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POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Periodic Reporting) Docket No. RM2008-2

VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. COMMENTS REGARDING COSTING METHODS USED IN PERIODIC REPORTING
(September 8, 2008)

Background

On August 11, 2008, the Postal Service filed a Request for Commission Order Amending the Established Costing Methodologies for Purposes of Preparing the FY 2008 Annual Compliance Report, proposing eight changes to current costing methodologies that it would like to implement in its FY 2008 Annual Compliance Report ("ACR"). Treating the Postal Service's request as a request for an informal rulemaking under section 553 of the Administrative Procedures Act (5 U.S.C. § 553), the Commission opened Docket No. RM2008-2 and set September 8, 2008 as the deadline to receive comments on the proposed rulemaking and September 15, 2008 as the deadline for reply comments. *See* Commission Order No. 99 (August 18, 2008).[1]

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (hereafter "Valpak") submit these joint comments in response to the request for comments in Order No. 99. Valpak addresses Proposals One, Two, and Seven.

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[1] On August 18, 2008, the Postal Service filed a motion to add a ninth costing methodology change to the present rulemaking. The Commission granted the Postal Service's motion on August 22, 2008 in Commission Order No. 102.

COMMENTS OF VALPAK ON CHANGES IN COSTING METHODS

I. Proposal One: Group-specific Costs within Cost Segment 18.

Proposal One would "change … the manner in which the Headquarters Finance Number (FN) Cost Segment 18 costs are categorized in the FY 2008 **Cost & Revenue Analysis (CRA) Report**." USPS Proposal, p. 5 (emphasis added).[2] The discussion accompanying Proposal One explains that some Cost Segment 18 ("CS18") costs, now classified as institutional, could be "group-specific" to either competitive or market-dominant products. The Postal Service appears to be saying that if the entire volume of competitive products were withdrawn, some CS18 costs are group-specific to those competitive products and therefore could be avoided in their entirety (even though these costs now are treated as fixed and invariant with respect to changes in volume).

To ascertain whether any costs in CS18 are group-specific, the Postal Service "has created a new attribute … called the *Product Activity Attribute*." (*Id.*, p. 6.) The scheme apparently would identify: (i) those Finance Numbers containing costs that support "only market-dominant" products; (ii) those Finance Numbers containing costs that support "only competitive" products; and (iii) those Finance Numbers containing costs that support "both groups of products" or "the Enterprise as a whole" (*see id.*, pp. 6-7).

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[2] On Friday, September 5, 2008, the Postal Service filed an errata indicating that its Proposal One would not be limited to Cost Segment 18, but would apply to all Cost Segments, with most of the costs to be identified were likely to be in Cost Segments 16, 17, 18, and 20. *See* Notice of the United States Postal Service Regarding Expanded Scope for Proposal One of the Requested Methodological Changes for the FY08 ACR – Errata (Sept. 5, 2008). Valpak's comments herein could not address the Postal Service's late expansion of Proposal One to cover other Cost Segments.

In support of the cost categorization in Proposal One, the Postal Service cites Commission Rule 3015.7(a), which states:

> Incremental costs will be used to test for cross-subsidies by market dominant products of competitive products. 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.

The Postal Service proposes that currently-attributable costs of competitive products be "supplement[ed]" by the costs in any identified Finance Numbers that are identified as group-specific to yield a new estimate of incremental costs. (USPS Proposal, p. 7.) Whether the Postal Service intends this new cost figure to be the final estimate used in the required test for cross-subsidy is ambiguous and, at a minimum, needs to be clarified. Hopefully, for the reasons set out below, the cost figure thus derived is only a first step in developing a comprehensive, reliable estimate of the incremental cost of competitive products in CS18.

A. The Incremental Cost of Competitive Products in CS18 Exceeds the Sum of the Group's Volume-variable Costs and Costs of Finance Numbers Found to Be Group-specific.

Commission Rule 3015.7(a) requires the development of an estimate of the incremental cost of competitive products. Prior Commission proceedings have established that the incremental cost of competitive products is equal to the reduction in total cost if the entire volume of competitive products were to be withdrawn and the Postal Service reconfigured its operations to produce the remaining products as efficiently as possible, and this definition of incremental cost is accepted and supported in the relevant economic literature.[3]

The exercise of estimating incremental cost for a group of products is not simple. As noted, it consists not only of estimating those costs that can be avoided if all competitive products are withdrawn **but also is predicated on the Postal Service reconfiguring its operations to produce the remaining market-dominant products as efficiently as possible**. Obviously, incremental costs are not volume-variable costs, nor are they attributable costs simply augmented by selected subsets of existing institutional cost pools.[4] Incremental costs are not based on costs as they now exist, but on all costs as they would exist after competitive products are withdrawn and operations are reconfigured. To estimate costs that the Postal Service could avoid, it is reasonable to begin with costs that are incurred for competitive products. The Postal Service states that "the Commission is currently using competitive products' attributable costs, supplemented to include causally related, group-specific costs, to test for cross-subsidies." (USPS Proposal, p. 5.) That is not sufficient, however. The search for incremental costs must look **within** existing cost pools, as discussed below (*see* section B-

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[3] *See, e.g.,* Direct Testimony of John C. Panzar on Behalf of United States Postal Service, USPS-T11, Docket No. R97-1, p. 8-11.

[4] The CRA Report is designed to produce and display attributable and institutional costs. A different analysis is required to develop reliable group incremental costs for competitive products, and it is suggested that in order to produce and display such costs appropriately, a separate report would be needed. If the Postal Service intends to redesign the CRA Report into a sort of hybrid report that somehow does double duty, as Proposal One seems to indicate, it should explain more fully what it contemplates.

3, *infra*) and go beyond mere identification of those cost pools or Finance Numbers that are exclusively group-specific in their entirety.

B. Difficulties with the Postal Service's Scheme.

The scheme laid out by the Postal Service, as outlined above, creates a number of problems, discussed herein.

1. The term "institutional cost" is made ambiguous. The new cost categories proposed by the Postal Service are ambiguous, and need clarification. For instance, the Postal Service states that "[g]roup-specific costs are those costs which **cannot be attributed to individual products**, but which are caused by either the competitive or market-dominant products as a group." (*Id.*, p. 5, emphasis added.) Therefore, group-specific costs clearly are **not** attributable costs — **nor**, of course, are they **product**-specific costs, since they are specific only in the context of the entire **group of products**. At the same time, the Postal Service apparently would exclude group-specific costs from institutional costs. To sum up, these newly-defined group-specific costs are **neither** (i) volume-variable costs **nor** (ii) product-specific costs, **nor** are they (iii) institutional costs, at least in the traditional sense, inasmuch as Proposal One would exclude them from institutional costs. Alternatively, the Postal Service may still consider group-specific costs to be non-volume-variable and, hence, institutional within the traditional taxonomy. If that were the case, then the Postal Service needs to devise a new way of designating what one could call "residual" institutional costs.[5] But changing the

[5] Under Proposal One, total overhead cost of the Postal Service would consist of (i) competitive product group-specific overhead cost, (ii) market-dominant group-specific overhead costs, and (iii) "residual," or "common" overhead costs.

definition of "institutional costs" is problematic since the Postal Accountability and Enhancement Act ("PAEA") uses the term "institutional costs" as it was defined in 2006. Some specific problems are identified below.

2. Institutional costs as referred to by PAEA. PAEA contains several references to "institutional costs," but does not define the term — presumably adopting its 2006 Commission definition.

a. 39 U.S.C. section 3622(b)(9) refers to "allocat[ing] the **total institutional costs** of the Postal Service appropriately between market-dominant and competitive products." (Emphasis added.) Removing group-specific costs from institutional costs creates an obvious issue with respect to interpreting the term "total."

b. 39 U.S.C. section 3633(a)(3) requires "that all competitive products collectively cover what the Commission determines to be an appropriate share of **the institutional costs** of the Postal Service."[6] Is this reference to the **total** institutional costs, or to some lesser amount (as the Postal Service proposal here would have it)? In other words, section 3633(a)(3), in requiring competitive products to cover an "appropriate share" of institutional costs, specifies that the institutional costs to be considered are those "of the Postal Service" — nothing less.

c. 39 U.S.C. section 3622(c)(10) requires that "special classifications" (*i.e.*, negotiated service agreements) "improve the net financial position of the Postal Service through

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[6] Under Proposal One, the institutional costs allocated under section 3622(b)(9) would not be the same as the institutional costs from which the Commission determines an appropriate share under section 3633(a)(3).

reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service…."[7] An improvement in overall contribution (and thus in net income) is equal to incremental revenue from the NSA minus the incremental volume-variable costs of the NSA. The notion of institutional cost envisioned here would seem to relate to the extent to which revenue exceeds volume-variable costs

d. 39 U.S.C. section 3622(e)(3)(A) states that workshare discounts need not be reduced if doing so would "lead to a loss of volume in the affected category or subclass of mail and reduce the aggregate contribution to the institutional costs of the Postal Service from the category or subclass subject to the discount…." Again, reductions in contribution, and thus in net income, would seem to relate most directly to the price minus the unit volume-variable cost.

e. 39 U.S.C. section 3652(b)(3) refers to an annual report to the Commission focusing on, among other things, workshare discounts and their "per-item contribution … to institutional costs." Per-item contribution typically has been measured as price minus the unit attributable cost.[8]

The above-cited references to institutional cost in the PAEA are consistent with institutional cost being the difference between price and unit attributable cost. However, it is

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[7] The Commission would need to decide if profitable competitive product negotiated service agreements ("NSAs") be viewed as contributing to the group-specific overhead costs of competitive products, or to the "residual" overhead costs of the Postal Service.

[8] Under Proposal One "per-item contribution" might be measured as (i) price minus (ii) unit attributable cost and minus (iii) any unit group-specific costs.

possible to interpret some of the PAEA's references to institutional costs in more than one way.

3. The Postal Service proposal may seriously underestimate the incremental costs of competitive products. Some considerations involved in preparing an estimate of incremental costs can be seen by looking at the Postal Service proposal to attach "product activity attributes" to Finance Numbers. To illustrate, suppose that the Postal Service has 100 Finance Numbers in Headquarters (CS18), and at the end of their exercise it finds that only one Finance Number is group-specific to competitive products, and four Finance Numbers are group-specific to market-dominant products. The other 95 Finance Numbers pertain to costs that support "both groups of products" or support "the Enterprise as a whole." This means that the other 95 Finance Numbers have some activity (or activities) that in some way, and to some (currently unknown) extent, support competitive products.[9] The Postal Service would then need to inquire whether the scope and size of activities within any of these 95 Finance Numbers could be reduced if all competitive products were withdrawn. If the Postal Service's proposed exercise winds up focusing exclusively on, and being limited to, the one Finance Number that is group-specific to competitive products, the result could underestimate the incremental costs of competitive products, perhaps grossly. In other words, ascertaining group-specific costs in the manner proposed by the Postal Service may be a necessary first step, but by no means is it sufficient.

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[9] This illustration may not be far fetched, as the Postal Service believes "[m]ost Headquarters activities and programs support the entire enterprise or support all products." USPS Proposal, p. 6.

Consider a hypothetical group of 15 people at Headquarters who work on NSAs, some of which relate to competitive products, and some of which relate to market-dominant products. It might be impossible to identify any people within this group who work exclusively on one product group. Nevertheless, the withdrawal of competitive products in their entirety might allow the size of this group to be reduced to, say, 10 people. Such a reduction in the group's size would be an exercise in reconfiguration, designed to conduct the remaining work load as efficiently as possible. The difference in cost between 15 and 10 people rightly would be considered part of the incremental cost of competitive products. Any failure to include such potential cost reductions would underestimate incremental costs.

C. A Reliable Estimate of Incremental Costs Requires Considerable Effort.

As indicated in the preceding sections, obtaining a reliable estimate of incremental cost for the entire group of competitive products within CS18 likely will require that a detailed inquiry be made of the activities encompassed in every Finance Number not classified as group-specific to either competitive products or market-dominant products. A cursory investigation which simply finds that activities in most Finance Numbers encompass both competitive and market-dominant products should not be regarded as sufficient.[10] Considerable effort, well beyond the Postal Service's indicated survey, thus may be required to obtain a reliable estimate of incremental cost, even for this single cost segment.

The Commission needs to be satisfied that the Postal Service's estimate of incremental costs in CS18 is both **comprehensive**, in terms of investigating the activities in every Finance

[10] Within CS18, only those Finance Numbers that are group-specific to market-dominant products will not require more detailed inquiry.

Number that deals in some way with competitive products, and **reliable**, as regards the methodology used to allocate costs of activities within mixed Finance Numbers.

D. The PAEA Requirement that Revenue from Competitive Products Cover an Appropriate Share of Institutional Costs Does Not Need to Be Made Unduly Complex.

PAEA requires 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). (The Commission's initial determination of an appropriate share is 5.5 percent.) However, the statute does not define the institutional costs on which the appropriate share is to be computed. Applying the understanding of institutional costs developed under the Postal Reorganization Act of 1970 ("PRA") regime that preceded enactment of PAEA, this requirement would be implemented by computing the difference between (1) **total revenues** of all competitive products, and (2) **total attributable costs** of all competitive products — and comparing this contribution with (3) the amount derived by applying the required percentage to the **totality** of the Postal Service's **institutional costs**. Ascertaining whether revenues from competitive products comply with this statutory hurdle appears to be reasonably straightforward. It also would appear to be an independent test, unrelated to the issue of whether competitive products collectively cover their incremental cost.

In the discussion accompanying Proposal One, the Postal Service states that:

> (a) the group-specific costs of the **market-dominant** products are "also important, as **the value of the institutional cost** will be **the residual** of Postal costs that are **not attributable** to products and are **not group-specific** to either group" (USPS Proposal, pp. 5-6, emphasis added);
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> (b) in addition to covering their incremental costs, the competitive products "also must cover an 'appropriate share' of institutional cost" (*id.*, p. 5); and

(c) the institutional-cost figure to which the appropriate share should be applied is **the institutional cost "remaining"** after the group-specific costs are removed (*id.*, p. 6, emphasis added).

So long as the"appropriate percentage" established by the Commission (initially 5.5 percent) does not change, the effect of the Postal Service's proposed subdivision of overhead expenses in CS18 would be to reduce the amount of the hurdle required for contribution from competitive products.[11]

Until a reliable estimate of incremental costs has been determined, the extent to which incremental costs of competitive products exceed their attributable costs will not be known. It is conceivable that a comprehensive survey of all cost segments will reveal the incremental costs of competitive products to be substantially greater than previously estimated. If so, then the difference between the incremental and attributable costs of competitive products could exceed 5.5 percent of total institutional costs, and the incremental cost test then would be the binding constraint that establishes the floor under revenues required from competitive products. Should this turn out to be the case, then having total revenues of competitive products meet the incremental cost test would be sufficient to assure that the contribution from competitive products exceeds the "appropriate share" of institutional cost, as required by 39 U.S.C. section 3633(a)(3). And, further, should this turn out to be the case, then redefining institutional cost in the manner envisioned by the Postal Service's subdivision of institutional

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[11] Proposal One explains: "To the extent costs are group-specific costs, the remaining 'institutional cost' will be a smaller amount than it would be otherwise" (*id.*, p. 6). When making its initial determination of an appropriate share of institutional costs for competitive products, the Commission based its decision on the totality of institutional costs. If the base of institutional costs used for that exercise were to be changed, the Commission may need to reconsider what percentage constitutes an appropriate share.

costs, as a means of reducing the required contribution, would add unnecessary complexity to the CRA Report without having any meaningful effect.

On the other hand, it could eventuate that the required share of institutional costs significantly exceeds the difference between incremental and attributable costs, and this share would be the effective floor on revenues that the Postal Service must derive from competitive products. Should this be the case, and should the Postal Service consider the hurdle posed by this constraint to be too high, then instead of reclassifying institutional costs within the CRA Report, the Postal Service should be able to file a request with the Commission that it reduce the percentage used to compute the "appropriate share" without changing the basic nature of the CRA Report.

E. Conclusion.

Valpak would encourage the Postal Service to conduct its proposed survey of all Finance Numbers in CS18 and, when so doing, also investigate the nature of activities in all Finance Numbers that are common to both competitive and market dominant products. The survey should make an assiduous attempt to identify **all** costs in CS18 that are incremental to competitive products.

At the same time, Valpak believes that the Postal Service should be asked to provide further support and justification for (1) changing the format or nature of the CRA Report, and (2) changing the definition of institutional costs used to compute an appropriate share for competitive products. Further, it should explain how it contemplates presenting the comprehensive development of incremental costs — *i.e.*, in a separate report, or as a modification to the current CRA Report.[12]

[12] In order for the development and presentment of incremental costs to be transparent to all interested parties, Valpak suggests that (i) the Postal Service may meed to produce a new reference comparable to the traditional Library Reference No. 1 (LR-USPS-1) filed in rate cases under the PRA, and (ii) it would be desirable for incremental costs to be displayed in a separate report.

II. Proposal Two: Group-Specific Cost Change Within Cost Segment 16.

Proposal Two supports "[a] methodology change … for the manner in which advertising costs (Cost Segment 16) for Click-N-Ship and Carrier Pickup are assigned in the FY 2008 **Cost & Revenue Analysis (CRA) Report**" (USPS Proposal, p. 9, emphasis added). More specifically, the Postal Service "propose[s] that advertising costs for Click-N-Ship and Carrier Pickup be assigned as a group-specific cost to competitive products, as the advertising for these services relates specifically to products that are competitive" (*id.*, p. 9).

Treating the advertising costs of Click-N-Ship and Carrier Pickup as group-specific to the competitive products for purposes of determining the incremental cost of the competitive products as a group appears reasonable. However, Postal Service refers to changing the way that these costs are "assigned **in the [CRA] Report**" (*id.*, p. 9, emphasis added). As with Proposal One, it is unclear if the Postal Service intends to create a new category of overhead costs that (i) are **not** volume-variable, (ii) are **not** product-specific, (iii) are **not** attributable on any basis, and (iv) are **not** part of institutional costs as traditionally defined (*i.e.*, **are** part of some newly-defined category of overhead costs within the CRA Report). Valpak repeats its concerns in Section I, seeing no need to change the manner in which costs are assigned in the CRA Report, and suggests that the incremental cost of the competitive products is better thought of as a distinct issue that should be developed and presented separately from the CRA Report.

III. Proposal Seven: Change in Distribution Key for VSD Costs.

Postal Service Proposal Seven begins by noting that, currently, after the volume-variability factor is applied to the accrued costs of Vehicle Service Drivers ("VSDs") (cost segment 8), the resulting volume variable costs "are distributed to products in the same proportions as cubic feet of originating mail obtained from Revenue, Pieces and Weight (RPW) statistics" (*id.*, p. 20).

Use of these RPW proportions to distribute volume-variable VSD costs in the FY 2007 Annual Compliance Report (and in prior years), without any data or analysis to support their applicability, has been a weak link with respect to tracing causation to individual classes and subclasses of mail.

In Proposal Seven, the Postal Service agrees that the justification for this key is weak, and it discusses one reason supporting this position — the key "incorrectly assigns Vehicle Service Driver costs to mail that originates at [its] Destination Delivery Unit (DDU)" (*id.*, p. 20). The Postal Service speculates that, "[p]resumably, this mail is entered at the DDU for delivery on routes from that office, and thus avoids VSD costs" (*id.*, p. 20).

Although the current distribution key may contain the identified flaw, the Postal Service is not proposing a revised distribution key that is derived from the mail actually carried by the drivers at issue. Rather, the Postal Service proposes what it considers a "reasonable proxy for distributing attributable VSD costs to products" (*id.*, p. 18). Specifically, in a section headed "Rationale" (*id.*, p. 21), the Postal Service states:

> **Absent a specific VSD distribution key,** the Postal Service takes the view that a distribution key consisting of the cubic foot mile proportions on INTRA-SCF runs provides **a reasonable proxy**

> for distributing attributable VSD costs to products. Relative proportions of mail transported by Intra-SCF contracts are much **more likely** to be representative of VSD mail than relative proportions of originating cube, which necessarily include DDU mail that VSD drivers are **unlikely** to transport. Intra-SCF highway contracts, by definition, provide local transportation and include **some trips** from mail processing facilities to delivery units. [*Id.*, p. 21 (emphasis added).]

The Postal Service statement in support of its proposed proxy is entirely speculative and conclusory. It has not presented any data to support the claim that the proposed proxy is any less flawed than the current proxy. Intra-SCF contracts are used to supplement existing VSD routes, and Proposal Seven gives no information to support the contention that such contracts are representative of mail transported by VSDs.

One element in a review of the suitability of the proposed proxy should be a detailed analysis of the nature of trips handled under **contract**, compared to trips handled by **VSDs**. In information filed with the Commission on August 29, 2008, the Postal Service provides some discussion of contract routes, saying generally that they are the same as VSD routes, but adds that contract routes are most likely to be the ones over 25 miles. It seems likely, then, that contract routes might be less likely to transport mail between SCFs and DDUs, and more likely to be the ones going to BMCs, other Processing and Distribution Centers, and maybe Air Mail Facilities, although the Postal Service says VSDs serve these kinds of routes too. If this is correct, contract routes might have a strong bias toward mail handled in the BMC network or transported by air.[13] Evidence on these matters demonstrating suitability of the new distribution key should be presented before major changes are authorized.

Another element in a review of the proposed proxy should be an analysis of the **effects of the change**, to see if they are in line with what might be expected. In this regard, the Postal Service proposal shows that the current key distributes 8.03 percent of the costs to Bound Printed Matter ("BPM") while the proposed key distributes only 2.98 percent (*id.*, table after p. 22). The billing determinants show that only 11.7 percent of presorted BPM is entered in DDUs (Library Reference USPS-FY07-4, Docket No. ACR2007). It appears that something other than the issue of DDU entry must explain this substantial effect, and it could be representativeness of the proposed key. When asked at the August 27, 2008 technical conference about the performance of an analysis of the effects, with specific reference to BPM, the Postal Service admitted its analysis was limited, with attention being given mostly to First-Class Mail and Standard Mail ECR.

In Valpak's opinion, progress does not consist of replacing one flawed distribution key with another that may flawed to an equal or even greater extent. Before accepting Proposal Seven, the Postal Service should first be required to explain why it cannot undertake to provide a key that is derived from the mail that VSD employees handle, and why, after more than 37 years since the PRA was enacted, a proxy must continue to be used instead of such a specific distribution key. Second, the Postal Service should be required to demonstrate that its

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[13] With respect to the existing and proposed distribution keys an interesting disparity between them (not discussed by the Postal Service) is that the existing key uses RPW volumes only, while the proposed key uses weight by miles driven (*i.e.*, ton-miles).

proposed proxy is better than the existing distribution key (which itself is a proxy for a specific distribution key).

Respectfully submitted,

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