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

REVIEW OF TREASURY REPORT

Docket No. PI2008-2

INITIAL COMMENTS OF THE UNITED STATES POSTAL SERVICE IN RESPONSE TO ORDER NO. 56 AND THE TREASURY REPORT
(April 1, 2008)

On January 28, 2008, the Commission issued Order No. 56, initiating this docket and soliciting comments on the report submitted to the Commission by the Department of the Treasury on December 19, 2007. *See* Report of the United States Department of the Treasury on Accounting Principles and Practices for the Operation of the United States Postal Service's Competitive Products Fund ("Report"). As its title indicates, the Report contains recommendations regarding the Competitive Products Fund created by the Postal Accountability and Enhancement Act (PAEA), and related topics regarding the transition to the new regulatory environment. Order No. 56 invited comments on any and all aspects of the Report, but also posed specific inquiries regarding matters in the Report on which the Commission wished commenters to focus special attention.

The Postal Service hereby submits its initial comments in response to Order No. 56. These comments are divided into two sections. In the first section, the Postal Service presents a general overview of the matters discussed in the Treasury Report, and its own proposals as to how the relevant statutory provisions can be applied in the most practical and meaningful manner possible. The Postal Service's primary conclusions are that the Treasury Report outlines a reasonable conceptual framework, and that the more detailed procedures described in these comments are consistent with that framework, and will achieve the applicable statutory objectives. In the second section of these comments, the Postal Service responds to the specific inquiries posed by the Commission in Order No. 56.

I. REASONABLE EXTENSION OF THE FRAMEWORK ARTICULATED IN THE TREASURY REPORT WILL FULFILL THE PURPOSES INTENDED BY CONGRESS FOR THE COMPETITIVE PRODUCTS FUND

The PAEA includes a number of provisions relating to fair competition with respect to competitive products. *See, e.g.,* 39 U.S.C. §§ 2011, 3633, 3634. The overarching objective of these provisions of the law is to "account" for operational, borrowing and investment activities of competitive products in order to prevent unfair competition, and to detect instances where unfair competition has occurred. The law presents an unusual challenge in its requirement in section 2011 to establish accounting practices and principles and report on competitive product financial activity. Language in the law uses terms that apply to three distinct financial subject areas, namely: (1) "funds", (2) accounting used for external financial statement reporting, and (3) postal regulatory costing. Each of these subject areas has its own set of "accounting principles and practices."

- Funds generally deal with financial activities related to receipts and disbursements of cash, like the Postal Service Fund.
- GAAP (Generally Accepted Accounting Principles) accounting deals with Balance Sheets and Income Statements based on accrued revenues and expenses.

- Postal regulatory costing deals with attributable and institutional costs by product.

Under the new law, section 2011 of title 39 uses terms from all three subject areas. Given the multiple sets of terms and concepts, there are no textbook rules to define how the Postal Service should develop and report competitive product financial activity. Therefore, the Commission must develop a set of procedures for the Postal Service to follow to report competitive product financial activity, including borrowing and investing, to demonstrate that competitive products are not subsidized by market-dominant products. These comments set forth a proposed set of reports and accounting procedures that the Postal Service believes meet that objective.

A. Analysis of Section 2011 Highlights References to Distinct Financial Subject Areas

The law establishes the Competitive Products Fund and the descriptions of the flows into and out of the fund use terms from fund accounting, GAAP accounting and postal economic costing. The absence of a single set of guiding principles for accounting and reporting of competitive product financial activity presents a challenge. To highlight this point, below are excerpts from section 2011 with certain phases underlined. The "type of financial information" (i.e. fund/cash, GAAP accounting, or postal economic costing) is annotated in "[ ]" and in **boldface.**

> *2011. Provisions relating to competitive products*
> *(a) (1) In this subsection, the term "<u>costs attributable</u>"* **[postal economic costing]** *has the meaning given such term by section 3631.*
> *(2) There is established in the Treasury of the United States a revolving fund, to be called the Postal Service Competitive Products Fund, which shall be available without fiscal year limitation for the <u>payment</u> of* **[fund/cash]** *–*
> *(A) <u>costs attributable</u> to competitive products* **[postal economic costing];** *and*

*(B)all other costs incurred by the Postal Service, to the extent allocable to competitive products***.**

(b) There shall be *<u>deposited</u>* *in the Competitive Products Fund* **[fund/cash]***, subject to withdrawal by the Postal Service—*

(1) *<u>revenues</u>* *from competitive products;* **[GAAP accounting revenues, estimated by product – e.g. Annual Compliance Report revenues];**
(2) *<u>amounts received</u>* *from obligations issued by the Postal Service under subsection (e);* **[fund/cash]**
(3) *<u>interest and dividends earned</u>* *on investments of the Competitive Products Fund;* **[GAAP accounting interest and dividends]**
(4) *any other* *<u>receipts</u>* *of the Postal Service***[fund/cash]** *(including from the sale of assets), to the extent allocable to competitive products.*

(d) With the approval of the Secretary of the Treasury, the Postal Service may *<u>deposit moneys</u>* **[fund/cash]** *of the Competitive Products Fund in any Federal Reserve bank, any depository for public funds, or in such other places and in such manner as the Postal Service and the Secretary may mutually agree.*

(e)(1)(A) Subject to the limitations specified in section 2005(a), the Postal Service is authorized to *<u>borrow money</u>* **[fund/cash]** *and to issue and sell such* *<u>obligations</u>* **[like GAAP accounting 'debt']** *as the Postal Service determines necessary to provide for competitive products and* *<u>deposit such amounts</u>* **[fund/cash]** *in the Competitive Products Fund***.**

(B) Subject to paragraph (5), any borrowings by the Postal Service under subparagraph (A) shall be supported and serviced by –

(i) the *<u>revenues</u>* **[GAAP accounting revenues, estimated by product – e.g. Annual Compliance Report revenues]** *and* *<u>receipts</u>* **[fund/cash]** *from competitive products and the* *<u>assets</u>* **[GAAP accounting balance sheet]** *related to the provision of competitive products (as determined under subsection (h));*

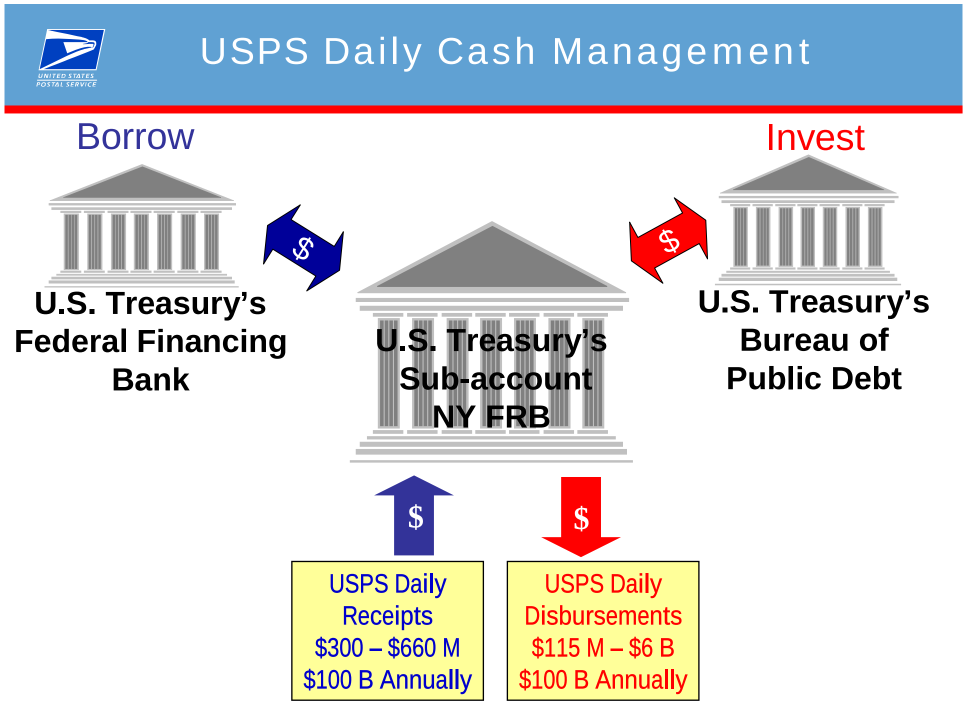
(5) *The Postal Service shall make* *<u>payments of principal, or interest</u>* **[fund/cash]***, or both on obligations issued under this section out of the* *<u>revenue</u>s* **[GAAP accounting revenues, estimated by product – e.g. Annual Compliance Report revenues]** *and* *<u>receipts</u>* **[fund/cash]***, from competitive products and assets related to the provision of competitive products (as determined under subsection (h)), or for purposes of any period before accounting practices and principles under subsection (h) have been established and applied, the best information available, including the* *<u>audited statements</u>* **[GAAP accounting]** *required by section 2008(e). For the purposes of this subsection, the total assets of the Competitive Products Fund shall be the greater of***—**
(A) the assets related to the provision of competitive products as calculated under subsection (h); or

> *(B) the percentage of <u>total Postal Service revenues</u>* **[GAAP accounting revenues, estimated by product – e.g. Annual Compliance Report revenues]** *and <u>receipts</u>* **[fund/cash]** *from competitive products times the <u>total assets of the Postal Service</u>* **[GAAP accounting balance sheet]**.

Given the intermingling of these distinct financial concepts, no textbook rules can provide guidance on the development of the appropriate accounting procedures to report Competitive Product financial activity and the determination of the annual Assumed Federal Income Tax.

For example, government funds tend to be inflows and outflows of cash or financial activity representing cash. The Postal Service's Daily Cash Management process is centered on the U.S. Treasury's sub-account at the New York Federal Reserve Bank (FRB). The balance in this account changes daily due to the net difference between cash receipts and disbursements of the Postal Service. Figure 1 below is an overview of the daily cash flows of the FRB account. Cash inflows include (but are not limited to) the following: cash receipts at retail windows, deposits made to customers' trust accounts and postage meters, the face amount of money order sold, payments from foreign postal administrations, payments from other government agencies, cash from borrowing from the US Treasury's Federal Financing Bank, and cash from divestiture of investments in Treasury securities. Cash outflows are cash disbursements for payroll and vendor payments. Cash outflows also include (among other items) the following: payments to other government agencies, settlement for redeemed money orders, payment to foreign posts, investments in Treasury securities with the US Treasury's Bureau of Public Debt, and repayment of debt to the Federal Financing Bank.

FIGURE 1



Daily cash flows are visible only in lump sum dollar amounts, and are identifiable only by payment channels. It is not possible to distinguish cash receipts or disbursements associated with particular products. Also, cash flows in a given period do not correspond to GAAP revenues and expenses for that period. For example, cash receipts include the receipts from sales of money orders, which are redeemed by customers for cash at a future time. Only the fees from the sale of money orders are reported as "revenue." Likewise, daily cash disbursements do not equate to daily expenses. Expenses include non-cash items such as depreciation and accrued expense for future payments, such as Repriced Annual Leave and Retirement liabilities. The Postal Service's daily cash management process is designed for the efficient movement of money, to ensure sufficient liquidity is available for required disbursements (supported through borrowing from the U.S. Treasury's Federal Financing Bank, as needed), and to earn income on any excess cash invested with the U.S. Treasury's Bureau of Public Debt.

The Postal Service suggests that the requirements and procedures for reporting Competitive Product financial activity be driven by the objective to provide transparency to competitive product financial activity, including borrowing and investing, and thus to demonstrate that the competitive products are not unfairly advantaged by virtue of their joint production with market-dominant products. A set of procedures must be formulated that achieves the objectives of the law; namely, that the Postal Service account for the activities of competitive products in such a way as to prevent unfairness in pricing, borrowing, and investing.

Section 2011 deals with limiting the borrowing and investment activities associated with competitive products in such a way that approximates the limitations of private-sector companies. Investment by private sector companies is constrained by available cash. Borrowing is constrained by the amount of cash and value of assets which could serve as collateral for the loan. The challenge in establishing accounting procedures for Section 2011 is that the "competitive products line of business" is not a stand-alone enterprise with its own balance sheet and cash flow. Competitive Product revenues are derived from GAAP-based annual accrued revenues and the "attributable costs" are derived from GAAP-based annual accrued costs and the Commission-defined cost attribution methodology.

In fact, it is impractical and unrealistic to define a balance sheet and cash flow for a "competitive products line of business" using Generally Accepted Accounting Principles. A Balance Sheet and its associated Statement of Cash Flows depend on being able to identify and track the inflow and outflow of the cash of an enterprise. As pointed out in the above discussion of the Daily Cash Management process, it is impossible for the Postal Service to relate its cash flows to specific products. The annual income statement for Competitive Products will therefore be based on *an allocation of total accrued revenues and accrued expenses to the competitive products,* which, in turn, are based on economic and statistical analyses. Cash inflows from postage sales, meter settings, and trust account deposits cannot be identified by the product or service. Cash outflows for salaries and benefits, transportation, equipment, and other purchases pay for services and assets used by all products, and they cannot be identified by the product or service provided using the resource. There is no way, short of establishing a physically separate business entity with its own retail windows, labor force, and network, to create a balance sheet and track cash flows for competitive products.

The Postal Service has developed a comprehensive set of proposed accounting procedures to address the purpose of the Competitive Products Fund, but which also recognize these constraints and conflicts. Those procedures are described next. The basic approaches outlined by the Treasury Report are summarized in Order No. 56 at pages 4-6. In the Treasury Report itself, its nine recommendations are presented at pages 32-33. The Postal Service considers the procedures it is proposing in these comments to be fully consistent with, and to constitute a reasonable extension of, the conclusions and suggestions contained within the Treasury Report. At the same time, these proposals are appropriately more concrete and detailed than those presented by Treasury.

B. Proposed Approach to Account for and Report Competitive Product Financial Activity

To begin, it may be useful to set forth appropriate definitions of the relevant terms and concepts. Using the analysis set forth above as background, the following is a list of the most reasonable definitions for competitive product financial activity:

Competitive Product Annual Revenue Share: the percentage of total Postal Service revenues from competitive products. Computed using the revenues reported on the Annual Compliance Report

Competitive Product Financial Obligations: Obligations issued by the Postal Service under Section 2011(e)(1)(A). The valuation of the debt should be based on Generally Accepted Accounting Principles (GAAP) and should be consistent with the valuation reported in the Postal Service's audited Consolidated Balance Sheet.

Competitive Product Financial Investments: Investments made under Section 2011(c). The valuation of the Investment should be based on Generally Accepted Accounting Principles (GAAP) and should be consistent with the valuation reported in the Postal Service's audited Consolidated Balance Sheet.

Next, we focus on five basic accounting principles. Despite the fact that there is no textbook set of accounting rules that can be used for the reporting of competitive products' financial activity, the Postal Service believes the following principles should be used to report such activity:

1. Reported amounts should be accurate
2. Reported amounts should be timely
3. Reported amounts should be complete

4. Reported amounts should be traceable to source data and transactions

5. Reported amounts should be reconcilable to other externally-reported financial data.

With these definitions and principles in mind, the Postal Service proposes that three annual reports be developed for competitive product financial activity:

1. ANNUAL INCOME REPORT

This report would display the basis on which to determine the amount of Annual Assumed Federal Income Tax for each Fiscal Year. The Postal Service proposes that the source of data for the Annual Income Report be the Annual Compliance Report.

2. ANNUAL FINANCIAL STATUS REPORT

This report would display the status and activity of three financial measures:

Cumulative Annual Income
Financial Obligations
Financial Investments

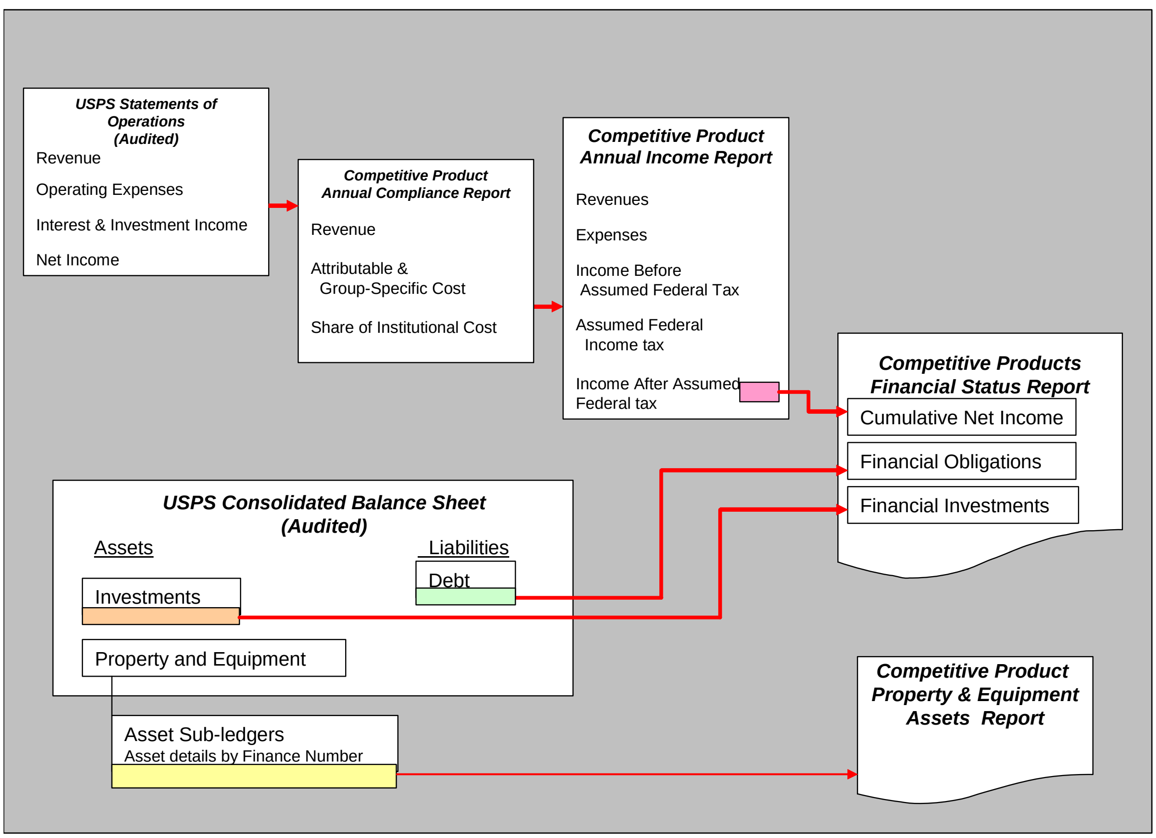
The proposed sources of data for the Annual Financial Status Report are the Annual Income Report and the reported General Ledger balances involving Obligations and Investments on the Postal Service's audited Consolidated Balance Sheet.

3. ANNUAL IDENTIFIED PROPERTY and EQUIPMENT ASSETS REPORT

This proposed report would provide a listing and valuation of Property and Equipment assets associated with providing competitive products. The source of data would be the audited Fixed Asset sub-ledgers of the Postal Service's accounting system.

Figure 2 provides the conceptual overview of the proposed approach for creating the data for the competitive product financial activity reports. Note that the starting point for all information on the reports of competitive product financial activity is audited financial statement data. The Postal Service's *Statement of Operations* is used to produce the Annual Compliance Report, and the information reported on the Annual Compliance Report is used as the source for the Annual Income Report. The Postal Service's *Consolidated Balance Sheet* is the source of information for Financial Obligations and Financial Investments. The Property and Equipment Asset Sub-ledgers are the source of data for the Competitive Product Property and Equipment Assets Report.

Figure 2



More detail on each proposed report is presented next.

ANNUAL INCOME REPORT

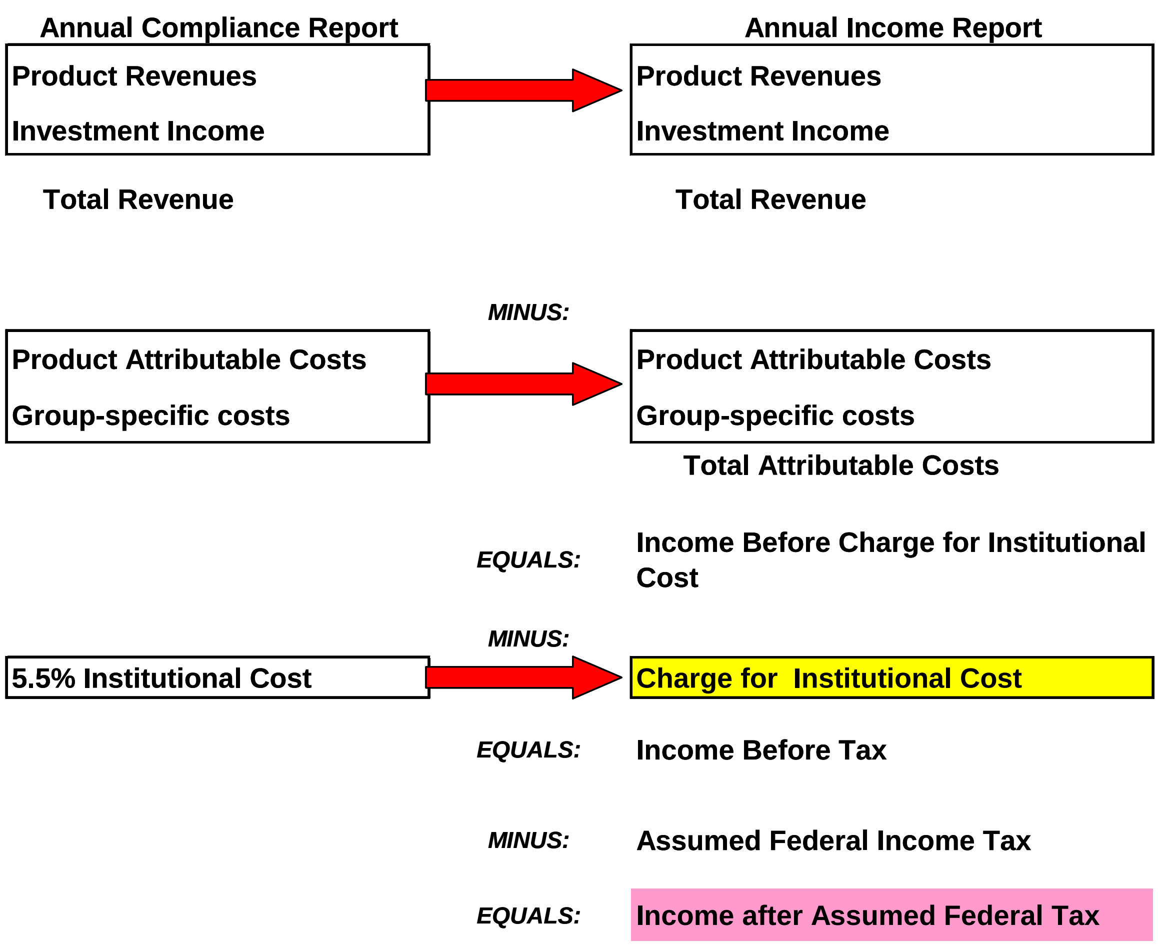
This report would display the basis on which to determine the amount of Annual Assumed Federal Income Tax for each Fiscal Year. The Postal Service proposes that the primary source of data for the Annual Income Report be the Annual Compliance Report (ACR).

The Postal Service agrees with Treasury that the Annual Compliance Report should be the source of data for competitive product revenues and expenses. *See*, *e.g.*,Treasury Report at 32-33. The Postal Service recommends that the competitive product portion of the Annual Compliance Report include Income from Financial Investments and Interest Expense associated with the Financial Obligations. The Annual Compliance Report would then be the source of all data for the Annual Income Report. In this fashion, the Annual Income Report would meet all five of the accounting principles outlined above.

Attributable cost, group-specific costs, and the Commission-defined appropriate share of institutional cost reported in the Annual Compliance Report should be the source of data for calculating the portions of the Annual Income Report specifically related to competitive product revenues and costs. The methodologies employed in the creation of the attributable and group-specific costs are determined by the Commission. The “group-specific” costs are those costs that are caused by the group of competitive products, and correspond to the “line of business” costs. The “institutional costs,” as stated in the Postal Service’s June 18, 2007 Initial Comments on the Commission’s Second Advance Notice of Proposed Rulemaking, are the residual of total costs left after deduction of the attributable costs, and after deduction of the group-specific costs caused by either the competitive or market-dominant groups of products. The data systems used to create the revenues and costs in the ACR will be reviewed and tested by the OIG. The ACR data will reconcile to the General Ledger and will be produced using approved and tested methodologies. Use of the ACR data ensures transparency with other financial data and consistency with pricing regulations. Figure 3 shows the relationship between the Annual Compliance Report and the Annual Income Report.

FIGURE 3

Competitive Products Annual Income Report and Relationship to Annual Compliance Report



As shown in Figure 3, the Annual Income Report should be the basis for the determination of the Assumed Federal Income Tax. Building on the notion that the reporting of competitive product financial activity involves the intermingling of concepts from fund accounting, GAAP accounting, and postal economic costing, the Postal Service believes there is a great deal of latitude in defining how to calculate the tax. The Postal Service agrees with Treasury's recommendation to use a simplified approach to determining the assumed Federal income tax, using a publicly available effective tax rate. *See* Treasury Report at 20-23. A simple approach is easier to understand and to validate. Also, it enables the Postal Service to avoid additional administrative cost and potential system changes.

Use of the simple effective tax rate supports the five basic accounting principles listed above. The effective rate would be accurate and based on publicly available information. The value of the Assumed Federal Income Tax could be determined in a timely fashion as a simple calculation of the effective tax rate multiplied by the Competitive Product Income Before Assumed Federal Income Tax.

ANNUAL FINANCIAL STATUS REPORT

This report would display the Fiscal Year end value, and the sources of changes to the prior year end value for:

- Cumulative Annual Income
- Financial Obligations
- Financial Investments

Figure 4 shows a sample of the report.

FIGURE 4

Competitive Product Annual Financial Status Report

	Beginning Value	Annual Income after Assumed Federal Income Tax	Ending Value
CUMULATIVE INCOME AFTER ANNUAL ASSUMED FEDERAL INCOME TAX ($000)	100,000	25,000	125,000

	Beginning Value	Change from Prior Year	Ending Value
FINANCIAL OBLIGATIONS ($000)	200,000	-15,000	185,000

	Beginning Value	Change from Prior Year	Ending Value
FINANCIAL INVESTMENTS ($000)	1,000	3,000	4,000

Each section of the Annual Financial Status Report is described below.

Cumulative Income After Assumed Federal Income Tax

This section shows the total annual income after the Assumed Federal Income Tax, beginning with the first fiscal year for which the Assumed Federal Income Tax is determined.

Financial Obligations

The total year-end value of Financial Obligations would represent the value of the outstanding Obligations as of the end of the fiscal year and would be consistent with the valuation reported on the Postal Service's Consolidated Balance Sheet. In the General Ledger System, the Postal Service proposes to identify Competitive Product Financial Obligations by a unique 3-digit sub-account on the appropriate General Ledger Account.

The Postal Service recommends that the Interest Expense on Competitive Product Financial Obligations be included in the competitive product group-specific costs in the Annual Compliance Report.

The proposed approach to determining the year-end value of Financial Obligations is consistent with the basic accounting principles listed above. The value would be accurate and complete, and could be determined in a timely fashion. The value could be traced to account balances reported on the audited Consolidated Trial Balance, and thus be reconcilable to the externally reported Consolidated Balance Sheet.

Financial Investments

The total year-end value of Financial Investments would represent the value of outstanding Investments as of the end of the fiscal year and would be consistent with the valuation reported on the Postal Service's Consolidated Balance Sheet. In the General Ledger System, the Postal Service proposes to identify Competitive Financial Investments by a unique 3-digit sub-account on the appropriate General Ledger Accounts. The Postal Service recommends the Investment Income or Loss on the Competitive Product Financial Investments be included in the competitive product revenues in the Annual Compliance Report.

The proposed approach to determining the year-end value of Investments is consistent with the five basic accounting principles. The value would be accurate and complete, and could be determined in a timely fashion. The value could be traced to account balances reported on the audited Consolidated Trial Balance, and thus be reconcilable to the externally reported Consolidated Balance Sheet.

ANNUAL IDENTIFIED PROPERTY and EQUIPMENT ASSETS REPORT

This report would provide a listing and valuation of property and equipment assets uniquely associated with providing competitive products. There are few, if any, physical assets *strictly identifiable* with competitive products at this point in time. Buildings, equipment, and vehicles are used to process, transport, and deliver market-dominant and competitive products together. It would be possible to identify assets "associated with providing competitive products" using existing accounting processes and systems, if the Postal Service chose to establish separate operational or administrative units devoted solely to competitive products.

The General Ledger system tracks the total cost and net book value of property and equipment in a small number of general ledger accounts. Sub-ledgers contain information on the individual assets, including the type of asset, identifying number, and attributes needed to calculate depreciation. Within the sub-ledgers, assets are assigned to an accountable "Finance Number". Finance Numbers correspond to managerial cost centers, and include post offices, districts, mail processing plants, and administrative units. The Finance Number is charged the depreciation expense. The manager responsible for the Finance Number is accountable for the property and equipment assets assigned to the Finance Number and must take physical inventories of the assets and report any discrepancies.

The Postal Service proposes that the existing process of assigning assets to Finance Numbers be used in the future to potentially identify those assets that are associated with competitive products, in *those cases where the Postal Service chooses to establish separate operational or administrative units devoted solely to competitive* *products.* Should the Postal Service choose to establish separate administrative units, processing plants, or other operating units solely for competitive products, the assets assigned to the Finance Numbers of those units would be easily identified and valued using the data in the asset sub-ledgers.

The proposed approach to determining the net book value of identified assets is consistent with the basic accounting principles listed above. The approach is entirely consistent with current accounting and internal control processes for property, plant and equipment. The Fixed Asset sub-ledgers are audited and reconciled to the General Ledger, and reconcilable to the externally reported Consolidated Balance Sheet. There is a complete audit trail from the General Ledger balance, to the Fixed Asset sub-ledger to the originating accounting transactions. The proposed report can be produced in a timely fashion using existing reports for Property and Equipment assets.

Using the Postal Service's proposal, the Property and Equipment Assets Report would list each individual asset in the Postal Service's Fixed Asset Sub-ledger and report the cost, accumulated depreciation, and net book value. A total net book value of all identified assets would be reported. Figure 4 displays the content of a sample report.

FIGURE 4

Competitive Product Property and Equipment Assets						
Finance Number	**Finance Name**	**Asset Identifier**	**Asset Description**	**Cost**	**Accumulated Depreciation**	**Net Book Value**
109999	Competitive Product Processing Facility	123456	Sorting Machine	$ 400,000	$ 200,000	$ 200,000
109999	Competitive Product Processing Facility	667005	Mechanization	$ 300,000	$ 250,000	$ 50,000
109999	Competitive Product Processing Facility	333333	Tractor	$ 30,000	$ 2,000	$ 28,000
TOTAL						**$278,000**

In summary, the Postal Service submits that the procedures outlined above constitute appropriate means to give effect to the purposes for which the PAEA establishes the Competitive Products Fund. Such procedures would provide more than ample safeguard against the cross-subsidization of competitive products by market dominant products. Moreover, submission by the Postal Service of an Annual Income Report, an Annual Financial Status Report, and an Annual List of Identified Property and Equipment Assets, each as described above, should suffice to meet the Postal Service's Competitive Products Fund reporting obligations pursuant to section 2011(h)(2)(B)(i)(III) of title 39.

II. CONSIDERATION OF THE QUESTIONS POSED BY THE COMMISSION IN ORDER NO. 56 PROVIDES NO BASIS TO ALTER TREASURY'S RECOMMENDATIONS, OR THE IMPLEMENTATION PLAN NOW PUT FORTH BY THE POSTAL SERVICE

As noted earlier, the Commission posed a series of inquiries in Order No. 56, to which it invited parties to respond. With the exception of a series of generally broader questions which appear at the end of Order No. 56, the questions are framed around certain of the nine recommendations contained in the Treasury Report. The Postal Service next discusses each of the Commission's questions, in the order in which they appear in Order No. 56. The responses are generally also organized by Treasury Recommendation, with page numbers from Order No. 56 appearing in parentheses. In the view of the Postal Service, none of the concerns raised by the Commission's inquiries undermine the applicability or the utility of the procedural framework proposed by the Postal Service in the first section of these Comments.

A. Treasury Recommendation 2

Q1. (Page 8) The Commission asks commenters to address Treasury's conclusion that a theoretical enterprise, rather than a stand-alone enterprise, should be constructed. Specifically, commenters are asked to comment on the assumptions, studies, and procedures that would be needed to establish the costs of a stand-alone competitive entity, the time and cost of implementing these studies, and the time and cost of achieving structural separation.

RESPONSE:

The calculation of stand alone costs would be a difficult and expensive exercise because it requires a key counterfactual assumption: that the competitive products are being supplied by a "single product" firm. This means that the current operational structure and cost data of the Postal Service, a multiproduct firm, cannot be used. We agree with the Treasury Report when it states:

> However, in order to meet PAEA's specific provisions for separate accounting for USPS competitive products, Treasury believes that a theoretical or "on paper only" corporation or enterprise should be analytically created for the competitive products. If this assumption were not made, then sophisticated cost modeling of a true stand-alone enterprise would be required. <u>However, such modeling would require a number of assumptions that would be difficult to subject to third-party validation, since they would significantly depend upon the approaches to service delivery built into the model. Moreover, such modeling would likely be very costly and take many years for the USPS to develop with little-to-no corresponding benefits.</u>

Treasury Report at 6 (emphasis added). Because the calculation of stand alone cost requires assumption of an entirely new hypothetical enterprise, it is critically dependent upon a multitude of difficult assumptions about the structure and nature of that enterprise. For example, one would have to determine the extent and nature of the new enterprise's retail network. Would it be as extensive as the Postal Service's current network, or would it be more limited? What would be the nature of each retail outlet? More generally, how would competitive products be inducted into the operations of the new enterprise?

Moreover, the required assumptions go beyond operations. Many questions about the hypothetical cost structure must be answered. One major area of speculation would involve making assumptions about labor relations for the new enterprise. Would it be bound by the current arbitration process? Would it be required to use only current Postal Service employees, or could it hire new ones? Similar sets of assumptions would have to be made about the financial structure of the fictional enterprise.

Because current Postal Service costing data are not directly applicable to the exercise, one approach might be to attempt to use cost data and operational information from the Postal Service's private sector competitors, such as United Parcel Service or FedEx. This has two major difficulties. First, it is not at all clear that these firms would be willing to share their detailed cost and operational data. Unlike the Postal Service, they have no legal requirement to do so, and in the past they have been hesitant to do so. In addition, they are also multi-product firms providing services that go well beyond those defined by the Postal Service's competitive products group. Thus, even use of these firms' data would require application of a long list of assumptions.

Q2. (Page 8) To what extent would economies of scale and scope be diminished if the Commission were to require the Postal Service to structurally separate its market dominant from it competitive lines of business?

RESPONSE:

Logically, structural separation would eliminate economies of scale and scope. Alternatively, as described in the Postal Service's comments to the FTC,[1] all products, both market-dominant and competitive ones, offered within an integrated, full-service postal system benefit from shared economies of scope. The postal structure functions as an integrated system financed by customers of all services. To a considerable extent, whether a particular service is a monopoly market-dominant product (advertisements; bills and statements), a non-monopoly market-dominant product (periodicals; books), or a competitive service (bulk parcels; expedited flat-shaped

[1] Comments of the United States Postal Service to the Federal Trade Commission Concerning USPS Study, Project No. P071200, at 6-7.

documents), it will be processed and delivered by some of the same employees in the same facilities and transported in the same vehicles, bearing postage purchased through the same channels.

The networks of between 300 and 400 major facilities, 37,000 retail offices, and 250,000 carrier routes that have been developed to link together all communities nationwide involve substantial components of common or institutional costs. Economies of scale and scope are evident and significant in processing, transportation, delivery, and retail functions.

- **Mail Processing**. Significant portions of major mail processing centers and operations at those facilities sort and dispatch both market-dominant and competitive mail pieces. Even where individual operations are employed for the main purpose of processing competitive products, significant amounts of market-dominant products are processed as well. In addition, where separate operations are performed for competitive products, the equipment (for parcel sorting or flat sorting) is used at other times of the day for sorting market-dominant mail. Competitive product volumes alone would not support the same degree of investment in equipment for sorting.
- **Transportation**. The transportation network is designed to transport both market-dominant and competitive products for the current configuration of major facilities and post offices. For contracted air transportation, the Postal Service transports both market-dominant and competitive products under a contract with

Federal Express.[2] In FY 2006 the FedEx agreement accounted for about 65 percent of air transportation expense. The remaining portion of contracted air transportation costs were incurred under contracts with commercial airlines and with United Parcel Service, both of which predominantly transport First-Class Mail market-dominant products. Contracted surface transportation handles both market-dominant and competitive products on the same vehicles. In the case of air and much of surface transportation, competitive products account for a large share of mail transported. As a result transporting market dominant and competitive products separately could entail significant network changes and likely higher costs for both product groups.

- **Delivery**. The competitive volume amounts to an estimated 15 pieces per delivery route per day. The practice of delivering competitive products separately on routes other than regular carrier routes is largely confined to areas where foot routes predominate, mainly large cities. On regular routes, large parcels and Express Mail are to some extent ''delivered' independently. This often requires a different park point, carrying a competitive piece from the vehicle to the door, or attempting customer contact. In these cases the two product groups share travel time to and from the route and network driving time between sections of delivery stops, use of the same scanning equipment and vehicles, and many fixed network activities, as well as facility costs. Providing separate delivery of these competitive products would therefore be more costly. Priority Mail flats and small

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[2] The FedEx agreement involves two different networks, Dayturn and Nighturn. Dayturn operates during the day, transporting mostly Priority Mail and First-Class Mail. Nighturn operates at night, transporting mostly Domestic Express Mail and International Express Mail.

parcels, on the other hand, are delivered on regular city routes with market-dominant products. In that case, separate delivery would be even more costly.

- **Retail**. Window operations are designed to accommodate both competitive and market-dominant products and the special services that support them. The reach and accessibility of these services depend on the availability of a national network. When a package or item cannot be delivered because of size or other factors, convenience to the customer depends on access to the nearest retail outlet.

Q3. (Page 8) Given the manner in which rates are established under the PAEA, e.g., that market dominant products are subject to a price cap, would structural separation reduce the risk of competitive products being subsidized by market dominant products?

RESPONSE:

Structural separation would not materially reduce the risk of competitive products being subsidized by market dominant products. That risk has already been reduced to an immaterial level by the established regulatory regimes (both PRA and, now, PAEA), and therefore even if structural separation were, *arguendo*, able to reduce that risk even further, the incremental reduction would be immaterial.

Q4(a). (Page 8) If it is decided that establishing a theoretical competitive enterprise is appropriate, what is the appropriate basis for assigning operating and/or capital costs to the theoretical competitive enterprise?

RESPONSE:

The approach used in developing costs for the Annual Compliance Report should be the basis for assigning operating and/or capital costs to the theoretical competitive enterprise.

Q4(b. (Page 8)) Is there a reasonable basis for directly assigning some types or categories of costs to competitive products based on underlying technologies and/or operating procedures? If so, what specific costs should be assigned in this way?

RESPONSE:

The basis for assigning costs should be the costing methods used for development of the Annual Compliance Report.

Q4 (c) (Page 9) Would there be a need to assign other costs not directly assignable (namely, joint and/or fixed costs), and if so, how should such costs be assigned?

RESPONSE:

No.

Q4(d) (Page 9) Would worksharing affect the assignment of costs other than direct costs? If so, how?

RESPONSE:

No, not necessarily.

Q5. (Page 9) What role, if any, should the concepts of profit centers and transfer pricing play?

RESPONSE:

Profit centers and transfer pricing are concepts that have from time to time been in vogue as good management practices. Neither profit centers nor transfer pricing are mentioned in Title IV of the PAEA, and do not seem to be otherwise suitable in this instance.

Profit centers are business segments for which revenue, costs, profit, and loss are computed in some way and then reported separately. In private industry, profit center management has faded into the background as balanced scorecard practices have proliferated. Balanced scorecards are linked to a series of specifically-defined and actionable strategic goals that drive performance. Strategic goals are defined to relate to the overall performance of an enterprise rather that pitting one operating unit against another, possibly at the expense of the whole. Because there are no certified or generally accepted set of accounting or reporting rules related to profit centers and profit center management is falling into disuse, focusing on profit center management techniques in this process would likely not be productive. A better approach would be to link reporting procedures to the particular framework and provisions of the PAEA.

Similarly, transfer pricing is not a concept that is tailored specifically to the reporting requirements in the PAEA. Transfer pricing typically assumes an arms length transaction between different components of an enterprises. Transfer prices are based on cost plus some reasonable markup. The PAEA provides its very own techniques for addressing this pricing issue, most obviously the allocation of institutional costs to competitive products. The 5.5 percent institutional cost assignment to competitive products effectively resolves transfer pricing concerns.

Q6. (Page 9) Should any Universal Service Obligation costs be assigned to the competitive products category? If not, why not? If so, on what basis?

RESPONSE:

Universal Service Obligation (USO) costs should not be assigned to the competitive products category. The cost of the Universal Service Obligation arises because the regulated entity is required to provide products or services for which it receives insufficient compensation to cover the costs of providing that product or service. Note that the universal service cost is not the total cost of the product or service, but the amount by which the cost exceeds revenue. This means that, in one sense, the universal service costs have already been attributed to products or services. Indeed such an attribution is required before universal service costs can be calculated. Consequently, there is no need to attribute universal service costs to products a second time.

Secondly, it is important to bear in mind the distinction between universal service and the obligation to provide universal service. A plain reading of the law would suggest that the Postal Service's USO applies exclusively to its market-dominant products. For example, though the Postal Service is required to provide services in all areas, the statutes only require the Postal Service to maintain at least one class of mail for letters with a uniform rate throughout the United States. It may well be that the Postal Service provides universal service for some competitive products, but that it is not obliged to do so by the law. Clearly, in such a case, it would be inappropriate to assign USO costs to competitive products.

Moreover, the Postal Service and Commission are both studying the Universal Service Obligation (USO), its costs, its funding, its impact on society, etc. Therefore, it seems wise to wait until more is known about the nature and magnitude of USO costs before deciding how, or whether, they should be distributed to products.

B. Treasury Recommendation 3

Q1. (Page 10) Are the Postal Service's current cost systems, after modification for new products, sufficient for allocating costs between competitive and market-dominant products? If not, what changes should be made to the cost systems?

RESPONSE:

Fulfillment of the PAEA costing requirements mandates that the following cost measures be accurately calculated by the Postal Service:

1. The attributable cost for each market dominant product.
2. The attributable cost for each competitive product.
3. The portion of "other" costs that is reasonably assignable to market dominant products as a group.
4. The total costs caused by the provision of competitive products as a group.
5. Institutional cost.

This list of measures covers a variety cost concepts at different levels of economic activity within the firm. The list requires not only identifying those costs associated with the provision of individual products, but also those costs associated with the provision of large groups of products, as well as those costs associated with sustaining the organization but not caused by individual products or groups of products.[3]

One approach to costing that provides the required costing measurements and is thus entirely consistent with the costing requirements of the PAEA is called "line of business" costing. (Although the following discussion is couched in terms of "line of business costs," as a practical matter, there is no material distinction between that term and the term "group-specific costs.") Line of business costing takes a higher level look at costs than the view currently taken in the attributable costing procedure in the Postal Service's Cost and Revenue Analysis (CRA) report. The line of business approach looks at the business entity both from the bottom up and from the top down and makes use of the fact that the entity's products are organized into lines of business. Because a line of business is a coherent economic structure, there are traceable lines of causality to both individual products and economically meaningful groups of products. In addition, the line of business approach permits identification of those costs which are not caused by any individual products or relevant groups of products.

The line of business costing approach thus has three levels of analysis. The first level is the product level. It is the most granular and works from a bottom-up approach. In postal costing parlance, the analysis at this level includes identifying both the volume variable costs and product specific costs for individual products. As a result, it produces

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[3] For example, in a network industry, enterprise-sustaining costs would arise from the provision of a network shared by all the products. Variations in the quantities provided of the individual products do not influence these network costs, but they are essential for the firm's ongoing existence. They are thus enterprise-sustaining.

cost measurements equivalent to the attributable costs for individual products currently calculated by the Postal Service.

The second level of analysis is at the line of business level. This is a top-down approach and looks at the economic organization of the Postal Service from the perspective of the economically relevant groups of products it provides. Each of these product groups is a line of business. (Hence, the functional equivalence of the terms “line of business costs” and “group-specific costs.”) In a single-product firm, the one line of business covers the entire economic activity of the firm, and the firm’s line of business cost is just its total cost. In a multiproduct firm, things are a bit more complicated, as the firm engages in multiple lines of businesses which may or may not be closely related. If the lines of business are totally separable, then there are no shared activities or costs across the business lines when the firm provides the various products. This is a rare outcome, however, because scope economies are generally the raison d’être for the existence of a multiproduct firm. In the unusual case of separable costs, the line of business costing would proceed as if there were simply a series of unrelated single-product firms whose costs happened to be summed.

In the more standard case for a multiproduct firm, in contrast, costing must proceed in recognition of the shared activities and costs. In this case, the line of business cost would measure the total cost caused by provision of the entire line of business. This would include both the attributable costs of the individual products and any costs caused by providing the business line but not caused by the individual products. An obvious example of this type of cost would be the salary and benefits for the president (or manager) of the line of business. These costs are termed line of business sustaining costs. The sum of the attributable costs for individual products (including product specific costs) and the line of business sustaining costs provides the total line of business cost.

The last level of analysis is at the highest level of the business organization. This analysis identifies and measures those costs not associated with any individual line of business but are generated in sustaining all of the lines of business. These costs are called “enterprise sustaining costs.” In network industries, for example, the cost of constructing and maintaining the common network infrastructure is generally an enterprise sustaining cost.

Figure 1 presents a diagrammatic view of the conceptual structure of line of business costs. As the figure shows, the line of business approach accounts for all of the costs of the firm and no costs are unanalyzed or unclassified. In this complete costing taxonomy, all costs are accounted for at one level or another. It is assumed, for purposes of the diagram, that the firm has two lines of business, A and B. Line of business A has three individual products and line of business B has two individual products. The volume variable and product specific costs for each product are calculated and then summed to determine the attributable cost for each product. The line of business sustaining costs for each business line are added to the sum of the line’s individual product attributable costs to find the total line of business costs. Finally, the two line of business costs are added to the enterprise sustaining cost to equal the total costs of the firm.

Because of its multi-level approach, Line of Business Costing provides the cost measurements required by the PAEA. Table 1 provides a correspondence between the PAEA cost measurements and the associated Line of Business cost measurements.

Table 1

PAEA COST MEASURMENT	LINE OF BUSINESS COST MEASUREMENT
The attributable cost for each market dominant product.	Attributable Product Costs for market dominant products
The attributable cost for each competitive product.	Attributable Product Costs for competitive products
The portion of “other” costs that is reasonably assignable to market dominant products as a group.	Line of Business Sustaining Cost for market dominant products
The total costs caused by the provision of competitive products as a group.	Line of Business Cost for competitive products
Institutional cost.	Enterprise Sustaining Cost.

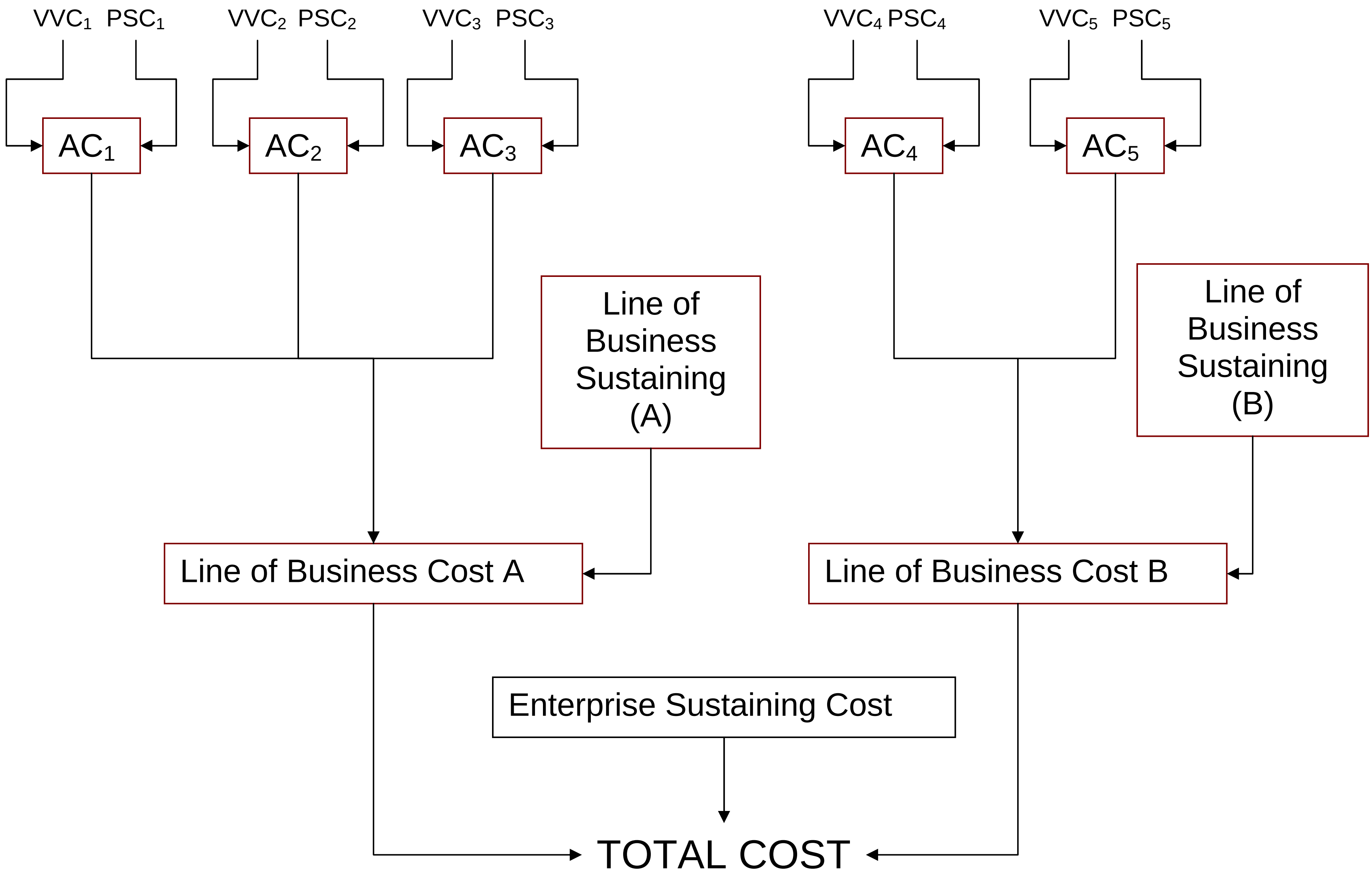
VVC1 PSC1
VVC2 PSC2
VVC3 PSC3
VVC4 PSC4
VVC5 PSC5
AC1
AC2
AC3
AC4
AC5
Line of Business Sustaining (A)
Line of Business Sustaining (B)
Line of Business Cost A
Line of Business Cost B
Enterprise Sustaining Cost
TOTAL COST

Figure 1

Q2. (Page 10) Should the incremental cost test be applied to individual competitive products or to competitive products as a whole? If the former, what is the basis for determining whether a competitive product that fails the incremental cost test is being subsidized by market dominant or other competitive products?

RESPONSE

The Commission interpreted section 3633(a)(1) to mean that the test for cross-subsidies applies collectively to competitive products, not individually to each product. *See* 39 CFR 3015.7(a). The Postal Service agrees that such an interpretation of section 3633(a)(1) is correct. In that context, incremental cost tests should only be applied to competitive products as a whole. Thus, the inquiry posed in the second part of this question does not apply.

C. Treasury Recommendation 5

Q1. (Page 11) A significant amount of Postal Service costs are currently classified as institutional, based on the use of cost drivers for cost allocation in rate analyses with most non-volume variable costs being assigned as institutional. Should any additional types of drivers and/or different types of cost attribution approaches be considered in determining costs for the competitive and market-dominant lines of business?

RESPONSE:

To provide accurate costs, the line of business approach discussed above relies upon the causal structure of production and avoids convenient and artificial allocations of costs. In this way, it avoids the fallacies of fully distributed costing. This means that the implementation of line of business costing is necessarily operational or activity based.

Implementation of line of business costing requires an operational review of the firm’s activities in order to develop accurate cost tracing. In other words, an effort must be made to measure how the firm's resources (*e.g.,* labor or materials) are consumed in the provision of products. This requires both an understanding of the activity structure of the firm and an understanding of the relationship between the firm's products and its activities.

The steps in implementing line of business costing are:

1. Identify the individual operations or activities required for providing the products and lines of business.
2. Measure the total cost for each of these activities or operations.
3. Measure the attributable and product specific costs for each product handled in the activity or operation. Attribute them to individual products.
4. Identify any operations or activities whose existence is caused by the provision of a single line of business. Any non-attributed cost for that operation or activity is included in the line of business sustaining cost for the relevant line of business.
5. Sum the attributable product costs within each line of business. Add the line of business sustaining cost to calculate each line of business cost.
6. Sum any remaining costs not attributed to products or included in line of business costs. This sum is the enterprise sustaining cost.

Q2. (Page 11) The Report suggests that in addition to attributing product-specific costs to competitive products, the Postal Service should also attribute what Treasury calls line of business costs that are common to competitive products. Id. at 9. This suggestion could be interpreted to mean either that competitive line of business costs are costs shared by all competitive products or costs that may be shared by more than one, but not necessarily all, competitive products. The Commission asks commenters to address the appropriate meaning of line of business costs, including the *basis on which to distinguish between market dominant and competitive lines of business.*

RESPONSE:

As discussed more fully above, line of business costs are designed to capture, in a practical way, all of the costs caused by the provision of a meaningful group of related products in a multiproduct firm. The line of business approach recognizes that there may be some costs associated with the provision of the group of products that are not caused by any individual product in the group. These are called “line of business sustaining” costs. ”

The cost tracing involved in calculating line of business costs should follow the actual operational and management structure of the enterprise. It should include the costs of any activities dedicated solely to the provision of the products in the line of business group. This would include activities associated with the provision of more than one product in the line of business. It should also include any portion of costs of common activities that can be causally linked to the line of business products. This latter exercise is merely an extension of the causally-based attribution exercise currently defined by Commission methodology.

Finally, it is essential that line of business cost tracing has an operational or activity basis. A review of the operations or activities involved in providing the line of business is a necessary prerequisite to the accurate attribution of costs.

Q 3. (Page 12) Does the Commission’s determination of an “appropriate share of institutional costs” under section 3633(c)(3) also satisfy, at least implicitly, section 3622(b)(9)? If not, why not and on what basis should institutional costs be allocated between market dominant and competitive products?

RESPONSE:

Yes, the “appropriate share” determination satisfies both sections.

D. Treasury Recommendation 6

Q1. (Page 12) Is the Postal Service’s current revenue reporting system (modified to accommodate new product definitions) adequate for reporting the Postal Service’s financial income and net taxable income?

RESPONSE:

Yes, the revenues for the Annual Income Report should come directly from the product revenues reported on the Annual Compliance Report. Therefore, the current revenue reporting system (modified to accommodate new product definitions) should be adequate.

Q2. (Page 12) If not, what modifications would be necessary?

RESPONSE:

Not applicable.

E. Treasury Recommendation 7

Q1. (Page 13) Is what Treasury suggests sufficient for purposes of calculating an assumed Federal income tax on competitive products? If not, what standard (or format) should apply?

RESPONSE:

Yes, the Treasury’s suggestion is sufficient for the purposes of calculating an assumed Federal income tax on competitive products.

Q2. (Page 13)   Please explain why any proposed additional information would be beneficial, and discuss whether the benefit associated with a more detailed statement outweighs the burden of any additional costs imposed by creating a more detailed statement.

RESPONSE:

The required reporting of competitive product financial activity involves the intermingling of concepts from fund accounting, public accounting, and postal economic costing. Tax law is designed for true stand-alone corporate entities with their own assets and balance sheets reported using Generally Accepted Accounting Principles, GAAP. GAAP does not apply to the reporting of competitive products financial activity.

The Treasury Report (page 20 and 21) correctly points out that “because the imputed income tax is merely transferred between funds of the USPS, it does not appear that the cost and effort of valuing, or revaluing, all the attributed competitive assets may be warranted”, and that “the motivation to legally minimize payment of income taxes for USPS is not exactly the same as for its competitors.” There is a cost-benefit for corporations to make investments to minimize taxes if the amount of avoided taxes is greater than the amount of the investment, but “this same cost-benefit would not be realized by the Postal Service.” Since the Assumed Federal Income Tax is a transfer from the Competitive Products Fund to the Postal Service Fund, any investment to avoid taxes has a real negative cash flow impact related to the cost of tax-avoidance efforts. *Id.*

F. Treasury Recommendation 8

Q1(a). (Page 14) Should a simplified approach be used for calculating an assumed Federal income tax?

RESPONSE:

Yes.

Q1(b). (Page 14) If so, what tax rate should be used and why?

RESPONSE:

The tax rate should be independently developed and publicly available. Treasury recommended using the most current CRS-reported (Congressional Research Service) average effective rate for C Corporation, non-financial entities, or another publicly available average effective corporate rate, preferably updated annually. This seems like a reasonable recommendation.

Q1(c). (Page 14) Should the tax rate be based on an analysis of Postal Service functions, markets, risks, and the performance by similar companies?

RESPONSE:

No. The Postal Service sees no benefit to spending resources to perform such an analysis.

Q1(d). (Page 15) If similar companies are considered relevant, then how does one determine similarity?

RESPONSE:

The Postal Service sees no benefit of spending resources to perform such an analysis.

Q2. (Page15) Would use of a simplified approach require any changes to the Postal Service's cost systems and/or accounting procedures not addressed in the Report? If so, please elaborate.

RESPONSE:

No. Using the Postal Service's proposed approach to developing the Annual Income Report, the calculation of the Assumed Federal Income Tax would be performed once a year by multiplying the Competitive Product Income before Tax by the Effective Tax Rate.

Q3. (Page 15) If a simplified approach should not be used, what approach should be used and why?

RESPONSE:

The Postal Service sees no benefit to a more complicated approach.

G. Final Series of Questions in Order No. 54

The following questions all appear on pages 15 and 16 of Order No. 56.

Q1. Does the PAEA allow a simplified approach to assigning assets to the competitive products fund for financial disclosure purposes and/or calculating an assumed Federal income tax?

RESPONSE:

Yes. The simplified approach addresses the primary concern of Section 2011, which is fair competition. There is no reason to impose a more burdensome and costly approach.

Q2. If a simplified approach is allowed, should it be used?

RESPONSE:

Yes

Q3. Section 3 of the Report notes that the PAEA does not define assets, but that the PAEA's requirement to pay principal or interest on obligations issued for the provision of competitive products in section 2011(e)(5) supports the conclusion that it is permissible to define assets as net assets. The Commission asks commenters to address whether or not this is a reasonable assumption.

RESPONSE:

It is a reasonable assumption. Like an enterprise, these "assets" could serve as collateral to support borrowing. For the purposes of borrowing, the "assets" associated with competitive products are the maximum of (A) the assets related to the provision of competitive products as calculated under subsection (h); or (B) the percentage of total Postal Service revenues and receipts from competitive products times the total assets of the Postal Service. The value of "Total Assets" reported in the audited financial statements is the net value.

Q4. Does the PAEA require an assignment of liabilities to the CPF? If so, on what basis should they be assigned?

RESPONSE:

No. The Postal Service should report the status of Competitive Product Financial Obligations as part of the Annual Financial Status Report.

Q5. Should a full set of financial statements, including income statement, balance sheet and statement of cash flow, be prepared for the CPF?

RESPONSE:

No. The Postal Service proposes the following reports for the CPF:

- Annual Income Report
- Annual Financial Status Report
- Annual List of Identified Property and Equipment Assets

Earlier sections of these comments provides details on the contents of, and the method used to develop, these reports.

Q6. What level of oversight should apply to the CPF?

RESPONSE:

The Commission, as the regulatory body of the Postal Service, should apply a similar level of oversight to the CPF as it does to elements of the Annual Compliance Report.

Q7. What accounting principles should apply to the CPF?

RESPONSE:

An earlier section of these comments describes five accounting principles that seem appropriate for the CPF.

Q8. What level of independent review of the Postal Service's CPF accounting and financial statements is sufficient and necessary under the PAEA?

RESPONSE:

A similar level of independent review as provided for the components of the Annual Compliance Report should be sufficient for CPF accounting and financial statements.

Q9. What type (public or private) of entity would be best suited to perform that independent review?

RESPONSE:

Given that the Commission will define the accounting procedures and reporting requirements, the Commission is best suited to perform the independent review.

Q10. Is there any information, not required to be reported under the PAEA, which should be included in the reports required under section 2011(h)(2)(B)(i)(III)?

RESPONSE:

No, the reports listed in the response to Question 5 and discussed previously in this filing are fully responsive to the requirements of Section 2011.

CONCLUSION

Order No. 56 states that, after reviewing the comments submitted in the proceeding, the Commission will commence a rulemaking on these matters. The Postal Service respectfully requests that, in developing proposed regulations, the Commission adopt the Competitive Products Fund procedures suggested by the Postal Service in these comments as the primary framework for those regulations.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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April 1, 2008

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with Section 12 of the Rules of Practice and Procedure.

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