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BEFORE THE
POSTAL REGULATORY COMMISSION

PERIODIC REPORTING	:	**DOCKET NO. RM2008-2**

REPLY COMMENTS OF UNITED PARCEL SERVICE ON NOTICE OF PROPOSED RULEMAKING ON COSTING METHODS USED IN PERIODIC REPORTING (September 15, 2008)

Pursuant to Commission Order No. 99 (August 18, 2008), United Parcel Service ("UPS") hereby replies to certain comments of other parties regarding the United States Postal Service's recently-proposed costing methodology changes.

1. UPS Supports the Postal Service's Efforts to Identify Group-Specific Costs.

Commission Rule 3015.7(a), which implements the statutorily required test to prevent the cross-subsidy of competitive products by market-dominant products, provides that, "To the extent that incremental cost data are unavailable, the Commission will use competitive products' attributable costs supplemented to include causally related, **group-specific** costs to test for cross-subsidies." 39 C.F.R. 3015.7(a) (emphasis added). Thus, until there are reliable estimates of incremental costs, the Postal Service is required to identify group-specific costs so that the Commission can meet its obligation to satisfy one of PAEA's key requirements.

Because group-specific costs are new to the postal taxonomy, the Postal Service must undertake studies and analyses to begin identifying them. In this request to amend certain existing costing methodologies, the Postal Service has advanced three proposals that attempt to identify and quantify market-dominant and competitive group-specific costs. Request of the United States Postal Service for Commission Order Amending the Established Costing Methodologies for Purposes of Preparing the FY 2008 Annual Compliance Report (August 11, 2008), Proposals 1, 2, and 5. The Parcel Shippers Association ("PSA") has criticized the foundations upon which the Postal Service's proposals are based. See Initial Comments of Parcel Shippers Association to PRC Notice and Order No. 99 (September 8, 2008) at 2-8. However, UPS commends the Postal Service for tackling the formidable task of identifying and reasonably quantifying group-specific costs, and we strongly encourage the Postal Service to continue its efforts.

The Commission should reject PSA's argument that group-specific costs include only those non-volume variable costs that are caused *exclusively* by either competitive or market-dominant products. See PSA Comments at 3-7. Instead, the Commission should encourage the Postal Service to develop and refine new methods under the watchful eye of both the Commission and the public. Otherwise, the Postal Service may be discouraged from improving its systems and ultimately achieving the changes necessary to implement the required test for cross-subsidy. PSA's approach would result in shifting costs that can be traced to competitive products as a whole into the institutional cost pool, which is borne primarily by market-dominant products. That is classic cross-subsidy.

2. If Implemented Correctly, Proposal 1 (Headquarters Finance Numbers) Will Improve the Accuracy of the Commission's Cross-Subsidy Test.

The Postal Service has set forth a plan in its Proposal 1 to identify both competitive and market-dominant group-specific costs by isolating certain Headquarters administrative and program costs that are associated with either the competitive or the market-dominant product groups. Postal Service Request at 5-8. This proposal is clearly intended and designed to improve the cost measurement system that will ultimately be used by the Commission to test for cross-subsidy. If implemented correctly, the proposal should begin to breathe life into the Commission's cross-subsidy test.

While UPS recognizes that the Postal Service has not provided every detail of its proposed study and the basis upon which it will decide whether certain costs are causally related to either market-dominant or competitive products, see PSA Comments at 2-5, we support the implementation of changes such as this one. We urge the Commission to give approval to the Postal Service's conceptual approach and await the results of its efforts before rejecting prematurely a promising attempt to identify group-specific costs.

3. Competitive Products Cause and Should Pay For Advertising Costs for Click-N-Ship and Carrier Pickup (Proposal 2).

PSA has questioned whether Carrier Pickup and Click-N-Ship advertising costs are caused "exclusively" by competitive products. PSA Comments at 5-7. While UPS is not in a position to comment on the factual issue raised by PSA, which has not yet been fully developed, it is clear from both the Postal Service's request and PSA's comments that competitive products should at least bear the largest share of these advertising costs, which are now treated as fully institutional. Indeed, this is a good example of the flaw in PSA's proposed "exclusivity" test.

4. The Commission Should Not Reduce the Minimum Share of Institutional Costs That Competitive Products Must Pay.

PSA argues that the Commission should lower competitive products' required share of institutional costs from 5.5% if the Commission allows the Postal Service to reclassify any institutional costs as competitive group-specific costs. PSA Comments at 2-3, 9-11. In short, PSA is suggesting that the Commission reevaluate competitive products' appropriate share of institutional costs every time costing methods are improved so as to better identify the costs that are caused by competitive products. PSA's argument is based on a misunderstanding of the appropriate share requirement, and the Commission should reject it.

PSA's reasoning fails to take into account the fact that as more costs previously-classified as institutional are identified with specific products or groups of products (whether competitive or market-dominant), the institutional cost pool will get smaller. Because the share of required contribution is based on a percentage of the total pool of institutional costs, a reduction in total institutional costs inevitably leads to a corresponding reduction in the actual amount of institutional costs ultimately paid by competitive products, even if their percentage share of those dollars stays the same.

As the Commission noted when setting the appropriate share at 5.5% -- a level that nearly equals the lowest share of institutional costs borne by competitive products over the past 18 years, see Comments of United Parcel Service in Response to Order Proposing Regulations to Establish a System of Ratemaking (September 24, 2007) at 5 -- the "[a]ppropriate share is a floor for all competitive products, but the hope (and expectation) is that competitive products will generate contributions in excess of the floor." Docket No. RM2007-1, Order No. 26 at ¶ 3056. Section 3633(a)(3) of PAEA sets a minimum share that competitive products must meet and are expected to exceed; it is not a "target" that requires downward adjustment every time improved costing methods are introduced. To do so would be to increase to an unprecedented level the institutional cost burden imposed on market-dominant products -- surely not the result intended by PAEA's emphasis on improved costing.

PSA's argument also implies that the Postal Service's identification of "group-specific" costs was not anticipated by the Commission when it determined that competitive products should pay at least 5.5% of the Postal Service's institutional costs. But the Commission adopted the 5.5% appropriate share floor at the same time and in the exact same regulation in which it required the identification of "group-specific" costs as part of the cross-subsidy test. See Docket No. RM2007-1, Order No. 43 (October 29, 2007) at 137-38. When the Commission endorsed "group-specific costs," it inevitably anticipated their use when it adopted the 5.5% appropriate share requirement only 5 lines later in its Order. See id. at 138.

Moreover, there is no need to adjust the 5.5% requirement at this time. PSA's speculation about competitive products' contribution in FY2007 is flawed. See PSA Comments at 10. Competitive products will not likely fail to meet the 5.5% appropriate share requirement in FY2008 were the Commission to approve the Postal Service's proposed costing changes. On the contrary, the Commission estimated that competitive products would contribute approximately 6.9% of institutional costs in FY2008 using the Postal Service's TY2008 projections from Docket No. R2006-1. Docket No. RM2007-1, Order No. 26 (August 15, 2007) at ¶ 3051. Since those estimates were made, the Postal Service has raised competitive product rates. In addition, the Postal Service has entered into multiple competitive negotiated service agreements, each of which it has estimated will increase competitive products' contribution to institutional costs. E.g., Docket No. CP2008-5, United States Postal Service Response to Order No. 78 and Notice of Filing Information Responsive to Part 3020 of the Commission's Rules of Practice and Procedure, Attachment A at 2. These facts suggest that competitive products will be able to meet and exceed the 5.5% requirement, even with the proposed costing changes implemented.

Assuming, *arguendo*, that an adjustment to negate the effect of improved costing might in theory make sense, it would be premature to do so at this time or for the foreseeable future. PAEA explicitly provides for a reevaluation of the appropriate share requirement every 5 years. 39 U.S.C. § 3633(b). Unless the Postal Service proposes to change the competitive products list by adding or removing several products (or one product that makes a substantial contribution to institutional costs), the Commission cannot and should not continually reevaluate the minimum appropriate share. Rather, Rule 3015.7(c) provides that competitive products' compliance with the appropriate share floor will be measured "[a]nnually, on a fiscal year basis … ." The Commission implemented the 5.5% appropriate share requirement less than one year ago, and has not yet fully evaluated the first set of competitive rates adopted under PAEA. As a result, regardless of any theoretical correctness of PSA's argument, now is simply not the time for the Commission to begin second-guessing its newly-adopted appropriate share requirement.

Conclusion

UPS supports the Postal Service's efforts to identify group-specific costs. If properly implemented, these proposals should improve the accuracy of the Commission's required test for cross-subsidy of competitive products by market-dominant products. The Commission should reject PSA's suggestion that it lower competitive products' minimum appropriate share of contribution to institutional costs.

Respectfully submitted,

John E. McKeever
Laura A. Biancke
Attorneys for United Parcel Service

DLA Piper US LLP
One Liberty Place
1650 Market Street
Suite 4900
Philadelphia, PA 19103
(215) 656-3310