

Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Modification of Costing Methods 2008-
Postal Service Proposals Ten and Eleven

Docket No. RM2008-6

PUBLIC REPRESENTATIVE COMMENTS
IN RESPONSE TO ORDER NO. 108

September 26, 2008

I. Summary of Postal Request and Initial Comments

On September 18, 2008, the Commission issued Order No. 108 requesting comments on the Postal Service's request to change costing data and methods in two areas for use in the FY 2008 ACR.¹ In Proposal Ten, the Postal Service requests distributing volume variable costs for the old Parcel Post subclass to Parcel Post Single-Piece, Parcel Select and Parcel Return Service (PRS) using recently modified distribution keys. In particular, the Postal Service proposes using the In-Office Cost System (IOCS) to distribute mail processing volume variable costs; the Carrier Cost System (CCS) to distribute delivery costs; and the Transportation Cost System (TRACS) to distribute vehicle service driver (VSD) and purchased transportation costs, all among the three parcel products.

Both the IOCS and CCS were modified to include separate distribution keys for the three products for all of FY 2008. However TRACS only includes this capability

¹ PRC Order No. 108, Notice of Proposed Rulemaking on Costing Methods Used in Periodic Reporting (Proposals Ten and Eleven), September 18, 2008 (Order No 108); Petition of the United States Postal Service Requesting Initiation of a Proceeding to Consider Further Proposed Methodology Changes for the FY 2008 ACR (Proposals Ten-Eleven), September 12, 2008 (Petition).

starting with the second quarter of FY 2008. For this reason, it appears that the Postal Service decided to request a two step procedure to distribute Parcel Post transportation costs for the upcoming ACR. With respect to this effort, first, the Service would use TRACS to distribute total Parcel Post costs to Single-Piece and Bulk Parcel. Then the existing method would be retained to distribute Bulk Parcel Post costs to Parcel Select and PRS. Order No. 108 at 3. However it is unclear from the Petition whether the Postal Service plans to retain this method or use TRACS to distribute all Parcel Post costs in subsequent years.

In Proposal Eleven, the Service requests distribution of city carrier volume variable collection costs to products based on the distribution of sampled collection box volume included in the newly modified City Carrier Cost System (CCCS). The current distribution of these costs is based on out of date data presented in Docket No. R84-1 and Revenue, Pieces and Weight (RPW) data reported annually. *Id.* at 4. The Public Representative assigned to this proceeding agrees that Proposal Eleven should be implemented. The remaining comments address certain aspects of Proposal Ten.

The Public Representative agrees in principle with the Postal Service that use of the referenced data collection systems as distribution keys for Parcel Post attributable costs would represent a substantial improvement over the approach used for the FY 2007 ACR. Because the new survey data were unavailable in FY 2007, the Service relied on existing Parcel Post mail flow models to determine unit volume variable cost differences among the three products in mail processing and

transportation.² By contrast, city carrier street time unit costs were kept uniform across the three products.³ Therefore, the Service states that differences between PRS and Parcel Select costs might have been understated because city carrier costs were not de-averaged. *Id.* at 3.

With respect to city carrier street costs, it appears that PRS mail would be unburdened with delivery costs under the Service's new approach because of mailer pick-up of such mail either at the RDDU or RBMC.⁴ However, recipients have the option of returning parcels to Destination Delivery Units (DDUs) or carriers as part of a pre-arranged pick-up, or placing parcels in collection boxes.⁵ Therefore, the portion of mail box collection costs distributed to PRS through use of the new CCCS distribution key should serve as a lower bound to true attributable carrier street costs for such mail.

It is also noted that the Service's request for distributing Parcel Post transportation costs to the three new products using TRACS includes both purchased transportation and VSD costs in scope. Therefore, Proposal Ten is consistent with the Service's Proposal Seven described in its earlier petition to distribute all VSD costs to all applicable products using TRACS.⁶ In response to that petition, deficiencies in the

² Mail processing model estimates for the FY2007 ACR were presented in USPS-FY07-15 and transportation cost estimates were provided in USPS-FY07-16.

³ Parcel Post variable costs for cost segment 7 were only reported at the total level in the amount of \$66.845M. See PRC-ACR2007-LR2.

⁴ If this assumption is incorrect, the Postal Service is requested to clarify and describe why delivery costs should be attributed in view of mailer pick-up at designated sites.

⁵ Postal Service Domestic Mail Manual 507 Mailer Services at 13.0.

⁶ 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 at 21.

Service's proposal were noted and continued use of the current method was recommended.⁷ In view of issues already raised, if the Commission recommends use of the current distribution key for VSD costs in its upcoming decision addressing the earlier petition, then the Public Representative would favor application of the Service's proposed two step procedure involving TRACS in FY 2008 only to purchased transportation costs. That is all VSD volume variable costs should be subtracted out before application of the procedure to the remaining transportation costs. The VSD costs would then be distributed to the three new Parcel Post products using the accepted method.

The Postal Service is also requested to confirm that the described two step procedure for distribution of transportation costs is only planned for the forthcoming ACR and that all future years would involve applying TRACS distribution keys directly to calculate volume variable costs for the three new products. If not, the Service is requested to provide an explanation as to why the two step procedure should be continued.

II. Viewing Parcel Select and PRS as a Bundled Product

The disaggregated costing approach submitted by the Service for Parcel Post products provides the proper framework for estimating marginal contributions from each of the parcel products when considered separately. However for pricing purposes, it is also useful to consider the bundled nature of PRS pieces and the

⁷ Public Representative Comments in Response to Order No. 99, September 8, 2008 at 10.

portion of Parcel Select pieces mailed by PRS permit holders. As currently constituted, both products can be considered bundled because neither can exist in the absence of the other product. The cost implications of the bundling are clear. All Parcel Select mailings by permit holders must cause all PRS costs from returned parcels. This cost linkage between the two volume types has important implications as to how marginal and incremental costs should be calculated by the Service with respect to Parcel Select volume.

To illustrate, consider a stylized Postal Service cost function for the two competitive parcel products $C(V_s, V_r)$ where V_s is Parcel Select volume and V_r is PRS volume.⁸ Further, assume that V_s can be subdivided into Parcel Select permit holder volume V_{s1} and the remainder mailed by non-permit holders V_{s2} . Last, assume the parcel return rate on original (Parcel Select) volume from permit holders is k . Then the original cost function can be expressed in the following reduced form:

$$G(V_{s1}, V_{s2}) = C(V_{s1} + V_{s2}, V_{s1}k),$$

where $V_r = V_{s1}k$. Note that the reduced form on the left hand side shows competitive parcel costs as a function of the two Parcel Select volume streams V_{s1} and V_{s2} only, because V_r is a function of V_{s1} .

Marginal costs with respect to V_{s1} and V_{s2} can then be calculated as:

$$\partial G / \partial V_{s1} = \partial C / \partial V_s + (\partial C / \partial V_r)k$$

$$\partial G / \partial V_{s2} = \partial C / \partial V_s.$$

⁸ The cost function can be interpreted as the sum of the cost segment functions applying to competitive parcel products. Of course, these segment level functions would include volume variables for all other products in the system as well. However other volumes would be considered fixed for present purposes and therefore the corresponding variables are suppressed in the indicated system level function.

The first expression shows that the extra cost from adding a piece of permit holder volume or $\partial G/\partial V_{s1}$ is comprised of a direct effect $\partial C/\partial V_s$ and an indirect effect $(\partial C/\partial V_r)k$. The direct effect is just the marginal cost with respect to all Parcel Select volumes, keeping PRS volume constant. The indirect effect explains the added PRS cost induced by the Parcel Select piece. The second expression shows that the marginal cost with respect to non-permit holder volumes or $\partial G/\partial V_{s2}$ is just the first term of the first expression. The second term from the expression is not included because non-permit holders do not induce any PRS mailings.

In conclusion, Parcel Select mail marginal costs are shown to be mailer-specific. In other words, these marginal costs only have meaning when considering mailer status within the product.⁹ Accordingly, because of the different cost generating characteristics within Parcel Select, the Public Representative recommends that the Postal Service report attributable costs for Parcel Select volumes separately for permit holder and non-permit holder volume streams in the forthcoming ACR. The sum of these two attributable costs would then constitute total attributable costs for the Parcel Select product.

At a minimum, this cost disaggregation would allow contributions from the two parcel select mailer groups to be determined. Also this type of reporting visibility,

⁹ The same distinction can be shown to apply when calculating incremental costs (the sum of marginal costs from zero to the last piece in the system).

when disaggregated further to the appropriate level, would facilitate adjustments to Parcel Select and PRS rates in a coordinated manner as circumstances dictate.¹⁰

Respectfully Submitted,

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¹⁰ PRS revenues would be included as part of the revenues generated by permit holders. Attributable costs for Parcel Select permit holders would include the sum of their volume-weighted portion of total Parcel Select volume variable costs, all PRS volume variable costs and any PRS product specific fixed costs incurred such as annual permit fees. Attributable costs for the remaining Parcel Select mailers would include only the remainder of Parcel Select volume variable costs. Dividing each side's total volume variable cost by the respective volume levels would yield each side's marginal cost as formulated above.