

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Review of Treasury Report)

Docket No. PI2008-2

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
INITIAL COMMENTS ON REPORT OF THE U.S. DEPARTMENT OF THE
TREASURY ON ACCOUNTING PRINCIPLES AND PRACTICES
FOR THE OPERATIONS OF THE UNITED STATES POSTAL SERVICE'S
COMPETITIVE PRODUCTS FUND
(April 1, 2008)**

BACKGROUND

On December 19, 2007, the U.S. Department of the Treasury issued its Report on Accounting Principles and Practices for the Operations of the United States Postal Service's Competitive Products Fund ("Treasury Report"), pursuant to the Postal Accountability and Enhancement Act ("PAEA"), Public Law 109-435, as codified in 39 U.S.C. section 2011(h). On January 28, 2008, the Commission issued Order No. 56, Notice and Order Providing an Opportunity to Comment on Treasury Report, requesting comments on the Treasury Report and presenting questions raised by the Commission. The deadline for comments is April 1, 2008, and the deadline for reply comments is May 1, 2008.

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereafter "Valpak") hereby submit these joint comments in response to Order No. 56.

Under PAEA, the Secretary of the Treasury was to deliver recommendations to the Commission for: (1) accounting practices and principles that the Postal Service should follow with the objectives of (i) identifying and valuing the assets, liabilities, capital, and operating

costs in connection with competitive products and (ii) preventing the subsidization of competitive products by market dominant products; and (2) the rules that should be followed in determining the assumed federal income tax on competitive products income. 39 U.S.C. § 2011(h)(1)(A). The Commission is then to give the Postal Service, mail users, and the public representative an opportunity to present their views on the Treasury recommendations, as it did in issuing Order No. 56.

The ultimate goal of this exercise is for the Commission to provide by rule for (1) “the establishment and application of the accounting practices and principles which shall be followed by the Postal Service,” (2) “the establishment and application of the substantive and procedural rules” to be followed in determining the assumed federal income tax on competitive products, and (3) “the submission by the Postal Service to the Postal Regulatory Commission of annual and other periodic reports setting forth such information as the Commission may require.” 39 U.S.C. § 2011(h)(2)(B).

The Treasury Report made nine specific recommendations. Commission Order No. 56 raised 28 issues with respect to some of those recommendations.

COMMENTS

Valpak’s Initial Comments hereby respond to certain of the questions posed by the Commission with respect to recommendations 2, 3, 5, 6, and 7 in the Treasury Report (paragraph numbering herein corresponds to questions posed by the Commission in Order No. 56).

A. Treasury Recommendation 2.

1. Valpak agrees with the assumption of the Treasury Report that market dominant and competitive products should **not** be divided into stand-alone operations. Any contemplation of physical, structural unbundling should be along functional lines, not product lines.¹ The Treasury Report stated, in its discussion of Recommendation 2, “Clearly, there is no USPS stand-alone corporation that sells competitive products only and PAEA does not change this.” To the extent that PAEA requires a separate income statement for competitive products, the Commission should seek a reasonable solution that restrains the time and cost required to resolve issues and prepare the requisite income statement. Elaborate, detailed studies and models should not be required. As Treasury pointed out, the “sophisticated cost modeling of a true stand-alone enterprise ... would likely be very costly and take many years for the USPS to develop with little-to-no corresponding benefits.” Treasury Report, p. 6. PAEA does not call for creation of stand-alone enterprises. PAEA created separate ratemaking systems for market dominant products and competitive products, and made other distinctions between those two product categories, but none of those distinctions involved structural separation. Furthermore, while PAEA assigned to the Commission the authority to establish accounting practices and Competitive Products Fund income tax requirements, PAEA assigned the task of assessing the future business model of the Postal Service to

¹ For a discussion of unbundling along functional lines, see “Enhancing Competition by Unbundling the Postal Administration” by John Haldi and William J. Olson, in *Progress Toward Liberalization of the Postal and Delivery Sector*, Crew & Kleindorfer, eds. Kluwer Academic Publishers, 2006, pp. 173-189.

the Comptroller General of the United States, and this task would appear to include a determination of whether the Postal Service should operate under a business model with market dominant products and competitive products structurally separated. *See* PAEA, section 710. Therefore, inquiry into this issue in this docket is a potential distraction from the responsibilities vested in the Commission by PAEA.

2. Some competitive products are processed jointly with market dominant products, and many competitive products are delivered jointly with market dominant products. Economies of scale and scope should result from this joint processing and delivery, and would be greatly diminished if structurally separate processing and delivery were required. The result would be higher unit costs, especially for competitive products, along with a reduction in the ability of competitive products to contribute to the Postal Service's general overhead costs.
3. Adequate safeguards to cross-subsidization of competitive products by market dominant products can and should be constructed in the form of improved costing methodology. Assuming that such safeguards are in place, the risk of cross-subsidization should be *de minimis*.
4. No costs should be "assigned" arbitrarily. Assignment of all costs should be on the basis of usage and causality. Some joint costs currently are attributed on the basis of usage, as TRACS does with volume variable transportation costs, and this is an appropriate model for handling joint costs.
5. Postal Service operations are organized around cost centers, not profit centers. Conceptually, individual competitive products might be thought of as "profit centers,"

since each competitive product has identifiable revenue and costs. However, the Postal Service generally does not have managers for individual competitive products, nor does it have a dedicated managerial staff responsible for all competitive products. Under these circumstances, Valpak sees little role for the concepts of profit centers and transfer pricing.

6. Universal Service Obligation (“USO”) costs, to the extent that they are not otherwise attributed, should be allocated to competitive products only on the basis of causality, *i.e.*, only USO costs found to be caused by competitive products should be allocated to competitive products. Any such allocation should await the complete of the Commission’s USO study identifying USO costs to the Commission’s satisfaction.

B. Treasury Recommendation 3.

1. Valpak wants competitive products to be successful. Although some market dominant mail users might argue that indiscriminately allocating more costs to competitive products is better for market dominant products, Valpak would disagree. Artificially inflating the costs of competitive products could harm those products, and cause a loss in the significant institutional contribution made by those products. Valpak agrees with the Treasury Report recommendations that existing costing and revenue systems (after being re-mapped to the new product designations) should be used for attribution to competitive products. However, in order to assure compliance with the various requirements of PAEA concerning the costs of competitive products, the Commission may desire to have the Postal Service develop costs that are more accurate and reliable

than the costs heretofore used for ratemaking under the Postal Reorganization Act of 1970. The Postal Service's current costs systems, which are a mix of statistical sampling and cost modeling, have been structured around subclasses. For those subclasses with a relatively small volume of mail, the statistical sampling has been known to produce results that vary considerably from year to year, and anomalous costing results have occurred not infrequently. Newly-defined products in some instances may coincide with previously-defined subclasses. Where this is not the case, the volume of newly-defined products will be less than the volume of the subclass in which the products previously were housed. For such products, consequently, an increase in statistical variation and anomalous results can be expected over that experienced previously with subclasses. With respect to statistical variation, the Commission may want to consider establishing minimal acceptable limits for reliability and require the Postal Service to increase sample size until those limits are met. With respect to anomalous results, the Commission may want to see more effort devoted to cost modeling, especially for those products where (i) volume is small, or (ii) statistical sampling has difficulty in reliably distinguishing between two similar products. With respect to costs developed through cost modeling, the Commission may want to consider establishing the maximum acceptable deviation between results from cost models and control costs from the CRA — *i.e.*, establish the maximum gross-up factor (*e.g.*, 125 percent) acceptable for reconciliation of modeled costs with CRA costs² —

² Modeled costs typically have understated CRA control costs, and consequently have had to be inflated to accord with the CRA control cost. The larger the gross-up factor

and require the Postal Service to invest additional resources in cost modeling until the model and requisite data are refined to the point where the model is capable of meeting the established limit.

2. Valpak suggests that the incremental cost test be applied both to **individual** competitive products **and** to all competitive products **as a whole**. It is well known that the incremental cost of a group of products may exceed the sum of the incremental cost of each individual product. If an individual competitive product should fail the incremental cost test, the Commission need not inquire as to the source of the subsidy, but instead should focus its attention on requiring revenues from such product to exceed its incremental costs.

C. Treasury Recommendation 5.

1. Valpak has no suggestions to make in response to the Commission's first question as posed.
2. Valpak has not considered line of business costs as such costs might pertain to competitive products. However, to the extent that certain costs are common to and caused by some **or** all competitive products, it would be appropriate to include such costs in the incremental costs of competitive products as a group. At this time, Valpak awaits with interest the Postal Service's efforts to develop group-incremental costs, *i.e.*, line of business costs.

used to inflate costs, the smaller the percentage of costs that have been successfully modeled.

3. Valpak is not aware of any reason why the “appropriate share of institutional costs” for competitive products under section 3633(a)(3) should differ from the share of institutional costs determined pursuant to section 3622(b)(9).

D. Treasury Recommendation 6.

1. Valpak views the Postal Service’s current revenue reporting system (modified to accommodate new product definitions) as entirely adequate for reporting the Postal Service’s gross revenue from each competitive product individually, and from all competitive products collectively.
2. Determination of net taxable income depends critically on determination of accurate and reliable costs for competitive products. (In this regard, *see* suggestions above in connection with Part B, Treasury Recommendation 3.)

E. Treasury Recommendation 7.

1. Treasury’s suggested statement showing competitive enterprise income would appear to be sufficient for determining income subject to the income tax requirement of PAEA. To the extent that competitive products share in any reported loss by the Postal Service as a whole (*see* the net loss reported for FY 2007 in Figure 1 of the Treasury Report), no income tax should be payable, and losses reported for the Competitive Products Fund should have the same carry-forward privilege as in the private sector.

2. At this point, Valpak perceives no need to incur any additional costs to create a more detailed statement of income.

Respectfully submitted,

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