

**UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001**

Periodic Reporting }

Docket No. RM2008-2

**INITIAL COMMENTS OF PARCEL SHIPPERS ASSOCIATION
TO PRC NOTICE AND ORDER NO. 99
(Supplemented by Order No. 102)
(ISSUED August 18, 2008)**

INTRODUCTION

In the above captioned proceeding, the Commission opened a docket to consider the request of the Postal Service to amend established costing methodologies for the purpose of preparing the FY2008 Annual Compliance Report. Request of the United States Postal Service for Commission Order Amending the Established Costing Methodologies for Purposes of Preparing the FY 2008 Annual Compliance Report (Request). In its Request the Postal Service proposes that the Commission concur in changes that it wants to make in costing methods to be used in its Annual Report. Subsequent to the Commission's Order, the Postal Service conducted a Technical Conference on August 27, 2008, and filed a "Notice of the United States Postal Service Regarding Materials Distributed Or Requested at the August 27, 2008 Technical Conference (filed August 29th, 2008)" (August 29 Notice).

The Parcel Shippers Association (PSA) appreciates this opportunity to submit comments on the Postal Service's Request, and also on the August 29 Notice.

PSA applauds the Postal Service for heeding the Commission's advice in the first annual compliance proceeding to present proposed methodology changes outside of the annual compliance process and for commencing efforts to identify group-specific costs. See FY 2007 Annual Compliance Determination (ACD) at 10. As explained below, however, PSA is concerned with the Postal Service's approach for identifying group-specific costs. PSA believes that the approach must be grounded in sound economic principles and applied consistently and comprehensively. Based upon the Postal Service's current proposals related to group-specific costs – Proposal 1 (which relates to Headquarters costs), Proposal 2 (which relates to Advertising Costs), and Proposal 5 (which relates to the mail processing activity "Out of Office, Delivering Express Mail") – we are concerned that the Postal Service's approach does not meet these standards.

1. Group-Specific Costs

PSA believes that the Commission should not approve these proposed changes related to group-specific costs based on a record as scant as the one developed thus far in this docket. If the Commission does, however, allow the Postal Service to proceed as requested with these proposed changes, it should make clear that this is not precedent for future determinations with respect to the identification of group-specific costs. The Commission also should adjust the appropriate share requirement

downward to take into account the effect of the proposed changes on the estimated share of institutional costs borne by competitive products.¹

There is at least one point upon which PSA and the Postal Service clearly agree – the appropriate test for determining whether costs are group-specific should derive from the “familiar incremental cost inquiry” approach:

. . . the relevant question to be considered is whether the non-volume variable costs under review would likely be incurred if the Market Dominant group of products were eliminated, or if the Competitive group of products were eliminated. If the answer to one or the other of these questions is “no,” then the requisite causal link between the costs and one of the groups of products has been established.

See August 29 Notice, at 5 (footnote 2).

Based upon this test, PSA believes that group-specific costs should only include those non-volume variable costs that are caused *exclusively* by either competitive products or market-dominant products. See Docket No. PI2008-2, PSA Reply Comments at 3, fn. 5. Based upon a review of the Request, we initially thought that the Postal Service agreed. In its Request, the Postal Service stated:

Group-specific costs are those costs which cannot be attributed to individual products, but which are caused by either the competitive or market-dominant products as a group...An example of a *competitive product group-specific cost* would be a HQ organization that **only** supports competitive products.

Request at 5 (bold added).

However, the Postal Service has since made clear that it is adopting a much broader and murkier definition—one that does not appear to be tightly linked to the careful causal connection that the “familiar incremental cost inquiry” approach requires.

¹ As PSA has explained previously, the Commission should adjust the appropriate share requirement to hold competitive products harmless for all changes in costing methods, not just those related to the identification of group-specific costs. See, e.g., Docket No. ACR2007, DMA-PSA Comments at 7-8.

In response to a question about the above-cited statement at the August 27 Technical Conference, a Postal Service participant, Karen Meehan, explained that “[g]roup-specific costs are those costs which cannot be attributed to individual products, but which are caused *predominantly* by either the competitive or market-dominant products as a group.” (Emphasis added). Then, two days later the Postal Service renounced “exclusivity” and said that costs which relate to both groups should be assigned to only one if a “substantial preponderance” of those costs relate to only one group. August 29 Notice at 4. At this point in the proceeding, it is unclear whether the standard proposed by the Postal Service is predominance, substantial preponderance, or something else. Of course, it is also unclear whether predominance would mean 95%, 75%, or just a majority. At this stage of the proceeding, it appears the Postal Service believes it will know group-specific costs when it sees them and, therefore, no explicit standard is necessary. PSA disagrees. Not only does the USPS approach contradict sound economics, the lack of an explicit standard precludes the development and consistent application of a decision rule.

We are concerned that, in its August 29 Notice, the USPS may have lost sight of the essential importance of establishing a causal connection when applying the incremental cost approach. If the causal connection is not exclusive then the approach has failed to establish the necessary relationship. In some cases, it is possible—at least in principle—for there to be an exclusive causal connection between the non-volume variable costs for an activity and a group of mail, even though variable costs for the activity are incurred for other mail. USPS has raised such a possibility in its proposal 4 in this proceeding which addresses non-volume variable costs for blue

collection boxes. This Postal Service argues that these non-volume variable costs should be treated as product-specific to First-Class Mail Single-Piece Letters and Cards even though other mail is deposited in the boxes. This proposal rests on an operational argument that the boxes would be eliminated if First-Class Mail Single-Piece Letters and Cards did not exist. Such a claim is difficult to establish—and should be scrutinized carefully—but if it *were* established, it would provide the necessary *exclusive causal* connection that would allow the incremental cost approach to be invoked. However, the fact that the necessary exclusive causal relationship sometimes exists when one group of mail is only a predominant or preponderant portion of the relevant mail volume, does not mean that *merely* identifying cases where there is a predominant or preponderant use by one group of mail is sufficient for determining group-specific non-volume variable costs. Rather, *it is the establishment of the exclusive causal nature of the relationship that is key.*

Thus, in addition to not approving proposals 2 and 5 (as discussed below) in this proceeding, the Commission should direct the Postal Service to use the narrower definition of group-specific costs recommended by PSA in carrying out its evaluation of Headquarters costs (USPS Proposal 1) and in future efforts to identify group-specific costs.

a) Carrier Pickup Advertising Costs

The Postal Service's second proposal in this proceeding, to classify Carrier Pickup and Click-N-Ship advertising costs (which totaled approximately \$40 million in FY2007, Request at 9), should not be approved because these costs are not caused exclusively by competitive products. Specifically, carrier pickup is a service offered for

market-dominant products (e.g., Merchandise Return Service (MRS) packages mailed at First-Class Mail rates) as well as for competitive products.² Although those responsible for the Postal Service filing were apparently unaware of this fact when the request was filed, the Postal Service has since confirmed this. See August 29 Notice at 3. In those comments the Postal Service downplays the importance of this fact, suggesting that MRS makes up only a small portion of Carrier Pickup volumes and thus the advertising costs meet its test (whatever it may be) for assignment as group-specific. See August 29 Notice at 6. However, the Postal Service has provided no Carrier Pickup volume data in support of its “small portion” claim. Again, the record is deficient. The Postal Service also suggests that the fact that it incurred Carrier Pickup advertising costs in FY 2007 (before MRS was eligible for carrier pickup) shows that FY 2008 Carrier Pickup advertising costs are caused entirely by competitive products. See August 29 Notice at 6. While PSA agrees that this does show that these advertising costs are not entirely caused by MRS, it does not prove that the advertising costs for Carrier Pickup (now that it is offered for some market-dominant packages) would go away if competitive products were eliminated, the test recommended by the Postal Service in its August 29 Notice.³

² Additionally, the Postal Service’s Pickup On Demand Service is available for single-piece Parcel Post, which is a market-dominant product. See www.usps.com/pickup. Postal Service participants at the August 27 technical conference were unaware of whether the carrier pickup advertising also mentioned the Postal Service’s Pickup On Demand Service.

³ In support of its position, the Postal Service’s August 29 Notice (at 3) also answered a question that it purports was asked at the August 27 technical conference regarding whether MRS was mentioned in the Carrier Pickup advertising. At least as PSA’s representative at the technical conference remembers it, the question actually asked at the technical conference was whether Carrier Pickup advertising was general advertising for the Carrier Pickup service or specific to a particular product and, if the latter, which products were mentioned. Knowing only whether MRS was mentioned in the advertising is not particularly helpful for determining whether the advertising should be classified as group-specific.

b) Click-N-Ship Advertising Costs

Similarly, the Postal Service has not provided sufficient information on Click-N-Ship advertising costs to assess whether these costs are appropriately treated as group-specific by establishing the required exclusive causal relationship. While Click-N-Ship can be used only for competitive products, other online postage solutions can be used for market-dominant products. In response to questions at the technical conference, Postal Service participants indicated that they did not know whether Click-N-Ship advertising mentioned other online postage solutions, e.g., the eBay online postage solution. Without this information, it is not possible to assess whether Click-N-Ship advertising costs would go away if competitive products were no longer offered.

c) Out of Office, Delivering Express Mail Costs

PSA is also concerned that the Postal Service is proposing to classify all non-volume variable “Out of Office, Delivering Express Mail” costs (Proposal 5) apparently based solely on the name of the activity. And, it is concerned about the Postal Service proposal to distribute all volume-variable “Out of Office, Delivering Express Mail” costs to domestic and international Express Mail. There is nothing on this record to show that Express Mail is the only mail delivered by postal employees in this activity. While it is tempting based upon the activity’s name to assume that only Express Mail is delivered in this activity, this may not be the case. This would not be unprecedented. The Commission found in the Docket No. R2000-1 omnibus rate case that Parcel Post mail comprised only a small percentage of volume delivered on Exclusive Parcel Post routes. PRC Op. R2000-1. para. 3236. The name is not dispositive.

Furthermore, it is important to note that the In Office Cost System (IOCS) data used to classify these costs as Express Mail costs is not analogous to the IOCS data used to distribute in-office mail processing costs. The classification of “Out of Office, Delivery Express Mail” costs is based on a single question about “off premises activity” (Q18A07) that includes a grab bag of possible answers, including such things as training and data collection.⁴ In this question, Express Mail is the only class of mail explicitly identified for pickup or delivery and it is listed as the first option, possibly leading to errors or bias in responses in cases where the answer may be unclear. Furthermore, in contrast to the procedure used for distributing in-office mail processing costs, there is no use of the extensive set of IOCS questions about the mailpiece itself that are used to make sure that the mail class is correctly identified.⁵

Again, without further study, it does not seem possible to properly assess whether there exists the required exclusive causal relationship that would allow the Commission to conclude that these costs would go away if competitive products were no longer offered. Given the significant costs (\$34 million) that would be converted from institutional to group-specific and assigned to competitive product costs, this change should be made, if at all, only after the Postal Service provides evidence that only Express Mail is delivered in the “Out of Office, Delivering Express mail” activity.

⁴ SAS programs MOD1POOL and NONMOD1, as described in the SAS Program Documentation in Supplement to USPS-FY-07-7 1-16-08 at 2, and USPS-LR-L-9/R2006-1 at A-22.

⁵ The IOCS questions used to identify the mailpiece class are described in USPS-LR-L-9/R2006-1 at A-35 to A-44.

2. Consistent Application of Standards to Market-Dominant and Competitive Products

Regardless of the standard chosen (whether it be “exclusivity”, “predominance”, or “substantial preponderance”), it is critical that it be applied consistently in the identification of both competitive product group-specific costs and market-dominant group-specific costs. Towards this end, if one of the latter two standards is adopted, the Commission should require the Postal Service to treat the vast majority of, if not all, institutional carrier costs (i.e., C/S 6, 7, and 10) and their associated piggybacks as market-dominant group-specific costs. More than 95 percent of attributable FY 2007 carrier costs were caused by market-dominant products.⁶ Clearly, “a substantial preponderance” and a “predominance” of these costs are caused by market dominant products.

3. Impact of Group-Specific Cost Proposals On Appropriate Share Requirement

The effect of identifying costs as group-specific can be enormous because essentially this exercise converts costs from “institutional” to “attributable.” As the Postal Service explains:

Competitive products also must cover an “appropriate share” of institutional cost. In addition to the identification of competitive product group-specific costs, the identification of market-dominant group-specific costs is also important, as the value of the institutional cost will be the residual of Postal costs that are not attributable to products and are not group-specific to either group. To the extent costs are group-specific costs, the remaining 'institutional cost' will be a smaller amount than it would be otherwise.

⁶ According to the FY 2007 Cost Segments and Components report (available at http://www.usps.com/financials/_xls/fy07segcomp1.xls), carrier costs for Priority Mail, Express Mail, Parcel Post, and International Mail comprised less than five percent of attributable carrier costs.

Request at 5-6. In other words, identifying costs as group-specific can affect whether the Postal Service is in compliance with the 5.5 percent appropriate share rule. While it is not possible at this point to determine the combined impact of the three USPS proposals related to group-specific costs (let alone the impact of future USPS proposals) on the estimated share of institutional costs borne by competitive products because Proposal 1 describes a study that has not yet been performed, the effect will certainly lower this share.

Proposals 2 and 5, if implemented in FY 2007, would have shifted \$74 million from institutional costs to competitive product group-specific costs,⁷ reducing the FY 2007 contribution of competitive products by more than 4%, while not moving any institutional costs to the market-dominant group-specific cost category. See Docket No. ACR2007, library reference USPS-FY07-9 (FY 2007 contribution of competitive products was estimated at approximately \$1.8 billion.) Perhaps more importantly from a regulatory perspective, these proposals would have pushed the share of institutional costs borne by competitive products in FY 2007 below the 5.5 percent floor, which if not accompanied by an offsetting adjustment to the appropriate share requirement would push competitive products out of compliance with Commission rules.⁸ The Commission should not allow this to occur.

⁷ The impact of Proposal 1 could also be large. While Proposal 1 is not focused only on competitive products, it could move “something between tens of millions and hundreds of millions...out of institutional costs and into group-specific costs.” Request at 8.

⁸ Calculated by subtracting \$74 million from total FY 2007 institutional costs and competitive products' contribution to institutional costs in Docket No. ACR2007, library reference USPS-FY07-9, and then calculating the competitive products' institutional cost share from the resulting figures.

As PSA has urged in previous proceedings, the Commission should adjust the appropriate share requirement to hold competitive products' harmless for changes in costing methods. See, e.g., Docket No. ACR2007, DMA-PSA Comments at 7-8. This is of critical importance given that the current 5.5 percent floor leaves little margin for error. Further, had the proposed methods been in effect when the appropriate share requirement was originally determined, competitive products' actual share of institutional costs would have been different, which almost certainly would have resulted in a different and lower appropriate share requirement.

4. Piece Meal Approach

PSA believes the above demonstrates why the Commission should not give precedential effect to the Postal Service proposed methodology underlying proposals 1, 2, and 5, and that it should not approve the piece meal implementation of a new method for classifying group-specific costs. Doing so could bias the calculation of competitive products' institutional cost share (which is the main statutory purpose for estimating group-specific costs). For example, focusing first on methods for estimating competitive product group-specific costs (which are the only group-specific costs that USPS has quantified in this proceeding) leads to a disproportionate reduction of competitive products' institutional cost contribution.

Finally, PSA sees no urgency that requires a piece meal approach or the adoption of this methodology without exploring its potential ramifications for other costs segments. To the extent that market-dominant and competitive product group-specific costs are combined as institutional, the appropriate share requirement apportions those costs between the two groups.

CONCLUSION

1. As our comments convincingly demonstrate, the Postal Service cannot simply isolate the competitive products as the only group to which to apply its allocation of group specific costs. That produces a totally unbalanced view of Postal Service costs which muddles rather than clarifies. The Postal Service should be directed to implement proposals related to group-specific costs in a comprehensive, rather than a piece meal, manner.

2. It simply is not acceptable for the Postal Service to establish a subjective standard for determining which costs are group-specific, whether that standard be “predominantly caused by”, or a “substantial preponderance of costs”, or a “majority of costs” or some other undefined percentage. Under the guise of a “minor” change in costing, the Postal Service has made a drastic change from a standard of “entirely caused” to an ill-defined something less than that.

3. Without intentionally doing so (at least the Postal Service has evidenced no intent), the USPS group-specific cost proposals (of which the quantified ones are limited to competitive products) will indirectly alter the appropriate share requirement for competitive products. If that percentage is to be changed, it is the Commission which should sanction that change, and not the unintended consequences of an unrelated Postal Service costing action. The Commission should alter the appropriate share requirement to offset the impact of costing changes.

4. In its request (at 1-2) the Postal Service pleads that its changes are “relatively minor changes in costing methodology,” and also claims that it has submitted “sufficient information for interested parties to develop views either supporting or opposing the adoption of these changes.” As our comments clearly demonstrate, the

changes are not relatively minor, at least as they impact the competitive products alone, and there certainly was not sufficient information supplied to make a judgment about whether the group-specific costs were or were not in fact caused by the competitive classes and to what extent. At least as far as the proposals addressed in our comments, the Commission should direct the Postal Service that it has not made a sufficient case for the assignment of those costs, and that they should not be included in the Postal Service's Annual Compliance Report.

Respectfully submitted,

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