

Before the
Postal Regulatory Commission
Washington, DC 20268-0001

Review of Treasury Report

Docket No. PI2008-2

PUBLIC REPRESENTATIVE'S COMMENTS
IN RESPONSE TO COMMISSION ORDER NO. 56

(April 1, 2008)

I. INTRODUCTION

Background. The Public Representative files the following comments in response to Commission Order No. 56, which establishes a Public Inquiry for consideration of recently-issued Treasury recommendations, related Commission questions, and a Federal Trade Commission report.¹ Order No. 56 at 2, 6 and 8. Treasury's recommendations are intended to assist the Commission in developing regulations for the Competitive Products Fund (CPF) mandated by the Postal Accountability and Enhancement Act (PAEA). The segment of the FTC Report pertinent to this Inquiry deals with corporatization of the Postal Service's competitive activities. See FTC Report at 93-98.

Since passage of the PAEA in late 2006, the Commission, with the cooperation of the Postal Service and interested stakeholders, has begun addressing transition issues through the rulemaking process. The first rulemaking was a comprehensive effort which established separate pricing mechanisms for market dominant products; defined competitive products; and set a minimum institutional cost contribution for

¹ Notice and Order Providing an Opportunity to Comment on Treasury Report, January 28, 2008 (Order No. 56). See also *Report of the U.S. Department of the Treasury on Accounting Principles and Practices for the Operation of the United States Postal Service's Competitive Products Fund*, December 2007 (Treasury Report) and *Accounting for Laws that Apply Differently to the United States Postal Service and Private Competitors*, December 2007 (FTC Report).

competitive products. See *generally* Docket No. RM2007-1. The Commission has recently contracted for a study of the Universal Service Obligation (USO), and has indicated it anticipates issuing initial notices in several rulemakings, including one involving reporting requirements, in the near future.

This Inquiry shifts the focus to the policies and mechanics of establishing the CPF and determining an assumed income tax. Both are key elements of the Postal Service's business model under the PAEA. Treasury presents many reasons to conclude that CPF and income tax-related issues will make this the most challenging rulemaking in the transition to the PAEA environment. It notes, for example, that "While [the PAEA is] deceptively simple in its mandate to impute an assumed federal income tax on the income from the USPS Competitive enterprise, compliance with the applicable PAEA provisions could be very complex." Treasury Report at 23. It also observes: "While several PAEA provisions are fairly specific in their requirements, there are several areas that are potentially open to interpretation and intent . . ." *Id.* at 33. And, throughout sections 2 and 3, Treasury identifies many considerations that complicate the effort.

At the same time, the Commission has a long history of success in interpreting complex — and sometimes competing — statutory provisions, and can draw on this experience in addressing PAEA implementation. In addition, Treasury identifies several options that appear to offer considerable potential for making the effort more manageable and less costly, while still achieving a result consistent with the PAEA's vision. By employing the flexible Public Inquiry format, formulating questions to focus the initial discussion, and allowing comments on the FTC Report, the Commission has demonstrated its willingness to provide a forum where building a consensus to support these options — or identifying areas of fundamental disagreement that foreclose them — can be usefully explored. In addition, commenters' submissions may assist the Commission in determining rulemaking priorities, in deciding whether separate tracks would be advisable for certain issues, and in assessing whether technical conferences or other tools, such as a Notice of Inquiry or Information Request, would be useful.

Scope of comments. The interests of the general public in this docket appear to lie in a Commission effort that works toward fulfilling several fundamental PAEA expectations in a productive, cost-effective, and balanced manner. The most significant expectation is that the outcome of this effort supports the continued existence of universal service. Other expectations include fairness to users of market dominant products (accomplished through PAEA cross-subsidy and cost tests²); parity for competitors; and enhanced transparency and accountability for the benefit of all.

Single-Piece First-Class Mail users also have a direct interest in a viable universal service and enhanced accountability, in line with the interests of the general public, and an important stake in the affordability of that service. Moreover, as they are in the market dominant category, they share the interest of others in this category (such as Standard Mail users) in the development of regulations that fairly implement the line of business distinctions in the PAEA, including key cost and contribution tests. Finally, to the extent Single-Piece First-Class Mail users are interested in having a wide choice of shipping services, they benefit from the Postal Service's retention of a competitive line of products and from the PAEA's interest in fairness for competitors. In addition, economies of scope presumably will produce systemwide efficiencies that hold down costs, and income tax transfers from the CPF to the Postal Service Fund will operate to the benefit of the market dominant category.

² The tests referred to include preventing competitive products from being cross-subsidized by the market dominant category; ensuring that competitive products cover attributable costs; and ensuring that competitive products make an appropriate contribution to institutional costs. See 39 U.S.C. §§ 3633(a)(1)-(3).

II. OVERVIEW

The Commission faces a threshold decision between a theoretical construct or structural separation. Treasury stakes out a position squarely in favor of a theoretical construct, and provides a convincing rationale that this approach is in the public interest. Given Treasury's standing and the nature of its recommendation, the Commission should proceed to develop regulations based on a theoretical construct. Treasury's standing also gives its recommendations considerable weight, but the PAEA assigns the Commission the ultimate responsibility for developing regulations in this area. One framework for assessing the recommendations and commenters' submissions is to consider whether they:

- Address matters that are largely within Treasury's area of expertise;
- Entail postal costing issues traditionally within the expertise of the Commission, the Postal Service, and postal practitioners;
- Involve areas of first impression under the PAEA, with no clear parallel under the Postal Reorganization Act, such as complex tax, accounting, and auditing principles and practices; or
- Involve matters that may need to be coordinated with other efforts, such as the USO Study or other rulemakings.

Upon identifying one or more core features, the Commission may find that it can accept some recommendations with confidence, such as those squarely within Treasury's expertise. To the extent the recommendations involve income tax, financial reporting, audit issues, or other matters that were not part of the Reorganization-era business model, the Commission may want to consider obtaining the assistance of subject matter experts if commenters' submissions do not cover these areas in the breadth or depth necessary to support a rulemaking. It also may want to consider the use of technical conferences or seminars to make this expertise available to the postal

community. Where postal costing and related systems are involved, the PAEA's codification of the Commission's longstanding Reorganization-era method of attribution appears to settle some questions. For others, the Commission may reasonably find that it can draw on its own expertise and the views of the postal community.³

III. RECOMMENDATION 2 PRESENTS A THRESHOLD QUESTION

Although Treasury characterizes its recommendations as “starting points” for further discussion and decisions, it is emphatic on one issue: the question of whether physical separation is needed to effectuate the PAEA-mandated demarcation between market dominant and competitive products. In fact, Treasury asserts that “the *only* viable method” to begin to address PAEA requirements for competitive products is to establish a theoretical, regulatory reporting construct. *Id.* at 4 (emphasis supplied). It observes that pursuant to this approach, the Postal Service would analytically segregate and identify the revenue and costs associated with competitive products “on paper only.” *Id.* Treasury's rationale is based on the complexity, cost, and time associated with modeling a true stand-alone enterprise, and on the conclusion that the result would provide “little-to-no corresponding benefits.” *Id.* at 6.

The Commission observes that in recommending the theoretical approach, Treasury recognizes, but rejects, the stand-alone option. It then poses a series of questions pursuing important aspects of both options and of the impact on economies of scope and scale. Order No. 56 at 7-9.

The Public Representative's view is that Treasury's standing in terms of expertise on this matter is such that the Commission could accept its recommendation as the basis for regulations, without more. At the same time, the Commission's pursuit of further data and information is appropriate, given its responsibility to consider all facets of the important decision it faces. Exploring the costs associated with a stand-alone

³ It is assumed that a longstanding concern regarding the level of costs that are not attributed and therefore spread across users in the form of institutional costs is not being addressed in this Inquiry or the ensuing rulemaking, but will be addressed as PAEA implementation progresses.

operation is one avenue; however, three other points warrant consideration. First, there is an array of financial and costing assumptions, techniques, and tools that can be successfully employed to create the theoretical enterprise, as well as sophisticated auditing approaches to monitor its operation. Thus, while many assumptions will have to be made in developing the “paper” enterprise, the approach is still likely to provide a level of assurance that is appropriate to the task, with less cost and disruption. Second, structural separation would also require making numerous assumptions and relying on statistical analyses and other studies, so it is not synonymous with more precision and accuracy. Third, while the CPF-related requirements the Commission develops will need to meet certain PAEA requirements, they should also foster the new law’s overall interest in creating a business model marked by ease of administration, effectiveness, and efficiency.

IV. MANY TREASURY RECOMMENDATIONS NECESSARILY PRESENT TAX AND ACCOUNTING ISSUES OF FIRST IMPRESSION FOR THE POSTAL COMMUNITY AND WARRANT CONSULTATION WITH SUBJECT MATTER EXPERTS

Treasury Recommendations 6, 7, and 8 address several related aspects of financial and tax reporting, and assume that the Commission opts for a theoretical enterprise. Recommendation 6 advocates using revenue numbers from the Postal Service’s existing financial systems as the source for reporting the competitive enterprise’s financial and taxable net income. Recommendation 7 advocates developing an income statement or statement of operations for the competitive enterprise (using revenues derived from the Postal Service’s current system), modified as appropriate for product definition. Treasury provides an illustrative statement Figure 1. Treasury Report at 10. Recommendation 8 calls for adoption of a simplified income tax approach, preferably using a published, regularly updated tax rate.

This set of recommendations appears to flow logically from Treasury’s conclusion that regulations should be based on a theoretical competitive enterprise, and promote considerations similar to those that influenced Treasury’s conclusion about the

theoretical construct, such as ease of administration, cost savings, and conservation of time. In general, Treasury's standing and its familiarity with complex organizations and tax matters again points strongly to the Commission's acceptance of its recommendations in this area.

More specifically, in response to Commission questions, it appears that the Commission should be able to use the Postal Service's existing financial systems as a basis for both reporting the financial profits and the taxable profits of the theoretical enterprise, after modification to reflect new product definitions. It also seems clear that the revenues used to determine the assumed federal income tax will have to be adjusted to conform to tax code treatment, but this is likely to require considerable additional, expert effort.

The adequacy of the type of financial statement presented in Figure 1 (supporting Treasury Recommendation 7) depends largely on the Commission's conclusions about its needs as a regulator. Subject matter experts could provide useful advice on the level of detail that would suffice. In addition, as development of other reporting efforts will be underway soon, the Commission may want to consider how production of financial information can be coordinated, to minimize burden and promote efficiency.

It also appears that the Commission's acceptance of a simplified tax approach is consistent with the interests of the general public. The Commission may first want to determine whether a consensus can be reached on the simplified tax approach, then pursue issues concerning the tax rate, such as appropriateness of using an effective tax rate and of identifying the Congressional Research Service as the source for the annual rate. Once these matters are resolved, the Commission is well situated to set up supporting mechanisms, such as those related to publishing the tax rate.

V. SOME TREASURY RECOMMENDATIONS AND OBSERVATIONS ENTAIL POSTAL COST AND REVENUE ASSUMPTIONS THAT CAN BE RESOLVED THROUGH STATUTORY INTERPRETATION AND THE ASSISTANCE OF THE POSTAL COMMUNITY

Treasury Recommendation 3 proposes tests to satisfy PAEA requirements requiring competitive products to cover their attributable costs and prohibiting cross-subsidy of competitive products. Recommendation 5 proposes modifying the Postal Service's current accounting system so that all costs can be assigned cost drivers that capture the causal relationship between the two lines of business and their applicable business costs. It then suggests treating the remaining unassigned costs as institutional costs and having the theoretical enterprise cover an appropriate percentage of them.

The Commission poses two questions with respect to Recommendation 3. The first is whether the Postal Service's current cost systems, after modification, would be sufficient for allocating costs between competitive and market dominant products. Order No. 56 at 10. In general, it appears that in keeping with the PAEA's interest in a business model that exhibits ease of administration and efficiency, using the Postal Service's current cost systems offers considerable advantages. Thus, the Commission may want to consider doing so, assuming adjustments are made for required product modification and for any other reasons deemed appropriate after review of commenters' submissions.

The Commission's second question focuses on the level of application of incremental costs. It notes that Treasury interprets section 3633(a)(1) to mean that the incremental cost test should be applied to each individual competitive product, while the Commission has interpreted this section to apply collectively to competitive products. It then asks whether the incremental cost test should be applied to individual competitive products or to competitive products as a whole. *Id.*, citing 39 C.F.R. § 3015.7(a).

The Public Representative notes that although this question involves costs, the answer ultimately turns on statutory interpretation, not tax or accounting expertise. Accordingly, while Treasury's recommendation deserves careful consideration, it also appears that the Commission could rely with confidence on its interpretation, which favors the collective approach.

The Commission poses three questions related to Recommendation 5. The first asks whether any additional types of drivers or different types of cost attribution approaches should be considered in determining costs for the competitive and market dominant lines of business. The second question asks for comments on the appropriate meaning of line of business costs, including the basis for distinguishing between market dominant and competitive lines of business. *Id.* at 11-12. The third question asks whether the Commission's determination of an appropriate share of institutional costs under 39 U.S.C. § 3633(c)(3) also satisfies, at least implicitly, section 3622(b)(9).

Definitive responses to these questions may require a type of expertise not needed under the former regulatory approach. Thus, this may be another area where the record would benefit from the advice of subject matter experts. The third question is largely a matter of statutory interpretation, and commenters' submissions are likely to provide useful observations on the issue the Commission raises.

VI. SEVERAL TREASURY RECOMMENDATIONS OR OBSERVATIONS SUPPORT TRANSPARENCY, ACCOUNTABILITY AND OVERSIGHT

In presenting its Recommendations, Treasury observes that while it suggests that the Postal Service attribute costs consistent with the Commission's definition of competitive products, more is needed to calculate a PAEA-compliant, corporate-like income statement or to impute an assumed income tax. In its view, this involves modifying the Postal Service's cost system to provide for the additional assignment of competitive products' costs so that it has several capabilities, including a "more granular level" of costing details. Treasury Report at 4-5. In addition, Recommendation 9 provides:

To ensure compliance with PAEA provisions and subsequent PRC clarification and direction for their implementation, USPS should provide sufficient accounting and financial statements of operations reporting and supporting information for the theoretical USPS Competitive enterprise. The information prepared and reported should be subject to sufficient independent review to ensure that it is fairly stated in all material respects, either in relation to the basic financial statements as a whole or on a stand-alone basis.

Id. at 29.

Treasury's recognition of the need for more granularity and for financial reporting at a level and scope sufficient to support independent review is fully consistent with the interests of the general public. The Commission usefully pursues related details in series of questions. *Id.* at 15. Preliminarily, it appears that the PAEA allows the Commission to adopt a simplified approach to assigning assets to the CPF for financial disclosure purposes and calculating an assumed Federal income tax. Questions related to financial reporting, oversight, and specific accounting principles raise issues of first impression under the PAEA. Postal practitioners may be able to provide useful insight on these matters, but the Commission may want to consider obtaining the assistance of subject matter experts. This appears to be especially true with respect to how comprehensive reports need to be to support the level of review the Commission considers appropriate. Finally, the Commission should consider, early in this effort, the potential impact of confidentiality claims on transparency and oversight.

VII. SUMMARY

The following bulleted points summarize some of the main points expressed in these comments:

- The Commission's acceptance of Treasury's recommendation in favor of a theoretical construct would be consistent with the interests of the general public.
- Acceptance of Treasury's recommendation in favor of using a simplified tax approach would also be consistent with the public interest; however, the Commission may want to consider obtaining the assistance of subject matter experts to deal with complex aspects of this approach. Technical conferences may help inform the postal community.
- Treasury's observations and related recommendations on granularity, financial reporting, and independent review are consistent with the interests of the general public. Determining a "sufficient" level and extent of detail is the province of the Commission as regulator. This determination involves both statutory interpretation and subject matter expertise.
- The Commission should consider affirmatively addressing the extent to which claims of commercial privilege may affect transparency and oversight.

Respectfully submitted,

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