

**BEFORE THE POSTAL REGULATORY COMMISSION  
WASHINGTON, D.C. 20268-0001**

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**Review of Treasury Report**

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**Docket No. PI2008-2**

**COMMENTS OF PITNEY BOWES INC. IN RESPONSE TO  
NOTICE AND ORDER PROVIDING AN OPPORTUNITY TO COMMENT  
ON TREASURY REPORT**

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## I. INTRODUCTION

Pitney Bowes is pleased to provide these comments in response to PRC Order No. 56 inviting comments on the *Report of the U.S. Department of Treasury on Accounting Principles and Practices for The Operations of the United States Postal Service's Competitive Products Fund* (December 2007)(Report). Section 401 of the Postal Accountability and Enhancement Act (PAEA)<sup>1</sup> required the Department of Treasury (Treasury), in consultation with the Postal Service and an independent certified public accounting firm, to develop recommendations for accounting practices and principles that will govern the operation of the Competitive Products Fund and the determination of an assumed Federal income tax to be imposed on competitive products income. The Report sets forth those recommendations.<sup>2</sup>

The Report contains nine recommendations. These comments focus on recommendations one through five which outline the principles and practices that should govern the division of costs and revenues between the Postal Service's market-dominant and competitive products. Competitive products comprise less than one percent of Postal Service volume and produce about ten percent of its revenues. The Postal Service estimated that the contribution by competitive products to its institutional costs was 5.65 percent in FY 2007. ACR2007, USPS-LR-FY07-9.

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<sup>1</sup> Pub. Law No. 109-435, 120 Stat. 3198 (Dec. 20, 2006). The PAEA amends various sections of title 39 of the United States Code. Unless otherwise noted, section references in these comments are to sections of title 39.

<sup>2</sup> See Report at 32-33.

## II. DISCUSSION

### A. Cost Accounting Principles

Pitney Bowes generally endorses recommendations one through five, subject only to the qualifications explained below. We strongly endorse maintaining the existing cost attribution systems and methods which have been developed in the four decades since the enactment of the 1970 Postal Reorganization Act (PRA).<sup>3</sup> Each recommendation is discussed separately below. While these recommendations facially pertain only to competitive products, they will also affect market-dominant products. In that regard, taken together, these recommendations should further the objectives of the “modern system of regulating rates and classes for market-dominant products” by (1) encouraging price predictability and stability, (2) reducing administrative burden and increasing transparency, (3) permitting the Postal Service to maximize incentives to reduce costs and increase efficiency, and (4) establishing and maintaining just and reasonable prices. Finally, they should result in systems that allocate institutional costs appropriately, and guard against cross-subsidization. *See* 39 U.S.C. §§ 3622(a)(9), 3633(a).

**Recommendation 1:** The current USPS economic cost attribution system should be modified so that the currently estimated class and subclass costs are remapped and attributed to the competitive products as defined by the PRC. Once remapped, product cost assignment should then be made consistent with the current USPS attribution rules and processes for marginal and incremental costs.

Recommendation 1 is to generally maintain the current Postal Service cost attribution system, but to change, as necessary, the “cost objects” for which costs are measured.<sup>4</sup> Report at 5. This change is necessary to judge compliance with section

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<sup>3</sup> Pub. L. 91-375, 84 Stat. 729.

<sup>4</sup> A cost object is “[a]n activity, output or item whose cost is to be measured. In a broad sense, a cost object can be an organizational division, a line of business, and a function, task, product, service or customer objective whose cost is measured by an activity-based-costing (ABC) accounting system.” Report at 37.

3633(a) and Commission rules relating to cross subsidy that require that “each competitive product covers its costs attributable.” 39 C.F.R. § 3015.7. To achieve this goal, costing systems must measure attributable costs by *individual product*. Existing cost and revenue analysis (CRA) cost systems, however, capture costs by mail *subclass*, the groupings which under the PRA were used to guard against cross subsidization. See former 39 U.S.C. § 3622(b)(3)<sup>5</sup>

Pitney Bowes agrees that the appropriate “cost object” is the product, not a subclass. The existing system should be modified to that end to correctly implement the PAEA. Importantly, Pitney Bowes notes that this change would not represent a fundamental change in *how* costs are measured, but only the cost object *for which* they are measured. Recommendation 1 strongly endorses using existing methods for measuring costs by product: “[o]nce remapped, product cost assignment should then be made consistent with the current USPS attribution rules and processes for marginal and incremental costs.” Report at 5. Pitney Bowes agrees.

**Recommendation 2:** To enable a practical solution to be developed that could be validated by third parties, a theoretical or “on paper only” enterprise — USPS Competitive — should be analytically created by assigning to it an appropriate share of all USPS costs.

Recommendation 2 is to “analytically create” an “on paper only” enterprise, “USPS Competitive,” by assigning this enterprise an “appropriate share” of all Postal Service costs. Report at 6-7. In making this recommendation, Treasury rejects the concept of structurally separating a competitive product enterprise from the market dominant one and also the

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<sup>5</sup> Former 39 U.S.C. §3622(b)(3) set forth “the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable . . . .” In practice, this rule was applied at the *subclass* level.

concept of analytically creating a “stand-alone [competitive product] enterprise.”

*Id.* at 6.

Pitney Bowes endorses this approach as an appropriate means to facilitate compliance with section 3633(a)(3) which requires that “competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.” 39 U.S.C. § 3633(a)(3). The PAEA’s inclusion of an *appropriate share* requirement is strong evidence that Congress envisioned that competitive and market-dominant products would continue to share networks, institutional costs, and economies of scope and scale. If, in the alternative, a competitive product enterprise were structurally separated from the Postal Service, there would be no reason for such an enterprise to cover any Postal Service institutional costs because those institutional costs would entirely relate to the provision of market-dominant products.

Pitney Bowes also emphasizes that structurally separating a competitive product enterprise, rather than analytically creating an “on paper only” enterprise, could do significant harm to market-dominant products. Market-dominant products as well as competitive products benefit from the economies of scale and scope resulting from a shared postal network. Losing the nearly \$2 billion contribution<sup>6</sup> that competitive products make to institutional costs would significantly erode the Postal Service’s financial position.

Thus, the loss of these economies that would result from structural separation could drive up Postal Service costs for market-dominant products, an outcome that is inconsistent with the goal of the PAEA to enhance the predictability and stability of market-dominant prices under a price-cap regime.

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<sup>6</sup> Docket No. ACR2007, USPS-FY07-9.

**Recommendation 3:** The volume-variable or marginal product costs currently reported by the USPS cost system should be used – after the product definition modification required by PAEA – to ensure that the competitive products cover their attributable costs. The reported incremental costs should be used to ensure that cross-subsidization of the competitive products by the market-dominant products is not occurring.

Recommendation 3 is to use the marginal costs reported by Postal Service costing systems (once remapped to the new “cost objects,” i.e., products) to ensure that each competitive product covers its attributable costs, *see* section 3633(a)(2), and use the incremental costs reported by Postal Service costing systems to ensure that cross-subsidization is not occurring in violation of section 3633(a)(3). We largely concur with this approach. We note, however, that the Commission includes product-specific fixed costs in its estimates of attributable costs. This is appropriate particularly since the Commission plans to use attributable costs as a proxy for incremental costs until incremental costs become available. *See* 39 C.F.R. § 3015.7(a). We also note the record suggests, consistent with Recommendation 3, that the economics profession accepts the incremental cost test as the appropriate test of whether a product is being cross-subsidized. *See* Docket No. R97-1, USPS-T-11 (Panzar) at 8.<sup>7</sup>

**Recommendation 4:** When the costs of the USO have been reliably determined and subjected to third-party validation, then the PRC should make any adjustments it deems necessary to the institutional cost assignment approach described in the following recommendation.

Recommendation 4 is that the Commission should review and potentially adjust its institutional cost assignment approach once reliable costs of the universal service obligation (USO) have been determined. Report at 8. Pitney Bowes agrees that any adjustment to the institutional cost assignment approach should await a reliable estimate

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<sup>7</sup> According to Dr. Panzar’s Docket No. R97-1 testimony, the incremental test states, “The revenues collected from any service (or group of services) must be at least as large as the additional (or incremental) cost of adding that service (or group of services) to the enterprise’s other offerings.”

of USO costs. Treasury, however, makes two observations that imply that no USO costs should be borne by competitive products.<sup>8</sup>

First, the Report points out that the USO imposes costs on Postal Service competitive products that the Postal Service's competitors do not have to bear. Report at 8. For example, while commercial operators would likely provide lower service levels than required by the USO in less profitable locations, the Postal Service does not have this freedom. Second, as Treasury found, the provision of competitive products does not cause the Postal Service to incur additional USO costs because "locations giving rise to significant revenues from competitive products tend also to be high-revenue locations for market-dominant products. Thus, a commercially oriented operator would specify service levels in high-revenue locations at levels at or above those required by the USO. Under these circumstances, the presence of competitive products does not impose any additional burden as a result of the USO." Report at 8.<sup>9</sup> In fact, the presence of competitive products helps reduce USO costs through increased economies of scale.<sup>10</sup>

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<sup>8</sup> It is also worth noting that, in other countries, market-dominant products generally fund USO costs. *See* Report at 8.

<sup>9</sup> To the extent the Postal Service suffers a competitive disadvantage as a result of its USO, this disadvantage is generally above and beyond the net disadvantage estimated by the Federal Trade Commission in its recent report. This is because the cost estimates used by the Federal Trade Commission in its analysis generally did not include those associated with the USO. *See, e.g.*, FTC Report at 56, Table 2.

<sup>10</sup> Additionally, competitive products benefit market-dominant products through their institutional cost contributions.

**Recommendation 5:** The current USPS cost accounting system should be modified so that all of the costs for USPS’s two lines of business (Market-Dominant and Competitive) can be assigned using cost drivers that capture the causal relationship between the lines of business and their applicable business costs. The remaining unassigned costs should be treated as institutional costs and an appropriate percentage of these institutional costs, which should be defined by the PRC by regulation, should be covered by the theoretical Competitive enterprise.

Recommendation 5 is that the Postal Service should modify its costing systems to capture “group-specific” costs, i.e., costs that are incurred exclusively for either competitive products or market-dominant products. As the Report notes, the Postal Service says it is in the process of making this change. Report at 8-9. Pitney Bowes strongly agrees with this recommendation and the change. As discussed above, to ensure that competitive products are not being cross-subsidized by market-dominant products, the incremental cost test should be applied to competitive products as a whole. Because competitive products group-specific costs would be eliminated if the Postal Service ceased to provide those products, these costs are “incremental” and should be included when applying the incremental cost test to competitive products collectively.

At this point, Pitney Bowes does not know how large these group-specific costs are or the extent to which this costing system modification will affect the measured share of institutional costs borne, respectively, by competitive and market-dominant products. Pitney Bowes also notes that these group-specific costs, once assigned to competitive and market-dominant products, are no longer part of the institutional cost pools subject to the appropriate share requirement. We expect that costing-system adjustments of the magnitude contemplated by this recommendation and the others could result in noncompliance with the appropriate share requirement as currently established. If this is

the case, the Commission should review the appropriate share requirement to determine whether the current 5.5 percent appropriate share level is appropriate.

**B. Assumed Federal Income Tax**

We have no substantive comments at this time on recommendations six through nine which address the assumed Federal income tax as required by section 3634 of the PAEA. *See* 39 U.S.C. § 3634. While the postal community has extensive expertise with accounting for postal costs and revenues, we suspect that the issues raised by the assumed Federal income tax represent uncharted territory for many in this community. For this reason, we suggest that the Commission convene a separate proceeding, or perhaps a series of technical conferences, to explore the issues involved here.

We believe the purpose of the assumed Federal income tax is to level the playing field in the competitive products market place and benefit market-dominant products because the assumed tax is transferred to the Postal Service Fund which supports market-dominant products. The Commission should seek to realize this goal in a manner that furthers the statutory objective “to reduce administrative burden and increase transparency.” 39 U.S.C. § 3622(b)(6). The accounting and tax rules can facilitate transparency. However, particularly with respect to the assumed Federal income tax rules, overly complex and cumbersome rules could create substantial administrative burden, be in effect opaque to all but the most expert in the field, and increase costs for competitive *and* market-dominant products.

This result would certainly not benefit the overall postal system. Nor is the adoption of overly complex rules required by the PAEA. The Commission has the responsibility for determining an “appropriate share” of institutional costs to be borne by

