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Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Regulations Establishing System of Ratemaking	))	Docket No. RM2007-1

OFFICE OF THE CONSUMER ADVOCATE COMMENTS IN RESPONSE TO SECOND ADVANCE NOTICE OF PROPOSED RULEMAKING ON REGULATIONS ESTABLISHING A SYSTEM OF RATEMAKING
(June 18, 2007)

INTRODUCTION

The Office of the Consumer Advocate ("OCA") hereby responds to the Commission's request for comments on regulations establishing a system of regulation pursuant to provisions of the Postal Accountability and Enforcement Act ("PAEA").[1]

The following comments assume the Commission will prescribe, in large measure, a system of regulation similar to the historical costing approaches used in previous omnibus rate cases with the procedural modifications commanded by the PAEA. These comments may not be precisely on point if the Commission wishes to establish an entirely new method of rate regulation for market-dominant products that is significantly at variance from the current method of determining attributable and institutional costs for market-dominant or competitive products. A new approach may consist of a fully streamlined system of regulation that does not rely upon detailed cost

[1] "Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," Order No. 15, May 17, 2007.

and revenue information or it may move in the opposite direction by establishing a system of regulation that requires significantly more detail to calculate precisely attributable costs and more fully allocated institutional costs. That is to say, a full response to some of the questions wouldrequire a better understanding of the regulatory system the Commission is considering. In any event, OCA's comments have assumed a theory of regulation generally familiar to the Commission and participants in proceedings before the Commission in rate and classification cases.

OCA's responsibility pursuant to §505 of the PAEA in this matter is to represent the interests of the general public.[2] Pursuant to that responsibility, OCA's comments attempt to recommend those systemic procedures that are believed to be consistent with the still unfamiliar and unexplored procedural provisions of the PAEA and, at the same time, will serve to ensure a healthy and financially viable Postal Service consistent with efficient operations and improved service performance in the future.

OCA's comments emphasize some of OCAs responses filed previously in this docket and support some of the comments filed by other participants. OCA offers the following recommendations in response to the Commission's enumerated questions:

1. OCA recommends using the point-to-point approach in implementing CPI-based price changes.

2. OCA notes the Postal Service's examples of price-change impacts do not reflect the potential for large percentage increases in rates for individual subclasses. OCA recommends a system of regulation capping subclass rate increases at 50 percent above the overall class increase.

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2 "§505. Officer of the Postal Regulatory Commission representing the general public

The Postal Regulatory Commission shall designate an officer of the Postal Regulatory Commission in all public proceedings (such as developing rules, regulations, and procedures) who shall represent the interests of the general public."

3. OCA recommends that to comply with the clear statutory requirement prohibiting workshare discounts from exceeding avoided costs, the Commission will need the Postal Service to file real-time data on a monthly basis.

4. OCA recommends that the Commission define, at least initially, the various types of current mail matter that constitute the listed competitive products by reference to the DMCS and IMM, as revised up to the time the relevant regulations are issued.

5. OCA has no comments at this time as to the types of information that may be needed to support new rates or classes of various applicabilities.

6. OCA recommends in 6(a-b) that the Postal Service file five types of needed data reports monthly.

OCA does not comment on 6(c) as to whether existing data systems are adequate for assuring compliance with §3633(a) regarding cross-subsidization and cost coverage.

OCA recommends in 6(d) standards for determining whether there is cross-subsidization of competitive products by market-dominant products: that is, a standard based upon whether the attributable costs for a single competitive product are covered and whether the competitive products as a whole cover an appropriate share of institutional costs.

OCA recommends in 6(e-g) that the rebuttable standard for assigning collective institutional costs to competitive products should be based upon the percentage of institutional costs assigned to a particular class in the most recent rate proceeding over a time period equivalent to the period under review, with adjustments, as necessary, from that level.

OCA recommends in 6(h) that, if the Postal Service is allowed a return on investment,, the Commission should utilize the capital structure and returns from comparable companies to be determined as explained in the comment.

7. OCA recommends that an assumed federal income tax not be treated as an attributable cost and that an assumed federal income tax should not be assigned as an attributable cost among competitive products.

8. OCA is not aware of any costs that need to be reassigned from the attributable to the institutional categories or vice versa. OCA recommends that Retiree Health Benefits be classified as attributable costs.

9. OCA recommends that based upon recent Commission policy the Commission should find each of several types of service (ICAs, NSAs, special

classifications, and classes not of general applicability) is a product, but is not necessarily a subclass.

A significant issue to be addressed will be the treatment of Postal Service investment, both for purposes of calculating cross-subsidization, assumed federal income tax and also for considering whether a rate of return on investment ought to be considered a reasonable cost for some or all of the Postal Service's operations. The Postal Service's lack of private equity investment raises some difficult questions for imputing capital structure, both for market-dominant and competitive product lines. The silence of the PAEA on this matter is deafening. Although retained earnings are explicitly permitted, nowhere in that Act is there suggestion that a return on investment is anticipated. On the other hand, return on investment is not explicitly excluded, and the Commission appears free, if it chooses, to establish a system of regulation providing reasonable returns on investment. OCA discusses in the response to Question 6(h) the analysis undertaken by other governmental agencies to construct an implied capital structure and assumed returns on investment.

The PAEA contains an interesting check and balance in §3634 that may serve to dampen the Postal Service's inherent urge to portray the lowest reasonable costs for its competitive products in order to maintain pricing flexibility and to earn as high a profit as possible on its competitive products. That provision is the countervailing requirement for the Postal Service to pay a portion of its competitive profits into the Postal Service Fund for assumed federal income taxes, thus distributing a portion of the return earned on competitive products to the benefit of the market-dominant products in proportion to the applicable corporate income tax rate. Thus, the lower the cost of competitive products, the greater will be any assumed income taxes paid from the Competitive Products Fund into the Postal Service Fund.

COMMENTS

Question 1. In Appendix C of its reply comments, the Postal Service provides a series of examples to illustrate its proposal for calculations that would ensure compliance with the price cap defined in sections 3622(d)(1)(A) and (2)(A). In part C of the appendix, the Postal Service describes its proposed method of calculating the CPI cap limitation. The cap would be equal to the difference between the most recently available monthly CPI and the monthly CPI for the same month of the previous year, divided by the monthly CPI for the previous year. The same result is reached by dividing the most recently available monthly CPI by the monthly CPI for the same month of the previous year and then subtracting one from the quotient.

This point-to-point approach may be contrasted with an alternative that would compare aggregated monthly CPI figures instead of those of a single month. For example, the most recently available monthly CPI could be averaged with the previous 11 monthly CPI values. This 12-month average could then be compared to the average for the previous 12 months in the same way that the single-month figures are in the Postal Service's proposal. Figures 1 and 2 show the cap as it would be calculated under both methods for each month in 2005 and 2006, respectively.

Figure 1

Comparison of 12-month Moving Average and Point to Point Percent Change in CPI-U (2005)

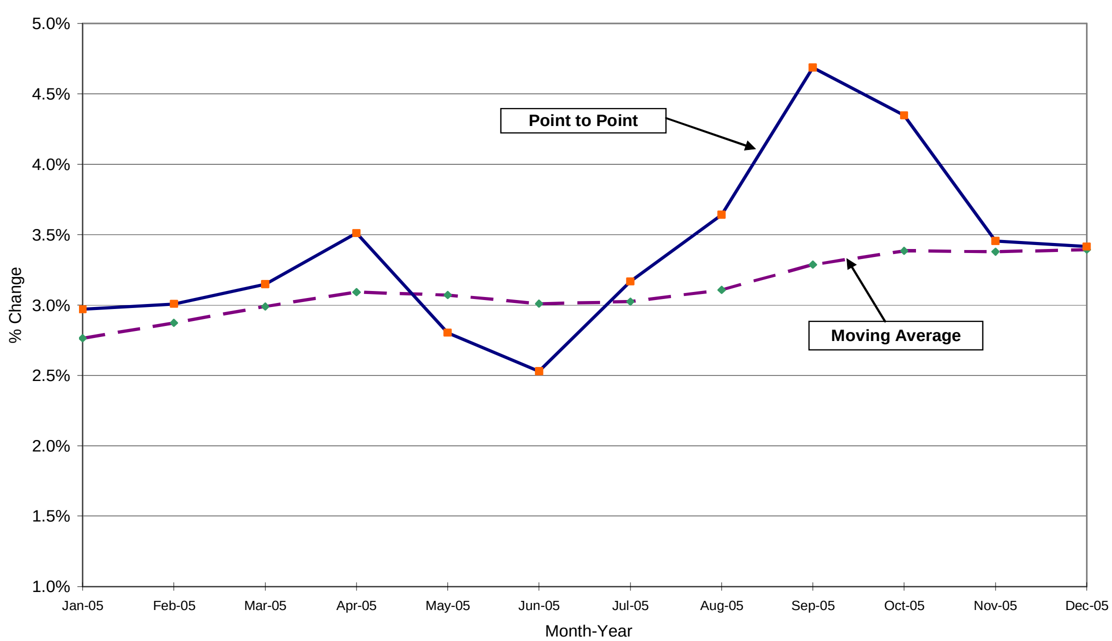
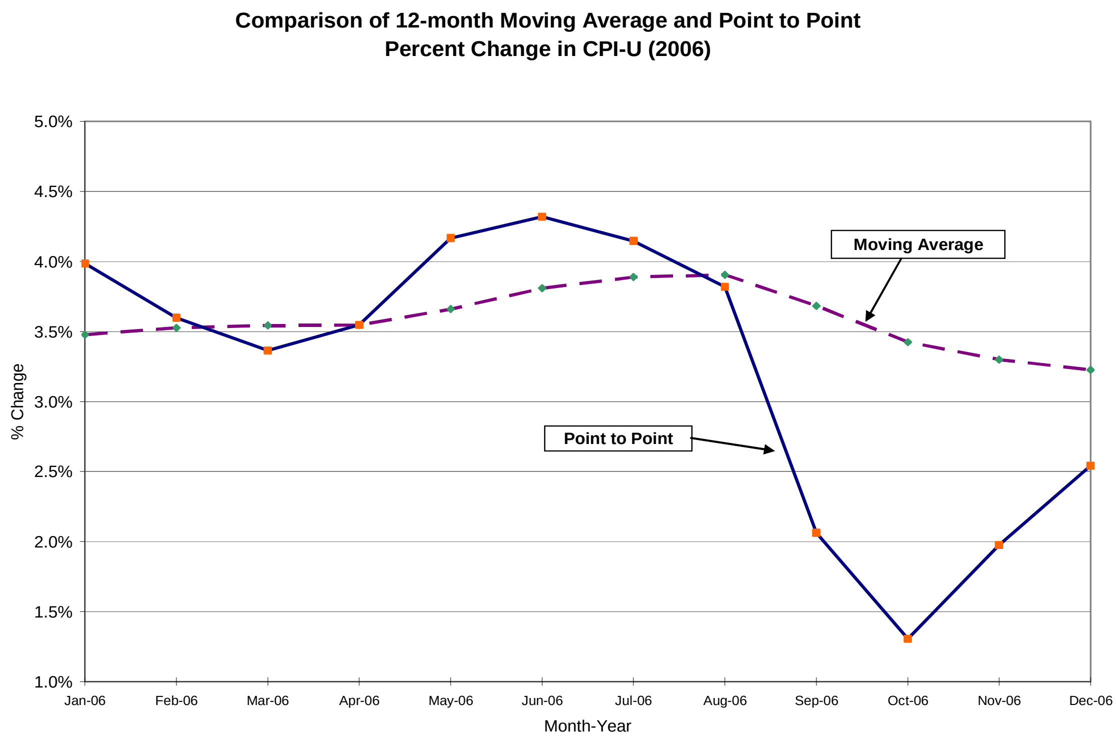


Figure 2



As the graphs show, the results of the point-to-point method exhibit a greater variation based on the month that is selected. The parties are requested to comment on the merits of each method and may offer additional alternatives. Please discuss how each method conforms to the language in §3622(d), as well as how each method comports with the objectives in §3622(b) and the factors in §3622(c).

Comment

I. A MONTHLY POINT-TO-POINT CPI COMPARISON RESULTS IN THE RELATIVELY IMMEDIATE UPDATING OF PRICES.

A comparison of the difference between the most recently available monthly CPI for all urban consumers unadjusted for seasonal variation (subsequently denoted as "CPI") and the monthly CPI for the same month of the previous year, can be used to establish a rate cap in which postage prices are updated—to nearly current price levels. This approach is denoted as the "point-to-point" approach. The CPI is available approximately two weeks after the conclusion of the reference month.[3] Allowing for a 45 day review, the Postal Service using the point-to-point approach could conceivably implement rates based on price levels current as of the end of the two previous months.

In contrast, a 12-month average CPI approach would have substantial lags in the updating of rates. The concept of a 12-month average CPI is most clearly discussed in terms of a specific month. For example, the 12-month average CPI for the month ending in December provides the average price level as of July 1 of the current year. Similarly, the 12-month average CPI for the month ending in December of the previous year provides the average price level as of July 1 of the previous year. Accordingly, if one compares the 12-month average CPI for December with the 12-month average for the previous December, one is actually comparing the level of price change between the price level of July of the current year and the price level as of July of the previous year. A price adjustment based on the 12-month approach would have a substantial lag.

A. Use of the Point-to-Point CPI Approach to Update and Revise Costs is Well-Accepted.

The use of escalator clauses in long term contracts to adjust for changing price levels is a commonly accepted commercial practice. The point-to-point measurement is the standard approach to escalation. The Bureau of Labor Statistics (BLS) publishes thousands of price indices, of which the unadjusted urban CPI, used in the PAEA, is probably the best known. We have been unable to find any instances of the use of the

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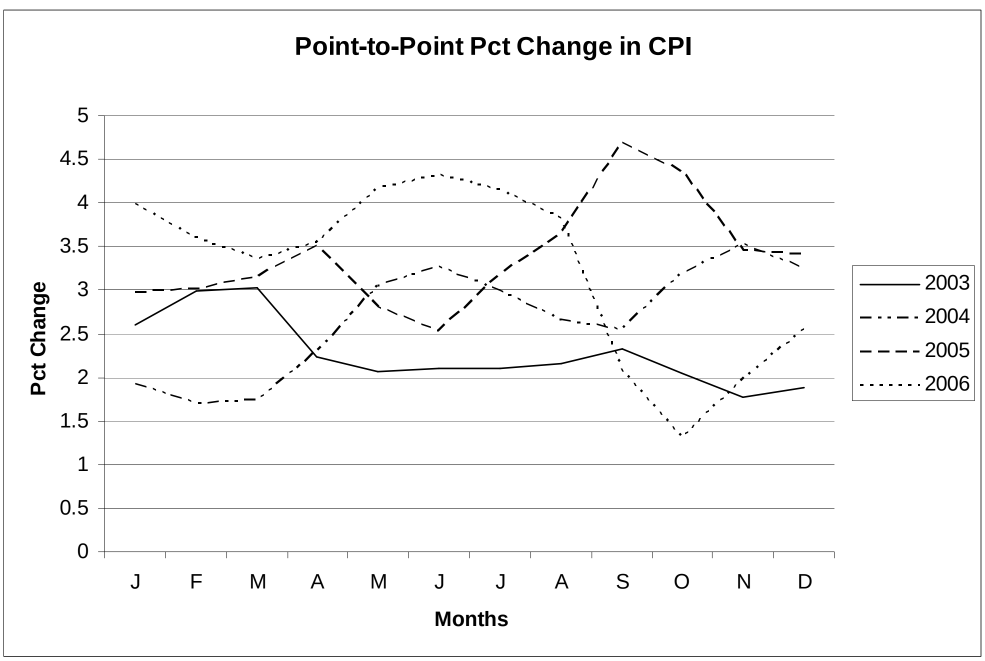
[3] Before 1999, BLS used a Laspeyres index to compute the CPI. Since 1999 BLS, has used geometric means within most items and area combinations; this assumes the same relative expenditure on items, but not the same absolute quantities of items. BLS continues to use the Laspeyres Index across items and areas in computing the index. The change in computation has resulted in the CPI being approximately .2 to .3 percent lower than it would have been under the previous approach.

12-month average approach, although we did find a variant to this approach used by the Social Security Administration. The Social Security Administration uses changes in average third quarter costs to average third quarter costs in computing the cost of living adjustment (COLA) for Social Security purposes. The seasonally adjusted CPI is never used in escalation computations, being subject to revision; the unadjusted CPI is never revised.

B. The Point-to-Point Approach is More Volatile than the 12-Month Average Approach.

Volatility on a monthly basis in the unadjusted CPI can result from variations in weather, changes in the timing of holidays, changes in economic conditions, and possibly other factors. The accompanying graph, based on four years of data, illustrates the volatility of the point-to-point approach using the point-to-point approach. There does not appear to be a strong monthly repetitive pattern.



In contrast, the 12-month moving average of the CPI is much less subject to variation than is the point-to-point index (as indicated in Figure 2 of the Second Notice), due to averaging twelve months of data. Significantly, regardless of which index is used, the ultimate level of price escalation is the same. The differences are simply in the timing of the amounts of increase and the somewhat greater volatility of the point-to-point approach.

With the point-to-point CPI approach, clearly the magnitude of a rate increase would vary depending on the month implemented. Furthermore, there is no basis for consistently determining that increases will be greater in one month or another. For example, if the Postal Service had used the CPI in setting new rates in 2006 based on the point-to-point approach, the magnitude of the increase would have ranged from approximately 1.4 to 4.3 percent. The choice of the month on which to base a rate increase will affect the size of the rate increase. However, application of the CPI index will, in the long run, result in a level of rates that cumulatively equal inflation. For example, a low increase will in general subsequently be offset by a higher increase. In the short run, the actual level of price increase will fluctuate somewhat, based on the point-to-point approach. In contrast, the fluctuation would be somewhat less under the 12-month approach, but the rates would also be significantly out-of-date when implemented.

C. Both Approaches Appear to Comport with the Requirements of §3622(d).

Either approach could be implemented for price changes at regular intervals within limits of the changing CPI. It should be noted, however, that the point-to-point approach is more current. Commercial contracts frequently contain escalator clauses, and the point-to-point approach is the standard approach used for escalation purposes.

D. The Two Approaches Meet the Requirements of § 3622(b) in Different Ways.

The 12-month average approach would provide the Postal Service with additional cost reduction and efficiency incentives, largely due to somewhat delayed increases in rates. However, cost reduction incentives are not missing in the point-to-point approach. In addition, there would be somewhat greater stability in increases due to the nature of a 12-month average. However, the delay in cost recovery would work negatively in terms of adequacy of revenues and the financial stability of the Postal Service. In contrast, the point-to-point approach is somewhat more volatile but provides greater immediacy of recognition of inflationary pressures. The long run recovery of costs is the same in the application of either approach; there are just differences in timing.

E. Neither Approach seems to be at Variance with the Requirements of § 3622 (c).

In general, the requirements of this section do not have an immediate relationship to the rate escalation issues. Section 3622(c) focuses on cost attribution, mail preparation, simplicity of rate structure, and the public interest. None of these factors are significantly more or less affected by the choice of either approach to CPI escalation.

II. OCA RECOMMENDS USE OF THE POINT-TO-POINT APPROACH IN IMPLEMENTING CPI BASED PRICE CHANGES.

OCA's conclusion is based on the fact that the point-to-point approach is the standard approach to cost escalation. OCA's conclusion is also based on the fact that the long-run results are identical using either approach, and on the assumption that the Postal Service will be sufficiently astute in the event of significant volatility in the CPI, to weigh carefully trade-offs between rate continuity and public acceptance of rate changes against the possibility of an unusually high CPI in a given month. In any case, implementation of a rate based on an unusually high CPI in one month would be offset in subsequent years by lower increases due to the cumulative nature of the approach.

Question 2. Appendix C of the Postal Service reply comments provides a series of examples to illustrate its proposal for calculations that would ensure compliance with the price cap defined in sections 3622(d)(1)(A) and (2)(A). Part B of the appendix describes the Postal Service's proposed method of calculating the annual change in rates to which the CPI cap shall be applied.

The discussion begins by proposing principles ("Standards 1 and 2") that the measure of the change in rates should satisfy. It concludes that any fixed volume weighting system will satisfy those principles. After explaining the practical impediment to the use of the ideal weights, it describes the weaknesses of two potential methods of measuring the base rates.

The Postal Service proposes to use the most recent 12 months of available data to establish the volume weights and to recalculate average revenue per piece by applying those weights to the current rates. The result would be considered the average base rate. The average new rate would then be calculated by applying the same weights to the new set of rates. The percentage difference between the average base (current) rate and the average new rate would be compared to the percentage change in CPI.

Parties are requested to comment on the method of calculating the annual change in rates under section 3622(d). Please discuss the strengths and weaknesses of the methods described by the Postal Service in Appendix C of its reply comments (and alternative methods, if desired) and how each method comports with the objectives in section 3622(b) and the factors in section 3622(c). Please include a discussion of how to treat an altered rate design, for example, one for which billing determinants do not exist, such as the new rates to be applied to Periodicals.

COMMENT

I. THE CALCULATIONS AS PRESENTED BY THE POSTAL SERVICE IN APPENDIX C ARE RELATIVELY STRAIGHTFORWARD BUT ARE NOT CONCLUSIVE.

The calculations presented by the Postal Service in Appendix C are relatively straightforward but are not conclusive. Unfortunately, the Postal Service's explanation does not go far enough in examining the proposed rate setting process. Example 1 examines a single-rate mail class, subject to two percent escalation. Example 2 extends the example to two subclasses. Both examples ignore quantities of mail. Example 3 shows that an across-the-board rate change for each subclass, assuming no volume adjustments, results in a computed across-the-board rate change equal to that assumed for each subclass. We learn from Example 4 that when rates do not change, the average revenue per piece does not increase. Finally, the Postal Service indicates that it proposes to use the most recent twelve months of historical volume data in calculating rates. It is difficult to find any error or particularly useful information in the presentation.

A. The Examples Presenting Across-The-Board Rate Increases By Subclass Do Not Appear To Be Relevant.

The Postal Service's presentation does not appear to be very useful in understanding the way in which the rate change process will work. To be specific, the rates for some subclasses will probably increase more than for others. The Postal Service has conducted extensive elasticity analyses and, given its desire for increased pricing flexibility, one might expect that inelastic subclasses will receive greater increases, while other subclasses will receive lesser increases, the overall increase being within the CPI. This is a normal approach in utility rate setting. For example, disparities of rate increases have been common in the setting of electric and gas rates. The setting of rates based on elasticity, social policy, corporate objectives, simplicity, continuity of expectations, and a myriad of other factors is well established. As indicated long ago by Garfield and Lovejoy,

> However, analyses of costs and studies of market-demand characteristics can take one just so far; ultimately, the setting of rates requires the exercise of experienced judgment. Rate making is an art and not an exact science It is for this reason that most commissions, once they have fixed the over-all revenue requirement, generally give substantial weight to managerial judgment in reviewing proposed schedules of rates.[4]

[4] Paul J. Garfield, and Wallace F. Lovejoy, *Public Utility Economics*, Prentice Hall, 1964, at 138.

The following sections analyze possible variants to the Postal Service's examples. We start with the Postal Service's Example 3 and show increasingly complex alternatives.

1. Example 3 as presented by the Postal Service shows an across-the-board rate increase.

Example 3

	Rate	Volume	Revenue
Rate Category A	30	100	3000
Rate Category B	20	50	1000
		150	4000
Weighted Average Revenue per piece:			26.66667
	Rate	Volume	Revenue
Rate Category A	30.6	100	3060
Rate Category B	20.4	50	1020
		150	4080
Weighted Average Revenue per piece:			27.2
Average Price Change:			0.02

Example 3 is not very realistic, given that it assumes all rates increase by the same amount. One can construct a case in which rates do not change by the same magnitude, as delineated in Example 3A:

Example 3A

	Rate	Volume	Revenue
Rate Category A	30	100	3000
Rate Category B	20	50	1000
		150	4000
Weighted Average Revenue per piece:			26.66667
	Rate	Volume	Revenue
Rate Category A	30.8	100	3080
Rate Category B	20	50	1000
		150	4080
Weighted Average Revenue per piece:			27.2
Average Price Change:			0.02

In the case of Example 3A, rates increase in Rate Category A but not in Rate Category B. With increased pricing flexibility and the perceived need to use the pricing mechanism in maintaining or growing revenue, Example 3A is most likely a more realistic example. This is pricing flexibility.

A key issue, therefore, is the degree to which the Postal Service should be able to increase rates by subclass within an overall class. It is not unusual to find in utility pricing that, in a class of service, no subclass element receives an increase more than "X percent" greater than the class in general. This provides flexibility to the utility as well as the implementation of reasonable constraints.

Unfortunately, the concept of "X Percent" is not well defined, being based on the judgmental considerations outlined in Garfield and Lovejoy. Although one can consider elasticities and projected changes in quantity demanded, it is still necessary to determine the level of a reasonable, maximum increase.

2. OCA recommends for Commission consideration that, in pursuing flexible pricing, the system of regulation should preclude the increase in subclass rates by more than 50 percent above the overall class increase.

Under this proposal, the Postal Service will have flexibility, both in terms of rapid increase in the rate level, and in terms of the ability to vary rates by subclass. Some of the principles of rate setting include continuity of expectations, implementation of rates that are understandable, and perceived and/or actual fairness. Accordingly, some level of subclass protection appears to be appropriate. We suggest 50 percent as reasonable: that is, if rates for a class of service increase by an overall maximum of two percent, no subclass rate would increase by more than three percent.

II. IN ITS PRESENTATION THE POSTAL SERVICE HAS IGNORED POTENTIAL MARKET RESPONSES TO CHANGES IN RATES.

The examples in the Postal Service's Appendix 3 make no use of the numerous elasticity studies filed before the Commission in previous cases. Instead, it is argued that historic volumes should be used. We endorse the use of historic volumes. This avoids the type of problem delineated in the following Example 3B, wherein the potential for rates to increase very significantly in a rate subclass is present.

A. Example 3B Assumes that with a Rate Increase One Subclass is Relatively Inelastic and that the Other Subclass with no Rate Increase Obtains Additional Business.

Example 3B

	Rate	Volume	Revenue
Rate Category A	30	100	3000
Rate Category B	20	50	1000
		150	4000
Weighted Average Revenue per piece:			26.66667
	Rate	Volume	Revenue
Rate Category A	30.8	99	3049.2
Rate Category B	20	53	1060
		152	4109.2
Weighted Average Revenue per piece:			27.03421
Average Price Change:			0.013783

As a result of implementing rates identical to the overall two percent rate increase in Example 3A, the final market result in Example 3B was indeed higher rates for one category, but an overall lower increase in average price change, based on the change of market mix. Subclass A received an increase of 2.7 percent, while subclass B received no increase. Both rate subclasses are contributing more revenue, in one case due to higher rates and in another case due to additional business. If one incorporated "after rates" volumes in the analysis, one might even argue for even higher rates on subclass A, for the total increase in Example 3B is less than 1.4 percent. Overall rates could be raised with the overall increase as measured by average price change becoming 2 percent, but one of the subclasses could wind up experiencing a much larger increase, as illustrated in Example 3C. In this case, the overall increase in rates is 2 percent, but Rate Category A experiences an increase of 3.7 percent.

Example 3C

	Rate	Volume	Revenue
Rate Category A	30	100	3000
Rate Category B	20	50	1000
		150	4000
Weighted Average Revenue per piece:			26.66667
	Rate	Volume	Revenue
Rate Category A	31.1	98	3047.8
Rate Category B	20	53	1060
		151	4107.8
Weighted Average Revenue per piece:			27.20397
Average Price Change:			0.020149

It is understandable that the Postal Service will wish to utilize demand, value of service, and elasticity characteristics in order to optimize revenue. Such efforts can generate additional revenues, and as previously discussed, are consistent with procedures under regulation in other industries. Our main concern is that subclass increases not be excessive, which is why we have proposed the Commission's system of rate increase regulation should provide that no subclass receive an increase greater than 50 percent greater than the overall class average.

The following Example 3D shows a multiyear projection, with continued quantity attrition in one subclass and a slight increase in usage in another subclass. An approximately two percent increase by class actually translates into an increase above 3 percent for a subclass. Clearly, revenues are increasing, and both subclasses are presumably covering more than their attributable costs, although we have no specific information on relative product profitability. This example again shows the importance of having a limit on subclass increases when the Postal Service is using its pricing flexibility. The overall level of rate increase is in the neighborhood of 2 percent, but Rate Category A experiences substantially higher increases.

Example 3D

year 1	Rate	Volume	Revenue	Pct . Increase
Rate Category A	30	100	3000	
Rate Category B	20	50	1000	
		150	4000	
Weighted Average Revenue per piece:			26.66667	
Year 2	Rate	Volume	Revenue	
Rate Category A	31.1	98	3047.8	3.666667
Rate Category B	20	53	1060	0
		151	4107.8	
Weighted Average Revenue per piece:			27.20397	
Average Price Change:				2.014901
Year 3	Rate	Volume	Revenue	
Rate Category A	32.14	96	3085.44	3.344051
Rate Category B	20	54	1080	0
		150	4165.44	
Weighted Average Revenue per piece:			27.7696	
Average Price Change:				2.079205

II. BILLING DETERMINANTS WILL NOT EXIST FOR NEW PRODUCTS, AND THE QUESTION IS HOW THIS SHOULD BE HANDLED.

Prices for Postal Service products have traditionally been based on Postal Service costs. Accordingly, it appears that the price for a new product should be set on the basis of cost in a fashion similar to the pricing of existing products. Clearly, a new product should cover its attributable costs. The determination of the assignment of institutional costs in deriving a price has been exhaustively discussed before this Commission.

The major issue is the lack of billing determinants when pricing a new product; however, at the end of a year billing determinants will, in fact, exist, thereby permitting an ongoing pricing analysis. If the lack of billing determinants should prove to be a problem, for the first three years of a product's introduction the Postal Service could be permitted to apply price increases similar to those experienced by the product most similar to the new product.

The key requirements of §3622(d) are the use of the CPI in establishing rates and the expectation that rates will change at regular intervals by predictable amounts. Recognizing that pricing flexibility is needed, adjustment of the increases in the use of the CPI is appropriate. The examples presented above show that rates for some subclasses could increase at a rate in excess of the CPI; such increases are less predictable than an increase limited to the CPI by class and subclass. However, the Postal Service has the ability to implement communication plans, customer education plans, and to use judgment relevant to continuity of rates in setting the new rates.

The main concepts in §3622(b) are adequacy of rates and pricing flexibility. The escalation procedures considered are consistent with those goals and the main concepts in §3622 (c).

Clearly the Postal Service will be using the CPI for rate escalation purposes. Accordingly, we advocate some limit on subclass increases relative to the overall class increase.

Question 3. Section 3622(e) directs the Commission to "ensure that workshare discounts do not exceed the cost that the Postal Service avoids as a result of the workshare activity," except in certain specified situations. In the context of a Notice of Rate Adjustment for a class of mail ---[5]

a. What information and/or data are needed to allow the Commission to evaluate whether new workshare discounts are consistent with this standard?

b. What information and/or data are needed to allow the Commission to evaluate whether unchanged workshare discounts remain consistent with this standard?

c. What information and/or data are needed to allow the Commission to evaluate whether changed workshare discounts remain consistent with this standard?

Comment

These questions appear to ask whether the Commission needs more or less data than have been used under the PRA to set discounts. With respect to unit cost data, it appears that the degree of disaggregation across discount levels used in the past should be sufficient. However, the currency of unit cost data will need significant improvement.

> When Felix Frankfurter was a professor at Harvard Law School, he told students there were three keys to interpreting a law: "(1) read the statute; (2) read the statute; (3) read the statute!"[6]

Frankfurter's adage applies with special force to the workshare discounts discussed in §3622(e). The Postal Service characterizes subsection (e) as a vague, "general principle."[7] However, subsection (e)(2) states:

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[5] "Second Advance Notice of Proposed Rulemaking on Regulations Establishing A System of Ratemaking," May 17, 2007, at 5.

[6] T.P. O'Neill, "Statutory Construction Should Be As Easy As 1, 2, 3," 152 Chicago Daily Law Bulletin, March 10, 2006, as viewed at http://www.jmls.edu/facultypubs/oneill/oneill_column_0306.shtml June 5, 2007.

[7] "Initial Comments of the United States Postal Service," April 6, 2007, at 19-20.

> The Postal Regulatory Commission shall ensure that [workshare] discounts do not exceed the cost that the Postal Service avoids as a result of workshare activity [except under explicit circumstances].

This statement is an unambiguous command. “The [PRC] shall ensure” that the new system of regulation achieves an explicit outcome: no discounts in excess of avoided cost. It is well established that "when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms." *Lamie v. United States Trustee,* 540 U.S. 526, 534 (2004).

> As a rule, where the language of a statute is clear and unambiguous, its clear meaning may not be evaded by an administrative body or a court under the guise of construction. In such circumstances, there is no room for judicial interpretation, and the language should generally be given effect without resort to extrinsic guides to construction.

73 Am. Jur. 2d Statutes § 113.

It follows that the data needed to implement §3622(e) are the data showing that “. . . discounts do not exceed the cost that the Postal Service avoids . . . .” This standard applies to every discount and without limitation as to time of day or day of the year. Thus, the Commission will need data as close to real time as possible, so that it can verify compliance with § 3622(e)(2) at any time necessary—particularly with respect to annual general increases. As the OCA has demonstrated previously,[8] the Commission will need monthly data updates.

Question 4. The Commission requests comments as to what is the current mail matter that constitutes each of the competitive products listed in §3631(a): "priority mail;" "expedited mail;" "bulk parcel post;" "bulk international mail;" and "mailgrams;"[9] The question also asks to what does the phrase "mail classification schedule" refer?

Comment

To answer clearly "[w]hat current mail matter is" for each of the identified competitive products first requires a discussion of the phrase "mail classification schedule". It also requires, as the Commission has asked, a discussion as to what the term "mail classification schedule" refers.

Section 3631(c) states in its entirety:

> (c) Rule of Construction.—Mail matter referred to in subsection (a) shall, for purposes of this subchapter, be considered to have the meaning given to such mail matter under the mail classification schedule.

For domestic mail, there is only one known mail classification schedule—the Domestic Mail Classification Schedule (DMCS), established and periodically revised by the Commission.[10] In drafting §3631(c), Congress did not identify the mail classification schedule as of a specific date, such as the date of enactment of the PAEA.[11] This fact suggests that the "mail classification schedule" referenced by §3631(c) means the

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[8] "OCA Comments in Response to Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," April 6, 2007, at 7.

[9] Mailgram service is no longer a Postal Service product and, consequently, will not be discussed. *See* Postal Bulletin 22189, September 14, 2006, at 10 (Effective August 17, 2006, the Postal Service and Western Union agreed to end Mailgram service.). To the extent there are any remaining costs associated with Mailgram service, those costs should be assigned to the competitive category.

[10] *See* Postal Regulatory Commission, *Domestic Mail Classification Schedule*, May 14, 2007.

[11] *Contrast* §3631(c) (Mail matter referred to in subsection (a) shall, for purposes of this subchapter, be considered to have the meaning given to such mail matter under the mail classification schedule.) with §3622(d)(2) (the Domestic Mail Classification Schedule as in effect on the date of enactment of the Postal Accountability and Enhancement Act.)

DMCS in effect at the time the Commission promulgates implementing regulations for competitive products. In OCA's view, for purposes of initially defining and describing those products that are market-dominant or competitive, "the meaning given to such mail mater under the mail classification schedule" should be determined by reference to the currently effective DMCS. In this proceeding, the currently effective *Domestic Mail Classification Schedule* applicable to competitive products is dated May 14, 2007, subject to revision by the Commission prior to issuing implementing regulations concerning competitive products.

In the case of domestic "priority mail," the meaning intended by Congress must be determined by reference to §223 of the DMCS, the Priority Mail subclass. In the case of domestic "expedited mail," the relevant sections of the DMCS are §§110-182, which defines and describes Express Mail as the only service offering under "expedited mail." In response to Question 4, parts a. and b., therefore, the current mail matter that constitutes "priority mail" and "expedited mail" is described in §223 and §§110-182 of the DMCS, respectively.

Moreover, there are no restrictions or qualifications under §3631(a) concerning domestic and international, or bulk versus non-bulk-entered (or single-piece) mail with respect to "priority mail" and "expedited mail". Thus, all "priority mail" and "expedited mail", whether domestic or international, bulk-entered or single-piece, must be treated as competitive products.

With respect to domestic "bulk parcel post," §521 of the DMCS defines and describes the Parcel Post subclass. Bulk-entered Parcel Post is described as "a mailing of at least 50 pieces" entered at a facility specified by the Postal Service." The relevant Parcel Post rate categories that require “a mailing of at least 50 pieces” are Parcel Select (§§521.23-.28), and Parcel Post pieces receiving the BMC Presort Discount (§521.41), Origin Bulk Mail Center (OBMC) Discount (§521.42), and the Barcode Discount (§521.5). In addition, there is the Bulk Parcel Post rate category (§521.3), which is described as “properly prepared and separated single mailings of 300 pieces or 2000 pounds.”

In its Reply Comments,[12] the Postal Service concurs with the definition of “bulk parcel post” presented by the Parcel Shipper’s Association (PSA):[13]

> It seems clear that “bulk parcel post” refers to the existing Parcel Select service, the [Bulk] Parcel Return Service, and workshared non-destination-entry Parcel Post (e.g., OBMC and BMC Presort parcels).

PSA’s definition excludes the Bulk Parcel Post rate category (§521.3), and Parcel Post pieces eligible for the Barcode Discount (§521.5). To be inclusive, the Bulk Parcel Post rate category and Parcel Post pieces eligible for the Barcode Discount should be considered mail matter within the meaning “bulk parcel post.”

The OCA, however, opposes the inclusion of Bulk Parcel Return Service (BPRS) in the competitive category. First, BPRS is a special service, applicable to Standard Mail parcels, and is not defined or described anywhere in the Parcel Postal subclass (§521.1, *et. seq.*). Given that BPRS is applicable to Standard Mail and a special service classification, it must be a market-dominant product because §3621 of the PAEA identifies Standard Mail and all special services, without qualification, as market-dominant. Second, neither PSA nor the Postal Service has made a *prima fascia* case

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[12] Reply Comments of the United States Postal Service (herein “Postal Service Reply Comments”), May 7, 2007.

that BPRS should be treated as a competitive product. There is no real competitive alternative to BPRS. In fact, BPRS is defined and priced by the Postal Service, which permits recipients to return Standard Mail parcels via BPRS to the original mailer who pays the return mail (i.e., BPRS) fee. If, however, the PSA and Postal Service argue that BPRS-eligible Standard Mail parcels can be returned at the recipient's expense using competitors of the Postal Service, it should be clear such parcels are being returned as single-piece parcels, and therefore compete in the market for "single-piece parcel post"—a market-dominant product per §3621(a)(5). Alternatively, if the PSA and Postal Service contend that BPRS is "bulk parcel post" by virtue of delivery "in bulk" by the Postal Service, it should be noted such parcels are not being entered in a "mailing of at least 50 pieces" (§521.23-.28) or mailings "of at least 300 pieces or 2000 pounds" (§521.3)—the definition of "bulk" for purposes of the Parcel Post subclass.

Unlike domestic mail services, there is no "international" mail classification schedule for international mail. Rather, reference must be made to the International Mail Manual (IMM),[14] which "contains the mailing standards of the Postal Service for international mail services."[15] For the same reasons discussed with respect to domestic mail, the "mail classification schedule" referenced by §3631(c) suggests, with respect to international mail, that "the meaning given to such mail matter under the mail classification schedule" should be determined by reference to the currently effective

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13 *Id.*, at 31, citing PSA Comments at 8, n.8.

14 *See* United States Postal Service, IMM Issue 34-*International Mail Manual*, May 14, 2007, incorporated by reference in the *Code of Federal Regulations* at 39 CFR § 20.1.

15 Postal Service Reply Comments, at 32 n. 97.

IMM at the time the Commission promulgates implementing regulations for competitive products.

As interpreted by the Postal Service, “bulk international mail” refers to “multi-item mailings tendered by a single mailer.”[16] The IMM clearly identifies International Priority Airlift (IPA) and International Surface Airlift (ISAL) as bulk-entered international mail.[17] Accordingly, in the absence of any reference in the IMM to “bulk” mailers, “bulk” mailings, or similar phrases, all remaining international mail is single-piece, and should be categorized as market-dominant.

In this regard, the Postal Service’s proposal that the Commission exercise its judgment and assign otherwise single-piece international mail items to the competitive products category should be rejected. The Postal Service identifies several single-piece products that it claims are “known to be subject to fierce competition, such as GXG [Global Express Guaranteed], Air Parcels (Priority Mail International service), and EMS (Express Mail International service).”[18] Based on such claims of “competition,” the Postal Service proposes to categorize its international mail as either market-dominant or competitive, including certain single-piece international mail.[19] The Postal Service should be required to justify such claims of competition before listing otherwise single-

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[16] Postal Service Reply Comments, at 32. A literal interpretation of this definition would permit the Postal Service to treat more than one international mail piece tendered by any mailer as “bulk” international mail—irrespective of the degree of competition, or lack thereof, in the market for such mail pieces. The OCA does not agree with such a mechanistic interpretation.

[17] *See* IMM §292.11 (International Priority Airmail . . . is available to bulk mailers of all First-Class Mail International items); *see also* IMM §293.1 (International Surface Air Lift (ISAL) is a bulk mailing system).

[18] Postal Service Reply Comments, at 32.

[19] Id. at 33.

piece international mail in the competitive category. To do otherwise would be in contravention of §3621(a)(10) of the PAEA.

Question 5. No comments at this time.

Question 6(a). Regarding §3633 – What data should be filed periodically with the Commission to enable it to assess the Postal Service's compliance with subsection:

i (a)(1),
ii. (a)(2), and
iii. (a)(3)?

Comment

Currently, the Postal Service provides some data on an annual basis, i.e., the Cost and Revenue Analysis report (CRA) and the Billing Determinants report (BD). OCA proposes filing three types of additional reports in order to evaluate the Postal Service's compliance with §3633(a) of the PAEA to prohibit subsidization of competitive products by market-dominant products, to ensure each competitive product covers its costs attributable, and to ensure that all competitive products collectively cover an appropriate share of institutional costs. In addition to the CRA and the BD, the OCA recommends the following three types of reports:

> The same type of data currently reported in the Postal Service's Annual Report;
>
> Costs and volumes by operation (or activity) and any other data needed to calculate rates offered to different customers; and
>
> Any additional data that may be needed to meet the requirements recommended by the Secretary of the Treasury pursuant to §2011(h).

OCA previously explained the need for the first two reports in comments on the Commission's Advance Notice of Proposed Rulemaking in this docket.[20] As indicated there, the reports are needed to evaluate the Postal Service's compliance the

[20] Docket No. RM2007-1, "OCA Comments in Response to Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," April 6, 2007, at 7.

objectives of the PAEA; particularly to insure transparency of operations and financial operations and to insure that there will be few, if any, surprises at the end of the year upon receipt of the required Postal Service's annual filings with the Commission. The Commission must also be cognizant of the potentially extensive data requirements that may result from the need to value assets, liabilities and capital costs in order to calculate assumed federal income taxes related to competitive products pursuant to §2011(h) of the PAEA.

Concern about a lack of data was expressed by at least one of the commenters to the notice in this rulemaking proceeding. Pitney Bowes said,

> If the Postal Service does not include cost data and information contemporaneous with the notice of intention to increase rates, interested parties would have no basis on which to challenge an unlawful rate until the Postal Service filed its annual report. Limiting the ability of interested parties to complain until the annual report is filed, however, diminishes the statutory protections afforded in the expanded compliant provisions and raises unwarranted procedural hurdles for complainants. (Footnote omitted.) [21]

[21] Docket No. RM2007-1, "Reply Comments of Pitney Bowes Inc. In Response to Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," May 7, 2007, at 19. *See also*, pages 17-18.

Question 6(b). How frequently, e.g., quarterly, annually, should such data be filed with the Commission?

Comment

The Postal Service should be required to submit the above data *monthly* and on a *year-to-date* (YTD) basis. The YTD information would reflect the most current information available, and thus, it is possible that the sum of each monthly report may not subsequently add up to the YTD data. In those instances where the data is not cumulative, the USPS should identify any corrections via a footnote explaining why the data does not add cumulatively.

Pitney Bowes has explained the need for the periodic filing of this data:

> The Commission should establish, by regulation, routine data production and transparency requirements (e.g., monthly or quarterly operational reports and data). Routine data production and transparency requirements would facilitate the annual compliance determination process; ensure that interested parties have access to contemporaneous data necessary permitting timely and meaningful review of rate changes, and reduce the administrative burden on the Postal Service and the Commission by deterring unwarranted complaints.[22]

Another advantage of full and periodic disclosure of data is to provide the Commission with information that will allow it to better respond to potential complaints regarding the Postal Service's compliance with various requirements of the PAEA. Although it may be desirable if the Commission's rules require future complainants to establish a *prima facie* case before their case will be heard, not only will more frequent data filings provide the Commission with timely information that may satisfy those who might otherwise complain about rates or service, but it will permit the Commission to

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22 *Ibid*.

evaluate more expeditiously complaints raised. More significantly, full and periodic disclosure will serve to reduce the Commission's need to acquire *ad hoc* additional information necessary to review complaints initially or in greater depth. This would avoid the delays inherent in extensive discovery or other time-consuming procedures the PAEA was designed to eliminate.

The availability of detailed periodic monthly data will also serve to ease the difficulties that could be presented to many important mailers who may have legitimate concerns but do not have the resources available to meet the relatively heavy burden of presenting a *prima facie* case upon the outset of a complaint. Comments by one group representing several active associations expressed their concerns in the following comment, "No complaint should be dismissed only because the complainant has not made a *prima facie* case within the four corners of the complaint."[23] That position is premised upon the contention that because of confidentiality or unavailability of data, a party may not be able to make a *prima facie* case. There may be circumstances that conceivably would justify the entertainment of a complaint by the Commission with <u>less than perfect data</u> because of those reasons. At the same time, however, the Commission should continue to insist that a complaint will be entertained only if a complainant is able to make a *prima facie* case that a real issue exists. Otherwise, as stated above, the Commission, the Postal Service and the parties may find virtually continuous litigation under the PAEA.

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[23] Docket No. RM2007-1, Joint Comments of American Business Media, Greeting Card Association, and Newspaper Association of America With Respect to the Complaint Process, April 6, 2007, at 5.

Requiring the USPS to provide the CRA and the Billing Determinants and data similar to that provided in the annual report on a monthly and YTD basis, as well as the other two additional types of reports mentioned in 6(a) above, will provide the Commission and all other interested parties with the transparency of data needed to identify those instances where complaints may not be fully justified. The data will also assist the Commission if the Postal Service introduces different ratemaking techniques, in a notice of rate change or in an annual report. As OCA previously pointed out, "A lack of surprise would allow for a speedy evaluation and determination of compliance."[24]

[24] Docket No. RM2007-1, "OCA Comments in Response to Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking," April 6, 2007, at 7.

Question 6(c). No comments at this time.

Question 6(d). What is the appropriate standard for determining whether competitive products are being subsidized by market-dominant products?

Comment

The appropriate standard for determining whether a competitive product is being subsidized by market-dominant products should be based on the ability of each competitive product to cover its attributable costs. However, the appropriate standard for determining whether competitive products are being subsidized by market-dominant products should be based on the ability of all competitive products, collectively, to cover both their attributable and an appropriate share of institutional costs as determined by the Commission.[25] To the extent that total competitive products breakeven (revenue covers all attributable costs and the appropriate share of institutional costs), as determined by the Commission, or show a positive net income, regardless of the amount, one must assume that the total competitive products group is not being subsidized by the market-dominant group. Also, if the competitive product group must pay any assumed income tax, that should be positive proof that competitive products are not being cross-subsidized by the market-dominant products. If the books for tax purposes were to differ from the books for purposes of analyzing cross-subsidization, then the payment of assumed taxes may not necessarily be proof of non-cross-subsidization. To reduce the complexity and ease the administrative burden, the Commission should not make two different calculations.

[25] §3633(a)(3).

Question 6(e). What standard should be applied to determine the appropriate share of institutional costs to be recovered collectively from competitive products?

Comment

Unless the Commission obtains extensive detailed roll-forward estimates of costs and revenues, which is not the intent of the PAEA, the Commission will not be in a position to apply any standard to determine the <u>prospective</u> recovery of institutional costs. Thus, the Commission must apply the standard is the prior year's costs and revenues. The Commission should use, as the starting point for its initial analysis, the cost coverages approved either in the most recent rate proceeding (currently Docket No. R2006-1) or in subsequent annual reviews that determine whether the actual cost coverages constitute an appropriate share of institutional costs.

Over the years, in rate proceedings culminating with the most recent rate case, Docket No. R2006-1, the Commission has conducted thorough reviews leading to a final determination as to the appropriate share of institutional cost that ought to be recovered by each class and subclass of service. The shares of institutional costs allowed in the most recent rate case for the competitive products provide a starting point for determining the share of institutional costs to be recovered by all of the competitive products.

Therefore, OCA proposes that as a *starting point*, the Commission require that the newly identified competitive products provide, in total, the same level of institutional cost coverage as was provided by the similar group of products in Docket No. R2006-1. For example, in Docket No. R2006-1, Priority Mail provided a contribution, to total allocated institutional costs, of 5 percent (rounded).[26] By applying the Docket No. R2006-1 total institutional cost contribution provided by Priority Mail, Expedited Mail (currently, Express Mail – see Part 4 above), Bulk Parcel Post and Bulk International mail[27] as a *starting point,* a solid foundation can be obtained on which the Commission can construct the final appropriate competitive products' institutional cost contribution.

OCA is not proposing that each competitive product, i.e., Priority Mail, etc. be required to make the same percentage of contribution to institutional costs as it did in Docket No. R2006-1. Rather, the percentage contribution each competitive product summed together made, in Docket No. R2006-1, is the *starting point* for the level of contribution that total competitive products must make to institutional costs. From that point, the Commission may apply adjustments, as it deems necessary, to reach the appropriate collective share of institutional costs.

In making adjustments to the collective share of institutional costs, one standard the Commission should apply is to adjust for the addition or deletion of a product to the competitive product group. For example, if a competitive product is deleted, then the total level of institutional costs to be borne by the competitive group should be adjusted downward to fairly reflect the diminished level of revenue, attributable costs and contribution to institutional costs. As a base line, in the case of deleted products, the

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26 PRC Op. R2006-1, volume 2, Appendix G, Schedule 1 (Priority Mail Contribution = 1,726,474 / 34,080,837)(Zeroes omitted.).

27 Mailgrams is not included as it is not currently a product offering of the Postal Service.

basis for the reduction in contribution to institutional costs should be the level of contribution the deleted item made to total competitive products' institutional costs in the prior year. If a new product is added to the competitive product group, the collective total institutional cost contribution should be increased to insure that the new product provides a just and reasonable contribution to institutional costs. However, for new competitive products, the addition of initial institutional cost contributions should not be set so high as to make it impossible for the new product or the collective competitive-product group to meet the revised contribution to institutional costs. However, as the new product gains market share, the Commission may consider increasing the level of contribution that the new product makes to institutional cost.

The Secretary of the Treasury in consultation with the Postal Service and an independent certified public accounting firm is to develop recommendations regarding accounting practices and principles with regard to identifying and valuing the assets and liabilities of the competitive products, including the capital and operating costs incurred in providing competitive products (§2011(h)). The recommendations are not due to the Commission until December 2007. At that point, the Commission may consider whether the best method of determining the level of institutional costs to be recovered collectively from competitive products is the total cost assigned to competitive products for purposes of calculating their assumed taxable income (based on the applicable FASB standards and the Internal Revenue Code of 1986 (§3534(a)) less the attributable costs of competitive products.

Question 6(f). Over what period of time should the standard identified in (e) be deemed valid?

Comment

By using the *starting point* described in part (6e) above, as an evolutionary process, the Commission will not need to review the competitive products' institutional cost contribution more frequently than annually. The review may be accomplished, during the annual Postal Service performance review of the prior year's operations, to determine whether or not the competitive products made an appropriate contribution to institutional costs the previous year under review.

Of course, at each annual review and as operational experience is gained under the PAEA, it is anticipated that the desired contribution to institutional costs from the competitive products will change, especially if, and when, new products are offered or existing products are revised.

If the Commission finds that, collectively, institutional costs were not recovered by the Postal Service, the Commission is empowered to order corrective action. Fashioning the prospective corrective remedy will be difficult in the absence of forward–looking estimates for the following year. Unless projections of future operations are estimated, the Commission will only have historical volume, cost and revenue data available with which to fashion a remedy.

Question 6(g). Should the standard identified in (e) raise a rebuttable presumption of validity?

Comment

In OCA's view, ease of administration suggests the desirability of establishing a standard that, when met by the Postal Service, provides, *at a minimum*, a rebuttable presumption of validity. Alternatively, the Commission might, by rule, establish a regulation providing that if the Postal Service complies with a particular standard for collectively recovering a share of institutional costs from competitive products, then the institutional contribution is deemed, *per se*, appropriate and irrebutable. This latter approach would greatly reduce the potential controversies surrounding the matter without reducing the Commission's flexibility. The PAEA provides latitude to the Commission to take this approach. Section 3633(a) provides the Commission the authority, without restriction, too "promulgate (and may from time to time thereafter revise) regulations to—(3) ensure…what the Commission determines to be an appropriate share of the institutional costs of the Postal Service." This authority is conferred without restriction. The PAEA's safety valve is that the Commission may from time to time revise itsregulations. This is not to say that the Commission would not be able to hear rebuttal in appropriate cases, but that would only be in rare instances.

Question 6(h). If return on investment (or assets) is used, what capital structure (assumed or otherwise) should be used for the Postal Service?

Comment

Although the Commission has not specifically stated its intentions regarding this issue, it is assumed that the capital structure and return on investment information would be used in determining competitive product costs for purposes of analyzing potential cross-subsidization of competitive products by market-dominant products. The estimated capital structure and return on investment would also be used in calculating assumed federal income taxes on competitive products. These comments describe how to estimate an appropriate capital structure and rate of return for the Postal Service based on the selection and analysis of appropriate comparable companies.

I. THE ASSUMED CAPITAL STRUCTURE FOR COMPETITIVE PRODUCTS SHOULD BE SIMILAR TO THAT USED BY COMPARABLE COMPANIES SIMILARLY SITUATED.

The business operations of the Postal Service serving competitive markets can be analyzed as a stand-alone company at arms-length from the Postal Service. One would expect the operating results of the stand-alone competitive operations to be similar to the operating results of other competitive companies with economically similar business operations in terms of functions performed, types of markets, and risks assumed. Information on the amount of capital used in serving competitive markets, the appropriate capital structure, and a market based level of return on capital can be generated from an analysis of companies with operations comparable to those of the Postal Service's competitive market operations.

There are three issues associated with the determination of the appropriate capital structure for competitive Postal Service products. First, given that the Postal Service is an interconnected network of functions and markets with commonalities of facilities between competitive and market-dominant products, what is the amount of capital associated with the delivery of the Postal Service's competitive products? Second, what is the basis for determining the capital structure for the competitive products segment of Postal Service operations in terms of amounts of debt and equity that should be associated with the competitive products? Third, what is the appropriate expected level of return that should be expected from the competitive operations—i.e., the return that would occur in an unsubsidized, competitive, stand-alone market?

A. The Breakout of Capital Between Competitive and Market-Dominant Products Should be Based on an Analysis of Data from Comparable Companies.

It is possible that the capital used by the Postal Service can be delineated between market-dominant and competitive markets through the identification of specific facilities, equipment, and other assets. If that is the case, then the issue of the amount of capital devoted to competitive products can be readily answered. However, in the more likely case that an allocation of the capital serving the existing network of postal facilities and resources needs to be performed to determine the capital breakout between competitive and market-dominant products, one would analyze the Postal Service's competitive product operations in comparison to a set of comparable, independent companies. One would expect the Postal Service's competitive operations to have financial characteristics similar to those of other independent comparable companies with a similarity of functions, markets, and risks.

1. First, identify a set of companies with functions, markets, and risks comparable to those which will be experienced by the Postal Service's competitive products operations.

Comparable companies are denoted as "comps". The selection of comps is a procedure well defined in the practice of economic valuation and transfer pricing.[28] Comps are defined in terms of the commonality of functions, markets, and risks between one company (or part of a company), in this case the competitive segment of the Postal Service, and a set of comparable companies, i.e., the comps. The focus is not on strict comparability in terms of product type or industry, but, rather, on comparability in terms of the economic functions performed, the types of markets served, and the risks encountered.[29] Strong commonality of industry or product is not considered to be important.

2. Second, once a set of comps is defined, examine the financial data of each comp for purposes of comparison with the company (in this case the competitive segments of the Postal Service) under consideration.

The Commission should examine the relationship between the level of sales and the capital used by the set of comps and the level of competitive market sales by the Postal Service. For each company in the comps, a three–year average of data is used in order to remove the effects of yearly fluctuations. Capital could then be allocated to

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[28] A substantial literature on the concepts discussed in this section can be found in Section 482 of the Tax Code and the concomitant literature.

[29] For example, if one were analyzing drug store operations, one might find that comparable companies engage primarily in retail distribution and warehousing: books, auto parts, five-and-dime, and other similar retail operations focused on the sale and distribution—but not the manufacturing—of end-use consumer goods. The actual end-use product sold would be irrelevant.

the Postal Service's competitive product sectors based on a median sales/capital ratio as derived from the comps.[30]

B. The Search for Comps is Based on Database Analysis and SIC Codes.

To locate comparable companies, initially review the Standard Industrial Classification ("SIC") Codes in order to find industries with companies performing functions similar to those performed by the Postal Service in providing products in a competitive market. For example, one could seek large service businesses with substantial amounts of logistics, customer service, materials processing and potentially a variety of other activities, to be defined. Then, use commercially available databases[31] to obtain specific company information for the comparable companies in terms of functions, markets, risks, and financial performance. Eliminate companies where comparability is lacking. Then compare the Postal Service's financial numbers and business operations with the set of comps.

1. Companies perform a variety of functions in bringing products to market.

Functions performed by companies can include (but are not necessarily limited to) engineering, manufacturing, research and development, product design, distribution, transportation, warehousing, legal, accounting, finance, etc. For companies to be comparable, the functions performed by each company need to be identical.

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30 An average could be used or, alternatively, a median value. When this approach is used for specialized purposes under the tax code, the appropriate quartile is specified. However, for the purposes of this analysis, we advocate the use of the median value—whose usage compensates for possible distortions due to size, outliers, etc.

31 Databases include MergentOnline, which presents information on more than 21,000 US and international companies; Compact D/SEC isno longer published , but a successor isavailable from Thomson; and Standard & Poor's Compustat PC Plus.

2. Markets can be defined in terms of size, degree of competition, and ongoing relationships.

The types of markets served affect company profitability, operations, and capital structure. Degree of market power, size of market, and market position may be important. Inter-company agreements, intangibles, and ongoing business relationships may be reflected in the economic substance of the transaction. The types of market served will affect the level of profits and capital structure. For companies to be comparable, the markets served by each company need to be identical to the markets served by the company being analyzed, in this case the Postal Service.

3. Market risks need to be similar.

Market risks include fluctuations in cost, demand, pricing, and inventory levels and the market risks for the comps need to be identical to those of the Postal Service. Other risks include the risks associated with the success or failure of research and development activities; financial risks, including fluctuations in the foreign currency rates of exchange and interest rates; credit and collection risks; product liability risks; and general business risks related to the ownership of property, plant, and equipment. All of these risks are relevant in defining similarities and differences between companies.

C. A "Functional Analysis" of Similarities Considers Economically Significant Activities.

1. For companies to be comparable, the entities should perform similar functions with respect to their activities.

There are over 10,000 publicly held companies with data available from the Securities Exchange Commission (SEC), and a variety of compiled commercial databases may be accessed to obtain company descriptions and data in a readily usable form. Based upon the data selection screens established,[32] one can quickly narrow the set of potential comps. For example, in the case of the part of the Postal Service focused on competitive products, companies with manufacturing, wholesaling, engineering, construction, raw materials, and other types of functions which are not common to the Postal Service can probably be eliminated. In the case of markets for competitive products, one would probably eliminate industries with significant levels of intangibles on the balance sheet. In the case of risks, eliminate companies subject to substantial market fluctuation, liability exposures, and international transactions. The types and mix of product lines and customer markets, as disclosed in the business description, will also serve as a basis for eliminating companies from potential comps.

2. By eliminating non-comparable companies, a list of companies comparable to the Postal Service in terms of functions, markets, and risks can be obtained.

Determining the degree of comparability between the Postal Service's competitive products and the proposed comps also requires a comparison of the significant economic conditions that could affect the prices charged, capital used, or profits earned by the competitive segment of the Postal Service, in comparison to the comps. Such economic conditions include the similarity of geographic markets, the relative size of each market, and the extent of the overall economic development in

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[32] With a database of over 10,000 companies to search for comps, data screens are used to eliminate non-comparable companies. The first screen could limit the analysis to certain SIC codes. The second screen could eliminate all companies with manufacturing (assuming that the company under analysis performed no manufacturing). The next screen could eliminate companies with negative profits. Then proceed with the criteria established until a set of comps remains. Comp sets typically range in size from 4 to 20 companies, although larger numbers of companies are possible. A comp set with three or fewer companies may be unduly restrictive.

each market, the level of the market (e.g., wholesale, retail, etc.), the relevant market share for the products, properties, or services under consideration, the location-specific costs of the factors of production and distribution, the extent of competition in each market with regard to the property or services under review, the economic condition of the particular industry including whether the market is in contraction or expansion, and the alternatives realistically available to the buyer and seller. In some cases, adjustments for different terms of sales and purchases, for inventory adjustments, and for changes in accounts receivable and payable may be necessary.

3. Companies that consistently generate operating losses would be eliminated from the analysis.

Companies that are just starting up, are persistently losing money, or are at risk of going out of business should be eliminated when performing an analysis of comps.

The companies remaining in the final set of comps would be economically similar in terms of the underlying economics (functions, markets, and risks) to the company under analysis, in this case, the segment of the Postal Service providing competitive products.

II. HAVING DETERMINED COMPANIES COMPARABLE TO THE POSTAL SERVICE, THE CAPITAL AND THE CAPITAL STRUCTURE FOR THE SEGMENT OF THE POSTAL SERVICE ENGAGED IN SELLING COMPETITIVE PRODUCTS CAN BE DETERMINED.

The capital/sales ratio determined from the comps is applied to the level of competitive product sales by the Postal Service to determine the amount of capital used in serving competitive products.

Having determined the amount of capital involved in competitive activities, one can then address the question of capital structure. Capital structure is defined in terms of the amount of capital obtained from equity and retained earnings, bonds, and loans. A firm's optimal capital structure would be the combination of assets and liabilities that maximizes the value of the firm.

A. The Modigliani-Miller (MM) Theorem[33] Provides a Starting Point for the Analysis of the Determination of Capital Structure.

The theory states that in the absence of tax effects, bankruptcy costs, transaction costs, and asymmetric information, and in the presence of an efficient equity market, the value of a firm is unaffected by how the firm is financed. The MM assumptions just stated are clearly unrealistic. For example, some firms are entirely financed by equity, but no firms are entirely financed by debt—an empirical demonstration that the theorem does not adequately describe actual business financing. Accordingly, the MM theorem, while of theoretical interest, primarily shows that market imperfections are important in influencing corporate financial policies and choices.

B. Market Structure, Risk and Other Financial Factors Confronting the Firm Appear to be of Importance in Determining the Optimal Capital Structure.

There is substantial business literature on capital structure and financing options, generally focused on financial decisions given various market conditions. Accordingly,

[33] Modigliani, F. and Miller, M. H., "The Cost of Capital, Theory of Investment," *American Economic Review* (1958), 48, 261–97; Miller, M. H. and Modigliani, F., "Dividend Policy," *Journal of Business*, (1961), 34(4), 411–33; Modigliani, F. and Miller, M. H., "Corporate Income Correction," *American Economic Review* (1963), 53(3), 433–43; Modigliani, F., (1980). "Introduction," *The Collected Papers of Franco Modigliani*, A. Abel (ed.), (1980), volume 3, pp. xi–xix, Cambridge, Massachusetts: MIT Press.

the set of comps—which would denote the set of firms essentially identical to the operation of the firm under consideration (in this case, the segment of the Postal Service operating in competitive markets)—is the relevant basis for determining the optimal capital structure. The optimal capital structure should be based on a median of the comps as appropriately identified.

C. The Return on Capital for Competitive Products Should be Similar to the Return on Capital Experienced by the Comps.

Given that one has a comp set of firms similar in functions, markets, and risks to those experienced by the competitive segment of the Postal Service, one would expect similar returns on capital.

III. A BRIEF, HYPOTHETICAL ANALYSIS ILLUSTRATES THE PROCEDURE

Table 1 presents financial data for a set of 6 companies. In a definitive analysis, these would be a number of companies whose functions, markets, and risks had been analyzed and found to be similar to those of the Postal Service, and the data would be based on three-year averages. However, the six companies in Table 1 should be considered to be hypothetical examples, with the data being presented to illustrate the principles discussed.[34] In a complete analysis there would be a presentation of the derivation of the number of companies, starting with the over 10,000 companies in a database and providing a rationale for the elimination of companies based on functions,

[34] Actual company identities are irrelevant, for the function/market/risk analysis has not been documented, and the companies have not been conclusively shown to be similar to the unregulated segment(s) of the Postal Service. For purposes of presentation only, six companies were selected based on *a priori* knowledge of the companies, not based on a traceable, supportable analysis. Accordingly, company identities are disguised, for there is no assurance that the companies are true comps. However, for purposes of illustration, the sample is adequate.

markets, risks, and/or additional criteria. The resulting number of comps would not necessarily be six; it could possibly be significantly higher or lower.

Table 1

Financial Data for a Set of Companies--Dollars in Billions						
	Company A	**Company B**	**Company C**	**Company D**	**Company E**	**Company F**
Revenue	3.2	24.7	54.6	298.8	30.85	39.6
Earnings Before Tax	0.355	2.1	4.2	16.75	2.6	5.55
Tax	0.13	0.4745	1.55	5.7	1	1.9
Total Assets	1.6595	31.35	36.15	129.2	21.5	34.15
Current liabilites	0.3775	7	10.35	46	5.1	6.65
Debt	0.153	8.35	8.9	23.25	2.6	3.25
Stockholder Equity	0.7885	12.85	14.9	51.3	10.55	16.6

Based on the data, one can compute the results presented in Table 2.

Table 2

Financial Data for a Set of Companies--Dollars in Billions Computation of Relationships							
	Company A	**Company B**	**Company C**	**Company D**	**Company E**	**Company F**	**Average**
Assets/Revenue	0.52	1.27	0.66	0.43	0.70	0.86	0.74
Earnings/Revenue	0.11	0.09	0.08	0.06	0.08	0.14	0.09
Earnings/Assets	0.21	0.07	0.12	0.13	0.12	0.16	12.50
Taxes/Earnings	0.37	0.23	0.37	0.34	0.38	0.34	0.34
LT Debt/Assets	0.09	0.27	0.25	0.18	0.12	0.10	0.17
StkhldrEquity/Assets	0.48	0.41	0.41	0.40	0.49	0.49	0.45

1. Assuming a meaningful set of comps, conclusions can be drawn on the financial aspects of the Postal Service's competitive products.

In this section, it should be noted that the conclusions are illustrative only, for the set of comps has not been established to be meaningful. First, in breaking out assets between competitive and market-dominant products, for every dollar of competitive product, 68 cents of overall Postal Service assets should be assigned to the competitive area, assuming that no asset specific breakout is being used. Second, in determining expected earnings, one would expect earnings of 8.5 cents on every dollar of revenue, or, alternatively, 12.5 cents per dollar of assets. Finally, long term debt as a percent of assets—based on the example comps—would be 17 percent, with 45 percent of assets being treated as stockholder equity.

2. The overall balance sheet and income statement of the Postal Service can be adjusted into sub-statements: an income and balance sheet for market-dominant products, and an income and balance sheet for competitive products, based on the level of competitive product sales.

Given that assets, revenues, and costs will to some degree be commingled between competitive and market-dominant products, the comp method provides an approach for obtaining a breakout of assets and earnings by market segment. Furthermore, the type of capital structure that should be expected is based on the median of the comps.

Question 7(a). The Commission requests comments regarding whether or not the assumed Federal income tax for the Postal Service is appropriately classified as an attributable cost.

Comments

Section 3634 of the PAEA sets out the types of activities and assets of the Postal Service which are to be assumed in calculating the income tax. Section 3634(a)(2) states:

> [T]he term 'assumed taxable income from competitive products', with respect to a year, refers to the amount representing what would be the taxable income of a corporation under the Internal Revenue Code of 1986 for the year, if –
>
> (A) the only activities of such corporation were the activities of the Postal Service allocable under §2011(h) to competitive products; and
>
> (B) the only assets held by such corporation were the assets of the Postal Service Allocable under §2011(h) to such activities.

Section 3634(b) establishes the period covered for the first computation of the assumed federal income tax and the subsequent transfer of the assumed federal income tax to the Postal Service Fund:

> …The Postal Service shall, for each year beginning with the year in which occurs the deadline for the Postal Service's first report to the Postal Regulatory Commission under §3652(a) --
>
> (1) compute its assumed Federal income tax on competitive products income for such year; and
>
> (2) transfer from the Competitive Products Fund to the Postal Service fund the amount of that assumed tax.

If a federal income tax is assumed, it may be concluded that the competitive products are profitable. If there is a profit on the competitive product activities, that profit is proof of an absence of cross-subsidization of the competitive products by the market-dominant products.[35] The assumed federal income tax calculation is to be based on the total collective competitive products taxable income, rather than on individual competitive products' income. In order for an income tax to be assumed, there must be taxable income. If there is taxable income, the costs for the direct attributable costs and indirect institutional costs have been exceeded. Thus, if there is assumed income tax, there is, by definition, revenue in excess of costs. It is irrelevant and unnecessary to describe the assumed taxes as attributable for purposes of determining if there is any prohibited cross-subsidization. Further, because income taxes are less than 100 percent of taxable income, there will necessarily be income remaining after income taxes that will provide a cushion of revenue above the attributable and apportioned institutional costs.

After the income tax has been calculated, the assumed income tax amount is transferred from the Competitive Products Fund to the Postal Service Fund (which is essentially transferring funds to market-dominant products). If, in addition, the assumed income tax were to be attributed as a cost of the competitive products, the effect would appear to be a double accounting of the assumed income tax for purposes of measuring possible cross-subsidization.

Similarly, suppose accounting rules are applied solely for tax purposes and taxable income results in payment of an assumed income tax, but when measured on the basis of the Commission's cost model, there is no income, and

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[35] A break-even situation would also prove that there was no cross-subsidization of competitive products by market-dominant products.

the attributable and institutional costs are not recovered. Even in that case, the assumed tax would likewise not constitute a cost properly attributable to the competitive products because the assumed tax is paid into the Postal Service Fund for the benefit of the market-dominant product operations. The assumed tax expense flows to the benefit of the market-dominant product operations inasmuch as the assumed tax is paid in actual dollars into the Postal Service Fund for the benefit of the market-dominant products. In this unusual case, to the extent the assumed income tax is paid into the fund, the payment would offset the calculated subsidization by market-dominant products of competitive product costs.

Question 7(b). On what basis should the assumed Federal income tax amount be reasonably assigned among competitive products?

Comment

The PAEA provides only for assessing a federal income tax for the competitive products *collectively*, and does not impose such a tax on each competitive product. The PAEA refers only to the tax on the products (plural) rather than individually. In any event, as noted in the response to question 7(a), above, no purpose is served by attributing taxes to individual products. Just as it would be improper to attribute the assumed income tax on the collective competitive products, it would be improper to attempt to assign portions of the tax among the competitive products.

Question 8(a)–(b). Section 3633(a)(2) requires each competitive product to cover its "costs attributable," which are defined as "the direct and indirect postal costs attributable to such product through reliably identified causal relationships." § 3631(b). The Commission has historically used attributable costs to develop recommended rates under the Postal Reorganization Act. Enactment of the PAEA raises issues concerning the need, if any, to modify the Commission's historic approach as well as the classification of costs arising under the PAEA.

The Commission has requested an opinion regarding whether or not the PAEA has redefined what costs should be categorized as either attributable or institutional. If a reclassification of costs from attributable, institutional, or vice versa, is proposed, the Commission has requested that the responding party identify the rationale for a proposed change.

Comment

It does not appear that the language of the PAEA requires the Commission to change the classification of any current direct or indirect postal costs. To date, the Commission's attribution of costs have been based upon reliably identified causal relationships as required by the PAEA. On the other hand, the PAEA does not forbid the Commission from exploring new methodologies for allocating direct or indirect postal costs.

Question 8(c). How should Retiree Health Benefit costs be classified?

Comment

Section 3631(b) of the PAEA defines costs attributable as "the direct and indirect postal costs attributable to such product through reliably identified causal relationships." In Docket No. R2005-1, USPS witness Tayman said, in response to the existing treatment of Health Benefits Costs:

> Annuitant health benefits costs are, and always have been, distributed to the same degree as all volume variable postal labor costs. This treatment is used because health care benefits for retirees are considered part of labor costs since we do not accrue costs for future health benefits of current employees.[36]

The Postal Service and the Commission formerly did not accrue annuitant health care benefit costs for current employees, because the Postal Service paid annuitant health benefits on a cash basis.[37]

5 USC Sec. 8906(g)(2)(A) states:

> The Government contributions authorized by this section for health benefits for an individual who first becomes an annuitant by reason of retirement from employment with the United States Postal Service on or after July 1, 1971, or for a survivor of such an individual or of an individual who died on or after July 1, 1971, while employed by the United States Postal Service, shall through September 30, 2016, be paid by the United States Postal Service, and thereafter shall be paid first from the Postal Service Retiree Health Benefits Fund up to the amount contained in the Fund, with any remaining amount paid by the United States Postal Service.

5 USC Sec. 8909a(d)(1) states:

> Not later than June 30, 2007, and by June 30 of each succeeding year, the Office shall compute the net present value of the future payments required under section 8906(g)(2)(A) and <u>attributable</u> to the service of Postal Service employees during the most recently ended fiscal year. (Emphasis added.)

The Postal Service must account for the annuitant health benefits on an accrual basis because the annuitant health benefit costs are related to the current labor force. Therefore, the accrued annuitant health benefit costs should be allocated as attributable to the same extent as the underlying labor costs.

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36 Docket No. R2005-1, VP/USPS-T6-2 (Tr. 2/170).

37 *2006 Annual Report*, United States Postal Service at 29.

Question 9. The Commission asks whether each of the following postal products and services is a "product" within the meaning of §102(6) of the PAEA: an International Customized Agreement, a Negotiated Service Agreement, a special classification, and a class "not of general applicability." Section 102(6) defines a "product" as "a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied[.]"

Comment

The definition of "product" in §102(6) differs in important respects from the definition of "subclass" used by the Commission. A plain reading of §102(6) makes clear that a postal "product" can consist of *either* distinct cost *or* market demand characteristics.

By contrast, the Commission considers both cost *and* market (demand) characteristics when establishing a mail subclass:

> To identify groupings of mail, which should be accorded subclass rather than rate category treatment, the Commission traditionally has sought to identify differences in both costs *and* market, or demand. (Emphasis added.)[38]

And:

> The Commission has consistently expected proponents of separate subclass treatment to show differences in both costs *and* demand. (Emphasis added.)[39]

The term "subclass" is not defined in the PAEA, although Congress surely knew of the Commission's previously stated criteria for establishing a subclass. If it so desired, Congress could have proposed an alternative definition of "subclass." Accordingly, the criteria necessary to determine whether a postal service is a "product"

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38 PRC Op. MC95-1, Para. 3022.

39 Id. at Para. 3023.

is less stringent under the PAEA than the criteria used by the Commission to determine a subclass. As a result, it should be expected that any postal service is (or could be) a "product" based upon cost differences alone, or based upon market characteristics alone. However, under the Commission's current policy, such a "product" cannot be accorded subclass treatment.

Thus, the short answer to Question 9 as to whether each International Customized Mail Agreement (ICMA), Negotiated Service Agreement (NSA), special classification, and class "not of general applicability" is a product is most likely yes, if there are either distinct cost *or* market characteristics associated with each. In the case of NSAs and special classifications, they are currently included in the DMCS. They have already met the Commission's stricter requirement to be recognized as a subclass. Therefore, such agreements and classifications clearly meet the lesser included definition of a product under §102(6).[40]

One further comment is warranted. In Question 9, part a., the Commission asks not only whether each ICMA is a "product," but more specifically, whether each ICMA is a "competitive product." The answer to this question turns on the underlying type of international mail or service that is the subject of the ICMA. Thus, for example, if an ICMA arrangement involves International Surface Air Lift, the ICMA should be regarded as a competitive product. If, however, an ICMA involves certain single-piece

[40] Information on the terms of International Customized Mail Agreements is not available to the public. To the extent the terms and arrangements contained in such agreements are similar to Negotiated Service Agreements concluded with domestic mailers, ICMAs are likely to meet the definition of a "product" within the meaning of §102(6).

international mail, such as Air Parcels, the ICMA should be regarded as a market-dominant product.

Wherefore, OCA respectfully submits these comments to Order No. 15 and asks that they be considered by the Commission.

Respectfully submitted,

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