes in postal regulation.¹¹ The report included a recommendation that the cost-of-service regulation be replaced with the price-cap regulation.¹²

Over the period from 1996 through 2006, more than ten postal bills were considered in the House and the Senate, most of which provided for some form of price-cap regulation. In late 2004, the Senate Committee on Governmental Affairs reported S.2468.¹³ Eight months later, the House Committee on Government Reform reported

⁹ Federal Communications Commission, *Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 2873 (1989). Almost two years later, the FCC adopted price-cap regulation for the AT&T local exchange carriers. Federal Communications Commission, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786 (1990). Since then, price cap regulation has been employed in other industries, such as the natural gas and electric power industries. Hemphill, R.C., Meitzen, M.E. & Schoech, P.E. (2003). Incentive Regulation in Network Industries: Experience and Prospects in the U.S. Telecommunications, Electricity, and Natural Gas Industries, *Review of Network Economics*, 2 (Issue 4), 316-337. Price cap regulation became the subject of a large number of academic papers and empirical studies. *E.g.*, Jaskow, *Incentive Regulation in Theory and Practice: Electricity Distribution and Transmission Networks*, January 21, 2006; and Sappington, D.E.M., & Weisman, D.L. (2010). Price cap regulation: what have we learned from 25 years of experience in the telecommunications industry, *Journal of Regulatory Economics*, 38, 227-257.

¹⁰ One of the witnesses who appeared at the April 16, 1997 hearing was Dr. John Kwoka, whose sworn Declaration for this proceeding accompanies these comments. *Hearing Before the Subcomm. on the Postal Service of the H. Comm. on Government Oversight and Reform*, 105th Cong. 33-51 (April 16, 1997) (Kwoka Congressional Testimony). Dr. Kwoka had been a member of the FCC team that drafted the AT&T price-cap regulation.

¹¹ President's Commission on the United States Postal Service, *Embracing the Future, Making the Tough Choices to Preserve Universal Mail Service*, July 31, 2003 (2003 Presidential Commission).

¹² *Id.* at 53 (Chapter 4: Protecting the Public Interest: Enhanced Accountability and Public-Policy Oversight).

¹³ S. Rep. No. 108-318, 108th Cong., 2d Sess. (Aug. 25, 2004) (S. Rep. No. 108-318)..

HR. 22.¹⁴ These were the last bills to be reported by either house before the enactment of the PAEA.

B. Highlights of the Final PAEA Compromise

The ratemaking system for market dominant products established under 39 U.S.C. § 3622:

- Replaced the PRA's cost-of-service regulatory regime, with a new regulatory framework that distinguishes between market dominant and competitive products and subjected market dominant products to price cap regulation. 39 U.S.C. Subchapter I—Provisions Relating to Market-Dominant Products and 39 U.S.C. Subchapter II—Provisions Relating to Competitive Products;
- Established a list of nine statutory objectives that the price cap system governing market dominant products was to be designed to achieve. 39 U.S.C. § 3622(b);
- One of the statutory objectives was to be designed to maintain high quality service standards established under 39 U.S.C. § 3691. See 39 U.S.C. § 3622(b)(3);
- Established a list of statutory factors that the Commission was required to consider in establishing and revising the market dominant regulatory system. 39 U.S.C. § 3622(c);
- Adopted a statutory price cap at the class level for market dominant products in the form of “an annual limitation on the percentage change in rates ... equal to the change in the Consumer Price Index for All Urban Consumers (CPI-U) unadjusted for seasonal variation over the most recent available 12-month period....” 39 U.S.C. § 3622(d)(1)(A); and 39 U.S.C. § 3622(d)(2)(A);
- Gave the Postal Service increased pricing flexibility, including the authority to offer workshare discounts, *see, e.g.*, 39 U.S.C. § 3622(e);
- Authorized the Postal Service to seek rate increases above the price cap for “extraordinary or exceptional circumstances”, 39 U.S.C. § 3622(d)(1)(E); and

¹⁴ H.R. Rep. No. 109-66, 109th Cong., 1st Sess. (April 28, 2005).

- Established procedures governing rate changes, see 39 U.S.C. § 3622(d)(1).

C. Implementation of the PAEA

On October 29, 2007, the Commission established final ratemaking regulations under the PAEA.¹⁵ The new regulations were adopted in furtherance of the directive in section 3622(a) that the Commission establish a system for market dominant products; the directive in section 3622(b) that the system be designed to achieve the specified statutory objectives; and the directive in section 3622(c) that the in designing and revising the system, the Commission take into account the stated statutory factors.

Under the system adopted by the Commission, statutory objectives and factors are to play a continuing role. Thus, in filings to change market dominant rates, the Postal Service is required to include “[a] discussion that demonstrates how the planned rate adjustments are designed to help achieve the objectives listed in 39 U.S.C. § 3622(b) and properly take into account the factors listed in 39 U.S.C. § 3622(c).”¹⁶ Objectives and factors may also be considered in the Commission’s pre-implementation review of proposed rate changes, although such a review is not usually undertaken because of the limited time available for review.¹⁷ Finally, objectives and factors are susceptible to more searching review in the Commission’s Annual Compliance Determinations (ACDs), complaint cases, and rulemaking proceedings. *Id.* In all of these proceedings, explicit or implicit definitions of objectives and factors can potentially

¹⁵ Docket No. RM2007-1, Establishing Ratemaking Regulations for Market Dominant and Competitive Products (With Table of Contents), October 29, 2007 (Order No. 43); and Errata Notice Concerning Order No. 43, October 31, 2007. Order No. 43 was preceded by a series of earlier orders that sought comments on how the Commission should implement the PAEA. See, e.g., Docket No. RM2007-1, Order Proposing Regulations to Establish a New System of Ratemaking, August 15, 2007 (Order No. 26); and Errata to Order No. 26, August 16, 2007 (Order No. 26).

¹⁶ 39 C.F.R. § 3010.14(a)(7). For convenience, the citations to Commission regulations in these comments are to section numbers in the current Code of Federal Regulations.

¹⁷ See Order No. 43 at 12-13.

be found in the filings of the Postal Service and other participants, as well as in Commission notices and orders.

Of paramount significance for this proceeding, is the fact that the statutory objectives and factors are to be used as the standard against which to evaluate the PAEA's regulatory system for market dominant products. 39 U.S.C. § 3622(d)(3).

IV. The 10-Year Review Required by Section 3622(d)(3)

A. Section 3622(d)(3):

Section 3622(d)(3) provides that the first review of the system for regulating market dominant products is to occur after ten years of experience:

“(3) Review.—Ten years after the date of enactment of the Postal Accountability and Enhancement Act and as appropriate thereafter, the Commission shall review the system for regulating rates and classes for market-dominant products established under this section to determine if the system is achieving the objectives in subsection (b), taking into account the factors in subsection (c). If the Commission determines, after notice and opportunity for public comment, that the system is not achieving the objectives in subsection (b), taking into account the factors in subsection (c), the Commission may, by regulation, make such modification or adopt such alternative system for regulating rates and classes for market-dominant products as necessary to achieve the objectives.

B. The ANOPR: A Two-Part Review

The Commission has adopted a two-step review process. See ANOPR at 2.¹⁸ The first step involves determining whether the system for regulating market dominant

¹⁸ On April 7, 2016, the Postal Service petitioned the Commission for a rulemaking to clarify the scope of the 10-year review. Docket No. RM2016-9, Petition of the United States Postal Service for the Initiation of a Proceeding to Clarify the Scope of the Review of the System for Regulating Market-Dominant Rates and Classes, April 7, 2016. The Commission decided to reserve judgment on the petition until after it had established the 10-year review docket. Order Holding Petition in Abeyance, April 12, 2016 (Order No. 3237). In the ANOPR, the Commission stated that it will consider the scope issue raised by the Postal Service petition in this proceeding. ANOPR at 2, n.4.

products is achieving the objectives of section 3622(b). *Id.* If the Commission concludes that the system is achieving the statutory objectives, the inquiry will come to an end and there will be no need to consider changes to the existing system. If, however, the Commission determines that the existing system is not achieving the statutory objectives of section 3622(b), the Commission will then proceed to a determination of the appropriate corrective action. *Id.*

To assist commenters, the Commission has provided (1) a general summary of the intended scope of its review; (2) a preliminary definition of each of the objectives in section 3622(b), *id.* at 3-8; and (3) suggested measurable key concepts and potential measurement criteria within each statutory objective, *id.* Omitted from the ANOPR were any proposed definitions or measurement suggestions for the factors in section 3622(c) that are to inform the definition or application of the objectives in section 3622(b).

Commenters have been invited to address the appropriateness of the process and structure proposed by the Commission for conducting its review; the question of whether the current regulatory system is achieving the statutory objectives in light of the statutory factors; and what changes, if any, should be made to the current system.

V. The Modern System of Regulation Is Not Achieving the Objectives of Section 3622(b)

A. The System for Regulating the Rates and Classes of Market Dominant Products Includes Consideration of Service Performance

In its ANOPR, the Commission states that it “intends to examine all aspects of the ratemaking system provided within section 3622, including [a list of specific subjects expressly covered by various subsections of section 3622].”¹⁹ The Public

¹⁹ ANOPR at 2-3. The Commission lists the following aspects of the market dominant system: “the annual limitation on the percentage changes in rates, the schedule for rate changes, the 45-day notice before the implementation of rate adjustments, expedited rate changes due to extraordinary or exceptional circumstances, class level application of the annual limitation, the rounding of rates and fees, the use of unused rate authority, and workshare discounts.” ANOPR at 2-3 (footnotes omitted).

Representative interprets the Commission's use of the word "including" to mean that the list is non-exclusive and that commenters can address other subjects not identified by the Commission but properly within the scope of the 10-year review. One such additional subject is service performance.

Although not included on the Commission's list, service performance is among the objectives that the market dominant *system* is to be designed to achieve. See 39 U.S.C. § 3622(b)(3) ("(3) To maintain high quality service standards established under section 3691."). As such, the service performance provisions in section 3691 are an appropriate subject for examination in the 10-year review proceeding. The Commission implicitly recognizes this when it presents a preliminary definition of Objective (3). See ANOPR at 5-6.

There is an additional reason why the service performance provisions of section 3691 must be considered as part of the 10-year review. As Dr. Kwoka points out in his Declaration, there is an important connection between price-cap regulation and service performance that must be considered in designing a regulatory system that relies upon price caps. Kwoka Decl. at 9-11. That connection lies in the fact that businesses subject to price cap regulation can facilitate their ability to keep prices within a price cap or increase their profitability by reducing the quality (and therefore the cost) of providing service. This connection between prices and the costs of providing quality service has been recognized by including the maintenance of high quality service standards among the objectives of the market dominant regulatory system. That connection is discussed in Sections VI.C.1 and VI.C.3, *infra*.

B. The Statutory Standard for Reviewing the System's Performance is Ambiguous

Section 3622(d)(3) directs the Commission to focus its review of the market dominant regulatory system on whether "the system is achieving the objectives in subsection (b), taking into account the factors in subsection (c)...." This statutory standard for conducting the 10-year review is patently ambiguous.

The ambiguity has several sources. First, none of the objectives that are to be used to assess the system's performance are defined by the statute. Second, the legislative history of the PAEA does not even identify the source of the statutory objectives. Nor does it provide guidance regarding how they are to be interpreted and applied. Objectives first appeared in H.R. 4970, a predecessor to the bill ultimately enacted as the PAEA. H.R. 4970 was introduced in the House during the 107th Congress on June 20, 2001.²⁰ Nothing in the legislative history of that bill discussed the source or intended meaning of the objectives. Subsequent bills included the objectives, but, again, the legislative history of those bills fails to disclose their source or intended meaning or application.²¹ The same is true of the final House and Senate bills that preceded enactment of the PAEA.²²

1. The Commission's Preliminary Definitions of Objectives

Recognizing that the statutory standard is ambiguous, the Commission has offered "preliminary definitions" of the nine objectives and has invited comments on those definitions. In doing so, the Commission appears to lose sight of the fact that it has interpreted and applied the objectives in numerous contexts over the past 10 years. The Public Representative submits that those prior Commission interpretations and applications of the objectives are the most appropriate standards for assessing the system's performance and, at a minimum, should be the starting point in the 10-year review. If a need to modify or supplement those interpretations exists, the Commission can do that. If no such need can be demonstrated, the Commission should use the existing interpretations and applications of the statutory objectives to conduct the 10-

²⁰ Postal Accountability and Enhancement Act, H.R. 4970, 107th Cong. § 3622 (2001).

²¹ See Postal Accountability and Enhancement Act, H.R. 4371, 108th Cong. § 3622(b) (2004). The committee report accompanying H.R. 4371 merely restated the objectives but offered no explanation regarding their intended meaning. See, H.R. Rep. No. 108-672, pt. 1, at 6 (2004).

²² See H. Rep. No. 109-66, pt.1, at 47 (2005) (accompanying H.R. 22); and S. Rep. No. 108-318, at 42 (2004) (accompanying S. 2468).

year review. This is not the time to “reinvent the wheel,” unless it can be shown that the wheel needs to be reinvented.

2. “Measureable Key Concepts” Suggested by the Commission

In addition to providing preliminary definitions of the statutory objectives, the Commission has also suggested certain “measurable key concepts” in an apparent effort to deal with the relative measurement concepts contained in the statutory objectives, such as “maximize” or “increase”. ANOPR at 3. As presented, this approach seems to suggest that after 10 years of experience in applying the statutory objectives, the standards developed and used by the Commission to apply those objectives can now be superseded by adopting new “key measureable concepts” for the purposes of this proceeding.

When it embarked upon its administration of the PAEA 10 years ago, the Commission expressly recognized the need for exercising its discretion in developing appropriate measures for the statutory objectives:²³

To be sure, some of the objectives and factors individually do not easily lend themselves to quantifiable measure of compliance. Some, such as Objective 1 (maximizing incentives to reduce costs an increase efficiency) ... are matters of degree, and would have to be developed over time through the application of the discretion of the Commission as part of its before the fact and after the fact rate reviews. On the other hand, some objectives can be measured against financial standards, accounting principles, and historical results, e.g., Objective 5 (assuring adequate revenues to maintain financial stability)....

Having spent 10 years developing methods for quantifying achievement of the objectives, the Commission should use those methods in the 10-year review proceeding, unless it can be demonstrated that those methods need to be changed. If

²³ Docket No. ACR2009, *Annual Compliance Determination*, March 29, 2010.

changes are needed, the Commission should build upon its earlier methods, not disregard them and start from scratch.

3. Ambiguities Not Addressed by the Commission

There are several other ambiguities that will have to be addressed during this proceeding. None of these were addressed in the ANOPR.

First, section 3622(b) provides that the system for regulating market dominant products is to “be designed to achieve the [statutory] objectives, *each of which shall be applied in conjunction with the others...*” 39 U.S.C. § 3622(b) (emphasis added). In the ANOPR, the Commission did not indicate how it believes objectives are to be assessed in conjunction with other objectives. For example, should all objectives be accorded equal weight regardless of circumstances? Or, depending upon the circumstances, should one objective or a particular combination of objectives be entitled to greater deference? This ambiguity will necessarily have to be addressed to ensure that the objectives are harmonized in determining whether the regulatory system is achieving the statutory objectives.

A second ambiguity not addressed in the ANOPR, involves the word “achieving”. “Achieving” is on its face ambiguous as to the ultimate degree to which the system is to attain the statutory objectives. It is also unclear as to whether the system must attain a level of achievement within the 10-year period following enactment of the PAEA, or if further improvement in the level of achievement projected to occur beyond that 10-year period can be relied upon to support a conclusion that the system is “achieving” the statutory objectives, and, if so, how far beyond the 10-year period the Commission can look in order to make that determination.

Finally, the Commission has refrained from providing definitions or measurement methods for the entire class of statutory factors in 39 U.S.C. § 3622(c):

Because the statute does not require that factors be independently achieved, the Commission is not proposing

definitions or measurement methods for the factors. However, over the course of the review, the factors will be taken into account for each objective, as required by the statute.

ANOPR at 3.

The Commission is correct when it states that the factors in section 3622(c) need not be independently achieved. However, the Commission cannot, at this stage, assume that definitions of these factors will be unnecessary in order “to determine if the system is achieving the objectives in subsection (b), taking into account the factors in subsection (c).” 39 U.S.C. § 3622(d)(3). Although the factors in section 3622(c) play a supporting role to the objectives in section 3622(b), that supporting role is essential to the proper assessment of whether the objectives in section 3622(b) are being achieved.

Most of the factors in section 3622(c) were used to implement the PAEA’s predecessor statute, the PRA.²⁴ They were given content through their application by the Commission’s predecessor, the Postal Rate Commission, during administration of the PRA;²⁵ were left in title 39; and were supplemented when Congress enacted the PAEA. Nothing in the PAEA, or its legislative history suggests that the prior definitions of pre-PAEA factors are to be ignored, or that the new factors added by the PAEA are to be deemed absent of content, or irrelevant to, interpretation of the provisions of the PAEA. In fact, the Commission has previously acknowledged its responsibility to incorporate consideration of the statutory factors in establishing *or revising* the cap-based system:

With this cap in place, the Commission was directed to design the system to achieve certain objectives set out in section 3622(b)(1) through (9). And, in establishing or revising the cap-based system, the Commission was directed to “take into

²⁴ See Docket No. ACR2010, *Annual Compliance Determination*, March 29, 2011, at 15 (FY 2010 ACD).

²⁵ See, e.g., Docket No. R71-1, Chief Examiner’s Initial Decision on Postal Rate and Fee Increases, February 3, 1972, at 31 (Factor 3) and 87 (Factor 4).

account” the factors set out in section 362(c)(1) through (14). The Commission understands this directive as one which clearly calls for the application of its considered judgment.

FY 2010 ACD at 19. To conduct the 10-year review correctly, the Commission must give the statutory factors appropriate consideration.

4. The Approach Recommended by the Public Representative

This proceeding has been established against the background of 10 years of experience under the PAEA. Over that period, the Commission has been called upon to interpret, either explicitly or implicitly, and apply the statutory objectives and factors. Although definitions of the objectives and factors have not been formally adopted by rule, they have been developed in the course of the Commission’s administration of the PAEA. For example, the Commission’s annual financial analysis of the Postal Service’s operations has identified and employed several accounting and financial concepts in order to analyze various aspects of the Postal Service’s financial situation. These accounting and financial concepts and the analyses in the Commission’s report have immediate relevance for the financial stability that is the subject of Objective 5. These “*de facto* definitions” provide content to statutory objectives and should be used unless the Commission can articulate a reason for not doing so.

Any ambiguities in the statutory objectives and factors not previously resolved should be addressed using traditional methods of statutory interpretation. Ambiguity in regulatory statutes is not unusual. Terms like “public convenience and necessity” and “just and reasonable” are not self-defining, yet have for decades been given content in particular factual contexts by regulatory agencies and reviewing courts.²⁶ The PAEA has itself already presented the Commission and reviewing courts with several cases in

²⁶ See, e.g., *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); and *Public Service Co. of New Mexico v. F.E.R.C.*, 832 F.2d 1201 (10th Cir. 1987).

which the Commission has had to deal with statutory ambiguities.²⁷ Resolution of the ambiguities presented by the objectives and factors in 39 U.S.C. §§ 3622(b) and (c) should, at this point, be a familiar exercise for the Commission.

The traditional methods of statutory interpretation should be used by the Commission to resolve those ambiguities. That approach begins with the plain meaning of the words of the statute, and, if necessary, goes beyond their plain meaning to consider such aspects of the statute as its structure, purposes, and policies; the roles in the statutory scheme of the provisions being considered; and any relevant the legislative history. See Order No. 864 at 31.

In accord with the general principle of statutory construction that statutes be considered as a coherent and symmetrical regulatory scheme with all parts fitted into a harmonious whole, each of the objectives in section 3622(b) must be interpreted with regard to the structure and purposes of Chapter 36—Postal Rates, Classes, and Services of title 39. In this case, those principles of statutory interpretation are reinforced by the direction in section 3622(b) that each objective “shall be applied in conjunction with the others.”

C. The Modern System of Regulation is not Achieving Some of the Objectives of Section 3622

Section 3622(b) provides that the system of regulation for market dominant products is intended to achieve nine objectives:

- (1) To maximize incentives to reduce costs and increase efficiency.
- (2) To create predictability and stability in rates.
- (3) To maintain high quality service standards established under section 3691.

²⁷ *E.g.*, *United States Postal Service v. Postal Regulatory Commission*, 640 F.3d 1263 (D.C. Cir. 2100) (review of Commission’s interpretation of “due to” in 39 U.S.C. § 3622(d)(1)(E); and *United States Postal Service v. Postal Regulatory Commission*, 676 F.3d 105 (D.C. Cir. 2012) (review of Commission’s interpretation of its authority to order rate increases in context of annual compliance determination).

- (4) To allow the Postal Service pricing flexibility.
- (5) To assure adequate revenues, including retained earnings, to maintain financial stability.
- (6) To reduce the administrative burden and increase the transparency of the ratemaking process.
- (7) To enhance mail security and deter terrorism.
- (8) To establish and maintain a just and reasonable schedule for rates and classifications, however the objective under this paragraph shall not be construed to prohibit the Postal Service from making changes of unequal magnitude within, between, or among classes of mail.
- (9) To allocate the total institutional costs of the Postal Service appropriately between market-dominant and competitive products.

39 U.S.C. § 3622(b).

While the statute neither prioritizes, nor weights these objectives, the events of the past 10 years have imbued Objective 5—the objective of “assur[ing] adequate revenues, including retained earnings, to maintain financial stability”—with transcendent importance. Over this 10-year period, the Postal Service has struggled to avoid financial collapse. Nor is there any persuasive reason to expect the current system to “assure adequate revenues, including retained earnings, to maintain financial stability” for the Postal Service as it moves forward into 2017 and beyond. For the foregoing reasons, the Public Representative submits that the market dominant regulatory system is failing to achieve Objective 5 and that the first order of business in the 10-year review should be to focus on the Postal Service’s financial situation.

The seriousness of the Postal Service’s financial situation also has adverse implications for another closely related statutory objective, the objective of “[maintain[ing] high quality service standards established under section 3691.” 39 U.S.C. § 3622(b)(3). For the reasons discussed below, the Public Representative submits that the current regulatory system for market dominant products is failing to achieve this latter objective.

Contributing to the Postal Service's financial burdens and service performance problems is the failure of the regulatory system to achieve Objective (4) by not providing the Postal Service with the pricing flexibility needed to deal with the chronically underwater Periodicals Class.

Finally, because of problems with the TFP measurement system, it is not clear that the market dominant regulatory system is achieving Objective (1)—the objective of “maximize[ing] incentives to reduce costs and achieve efficiency.”

1. Objective 5 (To Assure Adequate Revenues, Including Retained Earnings, to Maintain Financial Stability)

Three terms provide the foundation for Objective 5: “adequate revenues,” “retained earnings,” and “financial stability.” Even assuming the word “revenues” is deemed to have a plain meaning of money or other thing of value received by the Postal Service, the modifier “adequate” creates ambiguity by raising questions regarding the purposes for which revenues are intended to be adequate? The answer to that question is provided by the other two foundational terms in Objective 5: “retained earnings” and “financial stability.” “[A]dequate revenues” are revenues that “include retained earnings” that are “to maintain financial stability.”

At a very basic level, the term “retained earnings” can be readily understood to include that portion of revenues in excess of a business's needs to meet expenses (or to satisfy other present claims) of which a business maintains possession for some period of time.

The phrase “to maintain financial stability” is, on its face, ambiguous. The Commission has, however, resolved that ambiguity by employing several different tests in its annual examination of the Postal Service's financial condition. Those tests

examine, among other things, “sustainability,” “liquidity,” “trend analyses,” and “overall financial performance.”²⁸

The Commission’s analyses and the developments of the past 10 years can lead to only one conclusion, namely, that the regulatory system for market dominant products is not achieving Objective 5. That conclusion is amply supported.

First, although the Postal Service was profitable in years before the PAEA, every year since enactment of the PAEA, the Postal Service has incurred significant losses. These losses have been reported in each of its ACDs and are recapped in the Commission’s FY 2015 Financial Report.²⁹ Total losses over the past 10 years have been over \$56 billion. *Id.*

Second, the anticipated ability of the Postal Service to make \$5 billion-plus annual lump-sum retiree health benefit pre-funding payments quickly evaporated. The strain of those payment obligations on the Postal Service has been identified and discussed in various reports, including the Commission’s ACDs³⁰ and the Commission’s two Section 701 Reports.³¹ The Postal Service ultimately defaulted on those payment obligations.³² Equally disturbing has been the fact that in attempting to avoid default, the Postal Service exhausted its borrowing authority from the U.S. Treasury.³³ This has

²⁸ See, e.g., Postal Regulatory Commission, *Financial Analysis of United States Postal Service Financial Results and 10-K Statement*, Fiscal Year 2015, March 29, 2016, Ch.4 (FY 2015 Financial Report).

²⁹ FY 2015 Financial Report at 33, Table II-20.

³⁰ E.g., FY 2010 ACD at 5; Docket No. ACR2011, *Annual Compliance Determination*, March 29, 2012, at 5 (FY 2011 ACD); and Docket No. ACR 2012, *Annual Compliance Determination*, March 27, 2013, at 7.

³¹ E.g., *Postal Regulatory Commission, Section 701 Report, Analysis of the Postal Accountability and Enhancement Act of 2006*, November 14, 2016. In comments filed in connection with the 2016 Section 701 Report, the Public Representative surveyed events of the past five years showing the impact of the retiree health benefit prefunding requirements notwithstanding the Postal Service’s efforts to remain financially viable. Docket No. PI2016-3, Public Representative Comments, June 15, 2016, at 21-26.

³² FY 2015 Financial Report at 32.

³³ *Id.* at 33.

further limited the Postal Service's ability to invest in infrastructure needed to maintain and improve its services.³⁴

Third, another major contributor to the Postal Service's losses has been the steady decline in demand, particularly the demand for First-Class Mail.³⁵ That decline was abruptly accelerated by the Great Recession that prompted the Postal Service to file an exigent rate request.³⁶ The relief provided by the exigent surcharge approved by the Commission has ended thereby reducing Postal Service by approximately \$2.1 billion annually.³⁷

At the time the PAEA was enacted, anticipated declines in demand were cited as one of the principal reasons for adopting a new regulatory system.³⁸ It was hoped that the Postal Service could get ahead of the problem by instituting changes that would reduce costs and increase efficiencies before significant demand declines began.³⁹ Unfortunately, demand declines began almost immediately, so that by the time the PAEA was implemented, the Postal Service found itself in the middle of a significant and growing problem. Since then, studies have begun to identify and address the problems presented by the imposition of price cap regimes on industries with declining demand.⁴⁰

³⁴ Statement of the Postmaster General and Chief Executive Officer, Megan J. Brennan before the House Oversight and Government Reform Committee Hearing "Accomplishing Postal Reform in the 115th Congress—H.R. 756, the Postal Service Reform Act of 2017", U.S. House of Representatives, February 7, 2017, at 7-8.

³⁵ First-Class Mail, the Postal Service's most profitable class of mail, experienced a 40 percent decline in volumes since its peak in 2001. "U.S. Postal Service: Financial Challenges Continue," General Accountability Office, January, 2016.

³⁶ See Docket No. R2010-4, Exigent Request of the United States Postal Service, July 6, 2010.

³⁷ See FY 2015 Financial Report at 1.

³⁸ See S. Rep. No. 108-318 at 3.

³⁹ *Id.* at 8.

⁴⁰ Decker, C.J. (2016). Regulating networks in decline. *Journal of Regulatory Economics*, 49, 344-370; Brennan, T.J. & Crew, M. (2016). Price cap regulation and declining demand. In M.A. Crew & T.J. Brennan (Eds.), *The future of the postal sector in a digital world*. New York: Springer.

Fourth, contributing to the Postal Service's losses were losses by the Periodicals Class. Those losses were being recorded even prior to enactment of the PAEA. As will be discussed below, the failure of the regulatory system to achieve Objective 4 ("[t]o allow the Postal Service pricing flexibility") has contributed to losses by the Periodicals Class that have been chronic and a significant part of overall Postal Service losses.

Fifth, as will be discussed below, the fact that the system is not achieving Objective 5 is contributing to the fact that the system is not achieving other objectives, such as Objective 3 ("[t]o maintain high quality service standards established under section 3691") or Objective 8 (to establish and maintain a just and reasonable schedule for rates and classifications"). Similarly, the regulatory system's failure to achieve Objective 5 has an adverse effect on Objective 1 ("[t]o maximize incentives to reduce costs and increase efficiency") by limiting the financial ability to respond to incentives to increase efficiency. FY 2011 ACD at 61. When the connection between these statutory objectives is considered, as required by section 3622(b), the magnitude of problems with the current system becomes even clearer.

Sixth, the Postal Service's prospects for achieving Objective 5 going forward are not encouraging. In recent congressional testimony, the Chairman summarized the financial obstacles currently facing the Postal Service, in part, as follows⁴¹:

In summary, the Postal Service still faces significant financial obstacles for the future. The exigent surcharge was removed on April 10, 2016.... With the growing liability of retiree health benefits, the inability to borrow for needed capital investments, and the continued loss of high margin First-Class Mail revenues, the important task of improving the financial condition of the Postal Service is daunting.

In the same congressional hearing, the witness from the General Accountability Office stated simply that "[t]he status quo is not sustainable."⁴²

⁴¹ Testimony of Robert G. Taub, before the U.S. House Oversight & Government Reform Committee, February 7, 2017, at 21 (Taub Testimony).

For the foregoing reasons, the Public Representative submits that the current system for regulating the prices and classes of market dominant products is not achieving Objective 5.

2. Objective 4 (To Allow the Postal Service Pricing Flexibility)

The preliminary definition suggested by the ANOPR for Objective 4 speaks in terms of allowing the Postal Service “to exercise its discretion to set prices, the price structure, and the price structure for market dominant products, subject to other requirements under the law.” ANOPR at 6. The key measurable concept proposed by the ANOPR is “pricing flexibility,” for which several potential measurement methods are identified. *Id.*

The Public Representative submits that there is a glaring deficiency in the current regulatory system that can be identified without carefully crafting a definition. That deficiency, which is frustrating the regulatory system’s ability to achieve Objective 4, is the severe constraint the system has placed on the Postal Service by not permitting it to use pricing to eliminate the massive losses generated by the Periodicals Class.

At the time the PAEA was enacted, the Periodicals Class was already seriously underwater. In FY 2006, the Periodicals Class lost over \$374 million.⁴³ The price cap imposed by the PAEA was imposed at the class level. Since the Periodicals Class consisted of only two products—Inside County and Outside County--the effect of the price cap was to lock-in losses for the class and severely restrict the Postal Service’s ability to deal with those losses by exercising pricing flexibility. Since there are only two products in the Periodicals Class, an increase in the price of one product generally

⁴² “Key Considerations for Restoring Fiscal Sustainability,” Statement of Lori Rectanus, Director, Physical Infrastructure Issues, Testimony before the Committee on Oversight and Government Reform, House of Representatives, GAO-17-404T, February 7, 2017 at 1 (2017 GAO Testimony).

⁴³ United States Postal Service and Postal Regulatory Commission, *Periodicals Mail Study, Joint Report of the United States Postal Service and Postal Regulatory Commission*, released September, 2011 (Periodicals Mail Study).

requires an offsetting decrease in the price of the other product.⁴⁴ The only exception to this “zero-sum game” occurs when changes in the CPI-U index produce an increase in the cap for the class. However, these relatively small increases in the cap do not provide enough headroom for price increases that could produce meaningful improvement in the overall cost coverage for the class.⁴⁵

Given the severe limitations on the Postal Service’s ability to increase prices the only other potentially meaningful source of relief is by reducing the costs of the class.⁴⁶ This should be done and is being pursued.⁴⁷ But the absence of any near-term prospects of significant cost reductions makes the hope that cost reductions alone will provide meaningful improvement in cost coverage wildly optimistic.

The result has been that, since enactment of the PAEA, the Periodicals Class has posted large and chronic losses. Over the past 10 years, those losses have totaled approximately \$5.5 billion.⁴⁸ Given their magnitude, these losses have been a significant drag on the Postal Service’s finances.

The failure of the system to achieve Objective 4 is contributing to the regulatory system’s failure to achieve other objectives, such as Objective 5 (“[t]o assure adequate revenues, including retained earnings, to maintain financial stability”). The adverse impact on Objective 5, in turn, adversely affects the ability of the system to achieve

⁴⁴ See FY 2010 ACD at 94 (“Because Outside County Periodicals represents 96 percent of the class revenues, the Postal Service does not have the same discretion to set prices substantially above the price cap that it has with respect to products within Standard Mail.”).

⁴⁵ *Id.* at 92 (Chapter 7 Findings). The Postal Service can, of course, exercise pricing flexibility through modifications to the pricing structure. However, such modifications have proven incapable of overcoming the magnitude of the losses being incurred.

⁴⁶ However, “even after potential cost savings from operational efficiency improvements are realized, the focus must shift to how the revenue side of the cost coverage equation can be improved.” Periodicals Mail Study at 91.

⁴⁷ See Docket No. ACR2015, *Annual Compliance Determination*, March 28, 2016, Chapter 6: Flats Cost and Service Issues (FY 2015 ACD).

⁴⁸ From FY 2007 through FY 2015, total losses were over \$4.9 billion. FY 2015 ACD at 43 (Table III-1). In FY 2016, losses for the Periodicals were over \$531 million. Docket No. ACR2016, United States Postal Service FY 2016 Annual Compliance Report, December 29, 2016 at 51 (Table 4) (FY 2016 ACR).

Objective 3 (“[t]o maintain high quality service standards established under section 3691”) and Objective 1 (“[t]o maximize incentives to reduce costs and increase efficiency”). See discussion *supra* Section C.

For the foregoing reasons, the Public Representative submits that the current system for regulating the prices and classes of market dominant products is not achieving Objective 4.

3. Objective 3 (To Maintain High Quality Service Standards Established Under Section 3691)

The preliminary definition suggested by the ANOPR for Objective 3 limits that objective to “consistently achiev[ing] for each class of mail, stated days to delivery at a desired target rate.” ANOPR at 5. However, the key measurable concept proposed by the ANOPR is “high quality service standards,” for which several potential measurement methods are identified. One of the potential measurement methods clearly goes beyond “delivery by a target date” in the preliminary definition suggested for Objective 3. That potential measurement method would assess customer satisfaction. *Id.* at 6 (“determining how satisfied mail users are with service standards”).

The Public Representative submits that the reliance placed on section 3691 by Objective 3 necessarily implicates the additional objectives specifically identified in section 3691(b)(1).⁴⁹ An assessment of whether Objective 3 in section 3622(b) is being achieved must also include an assessment of whether the objectives in section 3691 are being achieved.

The experience of the past 10 years with service performance under the regulatory system’s price cap regime has been disappointing. Part of the Postal Service’s attempt to live within the price cap has involved a restructuring of its

⁴⁹ Those additional objectives involve (1) the value of postal services to senders and recipients; (2) regular and effective access to postal services; (3) delivery reliability, speed, and frequency; and the provision of objective external performance measurements.

processing and retail operations.⁵⁰ These restructurings combined with a relaxation of service standards and continuing problems meeting even the relaxed standards have been documented in the Commission's ACDs.⁵¹

As discussed by Dr. Kwoka in his accompanying Declaration, the degradation of service quality is a recognized risk of price cap regulation. Kwoka Decl. at 9-11. When a business faces pressure to increase or maintain profitability, there is a natural temptation to reduce costs by reducing service quality. *Id.* In the case of the Postal Service, it should not be surprising that the magnitude of its financial problems did, as a matter of survival, lead it aggressively to reduce costs, even to the point at which service quality was sacrificed and degraded. That is what has happened and, as a result, service quality has been degraded.

The failure of the regulatory system to achieve Objective 3 is a direct outgrowth of the system's unsuccessful struggle to achieve Objective 5 ("[t]o assure adequate revenues, including retained earnings, to maintain financial stability") without making changes that affect service performance. The failure to achieve Objective 3 is also tied indirectly to the regulatory system's failure to achieve Objective 4 ("[t]o allow the Postal Service pricing flexibility"). The latter failure has contributed to the failure to achieve Objective 5. See discussion, *supra*, Section C.2.

For the foregoing reasons, the Public Representative submits that the current system for regulating the prices and classes of market dominant products is not achieving Objective 3.

⁵⁰ See Docket No. N2012-1, Advisory Opinion on Mail Processing Network Rationalization Service Changes, September 28, 2012; Docket No. N2012-2, Advisory Opinion on Post Office Structure Plan, August 23, 2012.

⁵¹ See Docket No. ACR2014, *Annual Compliance Determination*, March 29, 2015, at 3 (FY 2014 ACD) ("in Chapter 5, the Commission finds that some products met service performance targets, while others still fail to meet their applicable targets."); and FY 2015 ACD at 3 ("In Chapter 5, the Commission finds that the majority of products failed to meet their service performance targets for FY 2015."). In addition to expressing concern over declines in service performance, the Commission included a new Chapter 6 in its FY 2015 ACD in which it began to explore the interrelated problems of service performance and profitability for flats products.

4. Objective 1 (Maximize Incentives to Reduce Costs and Increase Efficiency)

As the Commission explained in Order No. 3673, Objective 1 includes “three measurable key concepts” – maximize incentives, reduce costs and increase efficiency. Order No. 3673 at 4. To determine whether the Postal Service achieved Objective 1, as required by 39 U.S.C. § 3622(d)(3), the Commission has to access all three concepts in collaboration. In its preliminary definition of Objective 1, the Commission differentiates between operational and pricing efficiency. *Id.* Such a view of efficiency is reasonable as it reflects a position of the Postal Service or regulator exploring the field of potential regulatory mechanisms or measures (*i.e.*, operational or pricing) that could promote (and probably increase) efficiency. There is, however, another – and probably more primary – layer in the concept of “increase efficiency.” The Commission’s definition focuses on *how* to increase efficiency, a *priori* assuming that it is clear (or almost clear) “*what*” to increase. The layer that is left out in the definition is related to the understanding of what it means for the Postal Service to be efficient or inefficient. It is important, therefore, to revisit the concept of efficiency in order to determine what it means for the Postal Service to act efficiently, and whether all of the factors that define efficiency are captured by the current efficiency measures.

In Order No. 3673, the Commission suggested that “[m]easuring operational efficiency could involve reviewing trend analyses of total factor productivity.” Order No. 3673 at 14. Dr. Bzhilyanskaya devotes her declaration to the TFP that the Postal Service considers its historical measure of operational efficiency. While acknowledging that TFP has been widely used to access productive efficiency in service industries, she notes a number of its current limitations.

First, the TFP annual reports that the Postal Service files on the Commission website⁵² should include more transparent information related to the TFP indexes. The Postal Service's filing only contains a cover letter to accompany the spreadsheet, and does not include any explanatory documentation of the methodology underlying the tables and calculated indexes. Providing a methodological description would be especially relevant because the Postal Service adopted the TFP methodology in 1985 (or more than 30 years ago), and there is no up-to-date study or methodological documentation currently available on the Commission website.⁵³ Also, the Postal Service's annual TFP filing contains a significant number of separate worksheets with different types of data, but does not include any roadmap that would provide guidance on the reported data. Inclusion of additional related explanation (with the relevant definitions and sources for the reported data) would provide the general public with at least some guidance on the data reported in the numerous TFP worksheets. Finally, the data and indexes reported in the annual TFP tables do not have any evident relation to the annual and cumulative TFP indexes provided by the Postal Service in its Annual Report to Congress in its Statement of Postal Operations. It would be useful to clearly identify how data in TFP Tables is related to two aggregated TFP indexes reported in the annual Statement of Postal Operations. By providing all such additional information the Postal Service would significantly enhance the transparency of its TFP reports.

Second, TFP as an exhaustive measure of the Postal Service's efficiency, has its limitations. There are certain areas of improvement for both TFP and efficiency measures of the Postal Service in general. By comparing output with input, TFP primarily serves as a measure of productivity or productive efficiency, and might not fully

⁵² For the most recent FY 2016, USPS Annual Total Factor Productivity Data, see Docket No. ACR 2016, Responses of the United States Postal Service to Chairman's Information Request No. 3, Question 2, January 13, 2017, file "ChIR.3.Q.2.FY16.TFP.xlsx."

⁵³ In 1990, the Commission staff performed TFP study that is available on the Commission website, but in the Rate Commission Archives, and is not easily accessible by interested parties and general public. See A Study of U.S. Postal Service Productivity and its Measurement, Staff Study, Postal Rate Commission, May 9, 1990 (1990 PRC TFP Study), Volume 1 and 2. Available at: <https://www.prc.gov/dockets/archives>.

capture other aspects (or types) of efficiency including, but not limited to, scale, allocative, and dynamic efficiency. In Order No. 3673, the Commission acknowledges that pricing methods promoting allocative efficiency are different from pricing methods that promote productive efficiency. Order No. 3673 at 4. Although, theoretically, TFP is designed to measure the effect of technological progress, technological changes are beyond productivity improvements in physical equipment and often occur over a significant period of time. The economic impact of technological improvements (especially those that do not lead to immediate productivity growth), might not be visible for a number of years after the investments are made, and therefore would not be adequately captured by annual TFP. It would be useful to provide a better connection between the annual TFP indexes that focus more on a short-term productivity and the cumulative TFP trends that consider long-term productivity. However, whether a cumulative TFP index is able to measure dynamic efficiency is still a question that requires special attention. As articulated in the literature, innovations that result in quality improvements or new products are usually not captured by TFP. Other areas of improvements to TFP measures include exploration of alternative indexing procedures or modeling functions. In the face of rising competition, it is also important to have a measure that would allow comparing efficiency of the Postal Service with efficiency of its private sector competitors. Viewing efficiency from the demand and supply sides is also very important, considering that the Postal Service is bound by its universal service obligations.

Taking into account a high level of uncertainty associated with the “increase efficiency” concept and, specifically, with measuring Postal Service’ efficiency, the Public Representative cannot conclude the Postal Service has met or is achieving its objective to maximize incentives to reduce costs and increase efficiency.

5. Conclusion: The System is Failing to Achieve the Statutory Objectives

Based upon clear evidence that the regulatory system is failing to achieve Objective 5, Objective 4, and Objective 3, together with the inability to conclude that the system is achieving Objective 1, the Public Representative recommends that the Commission find that the system is not achieving the statutory objectives of section 3622(b) and that the system must be modified or an alternative system adopted.

VI. Commission Action Required

A. The PAEA's Market Dominant Regulatory System Requires Changes to Achieve the Objectives of Financial Stability and High Quality Service, to Provide the Postal Service with Adequate Pricing Flexibility, and to Ensure that Incentives to Increase Efficiency are Maximized

1. The Commission Has Broad Authority to Address the System's Failure to Achieve Statutory Objectives

Section 3622(d)(3) gives the Commission broad authority to make changes to the market dominant regulatory system:

If the Commission determines, after notice and opportunity for public comment, that the system is not achieving the objectives in subsection (b), taking into account the factors in subsection (c), the Commission may, by regulation, make such modification or adopt such alternative system for regulating rates and classes for market-dominant products as necessary to achieve the objectives.

Although, for the past 10 years the price cap provided for in section 3622(d)(1) and (2) has been accepted as the central, almost immutable, element of the PAEA's market dominant regulatory system, section 3622(d)(3) gives the Commission the authority to abandon the price cap at the conclusion of its 10-year review.

It is true that subsection 3622(d)(1) provides that "[t]he system for regulating rates and classes for market dominant products *shall* ... (A) include [a CPI-U based

price cap]. 39 U.S.C. § 3622(d)(1) (emphasis added). However, the statutory provisions for the 10-year review authorize the Commission to modify or replace such *system* if it is not achieving the statutory objectives. See 39 U.S.C. § 3622(d)(3). The *system* that is subject to modification or replacement includes the price cap provided for in section 3622(d)(1) and (2). On its face, the statute gives the Commission clear authority to replace even the price cap. What the Commission cannot change are the statutory objectives in section 3622(b) and the factors in section 3622(c) that inform the objectives.

Notwithstanding the Commission's broad authority to make changes in the market dominant regulatory system, the Public Representative recommends that, for policy reasons, the Commission continue to employ price-cap regulation for market dominant products. In his sworn Declaration, Dr. Kwoka discusses reasons why price-cap regulation remains suitable and sound for the Postal Service. Price-cap regulation breaks the connection between price and profits and strengthens management incentives to lower costs. Equally important, it must have the least possible markup over cost for the lowest prices consistent with breakeven operation of the firm. Kwoka Decl. at 5-6.

Professor Kwoka has also held positions at George Washington University and the University of North Carolina at Chapel Hill, with visiting positions at Northwestern University, Harvard University, the Brookings Institution, and the John F. Kennedy School of Government at Harvard. He has experience as an economist at the Federal Trade Commission, the Economic Policy Office of the Antitrust Division of the Justice Department, the FCC and several on editorial boards of several journals. He has published more than 80 articles and 3 books in his field.

At the FCC, Dr. Kwoka developed price cap plans for AT&T and then local exchange carriers (LECs) that were implemented in 1989 and 1991, respectively. He worked to convert the conceptual framework of price caps into an operations plan to

achieve price-cap objectives and authored two publications outlining analytical and practical issues when implementing telecom price caps.

In addition, Dr. Kwoka testified before the Subcommittee on the Postal Service of the House Committee on Government Reform and Oversight concerning the Postal Reform Act of 1997. His testimony helped lay the foundation for what became the “modern system of rate regulation” embodied in the PAEA.

The advantages of price-cap regulation can be maintained and the serious financial and service performance issues experienced under the PAEA’s price cap can be mitigated, provided the Commission adopts the modifications recommended below. Those changes are consistent with price cap theory.

2. Overview of Recommended Remedies to Achieve Financial Stability

This 10-year review removes the *legislative handcuffs* from the Commission and permits the Commission to act to ensure that the financial stability objective is being achieved, and thus enhance the Postal Service’s ability to achieve other PAEA objectives. Dr. Kwoka discusses this throughout his Declaration. Some fear that the Postal Service’s position is dire and propose extreme solutions, apparently to insure against a shortage in health benefit payments 30 or 40 years ahead, while the debate allows the Postal Service’s current vehicle fleet to disintegrate. However, the FY 2017 adjustment for prefunding health benefits required by the PAEA has dramatically reduced the Postal Service’s annual costs to only \$2.6 billion. Concurrently, the new health benefit fund payment amount has expanded the options reasonably available for recovering total costs through reasonable rate increases by adjusting the price cap mechanism. In addition, recent increases in competitive product earnings may also provide additional assistance toward recovery of total Postal Service costs.

Some would say the Postal Service cannot get to long-term financial stability from here without extreme measures. To be sure, many years of potential small rate

adjustments have been squandered away. However, if only one leveling rate increase had been implemented in 2007, much of the shortfall in funding would have been eliminated and the way ahead would have been relatively painless. For all the financial difficulties of the Postal Service over the last 10 years, only a 3.1 cent increase on each piece of mail would have eliminated the Postal Service's financial deficits.⁵⁴

The Commission must start its search toward achieving financial stability with the purpose of establishing rates that will accomplish the purpose of meeting all financial goals, rather than by tentatively increasing rates or providing for other adjustments that leave the Postal Service financially moribund. At least, the Commission must make an effort to achieve all of the PAEA's objectives, especially one of financial stability that is so obviously measureable. There are many routes toward permissible regulations that maintain a price cap, that provide opportunity for full coverage of total costs going forward, and that would allow some consistent annual pay-down of debt to the U.S. Treasury and a gradual accumulation of retained earnings as insurance against contingencies. As the Declarations of Drs. Kwoka and Brennan recommend, modifications of the price cap provide a route towards to financial stability by relatively minor revision of Commission regulations.

As discussed above, the Postal Service's finances have deteriorated substantially in the last 10 years and it has not, and is not achieving, the financial stability listed as Objective 5. The negative Altman Z-Score for FY 2015 as well as numerous other sources provide support for this conclusion.⁵⁵ Financial stability could be achieved, or at least it would be improved significantly if not fully guaranteed, if the

⁵⁴ *Peeling the Onion: The Real Cost of Mail, Office of Inspector General, United States Postal Service, Report No. RARC-WP-16-009, April 18, 2016, at 1* ("The Postal Service would have broken even with 3.1 additional cents per mail piece in cost saving or additional revenue, or a combination of both, including prefunding.").

⁵⁵ *Financial Analysis of United States Postal Service, Financial Results and 10-K Statement, FY 2015*, Postal Regulatory Commission, March 29, 2016, at 77-86. For FY 2016, the Altman Z-Score deteriorated further. Taub Testimony at 17.

Commission's regulations are modified as recommended below by the Public Representative and in the accompanying Declarations of Drs. Kwoka and Brennan.

Legislation was again recently proposed in the House, H.R. 756, *Postal Service Reform Act of 2017*, and H.R. 760, the *Postal Service Financial Improvement Act of 2017*. Nevertheless, the Commission must proceed pursuant to the law as it currently exists and cannot count on passage of that or any other legislative proposal, particularly given the long history of delays on Postal Service legislation intended to improve the Postal Service's financial condition.

Although the details are more complicated, the Commission's goals for this 10 year review toward achieving the critical Objective 5 of financial stability for the Postal Service can be simply stated:

1. The Postal Service's revenue under the price cap formula must be increased to enable recovery of its RHBf fund amortization payments as a separate exogenous factor in the price cap. The Declaration of Dr. Kwoka, a noted expert on price cap theory strongly recommends this modification of the price cap. See Kwoka Decl. at 26.
2. The price cap formula also must be modified to include an annual adjustment to account for changes in demand. The Declaration of Dr. Brennan, a highly regarded expert on price cap theory and potential adjustments, discusses the fairness of such an adjustment and recommends the mechanism for adding a demand adjustment to the price cap. See Brennan Decl. at 15-18; see *also* Kwoka Decl. at 27.
3. Adjust the price cap for Periodicals to give the Postal Service the opportunity to attempt improvements in cost coverages.
4. As a final step from this review, in the event the Commission decides not to employ the above adjustments to the price cap, and rates remain insufficient to recover total costs, then a one-time rate reset should be allowed, but not ordered, by the Commission to permit the Postal Service's rates to recover estimated total costs consistent with the principle that price caps must start, or on review be reset, at rates designed to recover total costs in the first year after reset.

The above steps will further the following additional goals for financial stability:

- The Postal Service should have sufficient revenue to annually pay down some portion of its outstanding debt of \$15 billion to the U.S. Treasury.

- The Postal Service revenue should be sufficient to generate retained earnings for future investment in needed facilities and equipment to maintain its level of service and to enhance service, where appropriate. Retained earnings are also necessary for contingencies such as the need for newly developed technologically advanced equipment, precipitous reductions in demand or technological changes that reduce structural demand below anticipated levels.

3. Proposed Remedies Are Reasonable

With minimal adjustments to its price-cap regulations, the Commission can readily modify the modern system of regulation to accomplish the above goals with little disruption to mailers and minimizing the impact to other stakeholders. Given the negative impacts of the strict price cap limitation on postal services in the last 10 years, with the near collapse of the Postal Service for lack of cash working capital, the solutions today are obvious and the rewards are great. If accomplished, these goals would place the Postal Service in at least the same financial position where it was in FY 2005. That is, a remaining line of credit of approximately \$6 billion, no crushing burden for health and pension payments, and net income generating a small but reasonable amount of retained earnings.

These goals are not unreasonable; they are feasible with relatively minor Commission modifications of the modern rate regulation system while maintaining the integrity of the price cap system. However, it must be acknowledged that there is no way for the Commission to begin returning the Postal Service immediately to financial stability without permitting, through one means or another, a price cap modification that increases rates FY 2018 amounting to at least \$2.6 billion annually in order to ensure payment of the new 40 year amortization amount for the RHBF. In addition, as discussed below, at least another \$0.7 billion rate increase likely will be necessary before total Postal Service revenue matches total cost.⁵⁶

⁵⁶ Now, although the RHBF amortization payment has been reduced to \$2.6 billion, under current rates the Postal Service may not be able to pay the RHBF amount of \$2.6 billion due September 30, 2017. The recommendation in this docket could not be effective until FY 2018 has commenced.

The last 10 years have been difficult for the Postal Service and would have been impossible were it not for the fact that the Postal Service could withhold its payments to the U.S. Treasury without filing for bankruptcy or ceasing operations. Nevertheless, the operations were so precarious that early in FY 2012 the Postal Service's cash liquidity was mostly in the range of only \$2 to \$3 billion, well below the minimum liquidity level of \$7 billion (about 32 days of operations).⁵⁷ At that time, the Postal Service was also very concerned that even if it did not pay the \$11.2 billion to the RHBF due at the end of that fiscal year, and borrowed its remaining line of credit up to \$15 billion, it would have only \$600 million in cash. It characterized this as "a dangerously low level of liquidity as it is equivalent to only three days of operating costs. It also assumes we are able to achieve our operating plan with significant cost reductions and no unforeseen drops in revenue." *Id.* Yet, because of the limitations on the exigent circumstances provision in the PAEA, the Commission was restricted by the PAEA and *unable* to provide the Postal Service all of the relief it needed. Although the Postal Service's cash position has improved slowly, it remains unable to make the RHBF payment.

B. Annual RHBF Requirement as an Exogenous Z-Factor in the Price Cap

1. Dr. Kwoka's Recommendations

The system of regulation should be changed to treat the RHBF amortization costs as an "exogenous factor" in the price cap. Exogenous factors are costs over which the regulated firm cannot exercise control. Under the price cap theory, these costs can be isolated, removed from the CPI-U limitation, and accounted for with separate nomenclature within the price cap formula.⁵⁸

⁵⁷ Form 10-K Report at 33; United States Postal Service, Integrated Financial Plan FY 2012 (IFP), filed November 23, 2011 at 6.

⁵⁸ Economists have considered a variety of criteria for determining when exogenous factors are appropriate. California state law, for example, uses a more restrictive set of criteria. United States Postal Service Office of the Inspector General, *Revisiting the CPI-Only Price Cap Formula*, RARC-WP-13-007, April 12, 2013, at 48.

As Dr. Kwoka explains, price cap systems can isolate certain types of costs and recognize them as separate X, Y, or Z factors within the cap, *i.e.*, $CPI-U - X + Y + Z$. He states that price caps typically use a broad price index like CPI-U, a productivity factor X, and “one or more factors to capture exogenous cost changes” in the form of Z factors or Y factors that pass through dollar-for-dollar type costs.⁵⁹ This approach is used for costs that the firm is responsible for covering but which are outside of its control and “not subject to efforts at efficiencies.” Kwoka Decl. at 7. Dr. Kwoka recommends that consistent with price cap theory, the RHBF payment requirement should be included in the price cap formula as a Z factor.

Price cap regulation functions by enforcing cost discipline on the regulated entity. As Dr. Kwoka notes, it “break[s] the connection between price and the firm’s realized profit,” thus “strengthening its incentives to lower cost.” Kwoka Decl. at 5. In this way, price-cap regulation “transforms the regulated firm into essentially a competitive firm” which “restores the incentive to control costs that traditional regulation takes away.” Brennan Decl. at 5. However, if a firm’s costs are “not really under its control, no amount of incentives will matter.” Kwoka Decl. at 14. In other words, where the firm cannot affect the underlying costs, the incentives structure that price-cap regulation creates is ineffective.

The Postal Service has no direct method of influencing RHBF amortization cost. It can only indirectly affect the cost through methods with substantial operational repercussions, such as decreasing its total labor force. Conceptually, considering the RHBF amortization cost as exogenous makes sense under price cap theory. An exogenous RHBF would grant the Postal Service additional price cap authority for an estimated \$2.6 billion,⁶⁰ and help return it to financial stability, thus achieving Objective 5.

⁵⁹ The Public Representative is not recommending a Y factor at this time.

⁶⁰ Before the House Committee on Oversight and Government Reform, the GAO testified that the FY 2017 estimates may change later this year when the Office of Personnel Management (OPM)

In practice, an exogenous RHBF may give rise to certain issues. One such issue is assessing the impact of the RHBF in order to quantify the Z factor that should be applied. A straightforward approach would be to include the RHBF obligation in its entirety. This method is logical because the Postal Service's past losses have mirrored the RHBF obligation. The Commission could find that, effectively, no part of this RHBF amount is currently included in rates. However, if the Commission believes that the current rates include the RHBF amortization payments, it may feel it necessary to seek to quantify the portion of those rates included as RHBF amortization cost in an effort to prevent the possibility of a partial double recovery.⁶¹ Yet another issue is that the Postal Service has not funded its RHBF obligations since 2010 and provision for recovery of the RHBF amortization amounts must be made. A brief review of the postal rate history will demonstrate the challenge these issues present.

In 2002-03, the Postal Service discovered that it had been overfunding its civil service retirement account. In response, Congress intervened with a reform designed to redirect the surplus funds.⁶² The law required the Postal Service to pay down its debt and pay future funds into an escrow account. *Id.* These funds were identified as an operating expense and not available for Postal Service use. *Id.* In the backdrop, the Postal Service's financial condition continued to deteriorate.

In 2005, the Postal Service instituted a rate case in Docket No. R2005-1 seeking a rate increase to fund the \$3.1 billion escrow obligation created by the 2003 reform.⁶³ The Commission granted the Postal Service's request. At that time, several predecessor bills to the PAEA that included the pre-funding requirement for the RHBF were percolating on Capitol Hill.

provides the Postal Service the amounts of the required payment. United States. Cong. House. Committee on Oversight and Government Reform. 115th Cong. 2d Sess. at 9. GAO testimony at 9.

⁶¹ In such case, the Commission might quantify the portion of the RHBF obligation embedded in current rates and add a Z factor in the amount of the remainder.

⁶² Postal Service Retirement System Funding Reform Act of 2003, Pub. L. No. 108-18, 117 Stat. 624, April 23, 2003.

⁶³ Docket No. R2005-1, Opinion and Recommended Decision, November 1, 2005 at 3.

Even then, the idea of considering the RHBF amortization costs as an exogenous factor was nothing new. On April 16, 1997, Dr. Kwoka presented the idea to the Subcommittee on the Postal Service.⁶⁴ Nevertheless, the Postal Service could not know for certain whether the proposed statutory requirement would come to pass and the rates requested at the Commission were anticipated to cover its escrow payment.

One year later, the PAEA instituted the pre-funding requirement. At this point, the Postal Service was faced with the specifics of its pre-funding obligations. Its RHBF amortization cost under PAEA totaled over \$5 billion per year, approximately \$2 billion more than the \$3.1 billion allotted for civil service retirement system payments in 2005.

The PAEA allowed the Postal Service the opportunity for a final rate case. This was a critical juncture; the initial base-line rate setting is crucial to the success or failure of a price cap. Kwoka Decl. at 6. The Postal Service opted not to file a final rate case. The reasoning for this decision has been the subject of considerable speculation. Some observers attribute this decision to a legislative compromise. Regardless, the Postal Service indicated at the time that it believed the pre-funding payment schedule was possible under the existing rates.⁶⁵ This is especially notable given that the pre-funding payment schedule was front-loaded. Congress structured the payments to be considerably larger during the first ten years of the PAEA with the remainder to be amortized over the subsequent 40 years.

Ultimately, the RHBF amortization payment projections were more art than science. As is often noted, the pre-funding requirement is unique among federal agencies. Unlike its administration of the civil service retirement system, Congress had no comparable system to use in modeling the pre-funding payments. Furthermore, the PAEA endeavored to forecast payments for a 10-year period or more. As the Great

⁶⁴ *General Oversight of the U.S. Postal Service: Hearings before the Subcommittee on the Postal Service of the House Committee on Government Reform and Oversight*, 104th Cong., 1st Sess. (1997), April 16, 1997 at 41.

⁶⁵ "New Postal Law: A Message from the Postmaster General," PCC Insider, December 20, 2006.

Recession in 2008 demonstrated, predicting financial conditions for a period of that length is extremely challenging.

To be sure, the initial rates used for the price cap attempted to account for the RHBF amortization obligation despite these complications. To some extent, it might be considered that the costs were baked into the Postal Service's rates. With the benefit of hindsight, however, the Postal Service's consistent, substantial shortfalls in their payments make clear that either the costs were priced incorrectly, due to incomplete information or otherwise (as is likely), or the Postal Service has engaged in significant mismanagement elsewhere. In the Public Representative's view, the dramatic cost-cutting measures that the Postal Service has undertaken, with regard to its labor force and elsewhere, render the latter possibility unlikely.⁶⁶

If the Commission accepts that the retiree health benefit costs were not accurately priced into the Postal Service's rates, the question becomes how to treat these costs moving forward. Dr. Kwoka asserts that "[t]he mandatory prefunding requirement should be recognized for what it is—an exogenous lump sum revenue requirement imposed on the Postal Service." Kwoka Decl. at 23. In his view, the retiree health benefits cost "is not a current economic cost of operation of the usual sort that the price cap is designed to cover." *Id.* He concludes that "the price cap formula should include those costs separate from the operating costs that are the focus of the plan." *Id.* He emphasizes this approach is "thoroughly consistent with the theory and practice of price cap regulation" and "simply reflect[s] the need to tailor this specific plan to the particulars of the Postal Service and its markets, much as [has] been done in other applications of price cap plans." Kwoka Decl. at 25.

Dr. Kwoka's recommendation clearly enhances the system of regulation's ability to achieve financial stability, as required by Objective 5. It also helps the system

⁶⁶ The Postal Service has cut approximately 300,000 workers from its peak employment to today. <https://about.usps.com/who-we-are/postal-history/employees-since-1926.pdf>

achieve Objective 6 by reducing the administrative burden and improving transparency of the ratemaking process.

As the complex history leading up to the PAEA demonstrates, the RHBF amortization cost has significantly complicated the ratemaking process. Throughout the legislative hearing proceedings preceding the PAEA, the Postal Service struggled to assess whether it could shoulder its RHBF obligations. Subsequent events indicate that the Postal Service could not correctly quantify and provision for these costs in the pre-PAEA ratemaking proceedings.

The history also demonstrates that the Postal Service's uncertainty regarding these costs has perpetuated the problem that the Postal Service faces today. Assuming that the RHBF costs are included in the price cap has frustrated the Postal Service's efforts to establish sufficient rates and created an enduring issue that the Postal Service has not been able to overcome. Addressing the RHBF costs will prevent further, identical, ratemaking complications from arising in the future.

Furthermore, the regulatory system cannot provide ratemaking transparency with regard to the substantial RHBF amortization cost without precisely identifying the rate impact of that cost. Currently, the RHBF amortization cost creates noise within the price cap, decreasing visibility of other costs and complicating the Commission's task of monitoring the cap. A fair litmus test for transparency is, if the Postal Service is funding its obligations, whether the stakeholders would be able to assess the impact of the RHBF amortization cost. The Public Representative submits that, given that the Postal Service cannot make that determination, the answer must be no, the stakeholders were unable to assess the impact.

In conclusion, as Dr. Kwoka notes, there are significant theoretical reasons for recognizing the RHBF amortization cost in the price cap as a Z factor not subject to the CPI-U. These reasons alone justify separate treatment in the price cap for the RHBF amortization cost. The root cause of many of the issues discussed above is the inclusion of a substantial and variable set of costs into the price cap that conceptually

do not belong. For the Commission's purposes, though, it is ultimately the practical considerations that are most important. As mentioned, the RHBF amortization cost has significantly complicated ratemaking in the past. If this cost is not separately treated in the cap, it is likely that any future ratemaking will continue to feel the reverberations of these past issues. If the cost is assessed and handled as a Z factor, the Postal Service can move forward and have the opportunity to recover its total costs within the price cap. For these reasons, the Public Representative recommends that the Commission adopt a Z factor that accounts for the entirety of the RHBF obligations.

2. Reduced Amortization Requirement of RHBF and Pension Funds for FY 2017

The revision of amortization payments for retiree health benefits down to \$2.6 billion has improved the possibility for increasing revenues to make payments through adjustment of the price cap.⁶⁷ Combined with the revisions to the pension funding schedules for FY 2017, as required by the PAEA, the Postal Service's annual liability has fallen precipitously. The revisions reduced the Postal Service's annual liabilities by \$2.7 billion, almost halfway towards the recent annual FY 2016 shortfall (loss) of \$5.8 billion, and leaving an amortization payment of only \$2.6 billion due to the RHBF in FY 2017.

Table 1, below, was prepared by GAO for recent testimony before the House Committee on Oversight and Government Reform. 2017 GAO Testimony at 9, Table 1. It lists the redistribution of required amortization and normal payments due in FY 2017 for the RHBF and CSRS/FERS pension funds. The redistribution of payment obligations reduced the Postal Service's total obligation for those three funds from \$13 billion in FY 2016 down to \$10.3 billion in FY 2017.

⁶⁷ Calculation of the RHBF involves several areas of judgments and will vary significantly, depending on assumptions. For instance, using the year end FY 2016 data, the unfunded obligation that is assumed to be about \$52 billion could range from or \$39 billion to \$68 billion, solely by varying the interest rate by 1 percent. Thus, modifications to the price cap will not necessarily be static.

In FY 2016, the Postal Service paid out a total of \$7.0 billion for RHBF and CSRS/FERS normal cost and prefunding, \$6 billion less than its liability for those funds and very close to its \$5.8 billion total Postal Service loss for FY2016. The table shows that after recalculation of the RHBF requirement and realignment of other payments, the Postal Service will owe \$3.3 billion more in FY 2017 than the \$7 billion it paid out last year for RHBF and pension payments. Assuming \$7 billion was the Postal Service's total ability to pay into the fund in FY 2016, then, if all things remain equal, in FY 2017, the Postal Service likely will be unable to pay \$3.3 billion, of which \$2.6 billion is the required amortization of RHBF.⁶⁸

The \$3.3 billion may actually be lower than estimated. The footnote on the Table indicates \$0.2 billion for FERS was not paid pending a request for OPM's reconsideration of the amount. There is no indication whether the Postal Service had funds to make that payment. If the Postal Service could have paid \$0.2 billion of the additional \$3.3 billion required in excess of FY 2016 payments, then, all things being equal the following year, the Postal Service's revenue would be short only \$3.1 billion rather than \$3.3 billion initially required in FY 2017.

Based on the above analysis, without utilizing a Postal Service demand analysis model, it is reasonable to conclude that for FY 2017, at least, an increase in revenue of \$3.3 billion as a rate increase, without accounting for any effects of elasticity, would cause revenue to closely approximate total costs. The Commission will have the actual FY 2017 figures available as well as better projections for FY 2018 when it finalizes its regulations. The Commission will be better able to estimate the total revenue needed to recover the FY 2017 revenue shortfall during FY 2018, which should not vary

⁶⁸ Of course, if the Postal Service has a loss for the year, it may select those obligations it will not pay. Because the Postal Service's loss in FY 2016 was very similar to its \$5.8 billion obligation which it did not pay, it may be assumed that, without additional profits in FY2017, the shortfall will continue to closely equate to unpaid funding requirements and thus drop to \$3.3 billion, or lower to \$3.1 billion if OPM agrees with the Postal Service that the \$0.2 billion FERS payment is not due.

significantly from the above amounts. The advisability of the price cap adjustment proposed by Dr. Kwoka will become evident.

Table 1: U.S. Postal Service (USPS) Payments for Retiree Health and Pension Fiscal Years 2016 and 2017 (\$ Billions)

USPS payment	Fiscal year 2016 - Required	Fiscal year 2016 - paid	Fiscal year 2017 - required (estimate)
Retiree health benefits			
Health premiums	\$3.3	\$3.3	Not applicable
Fixed prefunding	\$5.8	\$0	Not applicable
Normal cost	Not applicable	Not applicable	\$2.9
Amortization	Not applicable	Not applicable	\$2.6
Pension benefits			
Civil Service Retirement System (CSRS)			
Amortization	Not applicable	Not applicable	\$1.2
Federal Employees Retirement System (FERS)			
Normal cost	\$3.7	\$3.7	\$3.3
Amortization	\$0.2	\$0	\$0.2
Total	\$13.0	\$7.0	\$10.3

Note: Fiscal year 2017 estimates may change later this year when the Office of Personnel Management (OPM) provides USPS with the amount of these required payments.

Since the date of the FY 2016 financial statements were reported, the Postal Service increased its rates early in 2017, package services business is continuing to expand, and the Postal Service is continuing cost saving measures, but market dominant demand may be declining slightly. Given these countervailing changes affecting total revenue and costs, the Postal Service's actual earnings, as well as its ability to make its amortization payments, will be unknown until September 30, 2017. At this time, there is no reason to expect that the Postal Service will be able make the \$2.6 billion RHBFF payment, as well as the remainder of the \$3.3 billion liability in excess of

its FY 2016 prefunding payments, *i.e.*, \$0.7 billion in FY 2017 or later years without additional price cap authorization.

3. The Impact of the Recent Exigent Rate Increase on Volume Demonstrates a Rate Increase of \$2.6 Billion for RHBF Would Have Only a Minor Impact on Volume

Recent history from the exigent rate increase demonstrates that there is room for the Commission to add the Z factor for RHBF to increase the price cap. That would result in increased rates of the magnitude necessary to fund total costs for the \$2.6 billion RHBF payment without significant mailer discomfort or volume reductions. The recent exigent rate increase amounted to an annual across the board increase of about \$2.1 billion,⁶⁹ a 4.3 percent rate increase.⁷⁰ After the rates were implemented in January 2014, through 2015 and into April 2016, there was very little impact on volume as shown on Table 2.

⁶⁹ Financial analysis of United States Postal Service Financial Results and 10-K Statement, Postal Regulatory Commission, March 29, 2016 at 9.

⁷⁰ Statement of Postmaster General and Chief Executive Officer, Megan J. Brennan before the House Oversight and Government Reform Committee, Hearings on H.R. 756, *Postal Service Reform Act*, February 7, 2017 at 15 (PMG Brennan Statement).

TABLE 2 Total Market Dominant Mail Volume FY 2012-FY 2016

Year	Percent Decline From Prior Year
FY 2012	5.6
FY 2013	1.4
FY 2014	1.9
FY 2015	1.2
FY 2016	0.4

Source: Taub Testimony, at 18.

The impact of the exigent case on the volume of market dominant mail was minimal. The above table shows that the declines in total market dominant mail volume for the last five years (FY 2012-FY 2016) has been steadily tapering off, despite the exigent case. As a reference, in FY 2012, well before the exigent case, market dominant volumes declined by 5.6 percent. By January 2014, when the exigent case went in to effect well after the start of the fiscal year, the rate of decline had diminished considerably and for that year the volume decline increased by only 0.5 percent from 1.4 percent to 1.9 percent. Then, for the full year the exigent case was in effect, FY 2015, the volume decline again slowed significantly from 1.9 percent down to 1.2 percent, and in FY 2016 when the exigent rates were in effect for just over one-half the year, the volume decline slowed even more significantly to only 0.4 percent for the year. For further reference, Dr. Brennan's numerical illustration calculates that over the 10 years since the PAEA passed, volumes declined an average of 1.6 percent per year. Brennan Decl. at 20.

Given the underlying longer-term volume reductions due to electronic diversion, there is little evidence the rate increases from the exigent rate case caused little more than a ripple in the volume pond, and probably had virtually no effect. Review of the volumes for the individual market dominant products shows the minimal declines were

consistent and similar for each of the market dominant products during that period when the exigent rate increase was in effect. *Id.*

This evidence of minimal volume impact from the exigent rate increases is corroborated by the often heard comment from the public when the First-Class stamp price was reduced by 2 cents after the exigent surcharge was removed. The public was mystified that the rate was being reduced. No grumbles were heard that the 49 cent rate was too high and ought to be reduced back to 47 cents. This anecdotal evidence about the recent exigent rate increase is telling.

If the exigent case produced additional annual revenue in FY 2015 of \$2.1 billion based on a rate increase of 4.3 percent, then, without taking into account the elasticity impact which, as shown above, is likely to be minimal regardless of elasticity assumed in the Postal Service's models, revenue of \$2.6 billion would likely derive from a 5.3 percent rate increase. Likewise, about \$3.3 billion could be recovered with an increase of about 6.7 percent. Neither of these percentages for rate increases is particularly onerous in the commercial or retail business world. In fact, they would probably go unnoticed in most instances.

All this demonstrates that there remains room for Commission authorized rate increases at least up to the \$2.1 billion level and easily up to \$2.6 billion or, if necessary, even up to \$3.3 billion without much impact on volume. One factor at work is the probability that the customers most responsive to price increases would have left the system in the earlier years of electronic diversion, while the remaining volumes are relatively less responsive to price increases. The good news is that because of the 2017 RHBF amortization adjustment, painfully large rate increases of \$5.8 billion are not needed to recover the current FHBF payment.

Fair, measured and consistent adjustments to the price cap and, thereby, to prices will not only ensure financial stability but will ensure rate stability and lead to a financially healthy Postal Service balance sheet. Further, there can be no question that in this period of parcel volume growth and increasing rates, competitive products should

also add to revenues and increase contribution. For instance, over the last three years, competitive products have increased contribution significantly. In FY 2014 competitive product contribution was \$4.3 billion.⁷¹ In FY 2015, competitive product contribution increased to \$4.5 billion.⁷² For FY 2016, the Postal Service reports its competitive products contributed \$6.0 billion.⁷³ Continued growth in this sector will assist the Postal Service in strengthening its financial stability.

C. Declining Demand Adjustment

1. Price Cap History and Shortcomings

An additional adjustment should be made annually to the CPI-U price cap to account for changes in demand for mail products and services that are outside of the Postal Services' control. A demand adjustment is necessary to maintain financial stability between periodic reviews of the system of regulation, as prescribed in section 3622.

Dr. Timothy J. Brennan, a noted economist, has studied and published papers on price-cap regulation. He has designed a preliminary mechanism to adjust for declining demand in a price cap regime. Dr. Brennan details this mechanism in his Declaration filed with these comments and in his recent publication with Michael Crew, which proposes an automatic adjustment to the price cap for declining demand.⁷⁴

Dr. Brennan has had a distinguished career over many years since 1978 as an economist. In addition to his current position as a professor, Dr. Brennan has experience with the U.S. Department of Justice, Antitrust Division, at a non-profit research organization-Resources for the Future, as an economist on the White House

⁷¹ Docket No. ACR2014, Annual Compliance Determination Report, December 29, 2014, at 83.

⁷² Docket No. ACR2015, Annual Compliance Determination Report, December 29, 2015, at 92.

⁷³ FY 2016 ACR at 90.

⁷⁴ Brennan, T.J. & Crew, M. (2016). Price Cap Regulation and Declining Demand. In M.A. Crew & T.J. Brennan (Eds.), *The Future of the Postal Sector in a Digital World*. New York: Springer.

Council of Economic Advisors, at the Canadian Competition Bureau, as a staff consultant at the Federal Trade Commission, and as Chief Economist at the FCC.

Dr. Brennan has studied price cap implementation for many years and has often written about the advantages and disadvantages of price cap regulation and potential improvements to the model. Brennan Decl. at 2 His Declaration discusses the shortcomings of price-cap regulation generally, and notes the constraints on the Postal Service's ability to borrow and the RHBF payment requirements that have led to its financial difficulties. *Id.* at 3. Dr. Brennan explains that price cap regulation replaced cost of service regulation because the latter provided no incentive for management to limit capital expenditures to control costs. *Id.* at 4-5. While cost of service regulation connects prices to costs; price cap regulation, on the other hand, separates prices from costs and permits management to retain cost savings. *Id.* at 5.

Price caps allow prices to go up by the rate of inflation, usually determined by a Consumer Price Index (CPI). Dr. Brennan makes an important point about the current CPI adjustment, "The purpose of this CPI adjustment is to keep the regulated firm from becoming insolvent just because its price has not kept up with inflation." *Id.* This reflects a general concern with price cap regulation that, by divorcing prices from costs, outside economic forces must be taken into account regularly to insure the maintenance of financial stability. Unless exogenous factors are added to the CPI-U price cap, Postal Service insolvency can occur. Prices must be allowed to increase (or decrease if appropriate) because, despite firms gaining operating efficiencies, the prices of regulated firms cannot be expected to continue to recover all costs without adjustment for those exogenous factors.

The most logical and universally applied exogenous factor is the cost of living adjustment. While in principle it reflects the firm's cost changes, often the index is not tailored to the regulated firm. Consequently, the index can underestimate the firm's input costs and, thereby, result in revenue shortfalls.

Dr. Brennan makes another important point concerning the initial price, or starting point, at the commencement of price cap regulation. He states that “[t]o ensure that the regulated firm is able to cover costs at the start, the initial price may be based on COSR [cost of service regulation] or inherited from prior use of COSR if PCR [price cap regulation] is replacing [cost of service regulation].” *Id.* at 5-6. Thus, a critical aspect of moving to price cap regulation is establishing the initial price to ensure that the “firm is able to cover costs at the start.”

It is well-known that the Postal Service was far from able to cover costs at the start of price cap regulation. In the year price cap regulation commenced, the Postal Service’s prices failed to recover costs. This shortfall has not only continued but has grown in the 10 years of price-cap regulation under the PAEA.

The Postal Service’s price cap formula does not include an “X factor,” a typical constraint of price cap regulation. An X factor is an offset for the firm’s productivity gains, calculated as CPI-U minus X. However, despite an X factor of essentially zero, the Postal Service has not been able to maintain financial stability over the last 10 years. *Id.* at 6. Given the current state of the Postal Service’s finances, it is clear that additional exogenous factors for secular trends need to be included in the price cap.⁷⁵

2. Dr. Brennan’s Concerns about Price Caps

Price cap regulation generally raises certain concerns for Dr. Brennan that should be kept in mind when considering price cap adjustments. Dr. Brennan suggests the initial price may not adequately compensate a firm under price cap regulation because external factors can affect average costs or demand, which do not determine prices under price cap regulation. *Id.* at 6-7. In other words, price cap regulation shifts risk onto the firm. This concern about initial prices is also applicable when, after review, prices are reset to ensure costs at the onset will be covered.

⁷⁵ This is in addition to the limited relief valve already in the PAEA under section 3622(d)(1)(E) for extraordinary or exceptional circumstances available only for unforeseen events.

Dr. Brennan also notes that, under price cap regulation, service quality is of concern because management does not directly benefit from higher quality. Instead, it benefits from lowering quality and retaining the resulting cost savings. He concludes that, while there may be some incentive under price cap regulation to improve quality in order to increase demand and thus profits, “the lower the regulated price under PCR [price cap regulation], the lower will be the quality of the service provided.” *Id.* at 7.

A third shortcoming of price cap regulation, Dr. Brennan notes, is its tendency, over time as productivity fails to conform to expectations, to result in large divergences of prices from costs, leading to either excess profits or financial instability. Subsequent periodic reviews can reduce, to some degree, this separation of prices from costs. *Id.* at 8.

Thus, Dr. Brennan believes that initial prices under price-cap regulation must be adjustable upward for additional external risks affecting average costs, that service quality generally suffers when prices are less, and that although review of prices can reduce the separation of costs from prices, that can attenuate the efficiency advantages of price-cap regulation. *Id.*

3. Effects of Declining Demand

Demand for First-Class Mail products and services peaked in the early part of this century, but total market demand did not peak until FY 2006. From the time the PAEA passed in 2006 to FY 2015, mail volume declined from its peak by 27 percent. First-Class Mail volume declined from its peak in FY 2001 through FY 2015 by 40 percent.⁷⁶ Declines are largely due to the incursion of electronic communication which is expected to continue for the foreseeable future. *Id.* Unless demand declines are recognized in the price cap, or financial stability is ensured by other changes in the

⁷⁶ *Id.* at 10, citing GAO testimony before Senate Committee on Homeland Security and Governmental Affairs, January 21, 2016.

Commission's regulations, the solvency of the Postal Service as well as its ability to maintain services over time will be jeopardized.

A fundamental principle of price-cap regulation is that "price caps are initially set with the expectation that the firm's total costs would be covered." *Id.* at 11. Notably, where "prices are capped by regulation, declining demand harms the firm's fiscal condition." *Id.* at 11. This is because the price is capped "above marginal cost." *Id.* A firm like the Postal Service with high fixed costs is particularly impacted when demand falters and revenue from that lost business exceeds savings in operating costs. *Id.*

For instance, Dr. Brennan makes a rough estimate that a one percent decline in market dominant volume demand would reduce revenue, net of attributable cost, by \$227 million. All this reaffirms that declining demand hurts the Postal Service's financial position. *Id.* at 12. The history of declining demand indicates that it cannot be attributed to the short-run effects of the 2007-2009 Great Recession. *Id.* Consequently, the price cap must be adjusted annually for declining demand along with annual rate filings to ensure "net revenue neutrality."

4. Principles of Price Cap Demand Adjustment

Dr. Brennan presents a price cap demand adjustment mechanism to avoid the harmful effects of declining demand on Postal Service solvency. Five principles underlie his proposal.

- The goal of the adjustment is "net revenue neutrality"
- The adjustment mechanism must be simple
- The adjustment mechanism is based on events outside Postal Service control
- The adjustment mechanism only responds to adverse financial effects of declining demand
- The adjustment mechanism also applies to increasing demand

5. Dr. Brennan's Proposed Adjustment Mechanism

Dr. Brennan's adjustment mechanism is designed as an annual percentage adjustment to price, just as the CPI-U is an adjustment to price. As explained above, the framework of the mechanism includes only three terms. The first term is the percentage that demand has changed in a year for a particular class of mail or category of service for reasons outside of Postal Service control. It is denoted as "Z." The second term is the percentage that average cost changes for a given percentage change in volume, *i.e.*, the "elasticity of average cost with respect volume," denoted as E_{AC} . This term represents the economies of scale and is approximated as the "contribution to institutional cost" divided by total revenue, also known as the percentage contribution. *Id.* at 16.⁷⁷ By way of illustration, for FY 2015 this elasticity would be calculated as about (-)45. *Id.* If the elasticity is multiplied by the first term, the decline in demand for the year, the result is the percentage change in average cost for that given year. This change in cost for the year due to falling demand represents the tentative change in price needed to cover higher costs. *Id.* It is tentative since the third term, "price elasticity of demand," denoted as E_D , must be taken into account because raising the price will affect demand, leading to another demand adjustment. *Id.* at 17.⁷⁸

It is easy to see that Brennan's proposal is not complicated. The complete adjustment mechanism is

$$\text{Adjustment term} = Z \times E_{AC} / (1 - E_{AC}E_D)$$

Dr. Brennan offers an example, designed to estimate an adjustment for the change in demand over the ten years from 2006 to 2015. Using GAO's estimate of a 27 percent decline in mail volumes, the Z quantity in the equation would equal (-)0.27. The estimate of the elasticity of the average cost as being the percentage contribution

⁷⁷ This is adapted from Brennan and Crew, 2016 at 7-8 references in Dr. Brennan's Declaration.

⁷⁸ The elasticity of demand may not be known precisely but may be approximated by other studies. Dr. Brennan's numerical example indicates the elasticity of demand may not matter much if it is not large. *Id.* at 18.

of institutional costs over that period is calculated at (-)45. For the third term, he uses (-)0.3 for elasticity of demand, applying his mechanism as follows:

$$\text{Adjustment term} = Z \times E_{AC} / (1 - E_{AC} E_D) = (-.27) \times -.45 / 1 - (-.45)(-.3) = 14.0 \text{ percent}$$

The adjustment term is calculated as 14 percent over a 10 year period, or about 1.3 percent increase per year, to neutralize the effect of declining demand. In practice, the adjustment would be calculated annually when new rates are filed for each class of service, or perhaps it could be calculated for products. Dr. Brennan concludes that his numerical illustration indicates “this adjustment factor is not too high to consider implementing.” *Id.* at 20.

Dr. Brennan also notes that if the potentially contentious demand elasticity term were ignored, and thereby assumed to be zero, the 10 year increase would drop to only 1.15 percent per year on average, “not a strikingly enormous difference from his rough estimate” of (-)0.3 and “possibly well within the range of the error of any attempt at more precise measurements.” *Id.*

6. Demand Adjustment Implementation Issues

The proposed demand adjustment mechanism is both simple and transparent. However, Dr. Brennan recognizes that issues may be raised about the implementation of the adjustment.

Declining demand. The proposed demand adjustment is intended to reflect only changes in demand (mail volumes) outside the Postal Service’s control and not reductions in quality of service or operational decisions. To counter those who would raise an objection that changes in demand are due to Postal Service actions, Dr. Brennan suggests placing the burden on those who object to demonstrate the changes in demand are due to Postal Service action. *Id.* at 20.

The Postal Service has already developed and practically applied the methodology for decomposing changes in mail volumes into different categories based

on the factors that cause this change. In Docket No. R2013-11, the Postal Service classified so called “sources of change” into multiple categories, either pre-recession-type factors or recession-induced factors.⁷⁹ In Order No. 1926, the Commission concluded that “growth of the internet and electronic diversion shares in the responsibility, along with the Great Recession, for the decline in mail volume” in the analyzed period of time.⁸⁰ Since both electronic diversion and the Great Recession represent events that are outside the control of the Postal Service, the associated loss in mail volume should be accounted for in the adjustment mechanism proposed by Dr. Brennan. Therefore, the Postal Service’s decomposition methodology presented in Docket No. R2013-11 appears applicable for estimating change in demand to be used in calculation of the price cap adjustment term.

Elasticity of average cost. The elasticity of average cost measures how much the Postal Service’s prices must rise for a given percentage drop in demand to have no effect on Postal Service income. A few approximations are used. First, assuming marginal cost is constant, the elasticity equals the negative of the ratio of fixed costs to total revenue and, second, that fixed costs are approximated by the contribution to institutional cost. *Id.* at 21. To the extent some attributable costs include fixed costs (*i.e.*, larger than otherwise), the ratio of the fixed cost to total cost would exceed the ratio of the contribution to institutional cost to total cost, suggesting a larger increase in rates. Disputes will be reduced to the extent attributable cost is variable and institutional costs are fixed. *Id.*

As Dr. Brennan explains in his Declaration, average elasticity of the cost is a ratio of fixed cost and total cost. Considering that the proposed adjustment mechanism will be implemented on a class or product level, it is important to be able to calculate average elasticity of cost at the class or product level. However, neither the Postal

⁷⁹ Docket No. R2011-3, Further Statement of Thomas E. Thress on Behalf of the United States Postal Service, September 26, 2013, at 5, 8-10.

⁸⁰ Docket No. R2011-3, Order Granting Exigent Surcharge Increase, December 24, 2013, at 65. (Order No. 1926).

Service's total cost nor fixed costs are known at the class or product level. Assuming that institutional cost provides a reasonable approximation for fixed cost, Dr. Brennan suggests that contribution to institutional cost would serve as a proxy for fixed cost at the product or class level. Currently, the Postal Service's institutional cost is higher than its overall contribution to institutional cost. Thus, in FY 2015, institutional cost for all mail and services constituted \$33.8 billion, and overall contribution to institutional cost was \$28.7 billion, which indicates more than \$5 billion in revenue shortages. See FY 2015 Financial Analysis Report at 44, 88. Considering this shortage, the use of contribution to institutional costs as a proxy of institutional cost appears reasonable and reflects a conservative approach to the estimation of an adjustment term proposed by Dr. Brennan. Simultaneously, considering that total cost is the sum of institutional and attributable costs, the use of contribution to institutional costs as a proxy for institutional costs leads to another approximation. The sum of attributable cost and contribution to institutional cost is the total revenue and, therefore, Dr. Brennan suggests using total revenue as a proxy for total cost on the class or product level.

Attributable cost still include some fixed cost (namely, product-specific cost), and institutional cost include a portion of inframarginal cost (that are variable, but not volume variable). Considering that the share of product specific cost in the attributable cost is small (less than one percent based on the data from FY 2015 Financial Analysis Report), and the share of the inframarginal cost in the overall institutional should be also small, the suggested approximation appears reasonable.

Price elasticity of demand. Dr. Brennan points out that the larger the elasticity of demand, the larger the demand adjustment of price. *Id.* at 21. Utilizing standard sources for elasticity of demand will reduce conflicts about that elasticity. The annual Market Dominant Demand Analysis report that is published by the Postal Service in the month of January would provide such a source.⁸¹ The Postal Service reports own-price

⁸¹ For the most recent Demand Analysis, see Market Dominant Demand Analysis, FY 2016, January 23, 2017 (FY 2016 Demand Analysis).

elasticities of demand by sub-classes of mail and often by shape or even product, which would allow estimating the adjustment term at the fine level of detail.⁸² However, as Dr. Brennan notes, his numerical illustration suggest the effects of his demand adjustment would not generally lead to such significant changes in prices as to require review of the level of contributions. *Id.* at 22.

In conclusion, Dr. Brennan reminds again that the purpose of the demand adjustment mechanism is to maintain the Postal Service's net revenue position when demand falls. The adjustment can be, and should be, applied in the interim between periodic reviews of the price cap regulation. *Id.* at 23.

D. Remedy to Permit Achievement of Objective 4 (Pricing Flexibility)

As discussed in section VI.C.2., *supra*, application of the price cap to the Periodicals Class has denied the Postal Service the pricing flexibility that Objective 4 was intended to achieve. In order to provide that flexibility, the price cap must be raised in order to give the Postal Service the opportunity to attempt improvements in cost coverages.

This adjustment to the price cap for the Periodicals Class would be in addition to the adjustments to the price cap formula discussed, *supra*, in section VI.B. (RHBF Z-Factor adjustment) and section VI.C. (declining demand adjustment). It would be a one-time reset that permits the Postal Service's rates to recover as nearly as possible estimated total costs for the Periodicals Class consistent with the principle that price caps should be set to cover total costs at the time the price caps are initialized or reset. See Kwoka Decl. at 6-7. As Dr. Kwoka states in his Declaration, "unless some action is taken to recover the attributable costs of Periodicals...,the Postal Service can continue

⁸² See FY 2016 Demand Analysis, file "VF-Jan2017.xlsx," tab 'Elasts.'

to provide such services only by overcharging for other services and/or by reducing service quality and investments in its overall operations.”⁸³ *Id.* at 27.

It is important to emphasize what the adoption of these remedies would not do. First, higher price caps would not relieve the Postal Service of its obligation responsibly to reduce costs or to increase efficiency. Nor, for that matter, should the Commission abandon its current effort to explore the operational reasons behind the failure to reduce costs. See FY 2015 ACD, Chapter VI: Flats Costs and Service Issues.

Second, the Postal Service would still be required to observe those statutory provisions that recognize the special place that periodicals occupy in the universe of postal products. *E.g.*, section 3622(c)(11) (recognizing ECSI value of certain mail classes and products); section 3626 (providing reduced rates for certain publications mailed within the county of their publication). For its part, the Commission would continue to exercise oversight of the Postal Service’s pricing proposals.

Third, raising caps for the Periodicals Class would not, by itself, raise prices for periodicals. What it would do is give the Postal Service the opportunity to exercise pricing flexibility. In doing so, the Postal Service would be expected to exercise that pricing flexibility in a responsible manner consistent with its obligations under title 39. In that connection, there is nothing inherently wrong with expecting postal products, including periodicals, to cover their costs. If compelling reasons exist for the subsidization of periodicals because of perceived societal benefits, that subsidization should, as it has in the past, come from taxpayers, not the Postal Service or other customers. Kwoka Decl. at 28.

⁸³ Dr. Kwoka also discusses the problem presented by the non-compensatory pricing of Standard Mail Flats, but notes that the problem can be addressed within the cap applicable to the Standard Mail Class. *Id.*

E. Price Cap Reset to Achieve Full Cost Recovery

In the event the Commission chooses to forego adjusting the price cap formula recommended above to recover total costs, the Commission may instead simply reset the price cap so that revenues in the first year after reset may equate as near as feasible to total costs. A one-time price-cap reset could be allowed, to permit the Postal Service's rates to recover estimated total costs consistent with the principle that price caps must start, or on review be reset, at rates designed to recover total costs in the first year after reset. This is consistent with Dr. Kwoka's view that, under price cap regulation, lowest prices consistent with breakeven operation of the firm are assumed to be recovering total costs at the beginning of the cycle or reset with "mid-course corrections" after four to five years to restore correspondence between price and cost. Kwoka Decl. at 6-7, 12. Based on the discussion above, and the GAO testimony regarding the additional funding requirements, if no adjustments are added to the price cap as it currently stands, a one-time price cap reset above the usual CPI-U increase of approximately \$3.3 billion would enable the Postal Service to recover all of its costs. Thereafter, cost savings, improved productivity and increased earnings from competitive rates should enable the Postal Service to begin to pay down its debt and accumulate retained earnings.

F. Remedy to Permit Achievement of Objective 3 (Maintenance of High Quality Service Standards)

While not all service quality problems can be attributed to the price cap, the experience of last 10 years provides adequate evidence that the price cap has contributed to those problems. See section VI.C.3, *supra*. Some of the original commenters on the Commission's proposed regulations for implementing the PAEA argued that adjustments to the price cap should be made if service quality were degraded. See Order No. 26, ¶ 2066; Order No. 43, ¶¶ 2079, 2081. The Postal Service opposed any such adjustments because, it argued, price cap adjustments were limited to adjustments for changes in the CPI-U index. See Order No. 44, ¶ 2082. The

Commission, noting that it did not have a specific proposal before it to review, decided against imposing such an adjustment mechanism. Order No. 26, ¶ 2067; Order No. 43, ¶ 2083.

Whatever legal limitations may have existed in 2007 that would have precluded adjustments to the price cap to incentivize improved service quality or penalize for degraded service quality, those limitations no longer exist. As part of the 10-year review, the Commission has the authority to provide for adjustments to the price cap for service quality. See section VI.A., *supra*.

Notwithstanding the Commission's increased efforts since the FY 2015 ACD to get to the bottom of service performance issues, an adjustment to the price cap for service quality issues may yet prove to be necessary. However, the establishment of incentives to maintain or improve service quality could be a complex task. Kwoka Decl. at 10-11. Moreover, the Public Representative submits that it would be premature to impose price cap adjustments for service quality until the effect of other adjustments to the price cap, (such as those proposed by the Public Representative in these comments) have had an opportunity to relieve the pressure for further service degradation and/or make additional revenues available to improve performance.

Aside from whatever technical problems might be encountered, the imposition of price cap adjustments for service quality at this time would present the Commission with a difficult choice. On the one hand, the imposition of a price cap penalty for failing to provide satisfactory service could be counterproductive by further compromising the Postal Service's ability to provide quality service. On the other hand, an upward adjustment to the price cap to incentivize improved service quality could be viewed as a reward for substandard service. It could also be unnecessary because the Postal Service would no longer need to consider lowering service standards to remain financially viable if the other adjustments to the price cap recommended by the Public Representative are adopted. Or such an incentive could prove to be unnecessary if the Commission's current efforts to explore service problems begin to bear fruit. See

FY 2015 ACD, Chapter V: Service Performance; and Chapter VI: Flats Costs and Service Issues. For these reasons, the Public Representative cautions against summary imposition of a price cap adjustment for service quality.

The Commission should, however, in conjunction with the price cap adjustments proposed in sections VI.B. (RHBF Z-Factor adjustment), VI.C. (declining demand adjustment), VI.D (Periodicals adjustment), and VI.E. (alternative adjustment), *supra*, begin consideration of whether and how such adjustments could be imposed if service quality does not improve. This would afford an opportunity for careful consideration of the issue while the Postal Service's financial condition is improving. If, after providing the Postal Service with more financial resources, service does not improve or declines further, a penalty might be imposed to incentivize service performance without imperiling the Postal Service's financial viability.

G. The Maximization of Incentives to Increase Efficiency Requires Consideration of Changes to the Total Productivity Factor Measurement Standard (Objective 1)

For the reasons given by Dr. Bzhilyanskaya in her Declaration, further investigation of the Total Productivity Standard is needed to insure its reliability.

H. More Frequent Reviews of the Regulatory System are Required

In his Declaration, Dr. Kwoka points out that the 10-year period between implementation of the PAEA and the first Commission review of the system for regulating market dominant products is much longer than the periods between implementation and first review of other price cap-based regimes. Kwoka Decl. at 29. Periodic reviews of how a price cap system is working are essential. Not all problems can be anticipated at the time the system is implemented. Over time, the trends of indicies, like the CPI-U, and cost trends can diverge producing either distress or windfalls for the regulated entity. *Id.* at 8. A review of the system permits corrective actions to be taken in a timely manner. See *id.* at 29. On the other hand, reviews that

occur too soon or too frequently create the risk that the constructive incentives inherent in a price cap system will be significantly reduced or eliminated. *Id.* at 8. Reviews that occur too soon or too often can also cause a price cap system to revert to a cost-of-service system. *Id.*

Dr. Kwoka considers the 10-year period before the first review of the market dominant regulatory system to have been unusually long. *Id.* at 29. The delay in conducting the first review has allowed design defects and changed circumstances contribute to the Postal Service's financial problems and inflict persistent harm on the Postal Service and its customers. *Id.* Dr. Kwoka concludes that the lesson to be learned from this experience is that further reviews should be conducted after a shorter period. *Id.* He recommends that a further review of the market dominant system be conducted no later than four years from implementation of the changes adopted by the Commission as a result of the current review. *Id.*

VII. CONCLUSION

For the reasons set forth above, the Public Representative submits:

1. That the modern system for regulating rates and classes for market dominant products is not achieving the objections in 39 U.S.C. § 3622(b) in light of the factors in 39 U.S.C. § 3622(c); and
2. That the Commission should modify the system as recommended herein.

Respectfully submitted,

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