

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Periodic Reporting

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Docket No. RM2008-2

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
REPLY COMMENTS REGARDING COSTING METHODS
USED IN PERIODIC REPORTING
(September 15, 2008)**

On August 18, 2008, the Commission issued Order No. 99, opening this docket, setting September 8, 2008 as the deadline to receive comments on certain costing methodology changes proposed by the Postal Service, and setting September 15, 2008 as the deadline for reply comments. Initial comments were filed by the American Postal Workers Union, AFL-CIO ("APWU"); the Greeting Card Association; Major Mailers Association; Robert W. Mitchell; Parcel Shippers Association ("PSA"); the Public Representative ("PR"); Time Warner Inc.; and Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (hereafter "Valpak"). Valpak submits these reply comments.

In its amended filing on September 5, 2008, the Postal Service stated its intention to extend the analysis in Proposal One to include all costs segments, and particularly Cost Segments 16, 17, and 20, and indicated that due to the late notice, it would understand if any issues pertaining to these other costs segments were addressed in the reply comments. If other parties address the expansion of the scope of Proposal One for the first time in their reply comments, Valpak would request the Commission to provide opportunity to respond to such comments.

I. Confusion Exists over Analyses Designed to Estimate Incremental and Attributable Costs, and the Appropriate Role of Group-Specific Fixed Costs in Each.

PSA filed initial comments which reflects some degree of confusion with respect to incremental costs. PSA emphasizes that costs in the fixed pools must be **exclusive** to the category of mail being analyzed:

- With regard to Proposal One, PSA said: “If the **causal** connection is not **exclusive** then the approach has failed to established the necessary relationship.” (P. 4, emphasis added.)
- With regard to Proposal Two, PSA said that Carrier Pickup advertising costs should not be viewed as group-specific “because these costs are not **caused exclusively** by competitive products.” (P. 5, emphasis added.) PSA makes a similar statement on Click-N-Ship advertising. (P. 7.)
- With regard to Proposal Four, PSA referred to the possibility that “the necessary exclusive **causal** relationship sometimes exists when one group of mail is only a predominant or preponderant portion of the relevant mail volume,” and added that “*it is the establishment of the **exclusive causal** nature of the relationship that is key.*” (P. 5, emphasis added, italics original.)

PSA’s comments miss the mark with respect to the development of incremental costs. The issue is not whether some pools of fixed costs are **exclusive** to the category being analyzed as PSA asserts, but rather whether a credible analysis has been performed to develop incremental costs.

Additionally, the PR fails to recognize that an analysis of incremental cost is fundamentally different from an analysis of volume-variable (marginal) cost, especially when the analysis is for the incremental cost of a group of products, such as the Postal Service’s competitive products. *See* discussion in Section II, *infra*. **Attributable costs** are guided by one concept, and **incremental costs** are guided by a different concept. For instance, cost

avoidance, discussed by the PR at some length, is fundamental to a study of incremental costs, but not marginal costs.

An analysis of incremental costs should recognize that when a category of mail, such as a product or a group of products, is withdrawn, several things can happen:

- (1) variable costs associated with the level of volume would decline;
- (2) certain product-specific or group-specific fixed costs can be eliminated;
- (3) additional cost burdens can arise in other areas¹; and
- (4) remaining operations can be restructured.

A credible analysis of incremental costs requires that each of these possibilities be analyzed and accounted for. Accordingly, progress is more likely to be made by a focus on capturing all effects of the change instead of arguing about the level of exclusivity (or purity) required. Incremental cost should reflect the net reduction in, or avoidance of costs that occurs when the product(s) in question are withdrawn. Although the Postal Service does not manifest confusion about the difference between analyses of incremental and attributable (volume-variable) cost exhibited, the Postal Service could have done more to clarify the distinction between the two types of costs.

¹ To illustrate, as the PR Initial Comments noted, if a decision were made to eliminate the blue collection boxes, which are used predominantly by mailers of First-Class single-piece letters, an additional burden might be transferred “to a combination of carrier pickup and/or window service.” (P. 7.) That is, if the volume of **First-Class single-piece** letters were to be withdrawn, **savings** would accrue from not having to sweep the collection boxes, **but** additional **costs** might be incurred by carrier pickup and window service activities for the limited number of pieces that are using the collection boxes which are **not First-Class single-piece** letters.

II. Group-Specific Fixed Costs Are Relevant to Estimating Incremental Costs for Competitive Products, but Should Not Be Attributed.

As discussed above, identifying **group-specific fixed** costs is an important step in estimating **incremental** costs of the competitive product group. Two parties, however, refer to **attributing** these costs:

- (1) In a discussion of the appropriate share of institutional cost for competitive products, PSA says that “[t]he effect of identifying costs as group-specific can be enormous because essentially this exercise converts costs from ‘institutional’ to ‘**attributable.**’” (PSA Initial Comments, p. 9, emphasis added.)
- (2) The PR describes Proposal One as “explain[ing] that certain institutional costs at headquarters could be recategorized as group-specific costs and **therefore attributable** to either market dominant or competitive products....” (PR Initial Comments, p. 2, emphasis added.) The PR adds: “Additionally, it appears that the **cost attribution** team contemplates using avoidable costs as an evaluational standard for determining whether particular FN costs **should be attributed.**” (*Id.*, p. 2, emphasis added.) “The Public Representative supports cost avoidance as an evaluational standard **for cost attribution** of headquarters costs. [Only where] costs are avoided in total or in part when the supported product group is eliminated, then ... the avoided portion of costs from

the FN [should] **be attributed as group-specific.**” (*Id.*, pp. 2-3, emphasis added.)

These parties appear to misread the Postal Service Request. The Postal Service does not propose **attributing** group-specific costs. In fact, the Postal Service explicitly states “[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.” (Request, p. 5, emphasis added.) It also says that “[p]ursuant to Commission Rule 3015.7(a), the Commission is currently using competitive products’ **attributable costs, supplemented to include causally related, group-specific costs, to test for cross-subsidies.**” (*Id.*, p. 5, emphasis added.) Similarly, it refers to “supplement[ing] existing volume-variable and product-specific analys[e]s of expenses in Headquarters Finance Numbers” (Request at 7), presumably for purposes of an incremental cost test. To be fair, some confusion does arise from the Postal Service’s indication that it plans to include group-specific costs in the Cost and Revenue Analysis Report (which historically has reported attributable costs), without any explanation or indication as to how group-specific costs will be displayed or included. We do not read the Postal Service proposal as resulting in a change to attribution rules, but if it were to do so, we would oppose it.

Under current rules, attribution of costs is limited to **individual products**, and product markups are based on these costs. These product costs can be aggregated to find attributable costs for any group of products or for the Postal Service as a whole. The mere thought of overlaying this product-focused system with the attribution of group-specific fixed costs to a **group of products** is troublesome. First, it would be a radical departure from the current

definition of attributable costs for a group of products. Second, combining two or more products to obtain a group would likely create a situation where the attributable cost of the group exceeds the sum of the attributable costs of the included products. Third, if group-specific costs were to be attributed, that would leave us without an accurate measure of volume-variable costs and transform attributable costs into a flawed measure of incremental costs — one that omits additional (or compensating) costs that occur elsewhere and neglects possible savings from restructuring — and the newly-defined attributable costs would have no meaningful link to volume-variable costs. For these reasons, group-specific costs should not be attributed.²

III. Valpak Agrees that the Postal Service Should Present Evidence to Support Proposed Changes in Cost Methods.

The Postal Service stated a hope that its proposals might be found to be simple, noncontroversial, sufficiently supported, and a “clear contribution to the goal of more accurate cost ascertainment.” (USPS Request at 2.) Comments of several parties have suggested, however, that the changes were not supported adequately. For example:

- (1) APWU refers to a “special study [last] conducted in R84-1” and argues that “current, accurate information” could be provided on Proposal Four. (APWU Initial Comments, p. 2.) It also argues that it should be

² Group-specific fixed costs is a concept that is germane to incremental costs, but not to attributable costs. Even in the context of incremental costs, group-specific fixed costs cannot be allocated to, and considered as part of, the incremental cost of individual products. The designation as “group-specific” means that they are specific to the group, but not to individual products within the group.

possible to provide more information relevant to Proposal Seven (on Vehicle Service Drivers). (*Id.*, p. 4.)

- (2) The PR also argues that better information should be available on Proposal Seven. (PR Initial Comments, p. 9.)
- (3) Time Warner provides considerable discussion of troublesome issues relating to Proposal Seven, and notes the lack of support for the proposal. (*See* Time Warner Initial Comments, pp. 7-9.)
- (4) PSA refers to the current record as “scant,” and with respect to Proposal Five says that “[t]he name [of the activity] is not dispositive” (PSA Initial Comments, pp. 2, 7.)

These criticisms are well founded.³ Improved support for changes in costing methods could and should have been provided by the Postal Service, particularly where discovery is limited. Valpak expects to address this issue more fully in its response to Order No. 104 in Docket No. RM2008-4. For now, the Commission should exercise considerable caution in approving changes that are unsupported and, even if adopted, would need revision in the foreseeable future.

³ Likewise, Valpak’s Initial Comments argued that the proposed distribution for Vehicle Service Drivers has not been demonstrated to be an improvement over the current one. (Valpak Initial Comments, pp. 15-18.)

IV. PSA's Concerns over the Appropriate Share of Institutional Cost for Competitive Products Are Not Well Founded.

PSA argues that if the Commission should accept the changes proposed by the Postal Service, “[t]he Commission also should adjust the appropriate share requirement downward to take into account the effect of the proposed changes on the estimated share of institution costs borne by competitive products.” PSA Initial Comments, pp. 2-3 (footnote omitted).

Apparently as a result of the Postal Service proposals, PSA believes that (i) the level of attributable costs will be revised upward, (ii) proportionately more group-specific costs will be found for competitive products than for market-dominant products, (iii) the institutional cost will be reduced somewhat when group-specific costs are shifted to attributable, (iv) the revenue constraint for competitive products will be equal to the new level of attributable costs plus the Commission-determined appropriate share proportion applied to the reduced level of institutional cost, and (v) the level of this constraint will be higher than before.

As discussed above, there is no reason to change the level of attributable costs, to which the 5.5 percent “appropriate share” of institutional costs is added and we do not believe the Postal Service is proposing to do so. Similarly, there is no reason to change the level of institutional cost, which should continue to be the residual of total cost less total attributable cost. Under these conditions, this particular pricing constraint faced by competitive products would not change.

It is clear, though, that a different pricing constraint involves the PAEA requirement that revenues of each competitive product exceed its incremental costs. Because of the way the

Commission implements the required test for cross-subsidy, it would appear that developing a reliable measure of incremental costs cannot be avoided.

Respectfully submitted,

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