POSTAL REGULATORY COMMISSION

39 CFR Part 3015

[Docket No. RM2017–1; Order No. 4402]

Competitive Postal Products

AGENCY: Postal Regulatory Commission.

ACTION: Proposed rulemaking.

SUMMARY: The Commission is proposing to amend its existing rule related to the minimum amount that competitive products as a whole are required to contribute to institutional costs annually. The proposed rule changes were developed during the Commission's second review of whether the appropriate share level should be retained, eliminated, or modified. The Commission invites public comment on the proposed rule.

DATES: *Comments are due:* April 16, 2018.

ADDRESSES: Submit comments electronically via the Commission's Filing Online system at *http://www.prc.gov.* Those who cannot submit comments electronically should contact the person identified in the **FOR FURTHER INFORMATION CONTACT** section by telephone for advice on filing alternatives.

FOR FURTHER INFORMATION CONTACT: David A. Trissell, General Counsel, at 202–789–6820.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Introduction

In this proceeding, the Commission conducts its second 39 U.S.C. 3633(b) review of the appropriate share that competitive products contribute to institutional costs. *See* 39 U.S.C. 3633(b). The purpose of the Commission's review is to determine whether the existing 5.5-percent appropriate share should be retained, modified, or eliminated after considering all relevant circumstances. *See id.; see also* 39 CFR 3015.7(c).

Postal Service products are characterized as either market dominant or competitive. 39 U.S.C. 3642(b)(1). Market dominant products are those products over which the Postal Service exercises sufficient market power to effectively set prices substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products.[1] Competitive products consist of all other Postal Service products.[2] All Postal Service costs are classified as either attributable or institutional. Attributable costs are costs that are assigned to specific products on the basis of reliably identified causal relationships.[3] Institutional costs are residual costs that cannot be specifically attributed to either market dominant or competitive products through reliably identified causal relationships.[4]

In this Notice of Proposed Rulemaking, the Commission proposes that a formula be used to calculate the minimum amount that competitive products as a whole are required to contribute to institutional costs annually (*i.e.,* the appropriate share). As discussed in the sections that follow, the Commission proposes to modify the appropriate share based on its analysis of all relevant circumstances in accordance with 39 U.S.C. 3633(b).

II. Procedural History

On November 22, 2016, the Commission issued an Advance Notice of Proposed Rulemaking establishing the instant docket, appointing a Public Representative, and providing interested persons with an opportunity to comment on the Commission's examination of the appropriate share.[5]

A. Summary of Filings

The Postal Service, the Public Representative, Amazon Fulfillment Services, Inc. (Amazon), the American Catalog Mailers Association (ACMA), Former Utility Regulators (FUR), the Greeting Card Association (GCA), the National Association of Letter Carriers, AFL–CIO (NALC), the Association for Postal Commerce (PostCom), Stamps.com, United Parcel Service, Inc. (UPS), and a collective group of market dominant mailers and competitive shippers filed initial comments.[6] In addition, representatives[7] for Amazon and UPS filed declarations supporting the initial comments.

Business Optimization Services (BOS), eBay, Inc. (eBay), the National Postal Policy Council (NPPC), National Association of Presort Mailers (NAPM), GCA, MDMCS, the Postal Service, the Public Representative, Amazon, and UPS filed reply comments. In addition, representatives for Amazon and UPS filed declarations supporting the reply comments.[8] Appendix A contains the full list of comments, reply comments, related citations, and related filings.[9]

Several motions were filed by Amazon and UPS between January 4, 2017, and February 9, 2017, relating to access to non-public materials.[10] In addition, on January 26, 2018, UPS filed a motion to supplement the record in this docket.[11] Appendix B provides a

[1] *Id.* Examples of market dominant products include products in the First-Class Mail, USPS Marketing Mail, and Periodicals classes.

[2] *Id.* Examples of competitive products include Priority Mail, Priority Mail Express, and First-Class Package Service.

[3] Attributable costing was most recently considered in Docket No. RM2016–2, wherein the Commission examined the concept of reliably identifiable causally related costs and expanded the scope of Postal Service cost attribution. *See generally* Docket No. RM2016–2, Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), September 9, 2016 (Order No. 3506). This case is currently pending before the United States Court of Appeals for the District of Columbia Circuit.

[4] Examples of institutional costs include the Postmaster General's salary, building project expenses, and area administration expenses.

[5] Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, November 22, 2016 (Order No. 3624). The Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products was published in the **Federal Register** on November 29, 2016. *See* 81 FR 85906.

[6] The collective group of mailers includes the Parcel Shippers Association (PSA), Alliance of Nonprofit Mailers, American Catalog Mailers Association, Continuity Shippers Association, Data & Marketing Association, Envelope Manufacturers Association, National Association of Presort Mailers, National Newspaper Association, PSI Systems, and Stamps.com (collectively ''Market Dominant Mailers and Competitive Shippers'' (MDMCS)). Parties that make up MDMCS are organizations that represent market dominant mailers, competitive product shippers, or users of both market dominant and competitive products. MDMCS Comments at 1.

[7] The Amazon representative was John C. Panzar (Panzar), and the UPS representative was J. Gregory Sidak (Sidak).

[8] The Amazon representative was Panzar, and the UPS representatives were Sidak and Dennis W. Carlton (Carlton).

[9] Federal Express Corporation (FedEx) filed comments on January 23, 2017. Comments of Federal Express Corporation, January 23, 2017. On January 26, 2017, FedEx filed a motion to withdraw its initial comments. *See* Motion to Withdraw Comments, January 26, 2017. This motion is granted. FedEx's comments, filed January 23, 2017, were not considered by the Commission as part of its review in this docket.

[10] Although some of these motions were filed in a separate docket, the movants specifically asserted that they intended to use the requested materials for purposes of the instant docket as well.

[11] United Parcel Service, Inc.'s Motion to Supplement Record, January 26, 2018 (Motion to Supplement Record). In its Motion to Supplement Record, UPS requests that the record in this docket be supplemented to include a portion of an informal transcript from a DC Circuit appellate case (No. 16–1354) in which UPS sought appellate review of Commission Order No. 3506 related to attributable costing. Motion to Supplement Record at 1–2. Both Amazon and PSA filed oppositions to UPS's Motion to Supplement Record. *See* Answer of Amazon.com Services, Inc., to Motion of United

list of motions and Commission orders on motions relating to access to non-public information filed in this proceeding.

B. Organization of Discussion

Section III of this Notice of Proposed Rulemaking provides an overview of 39 U.S.C. 3633 and a discussion of the Commission's two previous decisions concerning the appropriate share that competitive products are required to contribute to institutional costs.

Section IV discusses the proposed change to the appropriate share requirement. The Commission explains its proposed formula-based approach and analyzes its proposed formula pursuant to the requirements of 39 U.S.C. 3633(b).

In section V, the Commission provides an analysis of the relevant Federal Trade Commission (FTC) report pursuant to section 703(d) of the Postal Accountability and Enhancement Act (PAEA), Public Law 109–435, 120 Stat. 3198 (2006).[12]

Section VI discusses comments received in this docket that have not been addressed elsewhere in this Notice of Proposed Rulemaking, organized by whether the commenter proposed that the current 5.5-percent appropriate share be increased, maintained, or eliminated.

Sections VII and VIII explain the proposed changes to the rules and take administrative steps in order to allow for comments on the proposed changes by interested persons.

III. Background

A. Relevant Statutory Requirements

The PAEA requires that competitive products collectively cover what the Commission determines to be an appropriate share of the Postal Service's institutional costs. 39 U.S.C. 3633(a)(3). The Commission is required to revisit the appropriate share regulation at least every 5 years to determine if the contribution requirement should be ''retained in its current form, modified, or eliminated.'' 39 U.S.C. 3633.

In making such a determination, the Commission is required to consider ''all relevant circumstances, including the prevailing competitive conditions in the market, and the degree to which any costs are uniquely or disproportionately associated with any competitive products.'' *Id.* Thus, by its terms, section 3633(b) provides three separate elements that the Commission must consider during each review: (1) The prevailing competitive conditions in the market; (2) the degree to which any costs are uniquely or disproportionately associated with competitive products; and (3) all other relevant circumstances.

B. Previous Commission Decisions

1. Docket No. RM2007–1

In promulgating its initial competitive product rules following the enactment of the PAEA, the Commission set the minimum competitive product contribution level at 5.5 percent.[13] In doing so, the Commission considered various proposals for how best to quantify the appropriate share, including ''equal unit contribution,'' ''equal percentage markup,'' ''markup of competitive products' attributable costs,'' and ''percentage of revenues.''[14] The Commission ultimately determined that basing competitive products' contribution on a percentage of total institutional costs was more easily understood and mirrored the directive of section 3633(a)(3). *Id.* The Commission also determined that the appropriate share is a floor, or minimum amount, with ''the hope (and expectation) . . . that competitive products will generate contributions in excess of the floor.'' *Id.* at 72.

Although the Commission projected, based on the recommended rates at the time, that competitive products would contribute 6.9 percent to institutional costs in test year 2008,[15] the Commission set the minimum contribution level lower due to the differences between the old ratemaking system and the new one being implemented pursuant to the PAEA. Order No. 26 at 70–72. In addition, the Commission considered the risks inherent in a mandatory contribution level. At the time, the Commission considered that setting it too high could hinder the Postal Service's flexibility to compete, while setting it too low could give the Postal Service an artificial competitive advantage. *Id.* at 73.

Ultimately, the Commission considered the amount that competitive products had historically contributed to the Postal Service's institutional costs as a reasonable means of quantifying the appropriate share at that time. *Id.* at 74. The Commission estimated that competitive products' contribution to total institutional costs had been 5.4 percent and 5.7 percent in the two previous fiscal years, and it set the appropriate share at 5.5 percent. *Id.* at 73; Order No. 43 at 91.

2. Docket No. RM2012–3

The Commission completed its first review of the appropriate share, required by section 3633(b), in Docket No. RM2012–3.[16] The Commission first addressed the factors enumerated by section 3633(b), including the prevailing competitive conditions in the market and the degree to which any costs were uniquely or disproportionally associated with competitive products, followed by a discussion of other relevant circumstances. *See* 39 U.S.C. 3633(b). The Commission ultimately determined that the minimum appropriate share should be maintained at 5.5 percent. Order No. 1449 at 1–2.

a. Prevailing Competitive Conditions

The Commission found three ''prevailing competitive conditions in the market'' relevant to its analysis: (1) Whether any evidence existed suggesting that the Postal Service had benefitted from a competitive advantage with respect to competitive products; (2) changes to the Postal Service's market share with respect to competitive products between 2007 and 2011; and (3) changes to the market and to the Postal Service's competitors between 2007 and 2011. *Id.* at 14.

With regard to competitive advantage, the Commission first noted the FTC

Parcel Service, Inc. to Supplement Record, February 2, 2018; Response of Parcel Shippers Association to United Parcel Service, Inc.'s Motion to Supplement Record, February 2, 2018. The Commission denies the Motion to Supplement Record at this time. UPS or any other interested party may raise the informal transcript, as well as any related arguments concerning it, in timely filed comments in response to this Notice of Proposed Rulemaking.

[12] As discussed in greater detail below, uncodified section 703 of the PAEA directs the Commission, when revising regulations under 39 U.S.C. 3633, to consider subsequent events that affect the continuing validity of an FTC report that analyzed the Postal Service's economic advantages and disadvantages in the competitive product market when compared to private competitors. *See* PAEA, 120 Stat. 3244; *see also* Federal Trade Commission, Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors, December 2007 (FTC Report), available at: *https://www.ftc.gov/sites/default/files/documents/reports/accounting-laws-apply-differently-united-states-postal-service-and-its-private-competitors-report/080116postal.pdf.*

[13] *See* Docket No. RM2007–1, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, October 29, 2007, at 91, 138 (Order No. 43).

[14] *See* Docket No. RM2007–1, Order Proposing Regulations to Establish a System of Ratemaking, August 15, 2007, at 70 (Order No. 26).

[15] Under the system of ratemaking in place prior to the PAEA, rates were set to allow the Postal Service to break even over a series of years. As part of those pre-PAEA rate cases, the revenue necessary for the Postal Service to break even in a single year was calculated and rates were designed to meet that revenue requirement. Those break-even years were called ''test years.'' *See* Docket No. RM2017–3, Order on the Findings and Determination of the 39 U.S.C. 3622 Review, December 1, 2017, at 24 (Order No. 4257).

[16] *See* Docket No. RM2012–3, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, August 23, 2012 (Order No. 1449).

Report which had concluded that, with regard to competitive products, the Postal Service operated at a net competitive disadvantage relative to its competitors.[17] Next, the Commission concluded that there was not any evidence of predatory pricing by the Postal Service.[18] Finally, the Commission noted that one of the PAEA's reforms had been to make federal antitrust law generally applicable to the Postal Service, but no antitrust-related action had been taken against the Postal Service. *Id.* at 16.

The second market condition considered by the Commission was the Postal Service's share of the market. *Id.* The Commission determined that there had not been a significant increase in the Postal Service's market share between Fiscal Year (FY) 2007 and FY 2011, which minimized concerns about any artificial advantage the Postal Service might have over its competitors. *Id.* at 18.

The third and final market condition considered by the Commission was changes to the market and the Postal Service's competitors since the initial appropriate share level was set in 2007. *Id.* The Commission noted that the package delivery market was expected to expand in the coming years, and that a significant competitor (DHL) had exited the market. *Id.* Nevertheless, the Commission ultimately determined that, although these market changes had provided the Postal Service with an opportunity to expand its competitive services, the Postal Service had continued to price its competitive products in such a way that they contributed more than the required 5.5 percent towards institutional costs. *Id.* at 19. As a result, the Commission found that there was no evidence that changed circumstances had provided the Postal Service with an unfair advantage. *Id.*

b. Unique or Disproportionate Costs

In considering the second element of section 3633(b) related to unique or disproportionate costs, the Commission found that there were no unique or disproportionate costs associated with competitive products that would affect the appropriate share. *Id.* at 14 n.14.

c. Other Relevant Circumstances

The Commission also discussed multiple factors that it considered relevant to its review of the appropriate share.

First, the Commission addressed the contribution level of competitive products to institutional costs over the preceding 5 years. *Id.* at 19–21. The Commission determined that between 2007 and 2011 the contribution level had generally increased, ranging from 5.54 percent to 7.82 percent of total institutional costs, which in dollar terms represented a 29-percent increase since FY 2007. *Id.* at 20–21. Therefore, the Commission found that the 5.5-percent appropriate share requirement had not ''hampered'' the Postal Service in pricing its competitive products. *Id.* at 21.

The Commission then considered changes to competitive product offerings and the mail mix that occurred over the preceding 5 years. The two major changes that the Commission identified were the transfer of both commercial First-Class Mail Parcels and Commercial Standard Mail Parcels to the competitive product list.[19] Despite changes to competitive product offerings, the Commission determined that the 5.5-percent appropriate share continued to accurately reflect the proportion of institutional costs that should be borne by competitive products. *Id.* at 23.

The final factor addressed by the Commission was the level of uncertainty regarding the Postal Service's business and financial condition in FY 2012. *Id.* Specifically, two proposals by the Postal Service were pending at that time which proposed to alter certain service standards and restructure aspects of the Postal Service's retail network. *Id.* This, combined with the Postal Service's ''unsustainable'' financial performance in the most recently available quarterly data, led the Commission to conclude that the resolution of these uncertainties had the potential to affect the relationship of attributable costs to institutional costs, thus affecting the appropriate share contribution requirement in the future. *Id.*

In concluding its first 5-year review, the Commission determined that ''[t]aken together, the totality of these relevant considerations support[ed] a conclusion that retaining the . . . appropriate share contribution level [at 5.5 percent] [was] appropriate at [that] time.'' *Id.* at 24.

IV. Commission Analysis

A. Change in Approach to Setting Competitive Products' Appropriate Share

In Docket No. RM2007–1, the Commission used the historical contribution of competitive products to set the initial appropriate share percentage. In Docket No. RM2012–3, the Commission examined the requirements of 39 U.S.C. 3633(b) in an analysis that blended qualitative and quantitative factors, the result of which led the Commission to maintain the minimum appropriate share at 5.5 percent. In this review of the appropriate share, the Commission analyzes the requirements of 39 U.S.C. 3633(b) and proposes to change its approach to setting the minimum appropriate share by using a formula that would annually update the required amount based on market conditions.

When an agency action represents a change in policy or approach, three criteria must be met in order to justify the change: (1) The agency must acknowledge that it is changing its policy; (2) the agency must provide a reasoned explanation for the new policy; and (3) the policy must be permissible under the controlling statute.[20] As the Commission has already acknowledged that a formula-based approach represents a change in the approach to setting the appropriate share, the Commission now turns to its explanation for the changed approach.

At the time the appropriate share was initially set in Docket No. RM2007–1, the postal regulatory system was undergoing substantial changes as a result of the enactment of the PAEA. In setting the appropriate share at 5.5 percent, the Commission selected an ''easily understood'' percentage based on competitive products' historical contribution to institutional costs

[17] *Id.* at 14–15; *see* FTC Report at 64. The FTC Report is discussed in more detail in section V, *infra.*

[18] Order No. 1449 at 16. The Postal Service would be engaging in predatory pricing if it set its competitive services' prices below their marginal costs. *See id.* at 15. However, the Commission found that the Postal Service's ability to engage in such behavior is effectively mitigated by 39 U.S.C. 3633(a)(2), which requires each competitive product to cover its attributable costs. *Id.* Moreover, the Commission observed that because the appropriate share requirement assigns a portion of the Postal Service's fixed costs to competitive products collectively, it effectively works to impose an additional level of protection against anti-competitive pricing by forcing the Postal Service to set prices at levels capable of generating sufficient revenue to cover those costs. *Id.*

[19] *Id.* at 21–22. The Commission determined that as a result of these transfers, total competitive revenue and volume had increased by 55.8 percent and 21.4 percent, respectively. *Id.* at 22. As a share of total volume, these transfers increased competitive products' share from 0.8 percent to 1.6 percent. *Id.* The Commission recognized the possibility that should competitive product volumes increase substantially in relation to market dominant volumes, the Commission could consider modifying the appropriate share ''under the right circumstances.'' *Id.* at 22–23.

[20] *Fed. Commc'n Comm'n* v. *Fox Television Stations, Inc.,* 556 U.S. 502 (2009). The Court reviewed this issue after the FCC expanded what could be considered actionably indecent language under 18 U.S.C. 1464 and then enforced the expanded policy, which was later challenged by broadcasters.

during the previous 2 fiscal years. Order No. 26 at 70, 73. The Commission was also ''mindful of the risks of setting [the appropriate share] too high, particularly at the outset of the new system of regulation.'' *Id.* at 73.

Five years later, in Docket No. RM2012–3, the Commission maintained the appropriate share at a static 5.5 percent. At that time, the Postal Service had only offered competitive products for 5 years. Without any evidence that the Postal Service was benefiting from a competitive advantage or that the market was not competitive, the Commission determined maintaining the appropriate share at 5.5 percent was the correct course. Order No. 1449 at 16–19.

Relevant circumstances have changed since the Commission's last review and over the 11 years since the enactment of the PAEA. The economy has recovered since the global financial crisis of the late 2000s, and no major dockets regarding the nature of postal services (*i.e.,* N cases) are currently pending before the Commission, as they were in Docket No. RM2012–3. As discussed in section IV.C, *infra,* the Postal Service's market share, competitive volumes, and competitive contribution as a percentage of institutional costs have increased steadily since 2007. As a result, the Commission determines that the static 5.5-percent appropriate share should be modified to better reflect the modern competitive market. Given that the Commission now has over 11 years of data related to competitive products, a formula-based approach that more directly, accurately, and frequently incorporates prevailing competitive conditions in the market and other relevant circumstances can be constructed and applied.

The proposed change in approach is also permissible under title 39. As noted above, 39 U.S.C. 3633(a)(3) provides that the Commission shall promulgate and periodically revise the regulations that ''ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.'' 39 U.S.C. 3633(a)(3). In addition, the Commission must review the appropriate share at least every 5 years, taking into consideration the three elements set forth in 39 U.S.C. 3633(b).[21] Section 3633(a)(3) establishes the Commission's authority related to setting the appropriate share, while subsection (b) outlines the frequency of the Commission's review of the appropriate share, as well as the elements the Commission must consider as part of its review.

The plain language of section 3633 reflects an express delegation of authority to the Commission, by Congress, to determine what share of institutional costs is appropriate for competitive products to cover. Furthermore, Congress intended for the Commission to have flexibility with regard to the use of a specific approach.[22] The statute does not require the Commission to use any specific approach. The only limitation that is placed on the Commission's determination is that it must consider the three distinct elements described in section 3633(b). Section 3633(b) also plainly contemplates that the appropriate share could change because it specifies that the Commission should determine if the appropriate share should be retained, modified, or eliminated in each review pursuant to section 3633(b).

Although there is no committee or conference report issued for the bill that was enacted into law, the legislative history underlying the PAEA confirms the plain meaning interpretation of section 3633. The PAEA was the product of blending different versions of postal reform legislation authored by the House of Representatives and the Senate. Drafts between 2000 and 2005 all included the same conflicting language: House versions of the bill would have required competitive products to make ''a reasonable contribution'' to institutional costs, while Senate versions of the bill would have required competitive products to cover ''their share'' of institutional costs.[23]

The committee report accompanying H.R. 22, the House of Representatives' 2005 postal reform bill, noted that ''the requirement that competitive products collectively make a reasonable contribution to overhead'' was a ''broad standard'' which contained ''inherent flexibility,'' and that the standard was ''not intended to dictate a particular approach that the [Commission] should follow.''[24] Although S. 2468, the Senate's 2004 postal reform bill, used the phrase ''their share,'' the accompanying committee report explained that for the attribution of competitive product costs, including institutional costs, ''the technical decision of what cost analysis methodologies are sufficiently reliable at any given time to form the basis for attribution should be left to the [Commission].''[25] Both committee reports imply that the House and the Senate intended to provide the Commission with some decision-making flexibility with regard to the chosen approach. The blended result of these versions reflected the common view of substantial Commission discretion, with the PAEA's requirement that ''all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.'' *See* 39 U.S.C. 3633(a)(3).

Below, the Commission discusses the two major components of its proposed formula-based approach, explains all other terms in the formula, and describes how the formula would function in order to calculate the appropriate share. Following that, the Commission addresses how its formula-based approach satisfies the elements of section 3633(b).

B. Formula-Based Approach

As indicated above, due to changes in the market and an increase in the availability and accessibility of information over the last 11 years, the Commission is proposing the regular application of a formula-based approach to setting the appropriate share. This approach uses two components to annually capture changes in the market and the Postal Service's position in that market: the Postal Service Lerner Index and the Competitive Market Output.

1. Postal Service Lerner Index

Section 3633(b) requires the Commission to consider ''the prevailing competitive conditions in the market''

[21] *See* 39 U.S.C. 3633(b). The frequency of Commission review was first addressed in Docket No. RM2012–3, where the Commission stated that its ability to review the appropriate share more frequently than every 5 years allows the Commission to modify the appropriate share when there is a relevant change in circumstances. Docket No. RM2012–3, Order Granting, in Part, Motion of the Parcel Shippers Association to Extend the Period for Comments, March 7, 2012, at 4 (Order No. 1276).

[22] The Commission's view with regard to the level of flexibility intended by Congress is echoed by the Public Representative. In comparing various versions of the legislation that ultimately became the PAEA, the Public Representative states that ''although the earlier standard was revised from 'reasonable contribution' to 'appropriate share,' it is fair to conclude the drafters did not intend for the Commission to follow a particular approach when establishing the contribution standard.'' PR Comments at 5. Several other commenters use their views of Congress's intent and the legislative history to support their positions. *See, e.g.,* Postal Service Comments at 2–4; Panzar Decl. at 3–5; UPS Reply Comments at 6–8, 12–13; Sidak Reply Decl. at 7–10.

[23] *See, e.g.,* H.R. 4341, 108th Cong. at 15 (2004); S. 2468, 108th Cong. at 121 (2004); S. 662, 109th Cong. at 145 (2005).

[24] H.R. Rep. No. 109–66, pt. 1, at 49 (2005); *see* H.R. 22, 109th Cong. (2005).

[25] S. Rep. No. 108–318 at 9 (2004); S. 2468, 108th Cong. at 121 (2004).

as part of its review of the appropriate share. 39 U.S.C. 3633(b). The prior Commission decision relating to this requirement focused on a number of considerations, including: existence (or nonexistence) of evidence suggesting the Postal Service has benefitted from a competitive advantage with respect to its competitive products, changes to the Postal Service's market share since the previous review, and changes to the competitive market and Postal Service's competitors since the previous review. *See* section III.B.2, *supra.* Each consideration is directed at ascertaining the Postal Service's market power in the competitive market.[26]

Market power arises when a competitor in the market: (1) Can profitably set prices well above its costs and (2) enjoys some protection against entry or expansion by other competitors that would normally erode such prices and profits.[27] With the enactment of the PAEA, Congress sought to ensure a ''level playing field'' between the Postal Service and its competitors as a means of preserving competition.[28] Evaluating market power allows the Commission to assess whether competition is being preserved and whether the Postal Service possesses a competitive advantage.

In previous reviews, the Commission analyzed prevailing competitive conditions in the market and ascertained the Postal Service's market power using a qualitative approach. However, an alternative method of gauging the Postal Service's market power is quantitatively through a Lerner index.

A Lerner index measures market power for a given firm by measuring how far that firm's price is from its marginal cost, which is the cost of producing one additional good at a given level of volume.[29] Effectively, a Lerner index measures the profitability of an individual firm. As a firm's marginal cost increases relative to its price, the Lerner index will decrease, indicating that the firm's price is closer to marginal cost, and the firm possesses less market power. As a firm increases its price relative to its marginal cost, the Lerner index will increase, indicating that the firm is pricing further from marginal cost and possesses more market power. Thus, a Lerner index is a useful tool for measuring market power because it reflects the extent to which a firm is pricing above marginal costs.

The equation below represents the formula for a general Lerner index: [30]

$$Lerner\ Index = \frac{Price - Marginal\ Cost}{Price}$$

Because the Postal Service is a multi-product firm, it does not have a single marginal cost and price; rather, it consists of many products, each with its own marginal cost and set of prices. Therefore, to create a Lerner index specific to the Postal Service's competitive products, the general formula must be adapted to capture all competitive products. To do so, the Commission develops a Lerner index for the Postal Service's competitive products as a whole using the average unit volume-variable cost and revenue-per-piece for all competitive mail, as described below.

For the marginal cost variable, marginal cost data for the Postal Service are available through the Postal Service's Cost and Revenue Analysis (CRA) report.[31] The Postal Service submits the CRA report each year as part of its Annual Compliance Report (ACR), and the Commission uses the CRA as an input to its Postal Service Product Finances analysis (PFA), which the Commission produces every year as part of its Annual Compliance Determination (ACD).[32] The CRA calculates marginal costs using volume-variable costs. The volume-variable costs of the Postal Service are the costs of specific Postal Service operations (*e.g.,* mail processing, delivery), which vary with respect to the operation's cost driver (*e.g.,* volume, weight).[33] These volume-variable costs are then distributed to Postal Service products. *Id.* at 11–13. Dividing the total volume-variable cost of a product by the product's volume results in unit volume-variable costs, which are equivalent to marginal costs.[34] Applying this methodology, the Commission divides the sum of all competitive product volume-variable costs in the PFA by the sum of all competitive product volume to calculate competitive product unit volume-variable cost.

[26] It is important to note that the role of market power under section 3633(b) is similar to, but distinct from, the market power analysis that the Commission conducts under section 3642 of the PAEA. Under section 3642, the Commission is required to determine if an individual product should be classified as market dominant by considering whether ''the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products.'' 39 U.S.C. 3642(b)(1). The analysis that the Commission conducts in such cases involves identifying a relevant market for the product in question and then identifying reasonably interchangeable substitutes for that product. *See, e.g.,* Docket No. MC2013–57 and CP2013–75, Order Denying Request, December 23, 2014 (Order No. 2306); Docket No. MC2015–7, Order Denying Transfer of First-Class Mail Parcels to the Competitive Product Category, August 26, 2015 (Order No. 2686), *remanded,* 842 F.3d 1271 (D.C. Cir. 2016); Docket No. MC2015–7, Order Conditionally Approving Transfer, July 20, 2017 (Order No. 4009).

The role of market power under section 3633(b) is focused not on whether the Postal Service would face effective competition in the offering of a single product, but on the Postal Service's level of market power in offering competitive products generally. As such, it requires a broader view of market power than the inquiry under section 3642.

[27] Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law, Vol. IIB, at 109 (4th ed. 2014) (Areeda & Hovenkamp).

[28] *See, e.g.,* H.R. Rep. No. 109–66 at 44 (''Under the [PAEA], the Postal Service will compete on a level playing field, under many of the same terms and conditions as faced by its private sector competitors . . . .''); S. Rep. No. 108–318 at 27 (2004) (''[S]teps need to be taken to level the playing field between the Postal Service and its competitors in the competitive product market.'').

[29] *See* Jeffrey Church & Roger Ware, Industrial Organization: A Strategic Approach 29 (2000) (Church & Ware), available at: *https://works.bepress.com/jeffrey_church/23/.*

[30] The mathematical development of this index may be found in Church & Ware. *See* Church & Ware at 31–36.

[31] *See, e.g.,* Docket No. ACR2016, Library Reference USPS–FY16–1, December 29, 2016. For most firms, marginal cost data are not ordinarily available, limiting the ability to calculate a Lerner index to estimate a given firm's market power. Dennis W. Carlton & Jeffrey M. Perloff, Modern Industrial Organization 278 (4th ed. 2005) (Carlton & Perloff).

[32] *See* 39 U.S.C. 3652 and 3653; *see also, e.g.,* USPS–FY16–1; Docket No. ACR2016, Library Reference PRC–LR–ACR2016/1, March 28, 2017. The PFA is also frequently referred to in ACR dockets as PRC Library Reference 1.

[33] John C. Panzar, The Role of Costs for Postal Regulation, September 30, 2014, at 9–10, available at: *https://www.prc.gov/sites/default/files/reports/J%20Panzar%20Final%20093014.pdf.* The cost driver reflects the unit of a particular operational activity that causes change in the activity's cost. *Id.* at 11–12. For example, the cost driver for highway transportation is cubic-foot-miles, because the relevant variable that would change costs for this activity is the amount of space taken up by mail on trucks, and hence how many trucks are required to transport it. *Id.*

[34] *Id.* at 14–15; *see also* United States Postal Service, Rule 39 CFR Section 3050.60(f) Report for Fiscal Year 2016, July 3, 2017, Appendix H.

For the price variable, the Commission uses average revenue-per-piece, which incorporates all of the prices for all competitive products. The PFA presents revenue data by product. The Commission divides the sum of all competitive product revenue by the sum of all competitive product volume to calculate competitive product revenue-per-piece.

The formula for calculating a Lerner index specific to the Postal Service's competitive products is:

$$\textit{Postal Service Lerner Index} = \frac{\textit{Revenue-per-Piece} - \textit{Unit Volume-Variable Cost}}{\textit{Revenue-per-Piece}}$$

The Postal Service Lerner Index, as well as the year-over-year percentage change in the Index, is reported for FY 2007 through FY 2017 in Table IV–1 below.[35]

TABLE IV–1—POSTAL SERVICE LERNER INDEX, FY 2007–FY 2017 [36]

Fiscal year	Lerner index	Percentage change in lerner index
FY 2007	0.228	N/A
FY 2008	0.217	−5.1
FY 2009	0.251	15.9
FY 2010	0.298	18.6
FY 2011	0.276	−7.3
FY 2012	0.275	−0.3
FY 2013	0.290	5.4
FY 2014	0.292	0.8
FY 2015	0.284	−2.7
FY 2016	0.332	16.6
FY 2017	0.356	7.5

A typical Lerner index ranges from 0 to 1.[37] At 0, revenue-per-piece equals unit volume-variable cost, which represents a perfectly competitive environment in which a firm makes no profit. Thus, Lerner index numbers close to 0 are evidence of highly competitive environments. The further a firm's Lerner index shifts away from 0 and towards 1, the more market power that firm possesses.[38] Network industries, including the delivery industry in which the Postal Service competes, contain significant barriers to entering the market.[39] These barriers prevent perfect competition, and firms within a network industry naturally possess some degree of market power. As a result, Lerner index values in excess of 0 should be expected for the Postal Service.

As shown in Table IV–1, the Postal Service Lerner Index has increased from 0.228 in FY 2007 to 0.356 in FY 2017. Within this time period, there have been some relatively large year-over-year shifts, particularly in FY 2009, FY 2010, and FY 2016. These likely reflect the effects of the global financial crisis of the late 2000's and changes in market demand.

The global financial crisis of the late 2000's constituted a severe economic shock and reduced consumer demand. Reductions in consumer demand for Postal Service competitive products in FY 2009 were a significant factor in decreasing the Postal Service's competitive volume, and therefore its revenue and costs. These volume losses were disproportionately concentrated in categories with unit contributions below the average for competitive products. As a result, the average unit contribution of competitive mail increased, which resulted in the increase in the Postal Service Lerner Index.

As the economy recovered from the global financial crisis of the late 2000's, demand increased and as a result the Postal Service's competitive volume, revenue, and costs increased in FY 2010. The Postal Service also exercised its pricing flexibility under PAEA, and its use of pricing innovations such as competitive negotiated service agreements and flat-rate pricing contributed to a large increase in the average unit contribution of competitive mail. The increase in unit contribution outpaced the increase in average unit revenue, leading to an increase in the Postal Service Lerner Index in FY 2010.

In FY 2016, the volume of USPS Ground[40] products increased. These products have a relatively low unit volume-variable cost, so the increase in their volume was a primary cause for decreased unit volume-variable costs for competitive products as a whole. This decrease in unit volume-variable costs, combined with a much smaller decrease in average unit revenue, resulted in an increase in the Postal Service Lerner Index.

The Postal Service Lerner Index suggests that the Postal Service's market power has grown over the last 10 years. This growth, however, did not necessarily occur at the expense of the Postal Service's competitors. It is possible that the Postal Service's competitors have experienced similar growth in market power, due to the fact that overall demand for competitive delivery has increased dramatically over the last 10 years. In order to put the Postal Service's market power in context relative to the market as a whole, the Commission uses the Competitive Market Output in the formula, which captures the overall size of the competitive market in which the Postal Service operates.

2. Competitive Market Output

While the Postal Service Lerner Index measures the Postal Service's market power in the competitive market, the second component of the Commission's formula, the Competitive Market Output, measures the overall size of the competitive market.

Evaluating the overall size of the market provides context for assessing prevailing competitive conditions. Capturing the overall size of the competitive market is also important because the Postal Service's ability to increase contribution for competitive products should increase when the competitive market grows and decrease when the competitive market shrinks. The appropriate share should balance

[35] The FY 2007 PFA did not report volume-variable costs for all competitive products due to the market dominant and competitive product classifications not being finalized. For FY 2007, the Commission uses attributable cost less product-specific costs for Priority Mail, Express Mail, and Competitive International Mail to approximate volume-variable costs.

[36] Source: Library Reference PRC–LR–RM2017–1/1. Postal Service Lerner Index values are rounded to the thousandths place. The ''Percentage Change in Lerner Index'' column is based on unrounded figures, reported in PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017. *See* 39 U.S.C. 3653.

[37] As discussed in section IV.C.1.a, *infra,* index values less than 0 may indicate a firm is engaging in predatory pricing.

[38] F.M. Scherer & David Ross, Industrial Market Structure and Economic Performance 70–71 (3d ed. 1990).

[39] Network industries are industries with cost advantages arising from handling products together, whether large amounts of the same product (economies of scale), or several different products (economies of scope). *See* United States Postal Service Office of Inspector General, Risk Analysis Research Center, Report No. RARC–WP12–008, A Primer on Postal Costing Issues, March 20, 2012, at 2–3, available at: *https://www.uspsoig.gov/sites/default/files/document-library-files/2015/rarc-wp-12-008_0.pdf.*

[40] USPS Ground is a CRA classification that is used to identify Retail Ground, Parcel Select, and Parcel Return Service.

the Postal Service's ability to increase contribution in a growing market with the need to adjust for the realities of a declining market. Therefore, capturing the overall size of the competitive market is an important part of the appropriate share formula.

In order to measure the size of the competitive market, it is first necessary to define what the competitive market encompasses. For this appropriate share analysis, the competitive market encompasses two groups. The first group is the Postal Service's competitive products. As noted above, under the PAEA, Postal Service competitive products are any products that do not fall within the market dominant product definition. *See* section I, *supra; see also* 39 U.S.C. 3642(b)(1).

The second group is ''similar products'' offered by the Postal Service's competitors. This group excludes any competitors' products that the Postal Service does not actually compete with. For example, the Postal Service does not accept parcels weighing more than 70 pounds, so competitors' parcels over 70 pounds are excluded from the competitive market definition.[41]

Each of these groups has its own corresponding data source, and the two are combined to calculate the overall size of the competitive market.[42] The Commission determines that revenue, rather than volume, is the better measure of the overall size of the competitive market. Therefore, the data sources for both groups are revenue-based. Revenue data for both the Postal Service's competitive products and competitors offering similar products are directly comparable, as they constitute the value of all transactions. In contrast, volume data would have to be adjusted for intra-industry transactions. The revenue data are also available for all firms in the relevant market, whereas volume data for the Postal Service's competitors is unavailable.

For the revenue of Postal Service's competitive products, the Commission uses the PFA. For the revenue of Postal Service's competitors offering similar products, the Commission uses data obtained from two surveys conducted by the United States Census Bureau: The Quarterly Services Survey (QSS) and the Services Annual Survey (SAS).

a. PFA Data

To measure the Postal Service's competitive product revenue, the Commission uses the total competitive revenue reported in the PFA. These data are shown in Table IV–2 below.

TABLE IV–2—POSTAL SERVICE COMPETITIVE PRODUCT REVENUE, FY 2007–FY 2017 [43]

Fiscal year	Revenue (in millions)
FY 2007	$7,909
FY 2008	8,382
FY 2009	8,132
FY 2010	8,677
FY 2011	8,990
FY 2012	11,426
FY 2013	13,741
FY 2014	15,280
FY 2015	16,428
FY 2016	18,495
FY 2017	20,690

b. QSS/SAS Data

Revenue data for competitors offering similar products is obtained from the QSS and SAS. The QSS is a survey conducted by the United States Census Bureau to estimate operating revenues for each service sector of the economy. Revenue data are classified by subsector, with the relevant subsector in this case being North American Industry Classification System (NAICS) Code 492—''Couriers and Messengers.'' [44] The QSS provides data on a quarterly basis, which can be combined to correspond with the Postal Service's fiscal years. However, quarterly data are not available for FY 2007, FY 2008, or part of FY 2009.[45] As these data are necessary to incorporate all of the changes in the market's size since FY 2007, the Commission uses calendar year data from the SAS as a proxy for those fiscal years. The SAS is a survey conducted by the United States Census Bureau to calculate revenues, expenses, and other economic indicators for industries on a calendar year basis. For years where both QSS and SAS data are available, the sum of four quarters of QSS data are consistently 5 or 6 percent lower than the SAS data, as shown in Table IV–3 below.

[41] Domestic Mail Manual (DMM) section 3.2, available at: *https://pe.usps.com/text/dmm300/101.htm#ep1034246* (last accessed Feb. 1, 2018).

[42] This market definition effectively covers both last-mile and end-to-end deliveries of mail outside the market dominant system. ''Last-mile'' delivery is delivery from a firm's processing facility to the end recipient. The Postal Service routinely contracts with its competitors to provide such service, delivering competitive pieces that were entered with other firms to their end recipients. This contrasts with ''end-to-end'' service, in which one firm handles a mailpiece from acceptance to delivery, including ''last-mile'' delivery. Firms other than the Postal Service also provide last-mile delivery services.

[43] Source: PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

[44] NAICS is a classification system developed by the Office of Management and Budget within the Executive Office of the President of the United States. It is designed to classify business establishments by type of activity performed for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. NAICS Code 492 encompasses all parcel delivery by firms without a universal service obligation (USO).

[45] Quarterly data are only available beginning Calendar Year (CY) 2009, which excludes the first quarter of FY 2009. Data for Quarter 1 of FY 2009 is unavailable because this quarter took place in CY 2008 when the QSS did not survey this sector.

Table IV-3
Comparison of QSS and SAS Revenue Data for NAICS Code 492[46]

Calendar Year	SAS Data	Sum of QSS Data	Proportionate Difference ($\frac{QSS}{SAS}$)
2009	$68,166	$64,429	0.95
2010	$67,620	$63,855	0.94
2011	$71,692	$67,947	0.95
2012	$73,136	$69,362	0.95
2013	$75,406	$71,570	0.95
2014	$79,158	$75,118	0.95
2015	$82,698	$78,424	0.95
2016	$87,596	$81,919	0.94
Total	$605,472	$572,624	0.95

These differences are primarily due to sampling differences between the QSS and SAS and seasonality adjustments made in the SAS.[47] Absent any adjustment, the Competitive Market Output for FY 2007, FY 2008, and FY 2009 would not be comparable to subsequent years. This would result in an apparent decline in Competitive Market Output from FY 2009 to FY 2010 that is primarily due to differences between the SAS and QSS data methodologies, rather than a real change in the market. As a result, an adjustment to account for these differences is needed for FY 2007, FY 2008, and FY 2009. The Commission reduces the SAS data for CY 2007, CY 2008, and CY 2009 by 5 percent in order to align the SAS data with the QSS data. The Commission uses the adjusted SAS data from those calendar years for the corresponding fiscal years of the Postal Service, and it sums the quarterly QSS data from FY 2010 to FY 2016 by Postal Service fiscal year to align the QSS data with the PFA data. These revenue data are displayed in Table IV–4 below.

TABLE IV–4—COMPETITOR REVENUE FROM SIMILAR PRODUCTS, FY 2007—FY 2017 [48]

Fiscal year	Revenue (in millions)
FY 2007	$77,710
FY 2008	75,956
FY 2009	64,468
FY 2010	63,359
FY 2011	66,871
FY 2012	69,270
FY 2013	70,958
FY 2014	73,359
FY 2015	78,001
FY 2016	80,746
FY 2017	84,825

c. Combined Competitive Market Output Data

The PFA data and QSS/SAS data are combined to produce the Competitive Market Output. This information, along with the year-over-year percentage change in the Competitive Market Output, is reported in Table IV–5 below.

TABLE IV–5—COMPETITIVE MARKET OUTPUT, FY 2007—FY 2017 [49]

Fiscal year	Postal Service competitive product revenue (in millions)	Competitor revenue from similar products (in millions)	Competitive market output (in millions)	Percentage change in competitive market output
FY 2007	$7,909	$77,710	$85,619	N/A
FY 2008	8,382	75,956	84,338	−1.5
FY 2009	8,132	64,468	72,600	−13.9
FY 2010	8,677	63,359	72,036	−0.8
FY 2011	8,990	66,871	75,861	5.3
FY 2012	11,426	69,270	80,696	6.4
FY 2013	13,741	70,958	84,699	5.0
FY 2014	15,280	73,359	88,639	4.7
FY 2015	16,428	78,001	94,429	6.5
FY 2016	18,495	80,746	99,241	5.1
FY 2017	20,690	84,825	105,515	6.3

Table IV–5 illustrates that the Competitive Market Output data follow broad economic trends, declining from FY 2008 to FY 2010 during the global financial crisis of the late 2000s and increasing thereafter. However, Postal Service's revenue increased by a greater percentage than its competitors' revenue, due, in part, to its use of pricing flexibility, including the introduction of flat-rate pricing and negotiated service agreements between

[46] Source: PRC–LR–RM2017–1/1.

[47] The methodologies of the QSS and SAS surveys can be contrasted at *https://www.census.gov/services/sas/sastechdoc.html* and *https://www.census.gov/services/qss/qsstechdoc.html.*

[48] Source: PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

[49] *Source:* PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

FY 2008 and FY 2011. Several transfers of market dominant products to the competitive product category from FY 2010 to FY 2014 also contributed to the increases in the Postal Service's competitive product revenue between FY 2011 and FY 2015.[50]

3. Resulting Formula

With the two components discussed above, the Commission proposes to calculate the appropriate share using the following formula:[51]

$AS_{t+1} = AS_t * (1 + \%\Delta LI_{t-1} + \%\Delta CMO_{t-1})$

If $t = 0 = FY\ 2007$, $AS = 5.5\%$

Where

AS = Appropriate Share[52]
LI = Postal Service Lerner Index
CMO = Competitive Market Output
t = Fiscal Year

The Postal Service Lerner Index and Competitive Market Output are given equal weight in the calculation because the Commission considers both to carry equal importance in assessing the appropriate share of institutional costs. This is because it is necessary to balance changes in the competitive market with changes in the Postal Service's market power.

The Commission proposes to adjust the appropriate share annually by using the formula to calculate the minimum appropriate share for the upcoming fiscal year. Because the data necessary to calculate the minimum appropriate share for an upcoming fiscal year (which begins each October 1st) are not final until the most recent ACD is issued (typically at the end of March), the Commission proposes to report the new appropriate share level for the upcoming fiscal year as part of its ACD. The adjusted appropriate share would then be applicable for the upcoming fiscal year.[53] In order to calculate an upcoming fiscal year's appropriate share percentage (AS_{t+1}, the formula multiplies the sum of the percentage changes in the Postal Service Lerner Index and the Competitive Market Output from the previous fiscal years[54] $(1 + \%\Delta LI_{t-1} + \neq\Delta CMO_{t-1})$ by the current fiscal year's appropriate share (AS_t).[55]

This formula is recursive in order to fully incorporate changes in the Postal Service's market power and the overall market size from year to year.[56] By using the current fiscal year's appropriate share in the calculation of the next fiscal year's appropriate share, this formula includes the cumulative effects on the appropriate share from prior fiscal years. Using data from the prior fiscal year improves the predictability of the appropriate share formula and mitigates the effects of outlier years by incorporating them only after the effects of the outlier year have been reflected in the market.[57] The formula simplifies the planning process for the Postal Service and mailers because parties would know months before the start of a fiscal year what the appropriate share for that fiscal year will be.

As an example of how the formula functions, if the current year appropriate share is 5.5 percent, the Postal Service Lerner Index grew by 6 percent in the prior year, and Competitive Market Output declined by 3 percent in the prior year, the appropriate share for the next year is calculated as follows:

Appropriate Share = 5.5% * (1 + .06 = .03) = 5.57%

Under this scenario, the next year's appropriate share would be 5.7 percent. As noted above, this result will be the starting point for calculating the appropriate share for the following year.

Using 5.7 percent as the starting point for calculating the appropriate share for the following year, if the Postal Service Lerner Index grew by 2 percent and Competitive Market Output grew by 3 percent, then the calculation would be:

Appropriate Share = 5.7% * (1 + .02 = .03) = 6.0%

Under this scenario, the next year's appropriate share would be 6.0 percent and would become the starting point for calculating the appropriate share for the next year.

In order to calculate the appropriate share for future years, the Commission must first establish the beginning appropriate share percentage for the calculation, as well as the beginning fiscal year. In the terminology of the formula, this means defining the starting value of *AS* and *t*.

The Commission sets the beginning appropriate share level for the formula at 5.5 percent because that was the initial appropriate share set in FY 2007. As noted above in section III, the initial appropriate share of 5.5 percent was based on historical contribution levels, as well as the consideration that setting the appropriate share too high would create risks for the Postal Service.

The Commission would begin the formula calculation starting in FY 2007, calculating each subsequent fiscal year's appropriate share. This would ensure that the appropriate share fully reflects changes in the market since the PAEA was enacted. As discussed above, prevailing competitive conditions in the market and market uncertainties, as measured by the Postal Service's market power and the overall size of the market, have changed since FY 2007. Using FY 2007 as a starting point (*i.e.,* the initial *t* value) would allow the appropriate share to reflect the prevailing market conditions as they

[50] *See* Docket No. MC2010–20, Order Approving Request to Transfer Selected Post Office Box Service Locations to the Competitive Product List, June 17, 2010, at 16 (Order No. 473); Docket No. MC2010–36, Order Conditionally Granting Request to Transfer Commercial Standard Mail Parcels to the Competitive Product List, March 2, 2011, at 20 (Order No. 689); Docket No. MC2011–25, Order Approving Request to Transfer Additional Post Office Box Service Locations to the Competitive Product List, July 29, 2011, at 14–15 (Order No. 780); Docket No. CP2012–2, Order Approving Changes in Rates of General Applicability for Competitive Products, December 21, 2011, at 13 (Order No. 1062); Docket No. MC2012–13, Order Conditionally Granting Request to Transfer Parcel Post to the Competitive Product List, July 20, 2012, at 14 (Order No. 1411); Docket No. MC2012–44, Order Approving Request for Product List Transfer, September 10, 2012, at 9 (Order No. 1461); Docket No. MC2014–28, Order Approving Product List Transfer, August 19, 2014, at 8–9 (Order No. 2160).

[51] The mathematical structure of this formula, *i.e.,* multiplying a base percentage by the sum of factors, is common in regulated industries, particularly in developing price caps. *See* James Ming Chen, *Price-Level Regulation and Its Reform,* 99 Marq. L.R. 931, 944 (2016), available at: *http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=5295&context=mulr*.

[52] This figure would be expressed as a percentage and rounded to one decimal place for simplicity and consistency with the Commission's past practice of expressing an appropriate share using only one decimal place.

[53] The Commission notes that, as its completion of the FY 2017 ACD is likely to occur prior to its issuance of a final rule in this docket, the first formula-based adjustment under this proposed rule may be announced in the final rule, as opposed to the Commission's FY 2017 ACD. After that, however, the Commission proposes that all future changes would be announced as part of each ACD.

[54] The "1 + " is a necessary mathematical concept for any percentage change formula in order to incorporate the pre-existing value being changed. *See* Jagdish Arya & Robin Lardner, Mathematical Analysis for Business and Economics 202–03 (2d ed. 1985).

[55] UPS advocates for a cost-based appropriate share. *See* UPS Comments at 34–37. The Commission notes that its formula is not directly based on costs, although Postal Service costs are incorporated into the formula through the use of unit volume-variable costs in the Postal Service Lerner Index. The Commission looks at the market as a whole pursuant to 39 U.S.C. 3633(b)'s directive to consider the prevailing competitive conditions in the market, which necessitates looking at factors beyond costs to determine the appropriate share.

[56] A recursive formula is a formula where a previous term is used to calculate the next term in the sequence.

[57] Year-over-year data would not be available for contemporaneous calculation of the appropriate share. For the Competitive Market Output, QSS data are only available in November, after the end of a Postal Service fiscal year. For the Postal Service Lerner Index, data are only available when the Postal Service files the CRA as part of its ACR at the end of each calendar year, and only final when the Commission issues the ACD no later than 90 days afterwards. *See* 39 U.S.C. 3652 and 3653. As an example, the appropriate share for FY 2018 would be calculated using FY 2016 data for the Postal Service Lerner Index and Competitive Market Output.

have developed over time since the PAEA's enactment.

Table IV–6 below illustrates the application of the formula starting with an appropriate share of 5.5 percent in FY 2007.

TABLE IV–6—CALCULATION OF APPROPRIATE SHARE, FY 2007—FY 2019 [58]

Fiscal year	Appropriate share for the current year $(AS)_t$ (%)	Percentage change in Lerner index for the prior year ($\%\Delta LI_{t-1}$)	Percentage change in Competitive Market Output for the prior year ($\%\Delta CMO_{t-1}$)	Appropriate share for the following Year (AS_{t+1}) (%)
FY 2007	5.5	N/A	N/A	5.5
FY 2008	5.5	0.0	0.0	5.5
FY 2009	5.5	−5.1	−1.5	5.1
FY 2010	5.1	15.9	−13.9	5.2
FY 2011	5.2	18.6	−0.8	6.1
FY 2012	6.1	−7.3	5.3	6.0
FY 2013	6.0	−0.3	6.4	6.4
FY 2014	6.4	5.4	5.0	7.1
FY 2015	7.1	0.8	4.7	7.5
FY 2016	7.5	−2.7	6.5	7.8
FY 2017	7.8	16.6	5.1	9.5
FY 2018	9.5	7.5	6.3	10.8

As demonstrated in Table IV–6, the formula and each resulting appropriate share percentage follow trends in the market. Additionally, Table IV–6 shows what the FY 2019 appropriate share under the proposed formula would be based on the preliminary numbers currently available. The Commission is reviewing the CRA provided by the Postal Service in pending Docket No. ACR2017.

C. Analysis Pursuant to 39 U.S.C. 3633(b)

In this section, the Commission explains how its proposed formula-based approach captures the prevailing competitive conditions in the market and other relevant circumstances as required by 39 U.S.C. 3633(b). In addition, the Commission discusses whether any costs classified as institutional under the Commission's costing methodology are uniquely or disproportionately associated with Postal Service competitive products, as required by 39 U.S.C. 3633(b).

1. Prevailing Competitive Conditions in the Market

In past appropriate share determinations, the Commission has identified specific market conditions that are indicative of the prevailing competitive conditions in the market: (1) The existence (or nonexistence) of evidence suggesting that the Postal Service has benefitted from a competitive advantage with respect to competitive products; (2) changes to the Postal Service's market share with respect to competitive products since the Commission's last review; and (3) changes to the package delivery market and to the Postal Service's competitors since the Commission's last review.[59]

The formula-based approach developed by the Commission captures the three specific market conditions that the Commission has considered in its previous appropriate share determinations.[60]

a. Postal Service Competitive Advantage

In analyzing evidence of competitive advantage on the part of the Postal Service, the Commission has previously looked to the FTC's report regarding whether the Postal Service's competitive products have a net competitive advantage, as well as evidence of predatory pricing by the Postal Service.[61]

The Commission discusses the FTC Report and its assessment of whether subsequent events have affected the FTC's findings in section V, *infra.* Although that analysis is the Commission's primary method for analyzing whether the Postal Service's competitive products have a competitive advantage, the Postal Service Lerner Index also provides insight. The higher the Postal Service Lerner Index, the more market power the Postal Service possesses, and sudden large increases may indicate a competitive advantage under certain circumstances. However, as previously explained, a Lerner index is not a zero-sum index. In growing markets, competitors may experience similar increases in their Lerner indices when the benefits of growth are distributed among competitors.[62]

The Postal Service Lerner Index also indicates whether the Postal Service is engaged in predatory pricing for its competitive products as a whole, because if such were the case then the index value would be negative.[63] By definition, predatory pricing involves a firm setting its prices below marginal cost in order to drive its competitors out of the market. Church & Ware at 659. In

[58] Source: PRC–LR–RM2017–1/1. The FY 2019 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

[59] *See* Order No. 26 at 69–74; Order No. 1449 at 13–19.

[60] The proposed formula captures each of these three specific market conditions, as discussed in more detail in the remainder of this section. However, in limited cases (*e.g.,* antitrust actions against the Postal Service), a purely qualitative factor previously considered as a market condition could not be explicitly captured through the Commission's proposed formula. Nevertheless, these qualitative factors are, for the most part, implicitly captured. For example, although antitrust actions against the Postal Service are not explicitly captured, changes in the Postal Service's market power may offer insight into whether the Postal Service is engaging in the kinds of anticompetitive behavior that would underlie an antitrust action. *See* Areeda & Hovenkamp at 107 (''Market structure and market power are often crucial in antitrust analysis.'').

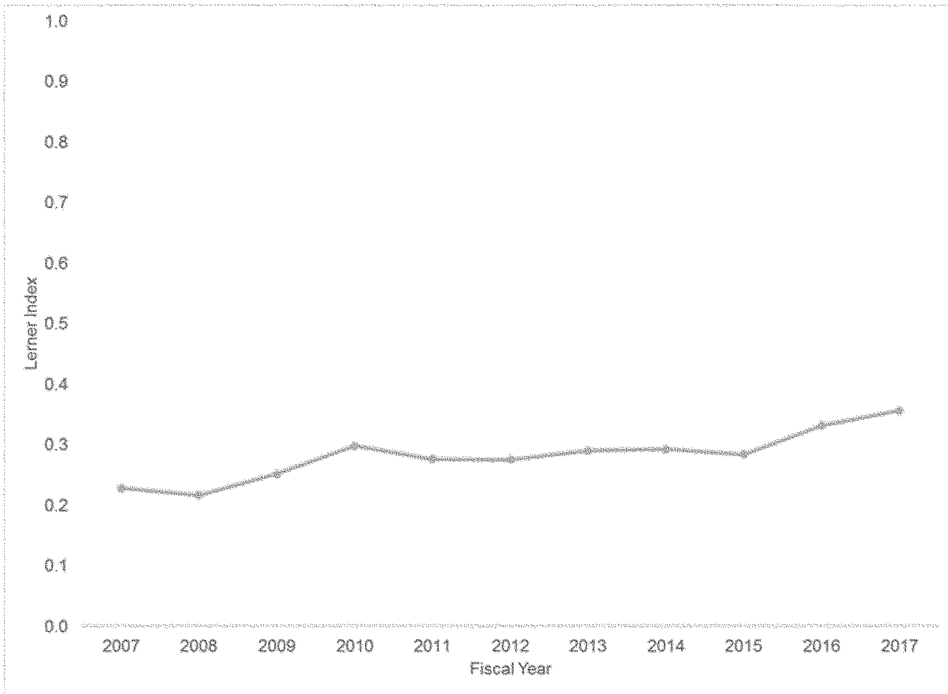
[61] *See* Order No. 1449 at 14–16. The Commission has also considered whether any antitrust actions had been filed against the Postal Service, as such actions may indicate a competitive advantage. The Commission was able to locate one antitrust action filed against the Postal Service, which did not involve competitive products and was dismissed in federal district court for not properly falling under 39 U.S.C. 409(e). *Tog, Inc.* v. *U.S. Postal Serv.,* No. 12–cv–01946–JLK, 2013 WL 3353883 (D. Colo. July 3, 2013). To the Commission's knowledge, no other antitrust actions have been filed against the Postal Service.

[62] The growing profits of the Postal Service's competitors demonstrate this. *See* PR Comments at 15–17; Amazon Comments at 23–28.

[63] While a negative Lerner index is mathematically possible, it is unlikely to be observed economically, because a firm with a negative Lerner index would be pricing below marginal cost and should therefore suspend production in the short run, and if cost or market characteristics do not change, exit the industry in the long run. *See* Steven E. Landsburg, Price Theory & Applications 277–80 (8th ed. 2011).

the Postal Service context, if unit volume-variable cost is greater than revenue-per-piece, then the difference between them will be less than zero; hence, the Postal Service Lerner Index will be negative.[64] Figure IV–1 below displays the Postal Service Lerner Index from FY 2007 to FY 2017.

Figure IV-1
Postal Service Competitive Lerner Index, FY 2007 – FY 2017[65]



As shown in Figure IV–1, the Postal Service Lerner Index has never been negative. Therefore, the Commission concludes that there is no evidence that the Postal Service has engaged in predatory pricing.[66] Developing the Postal Service's Lerner Index for use in an annual formula will provide an ongoing indication of whether or not the Postal Service is engaging in predatory pricing.

b. Postal Service Market Share

In analyzing changes to the Postal Service's market share, the Commission previously has looked to factors such as the Postal Service's revenue and volume share in the overall market. Order No. 1449 at 16–18. The Postal Service's market share can be directly calculated by dividing the Postal Service's competitive product revenue (shown in section IV.B.2.a, *supra*) by the total Competitive Market Output (shown in section IV.B.2.c, *supra*). The Postal Service's market share between FY 2007 and FY 2017 is reported in Figure IV–2 below.

[64] The Commission notes that the Postal Service's ability to engage in predatory pricing is also constrained by 39 U.S.C. 3633(a)(2), which requires that each of the Postal Service's competitive products ''covers its costs attributable.'' Under the Commission's costing methodology, marginal cost is the starting point for determining which costs are attributable to specific products. *See, e.g.,* Order No. 3506 at 41. The practical effect of this is to bar the Postal Service from pricing its products below marginal cost.

[65] Source: PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

[66] In their comments, Amazon, the Postal Service, the Public Representative, and Panzar all concur that there has been no evidence of predatory pricing by the Postal Service. *See* Amazon Comments at 32–33; Postal Service Comments at 10; PR Reply Comments at 3–5; Panzar Decl. at 6. No other commenter alleges that the Postal Service has engaged in predatory pricing.

Figure IV-2
The Postal Service's Revenue-Based Market Share, FY 2007 – FY 2017[67]

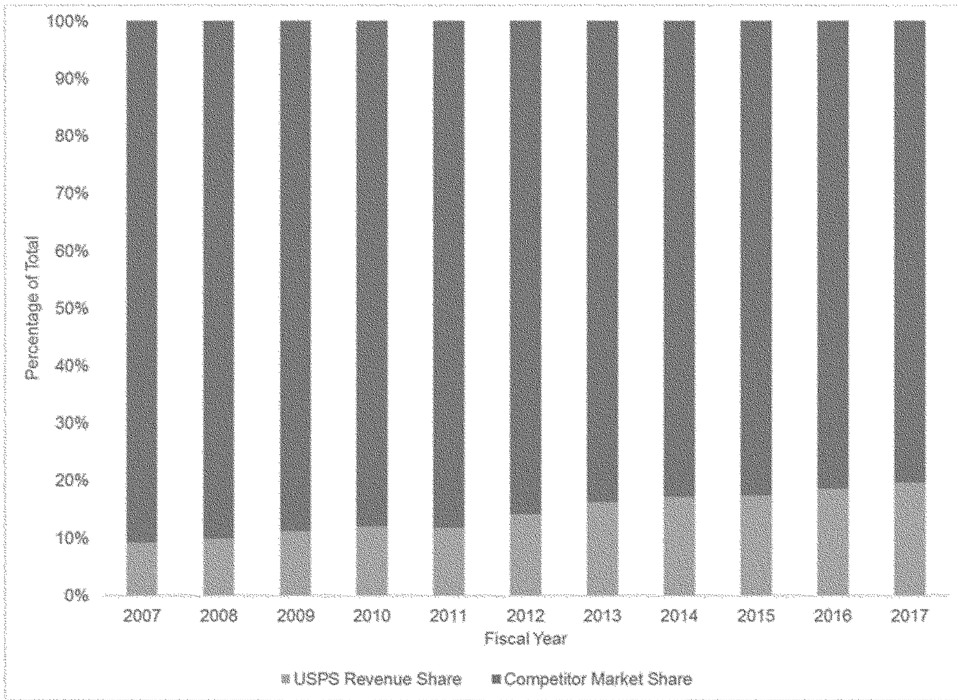


Figure IV–2 demonstrates that the Postal Service's revenue-based market share has grown since FY 2007 and that despite this growth, the Postal Service's overall market share remains relatively low.

The change in the Postal Service's market share by revenue would likely be reflected in both components of the Commission's proposed formula. If there were a large shift in revenue share between the Postal Service and competitors in the market, this would be reflected in the composition of the Competitive Market Output. Although the overall Competitive Market Output may not change dramatically, the numbers in the underlying calculation would reflect shifts between competitors and the Postal Service. If this revenue shift were to benefit the Postal Service, it would likely take the form of increased profitability, as the upward shift in revenue share would indicate increased demand for Postal Service deliveries. If the shift were to decrease the Postal Service's revenue, the Postal Service would likely experience a decrease in profitability. The Postal Service Lerner Index would reflect any increase or decrease in profitability that results from the changed prices due to increased or decreased demand for its products.

c. Changes to the Market and Competitors

In analyzing changes to the market and the competitors in it, the Commission has looked to such factors as growth in the overall market and firms entering or exiting the market. Order No. 1449 at 18–19. Overall growth in the market is directly reflected in the Competitive Market Output.

Both the Postal Service Lerner Index and Competitive Market Output reflect the entry and exit of firms from the market. If a firm enters the market and generates new business, the Competitive Market Output would increase. If a firm enters and takes business from the Postal Service, whether through pricing or innovation, the Postal Service would have to price closer to marginal cost in order to remain competitive, which would reduce the Postal Service Lerner Index. If a firm exits the market, the business it generated may be lost, which would be reflected in a decrease in the Competitive Market Output. Alternatively, the remaining competitors might alter their pricing strategies to gain that business, changing either the Postal Service Lerner Index or, depending on the nature of the pricing, the Competitive Market Output, or both.

2. Unique or Disproportionate Costs

The second element of section 3633(b) requires the Commission to consider "the degree to which any costs are uniquely or disproportionately associated with any competitive products." 39 U.S.C. 3633(b). In this section, the Commission first summarizes the comments and reply comments that relate to the Commission's costing methodology and then provides its analysis of the degree to which any costs are uniquely or disproportionately associated with any competitive products.

a. Relevant Comments

Commenters and reply commenters addressing the degree to which any costs are uniquely or disproportionately associated with competitive products and the Commission's costing methodology generally fall into two groups: (1) Those who allege the costing methodology is flawed and assert that it should result in an increased appropriate share and (2) those who contend the Commission's costing methodology is accurate and that there are no unique or disproportionate costs associated with competitive products that are not already attributed to competitive products.

[67] Source: PRC–LR–RM2017–1/. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

i. Comments Critical of Current Costing Methodology

UPS and Carlton allege a number of errors with the Commission's costing methodology as it relates to cost attribution. UPS asserts that ''[m]any costs currently classified as 'institutional' are 'uniquely or disproportionately associated with' competitive products.'' UPS Comments at 28. UPS takes the position that ''Congress saw the minimum contribution requirement as a means to ensure competitive products are held responsible for all costs with which they are 'disproportionately associated,' even when competitive products are not *exclusively* responsible for such costs.'' UPS Reply Comments at 17 (emphasis in original).

For example, UPS notes that most Postal Service management costs are classified as institutional. UPS Comments at 28–29. UPS asserts that, as competitive product volume increases relative to market dominant product volume, so too must the time and attention of management toward competitive products, and costs should be attributed accordingly. *Id.* UPS and Carlton also identify other cost categories as being attributable to competitive products, such as data processing supplies and services, inspection service field support, and building projects expenses.[68] UPS and Carlton maintain that these cost categories are largely treated as institutional, even though their cost would be reduced if the Postal Service did not deliver any competitive products.[69]

FUR and Sidak contend that the Postal Service has an incentive to attribute too many costs to market dominant products and too few to competitive products.[70] As a result, FUR asserts that ''a high degree of transparency and accuracy'' is needed. FUR Comments at 5. FUR is concerned that the methodology for assigning costs may not be accurate because the Postal Service attributes only about half of its costs, which they state invites inaccuracies and opportunity for cross-subsidization. *Id.* at 6, 13.

UPS and Carlton assert that the Commission's costing methodology incentivizes the Postal Service to operate with an inefficiently high level of fixed costs, which enables the Postal Service to provide competitive products at an artificially low marginal cost by limiting the percentage of overall costs which can be specifically attributed to competitive products.[71]

iI. Comments in Support of Current Costing Methodology

NAPM, MDMCS, and Amazon assert that this proceeding is the incorrect forum to address costing methodologies and that a separate docket should be opened if changes to cost models are needed.[72] Amazon, Panzar, and MDMCS point to the Commission's repeated invitations to stakeholders to file rulemaking proceedings if they believe existing cost attribution methods can be improved, and specifically to Docket No. RM2016–2, which was a UPS-petitioned rulemaking that explored these issues and resulted in a decrease of the share of total costs treated as institutional.[73]

NAPM ''disagree[s] with UPS's contention that the Postal Service's cost models are not transparent or accurate.'' NAPM Reply Comments at 2. Similarly, Amazon maintains that ''[t]he Commission has given the accuracy of its cost attribution methodology thorough scrutiny in costing rulemakings over the last decade.'' Amazon Reply Comments at 14. Panzar also echoes this, stating that the methodology used is the economically appropriate way to attribute costs. Panzar Reply Decl. at 3. The Postal Service denies the claim that its costing methodology fails to account for any costs which are properly attributable to individual products and explains that the costing system has been developed through public, adversarial proceedings. Postal Service Reply Comments at 30–32. Amazon asserts that UPS's contention that some institutional costs are caused by competitive products is supported by neither data nor evidence of a causal relationship. Amazon Reply Comments at 16–17.

b. Commission Analysis

As most recently discussed in Docket No. RM2016–2, the costing methodology employed by the Postal Service and the Commission is directed at determining those costs which are ''attributable to each class or type of mail service through reliably identified causal relationships.'' Order No. 3506 at 14. The requirement that cost attribution must be based on reliably identified causal relationships comes directly from section 3622 of the PAEA. *See* 39 U.S.C. 3622(c)(2). Any cost that cannot be specifically attributed to an individual product is considered a residual or institutional cost. Order No. 3506 at 10.

The Commission finds that there are no costs uniquely or disproportionately associated with competitive products that are not already attributed to competitive products. Under the Commission's methodology, any cost that is uniquely or disproportionately associated with any competitive product is identified as an attributable cost because it exhibits a reliably identifiable causal relationship with a specific competitive product. With regard to costs that are disproportionately associated with competitive products, the Commission's cost attribution methodology identifies relationships between costs and cost drivers, which include mail characteristics such as weight and shape (*e.g.,* letters or parcels). The costs associated with a cost driver are distributed to products in proportion to the prevalence of the driver within each product. For example, heavier products (*e.g.,* parcels) have more weight-driven costs attributed to them than lighter products (*e.g.,* letters). In this way, the costs attributed to products reflect any disproportionate association of those costs with any specific products (including any competitive products).

Under the Commission's methodology, the Commission also classifies any cost that is uniquely associated with any product (including any competitive product) as attributable to that product. These costs are often referred to as product-specific costs. For example, advertisements for a specific product and supplies for money orders are unique costs attributed to specific products under the Commission's methodology.

By definition, costs identified as institutional are those that cannot be causally linked to any specific product. Although UPS asserts that certain institutional costs are disproportionately associated with competitive products, UPS fails to provide any evidence of reliably identified causal relationships between the institutional costs it identifies and specific competitive products. For example, UPS states that the vast majority of management costs are treated as institutional, and it asserts that ''[Postal Service] management is clearly focused today on growing the competitive products business.'' UPS Comments at 28. In support, UPS quotes two news articles and an industry publication, which indicate the Postal

[68] UPS Reply Comments at 15 (citing Carlton Reply Decl. at 21–23); Carlton Reply Decl. at 22–23.

[69] UPS Reply Comments at 15–16; Carlton Reply Decl. at 22–23.

[70] FUR Comments at 5; Sidak Decl. at 12–14.

[71] Carlton Reply Decl. at 12; UPS Reply Comments at 10.

[72] NAPM Reply Comments at 3; MDMCS Reply Comments at 2–3; Amazon Reply Comments at 14–15.

[73] *See id.* at 14–15, 18; Panzar Reply Decl. at 4; MDMCS Reply Comments at 3.

Service is interested in competitive product growth but provide no evidence that management costs are disproportionately associated with competitive products through reliably identified causal relationships. *Id.* at 28–29. To the extent UPS or any other party is able to demonstrate that costs currently classified as institutional can be clearly linked to specific products through reliably identified causal relationships, the Commission invites a petition for rulemaking proposing changes to its methodology in a separate proceeding. In addition to inviting petitions for rulemaking on these issues, the Commission, as it has done in the past, continues to invite public participation and scrutiny in proceedings that propose changes to costing methodologies.

The comments alleging that the Postal Service operates with an inefficiently high level of fixed costs appear to conflate fixed costs with institutional costs and variable costs with attributable costs. Under the Commission's methodology not all attributable costs are variable, and not all institutional costs are fixed. Carlton also understates the extent to which fixed costs are attributed to individual products under the Commission's costing methodology due to the methodology's use of cost drivers. For example, if the Postal Service were to select inefficient processing technologies, the increased costs of those technologies would be attributed to the products using them, through the additional labor costs required to utilize the processing machines. An inefficient mail processing machine would require additional workhours in order to process the same amount of mail as a more efficient machine. Under the Commission's methodology, these workhours would be attributed to the products utilizing these machines, which would increase those products' marginal costs. Additionally, the economic fixed costs of facility space and depreciation would be attributed to the products utilizing the inefficient machine in the same proportion as workhours. This process, known as ''piggybacking,'' is a way of attributing indirect costs to specific products.[74] This reduces any incentive for the Postal Service to choose inefficient technologies with high fixed costs in the way that Carlton suggests, because many of those costs would be attributed to specific products under the Commission's current costing methodology.

For the reasons discussed above, the Commission concludes that its costing methodology already accounts for ''the degree to which any costs are uniquely or disproportionately associated with any competitive products.'' To the extent that any costs can be attributed to specific competitive products, they are already distributed under the Commission's current costing methodology and are not included in the institutional costs of the Postal Service.

3. Other Relevant Circumstances

As noted above, section 3633(b) also requires the Commission to consider ''all relevant circumstances.'' In previous orders regarding the appropriate share, the Commission has analyzed ''other relevant circumstances'' that could affect the appropriate share determination. Such circumstances have included: (1) Transfers to the competitive product list; (2) changes to the mail mix; (3) uncertainties in the marketplace; and (4) risks from setting the appropriate share too high or too low. The proposed formula-based approach incorporates all of these circumstances.

a. Transfers to the Competitive Product List

In its previous review, the Commission considered changes in competitive product offerings due to transfers from the market dominant product list to the competitive product list. Since the last review of the appropriate share, four products have been transferred to the competitive product list: Single-Piece Parcel Post; Outbound Single-Piece First-Class Mail International Packages (Small Packets) and Rolls; Inbound Surface Parcel Post; and First-Class Mail Parcels.[75] When a product is transferred from the market dominant to the competitive product list, the formula incorporates it directly through the Competitive Market Output, and indirectly through the Postal Service Lerner Index. A transferred product's revenue is included in the Postal Service's competitive product revenue and automatically included in the Postal Service's portion of the Competitive Market Output. Indirectly, the transferred product's revenue-per-piece and unit volume-variable cost is incorporated into the Postal Service Lerner Index composition, so that a change in the Postal Service's market power after the product transfer is also reflected.

b. Changes to the Mail Mix

Mail mix changes occur as demand for postal products shifts. Since FY 2007, demand for market dominant products has declined and demand for competitive products has grown, as shown by their respective volumes in Figure IV–3 below.

[74] *See* United States Postal Service, Rule 39 CFR Section 3050.60(f) Report for Fiscal Year 2016, July 3, 2017, Appendix H at 5.

[75] *See* Order No. 1411; Order No. 1461; Order No. 2160; Order No. 4009.

Figure IV-3
Total Market Dominant and Competitive Mail Volume, FY 2007 – FY 2017[76]

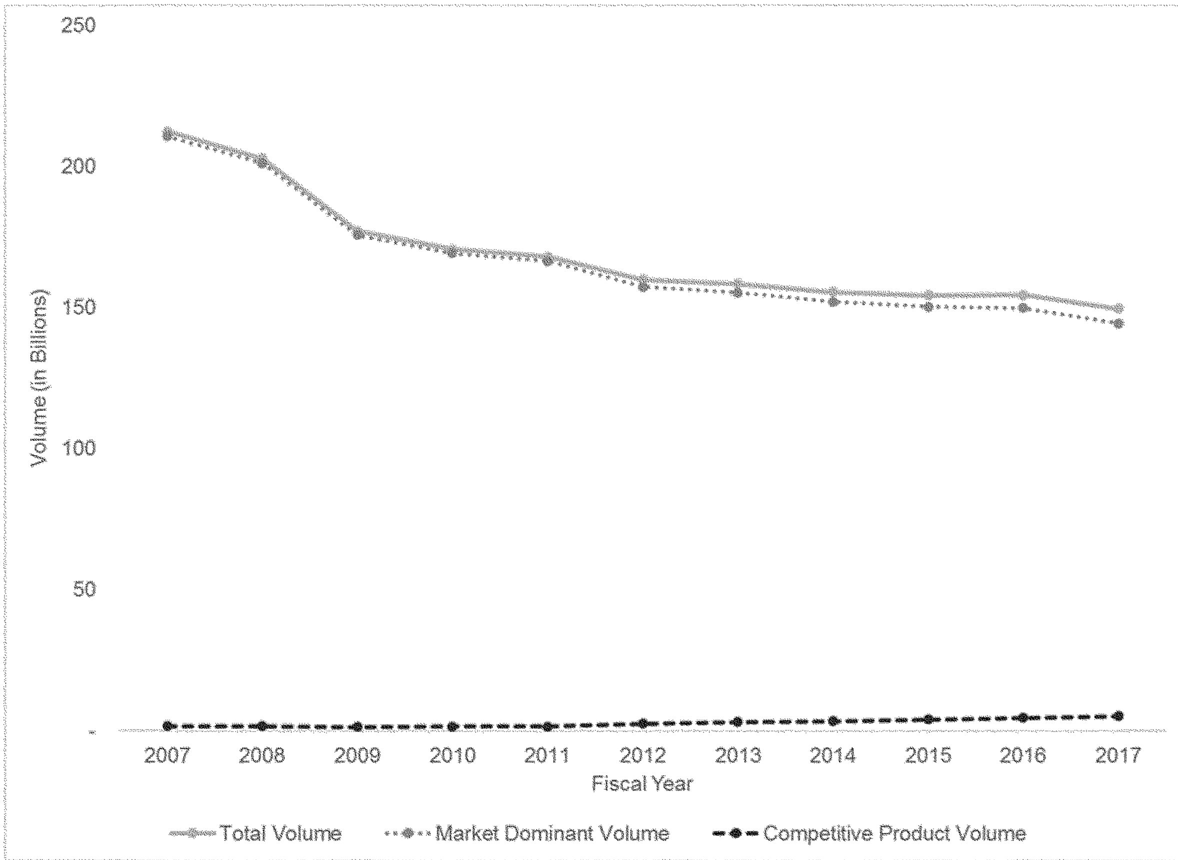
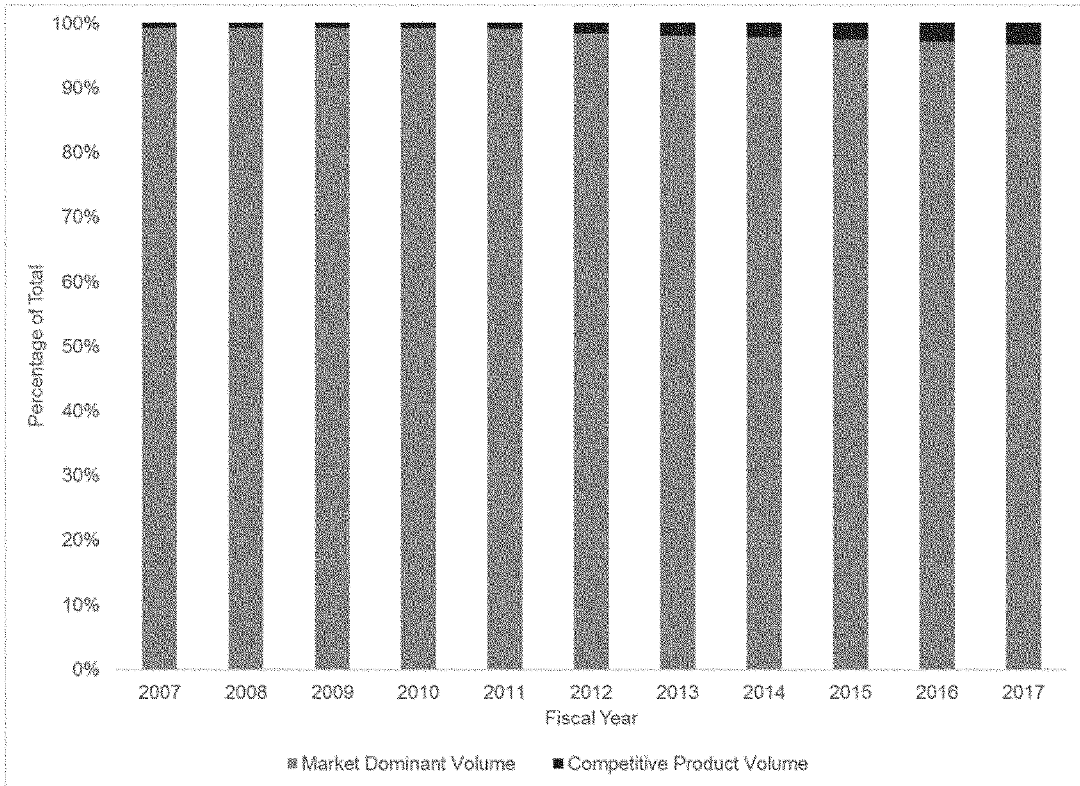


Figure IV–3 shows that since FY 2007, market dominant volume has decreased from 211 billion pieces to 144 billion pieces, while competitive volume has increased from 1.6 billion pieces to 5 billion pieces. Market dominant and competitive products' respective proportions of total Postal Service volume are demonstrated in Figure IV–4 below.

[76] Source: PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

Figure IV-4
Relative Proportions of Total Market Dominant and Competitive Volume, FY 2007 – FY 2017[77]



As shown in Figure IV–4, since FY 2007 market dominant volume has decreased from 99.2 percent of all mail to 96.6 percent, and competitive volume has increased from 0.8 percent of all mail to 3.4 percent. In Order No. 1449, the Commission noted that a significant increase in competitive volume, particularly in relation to market dominant volume, would warrant a change in the appropriate share. Order No. 1449 at 23. Under the proposed formula-based approach, the Competitive Market Output incorporates such changes in the mail mix by reflecting the revenue the Postal Service receives from any increase in competitive product volume. Additionally, the Postal Service Lerner Index will reflect the growth or decline of more or less profitable competitive products.

c. Uncertainties

Another relevant circumstance that the Commission has identified in the past is uncertainty in the postal system as a whole. During the Commission's last review of the appropriate share, several dockets regarding the nature of postal services were pending before the Commission that had the potential to bring about fundamental changes in the postal system. *See* Order No. 1449 at 23. Additionally, the Postal Service's financial position was precarious, and the economy was still recovering from the global financial crisis of the late 2000s.[78] Under the proposed formula-based approach, shifts in market demand or macroeconomic conditions would be reflected in the appropriate share determination through changes in the Postal Service Lerner Index and Competitive Market Output.

Additionally, the Commission notes that over the last 5 years there have been significant innovative developments and changes in e-commerce and the delivery industry.[79] It is important for the formula-based approach to incorporate such changes. Efforts at innovation or changes in e-commerce would be evident through the Competitive Market Output, because they would be reflected in the respective competitors' revenues as their innovations succeeded (or failed), resulting in more (or less) revenue. Innovation from competitors could also affect the Postal Service Lerner Index. If an innovation makes a competitor's products more attractive to customers, the Postal Service may need to set its prices lower than it otherwise would to attract and retain volume. This would result in lower unit profitability and a lower Postal Service Lerner Index.

d. Risks

In previous orders regarding the appropriate share, the Commission has analyzed potential risks involved in setting the appropriate share too high or too low as part of section 3633(b)'s ''other relevant circumstances'' element. *See, e.g.,* Order No. 1449 at 12.

If the appropriate share level were set too high, the Postal Service would be forced to raise its prices to non-competitive levels in order to meet the minimum contribution required by the appropriate share. At these higher prices, consumers would likely stop using the Postal Service and transfer their volume to cheaper competitors. Depending on the scale of the volume

[77] Source: PRC–LR–RM2017–1/1. The FY 2017 value is preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

[78] *Id.* at 23–24. As the Commission recently found in Order No. 4257, the Postal Service's financial situation remained precarious during the 10 years following the enactment of the PAEA. Order No. 4257 at 249.

[79] *See, e.g.,* United States Postal Service Office of Inspector General, Risk Analysis Research Center, The Evolving Logistics Landscape and the U.S. Postal Service, Risk Analysis Research Center, Report No. RARC–WP–16–015, August 15, 2016.

exodus and other factors,[80] the Postal Service may be unable to meet the minimum contribution. If the Postal Service were forced to exit the competitive market, competition in the market would decline, harming consumers and benefiting the Postal Service's competitors, who would be able to absorb the remaining volume and then set prices higher than the Postal Service had previously charged. The Commission's proposed formula-based approach addresses this issue by limiting increases in the appropriate share to no higher than appropriate to account for the Postal Service's growth in market power and the growth in the market as a whole.

Conversely, if the appropriate share were set too low, the Postal Service might be incentivized to discount its prices in order to gain market share. Such actions, however, would come at the expense of the Postal Service's profitability. Both the PAEA and the Postal Service's financial challenges incentivize profitability,[81] so little incentive exists for the Postal Service to significantly discount its prices. Additionally, the time lag in the formula discourages such discounting[82] because the negative consequences of such discounting (*i.e.,* lower revenue, and therefore lower contribution) would appear before the benefits (*i.e.,* a lower Postal Service Lerner Index).

The appropriate share has historically avoided the extremes of both being set too high and being set too low, and the proposed formula-based approach would continue to do so. Historically, the appropriate share has neither prevented the Postal Service from competing in the market, nor allowed the Postal Service to dominate the market. As Table IV–7 shows, the formula-based approach would have allowed the Postal Service to avoid both extremes over the past 10 years.

TABLE IV–7—POSTAL SERVICE CONTRIBUTION AND FORMULA-BASED APPROPRIATE SHARE, FY 2007–FY 2019[83]

Fiscal year	Postal service contribution as a percentage of institutional cost	Formula-based appropriate share (%)
FY 2007	5.67%	5.5
FY 2008	5.53%	5.5
FY 2009	6.78%	5.5
FY 2010	7.12%	5.1
FY 2011	7.82%	5.2
FY 2012	7.49%	6.1
FY 2013	11.64%	6.0
FY 2014	12.63%	6.4
FY 2015	13.37%	7.1
FY 2016	16.54%	7.5
FY 2017	23.16%	7.8
FY 2018	not yet available	9.5
FY 2019	not yet available	10.8

As Table IV–7 demonstrates, the Postal Service's actual contribution has exceeded the proposed formula-derived appropriate share in every year since FY 2007. This demonstrates that the proposed formula-based approach would not have forced the Postal Service to set prices too high, nor prevented the Postal Service from effectively competing, as an excessive appropriate share would have done. The proposed formula would also prevent prices from being set too low because it responds to changes in the Postal Service's market power and the overall market size. Although these historical data demonstrate that the proposed formula-based approach would have been successful in the overall positive market conditions existing from FY 2007 through FY 2017, the Commission also expects the proposed formula-based approach to be effective in preserving competition in adverse market scenarios because the formula allows for decreases in the minimum appropriate share when adverse market conditions negatively impact the Postal Service Lerner Index, Competitive Market Output, or both.

D. Conclusion

The proposed formula-based approach to determining the appropriate share is less subjective and more responsive to changing market conditions than the considerations the Commission relied upon in the past. It accounts for each of the considerations required by 39 U.S.C. 3633(b): The prevailing competitive conditions in the market; the degree to which any costs are uniquely or disproportionately associated with competitive products; and all other relevant circumstances. The proposed approach encompasses factors previously considered by the Commission, and it adjusts annually in order to reflect changes in market conditions. For these reasons, the Commission proposes to change to a formula-based approach.

V. Section 703(d) of the PAEA

As part of its enactment of the PAEA, Congress sought to determine whether the Postal Service's competitive products enjoyed any legal advantages over private companies providing similar products.[84] In section 703, Congress directed the FTC to prepare a report identifying federal and state laws that apply differently to the Postal Service's competitive products than similar products offered by private competitors.[85] The FTC was required to make recommendations concerning how to end any such legal differences and, in the interim, to account for the net economic effect resulting from such differences.[86] Additionally, section 703 directed the Commission, when revising regulations under 39 U.S.C. 3633, to consider the FTC's recommendations as well as subsequent events that affect the continuing validity of the FTC's net economic effect finding.[87]

In the instant proceeding, because the Commission proposes revisions to its regulations pursuant to 39 U.S.C. 3633(a)(3) and (b), an analysis pursuant to section 703(d) of the PAEA is necessary. In the sections below, the Commission discusses the FTC Report's net economic effect analysis, addresses comments related to section 703(d) received in this proceeding, describes the scope of the Commission's section 703(d) review, identifies events occurring since the FTC Report's issuance, and determines whether those events have affected the validity of the FTC's estimate of the net economic effect. The Commission does not address FTC recommendations because the FTC did not include any recommendations in the FTC Report. *See* FTC Report at 2.

A. FTC Report

The FTC issued its report in December 2007, which considered both the implicit subsidies enjoyed by and legal constraints imposed on the Postal Service's competitive products due to

[80] Other factors include competitors' price changes in response to volume shifts and changes in the Postal Service's competitive costs.

[81] *See* Order No. 4257 at 32–33, 165–178.

[82] See section IV.B.3, *supra,* and section VII, *infra,* for a discussion of the time lag.

[83] Source: PRC–LR–RM2017–1/1. The FY 2017 value in the second column and the FY 2019 value in the third column are preliminary, subject to revision of the underlying data in pending Docket No. ACR2017.

[84] *See* PAEA, 120 Stat. 3244; *see also* S. Rep. No. 108–318 at 29.

[85] PAEA section 703(a). Section 703 was not codified and is reproduced in the notes of 39 U.S.C.A. 3633. *See also* FTC Report.

[86] PAEA section 703(b).

[87] PAEA section 703(d).

the Postal Service's unique legal status.[88] In chapter IV of its report, the FTC completed its net economic effect analysis by specifically identifying those implicit subsides and legal constraints that could be quantified in order to calculate any impact on the Postal Service.[89] The FTC concluded that the Postal Service's unique legal status placed it at a net competitive disadvantage in offering competitive products relative to private competitors. *Id.* at 64.

1. Implicit Subsidies

The FTC listed multiple quantifiable implicit subsidies that the Postal Service received due to its status as a governmental entity. *Id.* at 57–58. These implicit subsides included the Postal Service's exemption from state and local taxes,[90] real property taxes, sales and use taxes, personal property taxes, and certain franchise and business taxes and fees. *Id.* at 57. The Postal Service is exempted from these taxes and fees because the Supremacy Clause prevents states from imposing taxes and some fees on federal agencies. *See id.* at 23–28. Other implicit subsidies included exemptions from parking tickets, vehicle registration fees, tolls, and tax compliance. *Id.* at 57. The FTC estimated that these implicit subsidies provided a benefit of $38 million to $113 million to Postal Service competitive products.[91]

In addition, the FTC discussed the borrowing authority permitted by the PAEA as a potential advantage the Postal Service receives unrelated to its status as a governmental entity.[92] The FTC noted the Postal Service has the ability to issue debt for use for competitive products possibly resulting in a more favorable interest rate compared to private competitors. *Id.* at 58. The FTC relied on figures provided by a commenter who estimated the Postal Service enjoyed a $30.45 million annual subsidy on its debt at the time, with competitive products enjoying approximately $1.4 to $4 million of the annual amount.[93] The FTC rounds the $1.4 million to $1 million in its calculation. *Id.* at 61.

2. Legal Constraints

The FTC listed six quantifiable legal constraints imposed on the Postal Service due to its status as a governmental entity. The first legal constraint included was the costs associated with the Alaska Bypass. *Id.* at 56. The FTC noted the Postal Service had extensive regulations governing its transportation of mail to remote areas within Alaska. *Id.* at 44; 39 U.S.C. 5402. The FTC also included the legal constraints associated with international mail transportation. FTC Report at 56. While competitors were able to negotiate competitive terms for international mail air transportation rates, the Postal Service's rates were regulated by the Department of Transportation. *Id.* at 44–45.

The FTC also identified certain employment and labor law restrictions limiting the Postal Service, and specifically included the Postal Service's inability to access subsidies offered to private employers under the Medicare Part D program in its calculation. FTC Report at 38–39, 56. The largest quantifiable legal constraint identified by the FTC was the wage premium the Postal Service must pay its employees due to the statutes that govern the Postal Service's relationship with its employees. *Id.* at 39–40, 56. In its analysis, the FTC used a figure submitted by the Postal Service indicating that, in most localities, the Postal Service must pay its employees 21.2 percent more than competitors. *Id.* at 39; *see id.* at 39 n.197 and 56 n.268.

Additionally, the FTC was able to quantify two pricing restrictions imposed on the Postal Service as a result of the PAEA related to market dominant Periodicals and non-profit mail. *Id.* at 56. The Postal Service's ability to set flexible rates for Periodicals and non-profit mail is limited by legal requirements that affect pricing for these products. *Id.* at 44, 55–56; 39 U.S.C. 3622(c)(11); 39 U.S.C. 3626(a)(6). Although these pricing restrictions were valued between $87 million and $204 million, the FTC admitted it was ''unclear how restrictions on periodical pricing and non-profit mail affect competitive product costs.'' FTC Report at 56. As a result, the FTC ultimately excluded these pricing restrictions from its calculation. *Id.* at 56, 64.

3. FTC Report Conclusion: Net Economic Effect

In accounting for the differences between the various implicit subsidies and legal constraints placed on competitive products due to the Postal Service's unique legal status, the FTC determined that the Postal Service's costs were $330 million to $782 million higher than they would be otherwise, while the implicit subsidies the Postal Service enjoyed totaled $39 million to $117 million. *Id.* at 64. Therefore, the FTC determined the Postal Service incurred costs between $213 million to $743 million higher due to its legal status. *Id.* As a result, the FTC concluded that the Postal Service's unique legal status causes it to have a net competitive disadvantage relative to its private competitors. *Id.*

B. Relevant Comments

1. Postal Service

As part of its comments in the instant proceeding, the Postal Service asserts that no credible study has undermined the fundamental validity of the FTC's findings, and that, if anything, the FTC

[88] *Id.* at 55–77. In its review of the Postal Service's unique legal status, the FTC analyzed laws applicable to the Postal Service due to its status as a governmental entity as well as those disadvantages imposed on and advantages allowed by the PAEA.

[89] *Id.* at 55–77, n.287. The FTC Report discussed additional implicit subsidies and legal constraints beyond those listed in its net economic effect analysis, but because the additional subsidies and constraints could either not be quantified or the effect on the Postal Service was unclear, the FTC did not include them as part of its final analysis. Some of the implicit subsidies included the Postal Service's access to federal funding and eminent domain, preferential customs treatment compared to competitors, immunity from certain conduct under the Federal Tort Claims Act, its exemption from paying federal income taxes, and potential advantages stemming from the Postal Service's letter and mailbox monopolies. *Id.* at 29–37, 47–52, 64. Some of the legal constraints included pricing restrictions on competitive products, the costs associated with the Postal Service's USO, the limited ability of the Postal Service to close post offices, the inability to outsource delivery routes to private carriers, requirements related to retirees, and the restraints on financing and investing. *Id.* at 37–45.

[90] The FTC did not rely on a specific state and local tax figure in its net economic effect conclusions because those taxes would vary year-to-year based on Postal Service's annual net income. *See id.* at 57 n.270. For the same reason, the Commission does not include an estimated figure of the state and local tax implicit subsidy in its section 703(d) analysis.

[91] *Id.* at 58. The implicit subsidies identified benefited both market dominant and competitive products, but given none were readily assignable to either category; the FTC used competitive products' appropriate share of institutional costs and competitive product revenue to create an estimated range of impact on Postal Service competitive products. The low end of the range was based on the implicit subsidies inclusion in institutional costs, which would require competitive products to cover 5.5 percent and the high end of the range was based on competitive product revenue. *Id.* at 57.

[92] The FTC Report also included a discussion on Return on Equity as a potential Postal Service advantage, indicating that should the Postal Service be required to achieve the same level of return on equity for competitive products that private carriers achieved, the Postal Service would have to make significant pricing and operational changes for its competitive products. *Id.* at 62–64. However, this advantage was not considered in the FTC's net economic effect analysis. *See id.* at 64.

[93] *Id.* at 59. Applying the same methodology discussed above, the borrowing advantage range was based on the requirement that competitive products cover 5.5 percent of institutional costs (low-end) and competitive product revenue (high-end). *Id.* at 59; *see supra* at 56 n.91.

Report significantly understates the Postal Service's net competitive disadvantage because it fails to consider all of the legal differences between the Postal Service and its private competitors. Postal Service Comments at 8. Specifically, the Postal Service identifies the lack of mandatory integration between the Federal Employees Health Benefits Program and Medicare Parts A and B as well as differences in retirement benefits and workers' compensation. *Id.* at 8–9. The Postal Service also notes that the FTC failed to account for the private delivery companies' superior freedom and business flexibility, as well as their own unique economies of scale and scope. *Id.* at 9. The Postal Service does not address any subsequent events that would affect the continuing validity of the FTC's estimate of the net economic effect.

2. UPS

UPS states that the FTC Report's conclusions were incomplete because the FTC did not include an estimate of the value of either the letter or mailbox monopolies. UPS Comments at 10. UPS asserts that because these monopolies provide the Postal Service with an advantage over the private sector, the FTC's inability to estimate their value makes it impossible to conclude from the FTC's Report that the Postal Service operates at a net competitive disadvantage relative to the private sector.[94] UPS similarly criticizes the FTC Report for failing to quantify the economies of scope deriving from the letter and mailbox monopolies, despite the FTC Report acknowledging that such economies exist.[95] UPS contends that when the Postal Service's monopoly and scope advantages are properly quantified, they outweigh the burdens identified in the FTC Report, running counter to the FTC Report's conclusion that the Postal Service operates at a net competitive disadvantage.[96]

Like the Postal Service, UPS does not address any subsequent events that affect the continuing validly of the FTC's estimate of net economic effect and focuses its comments on the accuracy of the FTC Report itself.

3. Public Representative

The Public Representative focuses specifically on subsequent events occurring in the market since the FTC Report was issued. PR Comments at 12–13. He notes the transfer of various mail services from the market dominant product list to the competitive product list has eliminated any impact the market dominant price cap had on those products.[97] He explains the product transfers changed ''to some degree'' the net economic effect described in the FTC Report. PR Comments at 13. The Public Representative states that, for the transferred products, the Postal Service can compete more directly with its competitors without the pricing constraints imposed by the price cap, ultimately leveling the playing field.[98]

C. Commission Section 703(d) Analysis

In this analysis, the Commission first defines the scope of its review pursuant to section 703(d) and then discusses events subsequent to the FTC Report that may affect the validity of the FTC Report's estimate of the net economic effect. Finally, the Commission performs a supplementary analysis, which supports its conclusion that the FTC's finding of a Postal Service net economic disadvantage continues to be valid.

1. Scope of Section 703(d)

Section 703(d) directs the Commission to ''take into account the recommendations of the Federal Trade Commission, and subsequent events that affect the continuing validity of the estimate of the net economic effect.'' The statute does not define the phrase ''take into account.'' The dictionary provides that the phrase ''to take into account'' is the definition for the word ''consider.''[99] The Commission thus applies the plain meaning of ''take into account'' and determines it will consider whether subsequent events have affected the continuing validity of the estimate of the net economic effect when the Commission proposes revisions to its regulations promulgated under 39 U.S.C. 3633.[100]

Likewise, the statute does not specifically define ''subsequent event.'' Section 703(d) is clear that the Commission's review is limited only to those subsequent events that affect the continuing validity of the FTC's net economic effect estimate. As discussed above, the FTC was tasked with identifying federal and state laws that apply differently to the Postal Service with respect to competitive products and using that information to estimate the laws' net economic effect on the Postal Service.[101] The FTC's net economic effect finding was based on the implicit subsidies and legal constraints that the FTC could quantify, each of which was linked to specific

[94] *Id.* Sidak likewise asserts that the FTC Report failed to quantify the postal monopoly and that, had it done so, this may have turned the FTC's finding to a net competitive advantage for the Postal Service. Sidak Reply Decl. at 11–13. Carlton states that the mailbox monopoly puts private firms at an artificial marginal cost disadvantage and that he is unaware of any efficiency rationale for the mailbox monopoly. Carlton Reply Decl. at 18–19. The Postal Service specifically denies that the postal monopoly confers any artificial advantage on it. Postal Service Comments at 6–10.

[95] UPS Comments at 10; Reply Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, March 9, 2017, at 19–24 (UPS Reply Comments).

[96] *Id.;* UPS Comments at 10, 15–18. UPS notes the Commission estimated the value of the postal monopoly at $5.45 billion and the cost of maintaining the USO at only $4.24 billion. UPS Reply Comments at 24. *See* Postal Regulatory Commission, FY 2016 Annual Report to the President and Congress, January 12, 2017, at 40, 48. UPS lists multiple criticisms of the Commission's calculation on the postal monopoly, including focusing incorrectly on lost profits and using an incomplete estimation model that does not account for the Postal Service's ability to leave small packages in mailboxes. UPS Comments at 16–17. *See also* Sidak Comments at 6 (citing Robert J. Shapiro, The Basis and Extent of the Monopoly Rights and Subsidies Claimed by the United States Postal Service, March 2015).

Although the Commission's review under section 703(d) is limited, the Amazon Reply Comments highlight some of the flaws with UPS's proposed recalculation. UPS relies on a previous Commission analysis of the postal monopoly and a paper by UPS Economist Robert Shapiro (Shapiro Paper). Amazon points out that the Commission's analysis of the postal monopoly did not estimate ''the cost advantages enjoyed by the Postal Service over private carriers'' and instead focused on the contribution the Postal Service would lose if the postal monopoly was repealed. Amazon Reply Comments at 24. As it relates to the Shapiro Paper, Amazon notes Shapiro estimated the Postal Service received a $14.5 billion benefit from its postal monopoly but contends this estimate contains multiple flaws. *Id.* As an example, Amazon identifies Shapiro's failure to delineate between market dominant products and competitive products making the estimate ''useless'' because market dominant products represent the majority of Postal Service volume. *Id.* at 24–27. Amazon further contends that UPS representative Sidak's estimate of the Postal Service's postal monopoly advantage is also flawed due to his heavy reliance on the Shapiro Paper and the lack of support provided for apportioning ''legal advantages'' to competitive products. *Id.* at 26–27.

[97] *Id. See also* Docket No. MC2010–20, Order Approving Request to Transfer Selected Post Office Box Service Locations to the Competitive Product List, June 17, 2010 (Order No. 472); Order No. 689; Order No. 780; Order No. 1411; Order No. 1461 (Outbound Single-Piece First-Class Mail International Packages and Rolls); Docket No. MC2014–28, Order No. 2160 (Inbound Surface Parcel Post (at UPU Rates)).

[98] *Id.* at 13. The Public Representative uses his conclusion to support the position that the appropriate share should be maintained at 5.5 percent because the playing field is already level. *Id.*

[99] Merriam-Webster, *https://www.merriam-webster.com/dictionary/consider. See also Small Refiner Lead Phase-Down Task Force* v. *EPA,* 705 F.2d 506, 515 (DC Cir. 1983) (confirming the plain language meaning of ''taking into account'' as requiring the agency ''consider'' statutory factors).

[100] As previously mentioned, the FTC did not provide any recommendations for the Commission to consider.

[101] *See generally* PAEA section 703(a) and (b).

federal or state laws. Therefore, the Commission determines ''subsequent event'' in section 703(d) refers to changes to federal or state laws quantified in the FTC's estimate of the net economic effect. As a result, the Commission finds the scope of its review under section 703(d) is limited to considering whether the laws behind the implicit subsidies and legal constraints quantified by the FTC have changed since the FTC Report's issuance, and if so, whether those changes affect the continuing validity of the FTC's estimate of the net economic effect of those laws.

Two commenters focus on what was excluded from the FTC's original estimate of the net economic effect and not on events occurring since the FTC Report's issuance that would affect the validity of that estimate. The Postal Service focuses on the FTC's failure to include healthcare, retirement, and workers' compensation costs and competitors' business flexibility, while UPS asserts that the FTC Report failed to estimate the value of the postal monopoly and the Postal Service's economies of scope. Both the Postal Service and UPS call for the Commission to reassess and recalculate the FTC's net economic effect estimate for information known at the time of the FTC Report that the FTC chose not to include or found was not quantifiable.

The reassessment and recalculation the Postal Service and UPS request is outside the scope of what section 703(d) calls on the Commission to do. As stated previously, section 703(d) requires the Commission to consider whether subsequent events affect the continuing validity of the FTC's estimate of net economic effect. As a result, the Commission does not reassess the FTC's original conclusions as to what implicit subsides and legal constraints should be included in and excluded from the estimate of the net economic effect and whether these constraints and subsidies were quantifiable.

In the analysis that follows, the Commission considers whether subsequent events have affected the validity of the FTC's estimate of the net economic effect and discusses what effects such events have on the FTC's estimate. The Commission then offers a supplemental analysis in support of its conclusion.

2. Events Subsequent to the FTC Report

Of the implicit subsidies and legal constraints separately accounted for in the FTC's calculation, the Commission finds that there has only been one law linked to a separately delineated element within the FTC's calculation that has been amended, thereby constituting an event subsequent to the FTC Report's issuance that affects the validity of the estimate of the net economic effect. In the FTC Report, the FTC explains that the Department of Transportation's regulation of international mail air transport rates cost the Postal Service up to $98 million more in FY 2006 than if the Postal Service were permitted to independently negotiate the rates on the free market as private companies were. FTC Report at 44, 56. The FTC apportioned $5 million to $13 million of the $98 million total costs associated with the legal constraint to competitive products specifically. *Id.* at 56.

In 2008, Congress eliminated the Department of Transportation's authority to regulate the prices paid by the Postal Service for air transport of international mail, allowing the Postal Service to negotiate terms for international air mail transportation contracts directly with airlines as private companies do.[102] As a result, this legal constraint originally estimated as a $5 million to $13 million additional cost to the Postal Service competitive products no longer exists.

The Commission finds no other changes to federal or state law affected the legal constraints estimate. The FTC Report estimated the total cost of the legal constraints imposed on the Postal Service ranged from $330 million to $782 million. FTC Report at 64. As Table V–1 demonstrates, after the constraint of international air transportation rate regulation is removed and the legal constraint total is recalculated, the total cost of the legal constraints imposed on the Postal Service is $325 million to $769 million.

As the Commission found no changes to the laws that generate the Postal Service's implicit subsidies, the Commission continues to accept the FTC's conclusion concerning the total cost of the implicit subsidies enjoyed by the Postal Service as $39 million to $117 million. Applying the updated estimate of the effect of legal constraints, Table V–1 demonstrates that the updated estimated net economic effect is $208 million to $730 million in net competitive disadvantage.

TABLE V–1—UPDATED ESTIMATE OF LEGAL CONSTRAINTS

Legal constraints	Estimate (in millions)	
	5.5%	13%
FTC's Legal Constraints Total	$330	$782
International Air Transportation	−5	−13
Updated Legal Constraints Total	325	769

TABLE V–2—UPDATED TOTAL RANGE

Updated range	Estimate (in millions)	
	5.5%	13%
Updated Legal Constraints Total	$325	$769
FTC's Total Implicit Subsidies	39	117

[102] *See* Public Law 110–405, 122 Stat. 4287 (2008); *see also* FTC Report at 44–45.

[103] The FTC subtracted the low subsidy from the high constraint and the high subsidy from the low constraint to create the maximum range of net economic effects. It is not guaranteed that both the subsidy and constraint will be near the same end of the estimated range (high or low). Using these differences maximized the range of possible effects. The Commission applies the same methodology in updating the total range of costs the Postal Service would incur.

TABLE V–2—UPDATED TOTAL RANGE—Continued

Updated range	Estimate (in millions)	
	5.5%	13%
Updated Total Range [103]	208	730

The Commission determines that the FTC's finding of a Postal Service net economic disadvantage continues to be valid. Although the subsequent event discussed above altered the overall estimate of the net economic effect, it does not undermine the FTC's overall finding of a net economic disadvantage.

3. Supplemental Analysis

Although the Commission's conclusion is based on legal changes occurring subsequent to the FTC Report's issuance, the Commission also performs a supplemental analysis by updating the high-end costs associated with both the implicit subsidies and legal constraints based on current competitive product revenue. This supports the Commission's finding that the FTC's estimate of a net competitive disadvantage remains valid.

As noted above, the FTC estimated the low-end cost impact of the quantifiable implicit subsidies and legal constraints on competitive products by using competitive products' 5.5-percent mandatory contribution to institutional costs, which was the appropriate share mandated at the time of the FTC's review. *See supra* at 56 n.91. Given that competitive products' appropriate share of institutional costs is currently 5.5 percent, it is unnecessary to update the low-end figures estimated by the FTC. *See* 39 CFR 3015.7(c).

The FTC's estimates of the high-end cost impact of the quantifiable implicit subsidies and legal constraints on competitive products was based on competitive product revenue, which at the time of the FTC's review was 13 percent of total Postal Service revenue. FTC Report at 55–57. Over the past 10 years, the Postal Service's competitive product revenue has increased, in part due to the increased number of competitive product offerings as a result of product transfers from the market dominant product list.[104] In FY 2017, competitive products made up 29.69 percent of total Postal Service revenue. USPS–FY17–1. Table V–3 shows the updated figures based on 29.69 percent of total revenue currently attributed to competitive products.

TABLE V–3—UPDATED ESTIMATES BASED ON CURRENT POSTAL SERVICE REVENUE

	Estimate (in millions)		
	5.5%	13%	29.69%
FTC's Legal Constraints Total	$330	$782	$1,785
International Air Transportation	−5	−13	−29
Updated Legal Constraints Total	325	769	1,756
FTC's Total Implicit Subsidies	39	117	267
Updated Total Range [105]	92	....	1,717

While the low-end estimated value of the implicit subsidies remains at $39 million, the adjusted high-end estimated value of implicit subsidies is $267 million, based on FY 2017 Postal Service competitive product revenue. The low-end estimated cost of the legal constraints continues to be $330 million, and the adjusted high-end estimated cost is $1,785 million, based on FY 2017 Postal Service competitive product revenue. As shown in Table V–3, when the high-end figure of the international mail air transportation legal constraint is updated to $29 million, and then both the low-end figure of $5 million and the updated high-end figure of $29 million are removed from the legal constraints total range, the impact is nominal, as the remaining legal constraints imposed on the Postal Service range from $325 million to $1,756 million. In combining the two ranges, using the same methodology as the FTC did in its report, the legal constraints imposed on the Postal Service continue to cause it to incur an estimated net economic disadvantage between $92 million and slightly more than $1.7 billion.

The updated range of the implicit subsidies and legal constraints support the Commission's determination that the FTC's initial estimate of a Postal Service net economic disadvantage remains valid.

D. Conclusion

In considering the effect of the sole subsequent event since the FTC Report's issuance, the Commission concludes the legal change to the Postal Service's ability to negotiate terms for international air mail transportation does not affect the continuing validity of the FTC's finding that the Postal Service operates at a net economic disadvantage.

VI. Comments and Analysis

To the extent comments and reply comments are directly applicable to the Commission's proposed approach or analysis above, the Commission summarizes and discusses them in the applicable sections, *supra.* In this

[104] The Public Representative contends the transfer of market dominant products to the competitive product list should be considered a subsequent event by the Commission as part of its section 703(d) analysis. *See* section V.B.3, *supra.* The Commission finds product transfers are outside the scope of its section 703(d) analysis, as product transfers do not relate to a legal change for either a quantifiable implicit subsidy or legal constraint discussed by the FTC. *See* FTC Report at 55–77. However, it should be noted that, in updating the high-end estimates of both the quantifiable implicit subsidies and legal constraints, the value of product transfers is reflected in those estimates as competitive product revenue captures all current competitive product offerings.

[105] *See supra* at 65 n.103.

section, the Commission discusses the remaining comments and reply comments received in response to Order No. 3624.

A. Increase the Appropriate Share

UPS, Sidak, Carlton, GCA, and FUR recommend that the Commission increase the appropriate share.[106] The Public Representative, the Postal Service, Amazon, Panzar, MDMCS, NAPM, NPPC, and BOS filed comments opposing an increase in the appropriate share.[107] Comments advocating to increase the appropriate share not previously discussed in this Notice of Proposed Rulemaking generally addressed two topics: (1) The question of whether the Postal Service has a competitive advantage and the risks associated with a low appropriate share and (2) approaches for setting the appropriate share. Following a summary of the comments, the Commission discusses the issues raised in the context of its proposed formula-based approach.

1. Competitive Advantage and Risks Associated With a Low Appropriate Share

a. Comments in Favor of Increasing the Appropriate Share

UPS and Sidak assert that the Postal Service possesses a competitive advantage over its competitors as a result of the economies of scale and scope arising from the postal monopoly.[108] UPS states that, given the Postal Service's increasing focus on the parcels market, the necessity of ensuring a ''fair playing field'' is even more vital today than it was during previous Commission appropriate share determinations. UPS Reply Comments at 7–8. UPS notes this is particularly important in the context of this proceeding because the appropriate share is the only provision to ensure the Postal Service competes on a level playing field. UPS Comments at 11–13.

UPS notes that, in terms of both volume and revenue, competitive products comprise a much larger part of the Postal Service's business today than they did in 2007, when the 5.5-percent level was initially set. *Id.* at 19, 22–24. UPS asserts that competitive products' share of the Postal Service's total volume has more than tripled since the PAEA's enactment, and that competitive products currently make up 26.6 percent of the Postal Service's total revenue. *Id.* at 22–23. Sidak echoes this, stating competitive volumes and revenues have substantially increased in recent years. Sidak Decl. at 9–10. UPS and Carlton further contend that overall institutional costs have increased even as market dominant volumes and revenues have decreased, suggesting that the growth of competitive product volume is driving the growth of overall institutional costs.[109]

In addition, multiple commenters emphasize what they view to be risks associated with maintaining a low appropriate share requirement. UPS asserts that the growth of Postal Service competitive products dissuades entry and expansion of competitors and disincentivizes competitor innovation and investment. UPS Comments at 25–26. Sidak opines that the Postal Service is incentivized to underprice its competitive products in order to increase the scale of its operations. Sidak Decl. at 11–12. He states that increasing the appropriate share is necessary to protect market dominant consumers and ensure financial stability for the Postal Service. *Id.* at 10, 14–16. In the short term, Sidak contends that the institutional cost recovery burden that a low appropriate share requirement places on market dominant products puts pressure on the Postal Service to make market dominant service cuts, effectively increasing the price of market dominant products. *Id.* at 15. He suggests that the Postal Service's ability to effectively increase prices (by reducing service) is strongest for market dominant products because demand for them is less elastic than demand for competitive products. *Id.*

FUR echoes this, stating that under assigning institutional costs burdens market dominant mailers and distorts the competitive market. FUR Comments at 3. FUR asserts that the current appropriate share requirement bears no relationship to any actual cost or revenue numbers, which is particularly problematic given the Postal Service's high level of institutional costs. This lack of a relationship heightens the potential for the Postal Service to cross-subsidize competitive products with market dominant products. FUR Comments at 11–12.

Sidak and Carlton also take the position that a low appropriate share requirement inhibits dynamic efficiency, wherein firms compete by introducing new products, entering new markets, or developing cost-reducing innovations, in favor of static efficiency, which lacks such innovation.[110] In particular, Carlton states that the dynamic efficiency of the parcel industry is threatened because incentives to invest in research and development by competitors are reduced due to the Postal Service's inefficiencies. Carlton Reply Decl. at 14. Carlton finds this to be concerning because in his view competitors are better innovators than the Postal Service.[111]

b. Comments in Opposition to Increasing the Appropriate Share

As discussed in the sections below, most commenters advocate that the appropriate share requirement be either left at its current level or eliminated entirely.[112] In response to UPS's assertion that the Postal Service has a competitive advantage, the Postal Service, Panzar, and Amazon deny that the postal monopoly or any other aspect of the Postal Service's unique legal status provides it with any competitive advantage relative to private carriers.[113] BOS maintains that the Postal Service remains at a competitive disadvantage relative to its competitors. BOS Reply Comments at 10.

Amazon, the Postal Service, and the Public Representative disagree with UPS's concerns about an unlevel playing field, contending those concerns lack evidentiary support, especially in light of the Postal Service's modest market share and its competitors' financial health and investments in innovation.[114] Amazon and the Public Representative also note that economies of scale and scope benefit both the Postal Service and its competitors. They

[106] *See, e.g.,* UPS Comments at 13–40; Sidak Decl. at 1; Carlton Reply Decl. at 31; GCA Comments at 6–7; FUR Comments at 13–14.

[107] *See, e.g.,* PR Reply Comments at 7; Postal Service Reply Comments at 6–37; Amazon Reply Comments at 35–48; Panzar Reply Decl. at 10–13; MDMCS Reply Comments at 1–3; NAPM Reply Comments at 2–3; NPPC Reply Comments at 5; BOS Reply Comments at 11–14.

[108] UPS Comments at 13–14; Sidak Decl. at 5–9.

[109] UPS Comments at 2–3, 9, 29–33; Carlton Reply Decl. at 26–27.

[110] Sidak Decl. at 16–17; Carlton Reply Decl. at 14–16. Dynamic efficiency exists, in a macroeconomic context, when an economy invests less than the return to capital. *See* Andrew B. Abel *et al., Assessing Dynamic Efficiency: Theory and Evidence,* The Review of Economic Studies, at 2 (1989), available at: *http://scholar.harvard.edu/files/mankiw/files/assessing_dynamic_efficiency.pdf.* Applied to a microeconomic context, dynamic efficiency exists when a market is growing because of entry and innovation. Static efficiency exists when a market is in equilibrium (prices are close to marginal cost, and supply is equal to demand), but not exhibiting growth.

[111] *Id.* at 14–16. Carlton asserts these views are widely supported by economic literature. *See, e.g., id.* at 17–18.

[112] *See, e.g.,* PR Comments at 2; *Stamps.com* Comments at 5; MDMCS Comments at 1; Amazon Comments at 1; ACMA Comments at 3.

[113] *See* Postal Service Reply Comments at 17–28; Panzar Reply Decl. at 6; Amazon Reply Comments at 23–27.

[114] *See* Amazon Reply Comments at 29–32; Postal Service Reply Comments at 15; PR Reply Comments at 2–3.

assert that many of the benefits competitors have are in the provision of services that the Postal Service is legally barred from providing, and that competitors benefit from the Postal Service's economies of scale and scope by using the Postal Service for last-mile delivery.[115] Panzar asserts that while some statutory provisions confer scale economies on the Postal Service, raising the appropriate share would not eliminate them and would instead transfer their benefits to profitable competitors. Panzar Reply Decl. at 6.

With regard to Sidak's assertions concerning the Postal Service's incentives to underprice competitive products to gain scale at the expense of profit, Amazon, Panzar, and the Postal Service all maintain that such arguments are unfounded.[116] The Postal Service asserts that Sidak's view is not factually supported and that if the Postal Service were to increase scale at the expense of profit, it would likely start with market dominant operations, which ''dwarf[ ] the scale of competitive operations.'' Postal Service Reply Comments at 29. Amazon and Panzar state that both trends (including price and contribution increases associated with competitive products) and theory disprove Sidak's position.[117] The Public Representative asserts that there has been no demonstration that the Postal Service is underpricing its competitive products or attempting to expand the scale of its operations at its rivals' expense using unfair tactics, and that it is ''highly unlikely'' that the Postal Service could leverage the postal monopoly in order to underprice its competitors. PR Reply Comments at 4, 10. He maintains that Sidak's argument, which focuses on the incentives of management in regulated industries, does not apply to the Postal Service's competitive products because those products have been specifically deregulated to allow the Postal Service to maximize profits. *Id.* at 10. He also posits that ''due to the Postal Service's precarious finances, it does not have the luxury of trading scale for profits.'' *Id.*

With regard to Sidak's and FUR's arguments regarding the institutional cost recovery burden placed on market dominant products, the Public Representative asserts that such arguments are misleading. *Id.* at 5. He maintains that the appropriate share requirement for competitive products has no impact on rates for market dominant products. *Id.* at 6, 9. BOS echoes this, stating as long as incremental costs are properly categorized, institutional costs cannot be caused by competitive products alone. BOS Reply Comments at 8.

With regard to UPS's, Sidak's, and Carlton's assertions that competitive products have driven increases in institutional costs, the Postal Service responds that institutional costs have risen due to the growth in delivery points, an increase in the Federal Employees Retirement System (FERS) supplemental liability payment, and a methodology change for city carriers—not the growth of competitive products. Postal Service Reply Comments at 32–33. With regard to Sidak's and Carlton's assertions concerning the effects of a low appropriate share requirement on dynamic efficiency, Amazon and Panzar both maintain that such arguments are unsound because there is evidence of both innovation and new entrants into the market.[118]

c. Commission Analysis

The Commission addresses UPS's and Sidak's comments asserting that the Postal Service has a competitive advantage and that the playing field is not level in section V, *supra.* The Commission concludes that the FTC's finding that the Postal Service operates at a net competitive disadvantage relative to its competitors remains valid. *See* section V, *supra.* However, the Commission agrees with UPS that competitive volume and revenue has grown over the past 11 years. As the Commission explains in section IV.A, *supra,* the Commission considers these changes as among the reasons it proposes a new approach to calculating the appropriate share. Further, the formula-based approach itself directly takes into account the growth in revenue and market share. Under the proposed approach, the appropriate share will increase during periods of Postal Service competitive product growth. *See* section IV.B and C, *supra.*

Concerning UPS's, Sidak's, and Carlton's assertions that competitive volume is driving a larger percentage of the Postal Service's institutional costs, the Commission finds that this assertion misconstrues the nature of institutional costs, which, by definition, do not have a reliably identifiable causal relationship with any specific Postal Service product(s). Therefore, an increase in institutional costs cannot be driven by competitive products because if such a cost increase could be attributed to competitive products then it would not be an institutional cost. The Commission further discusses the distinction between attributable and institutional costs in section IV.C.2, *supra.* The Commission also agrees with the Postal Service that other known sources are driving the increase in institutional costs. *See* Postal Service Reply Comments at 32–33.

With regard to Sidak's view that the Postal Service is incentivized to underprice its competitive products in order to increase the scale of its operations, the Commission finds that given the low volume of competitive products relative to the Postal Service's overall operations, underpricing competitive products would not be effective in significantly expanding the Postal Service's scale. Additionally, the incremental cost test restricts the extent to which the Postal Service can underprice competitive products by ensuring that competitive products recover, at a minimum, their incremental costs. *See* 39 U.S.C. 3633(a)(1). Further, there is no evidence that the Postal Service has attempted to expand its scale at the expense of profit. Instead, the record shows the Postal Service actively competing. *See* section IV, *supra.* For example, as Table IV–7 in section IV.C.3.d, *supra* shows, the contribution of competitive products as a percentage of institutional cost has grown substantially since FY 2007.

With regard to Sidak's and FUR's assertions that a higher appropriate share is necessary to protect market dominant mailers, the Commission notes that the commenters representing the interests of market dominant mailers in this proceeding do not have the same concerns and generally take an opposite view on if and by how much the appropriate share should be changed.[119] Some express concern that setting the appropriate share too high will harm market dominant mailers by making it more difficult for the Postal Service to contribute to institutional costs, as well as harm the overall finances of the Postal Service.[120] The Commission's proposed approach protects market dominant mailers because it ensures that competitive products are contributing an amount to institutional costs that is reflective of market conditions.

With regard to FUR's assertion that the lack of any specific connection

[115] Amazon Reply Comments at 27–29, 34–35; PR Reply Comments at 2–3, 7–8.

[116] Amazon Reply Comments at 20; Panzar Reply Decl. at 7–9; Postal Service Reply Comments at 28–29.

[117] Amazon Reply Comments at 10–13, 20–22; Panzar Reply Decl. at 7–9.

[118] Amazon Reply Comments at 34; Panzar Reply Decl. at 9–10.

[119] *See e.g.,* NPPC Reply Comments at 2; PostCom Comments at 2; *Stamps.com* Comments at 5; MDMCS Comments at 1; ACMA Comments at 3; GCA Reply Comments at 2.

[120] *See* NPPC Reply Comments at 5; MDMCS Comments at 7; ACMA Comments at 3.

between the appropriate share and the actual revenue or costs of competitive products is problematic due to the risk of cross-subsidy, this concern is obviated by the fact that the Commission employs an incremental cost test to prevent market dominant products from cross-subsidizing competitive products.[121]

With regard to Sidak's and Carlton's comments concerning dynamic efficiency, the Commission finds that the market itself does not appear to be lacking innovation. The delivery industry since the enactment of the PAEA has been defined by innovation and entry, including the introduction of more efficient vehicles, improved dynamic routing algorithms, Sunday delivery by the Postal Service, and the growth of Amazon as both a customer of, and competitor to, other delivery services.[122] Furthermore, the Commission's proposed formula-based approach is designed to address changes in both static and dynamic efficiency because it raises the appropriate share in response to both increases in the Postal Service's market power and growth in the overall market, whether such growth is based on increases in demand, entry of new firms, or innovations in the industry.

2. Proposed Methodology for Setting the Appropriate Share

a. Comments in Favor of Increasing Appropriate Share

UPS contends that the appropriate share level should ideally be based on the stand-alone costs of the Postal Service's competitive services. UPS Comments at 33. In the alternative, UPS asserts that the best proxy for the appropriate share level would be attributable cost shares—*i.e.,* for competitive products to contribute to institutional costs in the same proportion at which they contribute to total attributable costs. *Id.* at 34–35. UPS suggests that its approach is the one used by the European Commission in its regulation of European Union postal operators. *Id.* at 37–39. Suggesting a 3-year average be used, UPS states that the average of the last 3 years' attributable cost shares for competitive products was 29.4 percent. *Id.* at 35. Therefore, UPS contends that the appropriate share should be set at approximately 29 percent.[123]

As an alternative to this proposal, UPS states that if the Commission is not inclined to use attributable cost shares, then it should use revenue shares—*i.e.,* set the appropriate share equal to the revenue from competitive products as a percentage of the Postal Service's total revenue. *Id.* at 39. Under this approach, the appropriate share would be 24.2 percent. *Id.* UPS also urges the Commission to set the appropriate share to adjust annually to mitigate the risk of it ''becoming outdated shortly after it is set.'' *Id.* at 39–40.

GCA also proposes a methodology for increasing the appropriate share, which is based on an average of the actual contribution competitive products have made to institutional costs since FY 2010. GCA Comments at 6–7. GCA's proposed methodology would yield an appropriate share level of between 10.5 and 11 percent. *Id.* at 6.

b. Comments in Opposition to Increasing Appropriate Share

All reply commenters not affiliated with UPS generally oppose UPS's proposed approaches. Panzar specifically objects to UPS's proposal of a stand-alone competitive enterprise measure because he asserts it is a method for determining the maximum price and is inappropriate for setting a price floor. Panzar Reply Decl. at 6.

Several commenters object to UPS's proposed attributable cost shares approach. Amazon asserts that UPS's proposal is unfair to mailers, shippers, and consumers and would tilt the playing field in the marketplace against the Postal Service. Amazon Reply Comments at 22, 33–34. Amazon, Panzar, MDMCS, and GCA all assert that UPS's proposal essentially amounts to fully-allocated costing, an approach which the Commission has previously rejected.[124] Amazon maintains that fully-allocated costing is arbitrary because it assigns costs without a basis in causation and has been widely rejected by economists, Congress, and the courts. Amazon Reply Comments at 3, 36–47.

The Postal Service maintains that UPS's proposal is ''illogical and unworkable'' because in order for market dominant products to pay their attributable cost share, market dominant rates would have to be raised significantly, likely in violation of 39 U.S.C. 3622(d)'s price cap. Postal Service Reply Comments at 12–13. Additionally, the Postal Service asserts that UPS's proposal amounts to an equal markup requirement which fails to account for prevailing market conditions, and as such contradicts the underlying purpose of the appropriate share provision.[125] The Public Representative suggests that a fairer method than UPS's would be to look at the true proportion of institutional costs actually covered by competitive products because the Postal Service does not recover all of its institutional costs in a given year. PR Reply Comments at 8.

The Postal Service contends that UPS's proposal would fail to account for the asymmetric distribution of worksharing, which results in market dominant products having a higher cost coverage than competitive products and thus being better positioned to contribute more to institutional costs. Postal Service Reply Comments at 13–14. The Postal Service asserts that UPS's proposed methodology is arbitrary because competitive products' attributable costs are disproportionately concentrated in transportation, which competitive products consume more of than market dominant products. The Postal Service maintains that there is no reason to conclude that institutional costs should be allocated on the same basis. *Id.* at 14–15.

Several commenters are concerned that UPS's proposal would harm competition. NPPC characterizes an appropriate share of 29.4 percent as ''wholly unrealistic, not to mention noncompetitive (and probably unachievable).'' NPPC Reply Comments at 5. MDMCS asserts that UPS's proposal would require substantial competitive product price increases, which could jeopardize the Postal Service's position in the market and undermine the contribution that competitive products currently make to institutional costs. MDMCS Reply Comments at 1. NAPM contends that a substantial increase in the appropriate share would compel the Postal Service to raise competitive product prices substantially, jeopardizing its position in the market and, derivatively, the

[121] This test ensures that competitive products cover their incremental costs, or the costs avoided by not providing competitive products. *See, e.g.,* Docket No. ACR2016, Annual Compliance Determination, March 28, 2017, at 79; Order No. 3506 at 8.

[122] *See* PR Comments at 15–17; Amazon Comments at 23–28.

[123] *Id.* at 33; UPS Reply Comments at 19. UPS also notes that, if necessary, the increase could be phased in by setting the requirement as a weighted average of the 3-year average attributable cost share and the current appropriate share level. UPS Comments at 36–37.

[124] Amazon Reply Comments at 35–47; Panzar Reply Decl. at 10–13; MDMCS Reply Comments at 2; GCA Reply Comments at 1–2.

[125] *Id.* at 7–12. A markup requirement constitutes a minimum amount the Postal Service would have to charge beyond the cost of a product or set of products. An equal markup requirement is a markup for one product or for a set of products designed to ensure the product's contribution (or cost coverage) is as high as that of another product or set of products.

contribution that competitive products currently make to institutional costs. NAPM Reply Comments at 2. BOS echoes this, citing concerns that the Postal Service would have to increase competitive product prices, which would substantially harm the market. BOS Reply Comments at 2.

The Public Representative asserts that ''[r]egardless of the method used to calculate the benchmark contribution requirement, if the minimum contribution level is continually revised upward based on the most recent contribution level, the required contribution will increase as competitive product profits increase to ever higher levels until they become, in effect, a ceiling.'' PR Reply Comments at 7. He warns that such a scenario could ''increase competitive product prices in the near future to a level higher than the market will bear and thus . . . reduce [competitive products'] revenue and contribution.'' *Id.*

The Public Representative criticizes UPS's proposed revenue shares methodology, stating that such an approach ignores the fact that the increasing share of total revenue derived from competitive products is partially based on the decline in market dominant volumes. *Id.* at 5. As a result, he asserts that basing the appropriate share level on such methodology would overstate competitive products' share of institutional costs. *Id.* GCA is also opposed to the revenue shares methodology and asserts that it constitutes a form of fully-allocated costing. GCA Reply Comments at 1–2.

Several reply commenters were also opposed to GCA's proposed approach. The Postal Service asserts that historic institutional cost contribution levels do not yield a meaningful analysis of the market and would be unsupported by the PAEA and Commission precedent. Postal Service Reply Comments at 34–37. Amazon criticizes GCA's proposal on the ground that it ''would still be below the actual contribution from competitive products in any year since [FY] 2013 . . . .'' Amazon Reply Comments at 47. Amazon asserts that the non-binding nature of GCA's proposal illustrates why the Commission should eliminate the appropriate share requirement. *Id.* at 48.

c. Commission Analysis

With regard to UPS's proposal that the appropriate share be based on the stand-alone cost of the Postal Service's competitive business, the Commission finds that UPS appears to misconstrue the nature of stand-alone costs. Stand-alone costs are the costs used in evaluating the maximum price that can be charged to customers in order to avoid cross-subsidizing other products offered by a firm. *See* Panzar Reply Decl. at 6. Although stand-alone costs for Postal Service's competitive products could be used to develop maximum prices for those products to ensure there is no cross-subsidization of market dominant products, this is not required by the PAEA.[126] In addition, the Commission has and continues to view the appropriate share as a minimum requirement. As a result, an approach designed to develop a maximum price or ceiling would be inappropriate for setting a minimum price or floor.

With regard to UPS's proposal that the appropriate share be based on attributable cost shares, the Commission notes multiple issues with UPS's proposed approach. First, using attributable cost shares alone fails to take into account the relevant circumstances and prevailing competitive conditions in the market, as required by section 3633(b). The Postal Service's attributable cost shares do not provide any insight into its market power, the size of the overall competitive market, or any other prevailing competitive conditions. Although changes in attributable cost shares partly reflect transfers to the competitive product list from the market dominant product list, they are also affected to a much larger degree by the decline in market dominant mail volumes and costs.

Second, UPS's attributable cost shares proposal is tantamount to fully-allocated costing. Such an approach, which would allocate institutional costs to products based on those products' relative shares of total attributable costs, has long been rejected by the Commission and by economists in general as being inherently arbitrary.[127] Assigning costs in that manner does not reasonably reflect causation and can lead to widely different results depending on whether total volume or total attributable cost shares are used.[128] In addition, such an approach fails to maximize economic efficiency because it is not based on marginal cost and does not yield prices reflecting market demand. *Id.* The approach also violates the Commission's long-standing approach to cost attribution that necessitates attribution be established through reliably identified causal relationships.[129]

With regard to UPS's alternate proposal that the appropriate share be based on revenue shares, the Commission finds it suffers from similar weaknesses to the attributable cost shares proposal. First, considering revenue alone does not take into account the statutory criteria and Commission precedent. Moreover, the Postal Service's total revenue is also driven by its market dominant revenue, and market dominant mail has experienced declining demand since FY 2007 and a reduction in its revenue share relative to competitive product revenue. Should those trends continue, declines in market dominant revenue would increase the appropriate share for competitive products under the UPS proposal. The substantial impact that unrelated factors (*e.g.,* a decline in market dominant revenue) can have on the appropriate share under this approach demonstrates the major flaw with this and other approaches that assign costs based on non-causation factors.

The Commission agrees with UPS's suggestion that the appropriate share should adjust annually. At this time, the Commission finds that an annual adjustment would better reflect market conditions and mitigate the risks of the appropriate share being set too high or too low. As a result, the proposed formula-based approach would adjust the minimum appropriate share annually.

With regard to GCA's proposal that the appropriate share be based on an average of the actual contribution competitive products have made to institutional costs, the Commission finds it also suffers from several deficiencies. First, as with UPS's other proposals, relying on historic contribution alone does not address the prevailing competitive conditions in the market or the other required elements of

[126] The PAEA does, however, prohibit the cross-subsidization of competitive products by market dominant products. *See* 39 U.S.C. 3633(a)(1).

[127] *See, e.g.,* Docket No. R94–1, Opinion and Recommended Decision, November 30, 1994, Appendix F at 7; Docket No. R84–1, Opinion and Recommended Decision, Vol. I, September 7, 1984, at 143 (Docket No. R84–1 Opinion).

[128] *Id.* In its comments, UPS demonstrates this with the differing appropriate share percentages it calculates as a result of its attributable cost shares and revenue shares approaches.

[129] *See* 39 U.S.C. 3622(c)(2); Docket No. R84–1 Opinion at 140 (citing *Nat'l Ass'n of Greeting Card Publishers* v. *United States Postal Service,* 462 U.S. 810 (1983)). In *Nat'l Ass'n of Greeting Card Publishers,* the Supreme Court addressed UPS arguments similar to those it makes in this proceeding, stating: ''[p]etitioner [UPS] argues that extended use of cost-of-service principles is necessary to avoid subsidization of those classes of mail for which the Postal Service has competition . . . by other classes of mail for which the Postal Service enjoys a statutory monopoly . . . [,] [b]ut Congress adopted the . . . conclusion that, unless a reliable connection is established between a class of service and a cost, allocation of costs on cost-of-service principles is entirely arbitrary.'' *Nat'l Ass'n of Greeting Card Publishers,* 462 U.S. at 829 n.24.

section 3633(b). *See* 39 U.S.C. 3633(b). Second, it is unclear why GCA proposes to use the average historic contribution since FY 2010, rather than FY 2007 when the PAEA was enacted. Finally, relying on a rolling average of historic contribution levels can result in an appropriate share that does not react easily to economic changes. For example, if the Postal Service were to experience several years of high contribution, followed by a significant recessionary shock, an appropriate share level based on average historic contribution may become difficult for the Postal Service to achieve in the face of adverse market conditions. Similarly, if demand for Postal Service competitive products were to decline over time, it would take years for an appropriate share based on average historic contribution to incorporate the effect of this decline. In the meantime, the Postal Service may be unable to both respond to the decline through altering its pricing and meet the appropriate share. Because the Commission's proposed approach adapts to changes in market conditions, it mitigates the risks associated with changes in the market.

B. Maintain the Appropriate Share

The Public Representative, NPPC, and PostCom [130] recommend that the Commission maintain or slightly increase the appropriate share.[131] UPS and Carlton filed comments in opposition.[132] Following a summary of the comments, the Commission discusses the issues raised in the context of its proposed formula-based approach.

1. Comments in Favor of Maintaining the Appropriate Share

Although there are minor divergences in the commenters' views, the Public Representative, NPPC, and PostCom generally advocate that the Commission maintain or slightly increase the appropriate share.[133]

All three commenters discuss why they see the competitive market as functioning correctly. For example, the Public Representative maintains that UPS's and FedEx's profits indicate healthy competition in the competitive market. PR Comments at 17. He asserts that UPS and FedEx together comprise roughly 84 percent of the total competitive market, while the Postal Service comprises only about 15 percent. *Id.* at 11. He maintains that relative market share for the 3 largest delivery companies—UPS, FedEx, and the Postal Service—has been stable for years, indicating strong competitive conditions in the market. *Id.* at 14. In advocating for a moderate approach, PostCom supports maintaining ''the stable structure'' that has allowed the Postal Service to grow its competitive products while safeguarding against predatory pricing and cross-subsidization. PostCom Comments at 6–7. NPPC and PostCom emphasize the appropriate share's effectiveness in allowing the Postal Service's competitive products to compete and be profitable.[134]

Despite advocating for the appropriate share to be maintained at 5.5 percent, the commenters acknowledge the changes that have occurred in the competitive market. For example, the Public Representative identifies changes to the market, including the growth of e-commerce and the rise of Amazon, and notes that the Postal Service's financial condition remains precarious. PR Comments at 15. He acknowledges that competitive volumes have increased relative to market dominant volumes, but he states that competitive volumes remain a minor share of overall volume. *Id.* at 16. Similarly, PostCom also states that despite ''impressive growth in volumes, revenues, and contribution,'' competitive products have remained a small share of overall volume. PostCom Comments at 2, 5. NPPC discusses the growth in the package and overnight delivery markets, stating that a ''modest upward adjustment would not be unreasonable.'' NPPC Reply Comments at 5–6. However, NPPC cautions that any upward adjustment should not disrupt competitive products' pricing. *Id.* at 6.

All three commenters also raise concerns about the risks of setting the appropriate share too high and harming competition. The Public Representative asserts that if the Commission were to raise the appropriate share level, it could fuel industry-wide price increases for competitive products that solely benefit competitors. PR Comments at 17, 18. He is also concerned that ''there is simply too little margin for error,'' and that too high of an appropriate share would ''cause a loss of otherwise profitable volumes'' for the Postal Service. *Id.* at 18.

PostCom urges the Commission to avoid ''radical action that could serve to unfairly hamstring the Postal Service's pricing flexibility and endanger its ability to compete in the competitive marketplace.'' PostCom Comments at 1. PostCom asserts that the current appropriate share has not impeded the Postal Service's ability to compete, but it is concerned that a large increase in the appropriate share would be disruptive to the Postal Service and overall market. *Id.* at 6. Similarly, NPPC is concerned that too high of an appropriate share would ''[choke] off business in the Competitive Products area,'' which it states is not in the interests of market dominant mailers and would reduce overall competitiveness. NPPC Reply Comments at 5.

2. Comments in Opposition to Maintaining the Appropriate Share

As discussed in the sections above and below, many commenters advocate for a much larger increase in the appropriate share or for the appropriate share to be eliminated.[135] A few of those commenters voice general opposition to maintaining the appropriate share at 5.5 percent.[136] UPS and Carlton are the only commenters to respond directly to the positions of those who advocate for the appropriate share to be maintained or slightly increased.

UPS states the current 5.5-percent appropriate share does not ensure a level playing field, fails to account for competitive products' growth, and ''bears no rational relationship to current market conditions.'' UPS Comments at 1–2. UPS takes the position that competitive products are

[130] Although PostCom does not advocate for a particular appropriate share level, PostCom recommends that the Commission maintain a moderate approach. As a result, the Commission discusses PostCom's comments in this section.

[131] *See, e.g.,* PR Comments at 2; NPPC Reply Comments at 2; PostCom Comments at 2. The Postal Service and NALC make alternative arguments that if the Commission is not inclined to eliminate the appropriate share then it should be maintained at its current level. *See* Postal Service Comments at 1; NALC Comments at 4. *Stamps.com* takes the position that the appropriate share should be eliminated or retained. *Stamps.com* Comments at 5. The Commission includes *Stamps.com*'s comments in section VI.C.1, *infra.*

[132] *See, e.g.,* UPS Reply Comments at 1–2; Carlton Reply Decl. at 5.

[133] PR Comments at 2 (''the Commission should retain the current 5.5 percent requirement''); NPPC Reply Comments at 2 (''the Commission should either retain the current 5.5 percent minimum or raise it only modestly . . .''); PostCom Comments at 2 (''the PRC should follow a moderate approach. . .'').

[134] NPPC Reply Comments at 6; PostCom Comments at 4, 6.

[135] *See, e.g.,* UPS Comments at 4; Amazon Comments at 1.

[136] *See, e.g.,* FUR Comments at 9–12; (stating that the current appropriate share is too low in light of similar network type industries, competitive products' growth and increasing revenue, the lack of relationship between the current appropriate share and actual costs and revenues, and the high percentage of costs designated as institutional); Amazon Comments at 54–55 (citing to costs and risks the appropriate share imposes and stating that sound policy calls for removing unnecessary and non-binding rules); MDMCS Comments at 1–2 (stating that ''[e]ven leaving the required minimum contribution in place at its current level would be a needless invitation to mischief.'').

driving up the Postal Service's costs and investments, but have little responsibility to fund them. UPS Reply Comments at 1, 26. For this reason, UPS maintains that ''[c]urrent regulatory requirements . . . provide the Postal Service with an artificial advantage over the private sector,'' because private sector companies cannot ''avoid covering the costs and investments associated with selling [their] products.'' *Id.* at 1, 2. In UPS's view, the current 5.5-percent requirement ''is so low and outdated that it is effectively meaningless today.'' *Id.* at 2. UPS asserts that there will not be a level playing field unless the Postal Service sets prices high enough to produce sufficient revenue to cover all costs, which it states the current 5.5-percent appropriate share fails to do. *Id.* at 3.

Carlton states that maintaining the current 5.5-percent appropriate share ''would promote the inefficient expansion of USPS' competitive products, as well as harm innovation and the dynamic efficiency of the parcel delivery industry.'' Carlton Reply Decl. at 5. UPS dismisses the concerns raised by other commenters that raising the appropriate share would be detrimental to consumers and the Postal Service. It asserts that such arguments fail to consider the harm the Postal Service causes to dynamic efficiency, and asserts that no commenter demonstrated that the Postal Service's ability to compete would be harmed by an increase in the appropriate share. UPS Reply Comments at 34–35.

3. Commission Analysis

As discussed in detail in section IV, *supra,* the Commission finds that its proposed formula-based approach best captures the prevailing competitive conditions in the market and other relevant circumstances under 39 U.S.C. 3633(b).

Although several commenters advocating for the appropriate share to be maintained or slightly increased assert that the current appropriate share has been successful at preserving competition and has allowed the Postal Service to grow its competitive business, those commenters also acknowledge the substantial changes that the competitive market has experienced over the past 11 years. As the Commission discusses in section IV.A, *supra,* these changes render a change in approach appropriate at this time. The Commission agrees with the Public Representative and PostCom that competitive volume remains a minor share of overall volume. *See* section IV.C.3.b, *supra.* However, as the Commission discusses in sections IV.B and IV.C.1, the prevailing competitive conditions in the market have changed, with the Postal Service's market power and market share, as well as the competitive market as a whole, all growing since FY 2007.

Although under current market conditions the minimum appropriate share provided by the formula would increase over the current 5.5-percent requirement, the operation of the formula and the proposed annual adjustment of the appropriate share should mitigate many of the concerns raised by the commenters who advocate for the Commission to maintain or slightly increase the appropriate share. For example, several commenters express concern that the appropriate share will be set too high and harm the Postal Service's ability to compete (which they assert, in turn, will hurt competition as a whole and the Postal Service's finances). In section IV.C.3.d, *supra,* the Commission considers concerns with setting the appropriate share too high and discusses how the proposed formula limits increases to no higher than needed to account for growth in the Postal Service's market power or growth in the market as a whole. The proposed formula-based approach also mitigates this risk by adjusting annually to reflect market conditions. As a result, if the Postal Service were to lose market share and the competitive market were to retract, those changes would be reflected in a future decrease in the appropriate share. Further, as demonstrated by Table IV–7 in section IV.C.3.d, *supra,* the proposed formula-based approach should not force the Postal Service to raise prices or harm its ability to compete.

C. Eliminate the Appropriate Share

Amazon, Panzar, the Postal Service, *Stamps.com,* NALC, MDMCS, ACMA, eBay, and BOS recommend that the Commission eliminate the appropriate share.[137] UPS, Carlton, and Sidak filed comments opposing elimination of the appropriate share.[138] Following a summary of the comments, the Commission discusses the issues raised in the context of its proposed formula-based approach.

1. Comments in Favor of Eliminating the Appropriate Share

Several commenters cite the competitive nature of the market as a reason for eliminating the appropriate share. The Postal Service asserts that the current market is competitive—even more competitive than it was when the appropriate share was last reviewed—and that the Postal Service's competitors are profitable and growing. Postal Service Comments at 6–7, 17. It represents that its market position has remained relatively unchanged since the last review, although it acknowledges that the market has grown overall. *Id.* at 10–12. ACMA asserts that there is considerable competition in the delivery sector, despite each competitor having unique strengths and weaknesses. ACMA Comments at 1–2. *Stamps.com* states that the market is ''workably competitive,'' with many factors other than price affecting the market. *Stamps.com* Comments at 1–3. Amazon asserts that the Postal Service's competitors have ''undeniably thrived.'' Amazon Comments at 7–8.

Among the commenters advocating for elimination of the appropriate share, commenters generally maintain that the Postal Service does not have a competitive advantage, and many assert that the Postal Service is operating at a competitive disadvantage. The Postal Service, ACMA, and BOS state that the Postal Service remains at a competitive disadvantage relative to its competitors.[139] The Postal Service asserts that if the playing field is level or otherwise not tilted in favor of the Postal Service, ''the importance of the [appropriate share] provision is diminished, and the appropriate share requirement should at the very least be reduced, if not eliminated.'' Postal Service Comments at 4–5. Amazon maintains that on the whole, a balanced assessment of the benefits and burdens accruing to the Postal Service as a result of its unique governmental status shows that it receives no unfair advantage. Amazon Comments at 41.

Several commenters assert that the Postal Service is engaging in fair competition and, as a result, the appropriate share is unnecessary. MDMCS states the requirement is ''an irrelevant anachronism,'' because it is unnecessary to level the playing field, prohibit cross subsidization, or ensure that competitive products contribute to institutional costs. MDMCS Comments at 1. Similarly, Amazon and Panzar take the position that the appropriate share requirement is not necessary to provide

[137] *See, e.g.,* Amazon Comments at 1; Panzar Decl. at 2; Postal Service Comments at 1; *Stamps.com* Comments at 1; NALC Comments at 1; MDMCS Comments at 1; ACMA Comments at 3; eBay Reply Comments at 2; BOS Reply Comments at 14. The Commission notes that *Stamps.com* advocates for the appropriate share to be eliminated or retained at 5.5 percent. *Stamps.com* Comments at 5.

[138] *See, e.g.,* UPS Reply Comments at 3; Carlton Reply Decl. at 5; Sidak Reply Decl. at 1.

[139] Postal Service Comments at 6–10; ACMA Comments at 2; BOS Reply Comments at 8–10.

a ''level playing field'' for the Postal Service's competitors.[140] Amazon asserts that any unique legal treatment which the Postal Service receives is the result of deliberate policy choices made by Congress. Amazon Comments at 39. Moreover, Amazon maintains that the Postal Service's competitors have their own unique economies of scale and scope which are unavailable to the Postal Service, and that the economies of scale and scope in last-mile delivery which the Postal Service possesses are shared with its competitors, who are permitted to access the Postal Service's network. *Id.* at 34–42.

ACMA, MDMCS, *Stamps.com,* and Panzar assert that the Postal Service is behaving appropriately in the market, as it tries to maximize profits while retaining customers.[141] *Stamps.com* and Amazon maintain that contribution to institutional costs is an outcome of the Postal Service's pursuit of profits and pricing.[142] As a result, both assert that the minimum contribution has no role to play.[143] Similarly, eBay takes the position that the appropriate share requirement is unnecessary because historical experience has shown that the Postal Service prices its competitive products so as to increase contribution levels to institutional costs.[144]

Panzar, NALC, and MDMCS assert that there is no need for a minimum appropriate share because the Postal Service has increased competitive prices, the contribution of competitive products to institutional costs has exceeded the minimum appropriate share, and there has been no evidence of predatory pricing or unfair subsidization on the part of the Postal Service.[145] Similarly, Amazon asserts that the fact that the actual contribution level from competitive products has consistently exceeded the required level renders the appropriate share requirement effectively irrelevant as a pricing constraint. Amazon Comments at 29.

Amazon and MDMCS assert that the minimum share requirement is not necessary to protect against cross-subsidization of competitive products by market dominant products because the Commission already employs its incremental cost test to prevent cross-subsidization. This test ensures that competitive products cover their incremental costs, and these commenters maintain that as long as competitive product prices cover those products' incremental costs, there is no risk of cross-subsidization.[146] For the same reason, Amazon and Panzar maintain that the appropriate share requirement is not necessary to prevent predatory pricing by the Postal Service, because prices which cover their incremental costs, by definition, cannot be predatory.[147] The Postal Service states that there is no basis to find that it has engaged in predatory pricing. Postal Service Comments at 10.

Amazon asserts that the Postal Service ''is aggressively pursuing contribution from competitive products, not trying to minimize it.'' Amazon Comments at 19. Amazon explains that this has resulted in the growth of contribution to institutional costs by competitive products since the last review of the appropriate share, and it posits that much of this growth has been the result of above-inflation price increases. *Id.* at 19–20, 22–23. Amazon maintains that the Postal Service's competitors have also been able to impose above-inflation price increases for their products, and that they are profitable and are investing heavily in expansion and improved technology. *Id.* at 23, 28.

Amazon and Panzar take the position that the appropriate share requirement is not necessary to provide a margin of safety with regard to the Postal Service's cost estimates.[148] Amazon notes that current cost coverage levels for competitive products are high, and it maintains that the Postal Service's cost estimation methods have been demonstrated to be reliable. Amazon Comments at 33–34. Panzar maintains that the Postal Service should be permitted to price its competitive products down to the level of incremental costs. Panzar Decl. at 5–11.

Amazon, Panzar, *Stamps.com*, MDMCS, and NALC are concerned that if the appropriate share were set too high, both the Postal Service's finances and consumers would be harmed.[149] MDMCS and Amazon assert that shippers and ultimately consumers would be harmed through higher prices and shipping costs, and MDMCS, Amazon, Panzar, and ACMA suggest that all Postal Service customers would be hurt if declining finances resulted in service declines.[150] In addition, Amazon suggests that rural customers and customers who receive packages at residences would be most harmed. Amazon Comments at 47–51. Amazon maintains that the only winners in the case of a substantial price increase would be the Postal Service's competitors, which would gain additional pricing power. *Id.* at 10, 45–46.

MDMCS also expresses concern that having any appropriate share requirement is risky because market conditions could change unexpectedly (*e.g.,* a competitor could shift a portion of package volume from the Postal Service to its own delivery network). MDMCS Comments at 7. The Postal Service echoes this concern, stating that setting the appropriate share too high would injure consumers by pricing the Postal Service out of the market, lessening overall price and service competitiveness in the market and harming the Postal Service's ability to fund necessary network infrastructure. Postal Service Comments at 4–5. It also discusses the growth of last-mile delivery, which has been largely driven by three major customers. *Id.* at 12. The Postal Service asserts that a substantial reduction in packages from these three customers could impact its ability to maintain current levels of contribution, and it asserts that the risk of losing this volume ''cannot be dismissed as mere conjecture.'' *Id.* The Postal Service also discusses several changes to the market that it asserts may threaten the Postal Service's competitive position. *Id.* at 14. These changes include steadily increasing customer demands and expectations, major e-commerce retailers taking more logistics and delivery operations in-house, and new competition providing last-mile delivery. *Id.* at 14–16.

2. Comments in Opposition to Eliminating the Appropriate Share

Several commenters state generally that they are opposed to eliminating the appropriate share.[151] UPS, Sidak, and

[140] Amazon Comments at 34–43; Panzar Decl. at 7–8.

[141] ACMA Comments at 3; MDMCS Comments at 2; *Stamps.com* Comments at 3; Panzar Reply Decl. at 7–9.

[142] *Stamps.com* Comments at 4; Amazon Comments at 6.

[143] *Stamps.com* Comments at 5; Amazon Comments at 6.

[144] eBay Reply Comments at 2. eBay also notes that it posted a petition on its website, which received 32,805 signatures supporting elimination of the appropriate share from its online community. *Id.* at 3–4, App. A.

[145] *See* Panzar Decl. at 10–11; NALC Comments at 2, 3; MDMCS Comments at 2–6.

[146] Amazon Comments at 30–32; MDMCS Comments at 3.

[147] Amazon Comments at 32–33; Panzar Decl. at 5–6.

[148] Amazon Comments at 33–34; Panzar Decl. at 6–7.

[149] *See* Amazon Comments at 4–5, 9; Panzar Decl. at 11–12; *Stamps.com* Comments at 5; MDMCS Comments at 1–2, 6–7; NALC Comments at 4.

[150] MDMCS Comments at 7; Amazon Comments at 9–10, 43–46; Panzar Decl. at 14; ACMA Comments at 2.

[151] *See, e.g.,* PostCom Comments at 4, 6 (stating that ''dispensing with the appropriate share requirement does not appear to be a viable option,'' and that the appropriate share continues to have an important protective role against the possibility of

Continued

Carlton are the only commenters to respond directly to the positions of those who advocate for the appropriate share to be eliminated.

UPS asserts that the appropriate share is critical to ensuring the Postal Service competes on a level playing field. UPS Reply Comments at 7. UPS takes the position that ''without a significant contribution requirement, the playing field is artificially tilted in the Postal Service's favor.'' *Id.* at 19. As discussed in section V.B, *supra,* UPS and Sidak both maintain this is due in large part to the advantages of the postal monopoly.[152] UPS views the bar on the Postal Service's ability to sell non-postal products as insufficient to overcome the advantages of the postal monopoly. UPS Reply Comments at 24–26.

UPS opposes several of the views held by other commenters. UPS disagrees with the Postal Service's characterization that its position in the market has remained unchanged since the Commission last reviewed the appropriate share. *Id.* at 29. UPS provides an alternative analysis that shows that the Postal Service has ''achieved significant gains in ground-based services in recent years.'' *Id.* at 31. UPS contends that the Postal Service has rapidly gained market share in recent years in ''critical segments.'' *Id.* at 32. UPS also objects to the characterization by several commenters that price increases on competitive products alleviate concerns of market distortion. *Id.* at 32–33. UPS alleges that because the Postal Service's competitive products have been historically underpriced, the Postal Service is able to raise prices and undercut competitors at the same time. *Id.* at 33. UPS disputes the view that the appropriate share is not needed because the Postal Service has incentives to exceed it and advocates that the Commission not give weight to competitors' profitability. *Id.* at 33–34.

Carlton asserts that the problems with the current 5.5-percent appropriate share would be exacerbated if the appropriate share were eliminated. Carlton Reply Decl. at 5. He states that the Postal Service's incentives differ from those of the private firms because the Postal Service has less incentive to decrease costs, use capital assets wisely, maximize profits, and innovate. *Id.* at 7–8. As a result, Carlton views the Postal Service as having ''a long track record of inefficiency and excess capacity.'' *Id.* at 8. Sidak echoes this, stating that Panzar incorrectly assumes the Postal Service to be profit maximizing, and asserting that this assumption impacts the overall reliability of Panzar's analysis.[153] Sidak asserts that the Postal Service has the incentive to sacrifice profit in order to expand its scale, and he is concerned that this creates a further incentive for the Postal Service to underprice competitive products, engage in predatory pricing, and harm competitors and market dominant customers. *Id.* at 3–4, 5–6, 10–11, 13–14. He suggests that market dominant products are unable to bear higher costs and that the Postal Service will need to recover more institutional costs from competitive products ''[t]o avoid financial collapse.'' *Id.* at 14. Carlton and Sidak directly contest Amazon's and Panzar's view that requiring coverage of incremental costs alone is sufficient to preserve competition.[154] Sidak cites concerns that Amazon and other large shippers are incentivized to engage in rent-seeking behavior at the expense of market dominant customers and taxpayers. Sidak Reply Decl. at 2, 34–41. Carlton asserts that the incremental costs test for cross-subsidy only applies when the firm at issue operates efficiently. Carlton Reply Decl. at 7, 11. Carlton maintains that the Postal Service's inefficiency and excess capacity allow the Postal Service to expand competitive products and provide them at a lower incremental cost than if the Postal Service were efficient. *Id.* at 10–13. This is because underutilized labor and facilities, which would not exist if the Postal Service operated efficiently, can be used for competitive products. *Id.*

UPS echoes this, stating if the Postal Service downsized its operations as market dominant mail volumes declined, it would have been more expensive to add competitive products. UPS Reply Comments at 10. However, because it did not, UPS sees the Postal Service's low incremental costs as reflecting ''its high fixed costs rather than genuine economic efficiency.'' *Id.* at 11. Carlton asserts that this displaces activities by more efficient competitors, harms economic efficiency, and distorts competition. Carlton Reply Decl. at 11. Carlton also takes the position that the framework for estimating incremental costs is flawed because incremental costs are consistently understated due to a different view than the standard economic view, misattribution of costs, and implicit subsidies due to the Postal Service's government status. *Id.* at 19–30.

3. Commission Analysis

Several commenters contend that the market has become sufficiently competitive such that the appropriate share is no longer necessary. The Commission's analysis, however, demonstrates that the market continues to develop and change. As the Commission discusses in sections IV.B and IV.C.1, the Postal Service has gained some market power and increased its market share since the Commission's last review of the appropriate share, while the market as a whole has grown. As discussed in detail in section IV, *supra,* the Commission finds that its proposed formula-based approach best captures the prevailing competitive conditions in the market and other relevant circumstances under 39 U.S.C. 3633(b).

Many commenters take the position that either the playing field is level or the Postal Service operates at a competitive disadvantage, which they maintain supports elimination of the appropriate share. Those commenters point to a lack of predatory pricing on the part of the Postal Service, above-inflation price increases by both the Postal Service and its competitors, and increased contribution from competitive products to institutional costs. UPS and its representatives take the opposite view, maintaining that the playing field is not level, that the Postal Service's price increases are insufficient to alleviate concerns, that the Postal Service has made significant gains in areas like last-mile delivery, and that competitor profitability is irrelevant.

As discussed in section V, *supra,* the Commission concludes that the FTC's finding that the Postal Service operates with a net economic disadvantage in offering competitive products continues to be valid. However, the Commission does not find that the appropriate share should be eliminated as a result. Instead, the Commission contends that the proposed formula-based approach best captures the statutory criteria of 39 U.S.C. 3633(b) and balances the concerns of all groups—customers, competitors, market dominant mailers, shippers, and the general public.

As explained in section IV.C.1.a, *supra,* the inclusion of the Postal

cross subsidization or predatory pricing); NPPC Reply Comments at 3–4 (calling on the Commission to reject elimination of the appropriate share altogether and voicing concern that it could cause market dominant mailers to bear all institutional costs).

[152] *See* UPS Reply Comments at 19–24; Sidak Reply Decl. at 12.

[153] Sidak Reply Decl. at 2. Sidak asserts that much of Panzar's declaration would be inadmissible in federal court and urges the Commission to hold declarations to the same admissibility standard. Sidak encourages the Commission to disregard much of Panzar's declaration under a federal court standard. *Id.* at 16–34.

[154] Carlton Reply Decl. at 5; Sidak Reply Decl. at 2. UPS echoes Carlton's views throughout its reply comments. *See* UPS Reply Comments at 4–6, 8–12, 14–19.

Service Lerner Index in the proposed formula-based approach actively takes into account many of the considerations raised by commenters. For example, sudden large increases in the Postal Service Lerner Index may indicate a competitive advantage under certain circumstances, and under the proposed formula-based approach, an increase in the Postal Service Lerner Index will result in an increased appropriate share, assuming all else remains constant. In section IV.C.1.a, *supra,* the Commission also explains how the Postal Service Lerner Index can be used to test whether the Postal Service has engaged in predatory pricing for competitive products as a whole, which the Commission's analysis shows has not occurred over the past 11 years in Figure IV–1.

Although UPS asserts that competitor performance is not relevant to the Commission's inquiry, the Commission disagrees. Section 3633(b) requires the Commission to consider ''the prevailing competitive conditions in the market,'' which necessitates that the scope of the Commission's review look at the competitive market in which the Postal Service operates. The Commission includes the Competitive Market Output in the proposed formula to capture changes in the competitive market as whole. *See* section IV.B, *supra.*

Panzar advocates that the Postal Service be permitted to price its competitive products at their incremental costs. While setting price at marginal cost (or, for multi-product firms such as the Postal Service and its competitors, average incremental costs), is the economically efficient point, the Postal Service and its competitors have priced well above this point since FY 2007, and there is no evidence that competition has significantly suffered. As discussed in sections IV.B and IV.C, *supra,* the Postal Service has gained some market share and some additional market power, but its competitors have also become more profitable, and the market itself has grown through increased demand and new entrants. These above-cost prices are, therefore, a result of the inherent imperfect competition in the market. As competition in the market grows and circumstances change, evidence may arise which would warrant a further change to the appropriate share.

Although the Commission does not find that elimination of the appropriate share is the most appropriate course of action in light of current market conditions, the Commission will consider it in future reviews as one of the options set forth in the plain language of 39 U.S.C. 3633(b). The competitive market remains in a state of flux, innovation, and growth, with more efficient vehicles, dynamic routing algorithms, and Sunday delivery becoming increasingly common, and alternative forms of delivery (*e.g.,* drone delivery) being explored. Given this, the Commission finds that retaining the appropriate share and modifying it to capture market changes on an annual basis is the best approach at this time.

VII. Proposed Rules

In order to implement the Commission's proposed formula-based approach, existing § 3015.7(c), which describes the appropriate share, must be revised.

Proposed § 3015.7(c)(1) establishes the formula to be used in calculating the appropriate share and defines each term, as discussed above. *See* section IV.B.3, *supra.* Existing § 3015.7(c) states that the appropriate share of institutional costs to be covered by competitive products set forth in that rule is a minimum or floor. Proposed § 3015.7(c)(1) retains this concept.

Proposed § 3015.7(c)(2) describes the process by which the Commission shall update the appropriate share for each fiscal year. As discussed in section IV.B.3, *supra,* the Commission proposes to annually use the formula to calculate the minimum appropriate share for the upcoming fiscal year. Because the data necessary to calculate the appropriate share for an upcoming fiscal year (which begins each October 1st) is not final until the most recent ACD issues (typically at the end of the prior March), the Commission proposes to report the new minimum appropriate share level for the upcoming fiscal year as part of its ACD. For example, under the proposal, the Commission would calculate and report the appropriate share for FY 2020 as part of the FY 2018 ACD.

As indicated above, both components of the Commission's proposed formula-based approach rely on CRA data that is submitted by the Postal Service as part of its ACR. *See* section IV.B.3, *supra.* The timing of the availability of the CRA data makes the ACD an appropriate vehicle for calculating and reporting competitive products' appropriate share for the upcoming fiscal year. In addition, reporting the appropriate share for the upcoming fiscal year in the ACD would give the Postal Service time to incorporate any resulting changes into its proposed rates for the following fiscal year.

VIII. Administrative Actions

Additional information concerning this rulemaking may be accessed via the Commission's website at *http://www.prc.gov.* Interested persons may submit comments on this Notice of Proposed Rulemaking no later than 60 days after the date of publication of this Notice of Proposed Rulemaking in the **Federal Register**. Pursuant to 39 U.S.C. 505, Kenneth R. Moeller continues to be designated as an officer of the Commission (Public Representative) to represent the interests of the general public in this proceeding.

IX. Ordering Paragraphs

It is ordered:

1. Interested persons may submit comments no later than 60 days from the date of the publication of this document in the **Federal Register**.
2. Pursuant to 39 U.S.C. 505, Kenneth R. Moeller continues to be appointed to serve as the Public Representative in this proceeding.
3. The Secretary shall arrange for publication of this Order in the **Federal Register**.

By the Commission.

Stacy L. Ruble,

Secretary.

List of Subjects for 39 CFR Part 3015

Administrative practice and procedure.

For the reasons stated in the preamble, the Commission proposes to amend chapter III of title 39 of the Code of Federal Regulations as follows:

PART 3015—REGULATION OF RATES FOR COMPETITIVE PRODUCTS

■ 1. The authority citation for part 3015 continues to read as follows:

Authority: 39 U.S.C. 503; 3633.

■ 2. Amend § 3015.7 by revising paragraph (c) to read as follows:

§ 3015.7 Standards for compliance.

* * * * *

(c)(1) Annually, on a fiscal year basis, the appropriate share of institutional costs to be recovered from competitive products collectively, at a minimum, will be calculated using the following formula:

$$AS_{t+1} = AS_t * (1 + \%\Delta LI_{t-1} + \%\Delta CMO_{t-1})$$

Where,

AS = Appropriate Share, expressed as a percentage and rounded to one decimal place
LI = Postal Service Competitive Lerner Index
CMO = Competitive Market Output
t = Fiscal Year
If t = 0 = FY 2007, AS = 5.5 percent

(2) The Commission shall, as part of each Annual Compliance Determination, calculate and report

competitive products' appropriate share for the upcoming fiscal year using the formula set forth in paragraph (c)(1) of this section.

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