

Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Periodic Reporting

Docket No. RM2008-2

PUBLIC REPRESENTATIVE COMMENTS
IN RESPONSE TO ORDER NO. 99

September 8, 2008

On August 18, 2008, the Commission issued Order No. 99 requesting comments on the Postal Service's proposal, dated August 11, 2008, to change the established costing methodologies in eight specific areas.¹ On the same day the Commission issued its Order, the Service filed a motion adding one more proposed change to its initial list.² The Commission subsequently accepted the motion and amended its original order on August 21, 2008 to add that change.³

The Service's proposal requested initiation of an informal proceeding at this time so that changes in certain cost methods can be finalized prior to development of the FY 2008 Annual Compliance Report (ACR). Collectively, Service proposals are intended to provide more accurate assignment of costs to particular rate elements, products or product groups. Accordingly, the Public Representative assigned to this

¹ PRC Order No. 99, Notice of Proposed Rule Making on Costing Methods Used in Periodic Reporting, August 18, 2008 (Order No. 99); 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, August 11, 2008.

² Motion of the United States Postal Service to Supplement the List of Its Proposed Costing Changes for Purposes of Preparing the FY 2008 Annual Compliance Report, August 18, 2008.

³ Order Granting Postal Service Motion to Supplement List of Proposed Costing Changes, August 21, 2008.

proceeding provides the following comments on proposals one, four and seven filed by the Postal Service. Changes in cost methods explained by the Service for these proposals raise important issues pertinent to ratemaking, reporting of financial data by product line and related evaluations of profitabilities for single products and multiple product groupings.

1. USING AVOIDABLE COSTS TO DETERMINE GROUP-SPECIFIC ATTRIBUTABLE COSTS

In Proposal One, the Postal Service explains that certain institutional costs at headquarters could be recategorized as group-specific and therefore attributable to either market dominant or competitive products, depending on responses to a new survey and related evaluations. In the survey, managers of headquarters finance numbers (FNs) are asked to select from a list of items those products supported in each FN. A postal Cost Attribution Group Specific Cost Team has been assigned and will be responsible for assessing survey results and possibly reallocating costs to market dominant or competitive products as a group by FN when: a) all products selected are under market dominant or competitive categories or b) all but an incidental level of resources are devoted to either category.⁴ Additionally, it appears that the cost attribution team contemplates using avoidable costs as an evaluational standard for determining whether particular FN costs should be attributed. *Id.* at 5.

The Public Representative supports cost avoidance as an evaluational standard for cost attribution of headquarters costs in cases where (a) or (b) above are met.

⁴ Notice of the United States Postal Service Regarding Materials Distributed or Requested at the August 27, 2008 Technical Conference, Copies of Materials Distributed at the 8/27/08 Technical Conference, August 29, 2008 at 2.

That is when requirements for either item are fulfilled for a particular FN and related costs are avoided in total or in part when the supported product group is eliminated, then and only then should the avoided portion of costs from that FN be attributed as group-specific.

Moreover, to fully assess whether that evaluational standard is met requires that group-specific costs be viewed from a dynamic perspective. Cost avoidance can change over time for any number of reasons.⁵ Consequently, cost attribution reporting should be adjusted in these situations so that product contribution changes are captured correctly. Two examples presented below serve to demonstrate the underlying principle. The appendix to these comments elaborates on these examples and shows how the concept of cost avoidance can be used on a forward-looking basis to evaluate product contributions both over the short and the long term.

Consider a simple two-product case where the Postal Service provisions a market dominant product and is considering marketing a competitive product. Market dominant product revenues are \$1,000, total variable costs are \$200, and institutional costs are \$500. The Service estimates that competitive product revenues would also be \$1,000 and the corresponding variable costs would be \$800. Because institutional costs are fixed, the Service enters the competitive market and increases total profits by \$200. In this case, none of the institutional costs are allocated to market dominant or competitive products and therefore the respective product contributions of \$800 and \$200 are accurately reported. In fact, any attempt to allocate institutional costs to both products for reporting purposes can be recognized

⁵ A classic case would be in assessing labor costs before and after product entry. Costs for personnel hired to support a product are avoidable before entry but some portion is usually fixed after entry at least in the short term.

easily as misleading if such information were used to evaluate how total profits would change if either product were discontinued.

Now compare this result with a second example where resources generating the original \$500 institutional cost support each product uniquely. Initially, the Service provisions only the market dominant product as before, but now incurs \$250 in support costs for that product. Then assume that competitive market entry increases revenues by \$1,000, variable costs by \$600 (instead of \$800 as in the first example), and support costs by \$250. Therefore, the Service enters that market and increases system profits by \$150. In this case, clearly the Service should attribute \$250 in support costs to both products to correctly report the respective contributions of \$550 and \$150.

However, suppose subsequent to entry, competitive product variable costs increase to \$800. If the corresponding product support costs of \$250 continued to be fully avoidable, then PAEA compliance would require avoidance of the \$50 loss in some way, either by increasing price (assuming inelastic demand), adjusting service quality standards, a combination of both actions, or barring some other remedial action discontinuing the product. On the other hand, if the \$250 support cost were now unavoidable post entry, then the competitive product contribution increases to \$200 and no further action would be required. However, to report the higher contribution correctly in this latter instance requires that support costs now be reclassified as institutional. Conceivably, continued attribution of that amount could result in unwarranted market exit if management were unaware of the changed circumstance.

In sum, corrective decisions of this type depend critically on attributing avoidable costs as accurately as possible. Thus, postal team evaluations of total costs reported by FN and supporting only market dominant or competitive products (items (a) and (b) above) should be repeated at least annually in order to adjust attribution of group-specific costs as circumstances dictate.

2. ATTRIBUTION OF GENERAL COLLECTION BOX NON-VOLUME VARIABLE COSTS

In Proposal Four, the Postal Service requests attributing all non-volume variable costs for “sweeping” mail at general collection boxes to First-Class single-piece letters and cards. In the FY 2007 ACR, the Postal Service assigned all these non-volume variable costs to the First-Class single-piece subclass. Under the new mail classification schedule (MCS), First-Class single-piece letters and cards are melded into one product so the Service now proposes to treat these costs as product-specific to the two old subclasses. The Service justifies the cost reassignment by claiming that “over 90 percent of collection box mail is First-Class single-piece letters”. Order No. 99 at 10. They also state that collection boxes were put into service to handle First-Class Single-Piece Mail and therefore they properly attributed non-volume variable costs to such mail in the last.⁶

In response, the Commission rejected the Service’s allocation. They noted that that “the boxes themselves do not state that their use is solely for the collection of

⁶ Commission Information Request No. 2, February 11, 2008, at 2.

First-Class single-piece letters”.⁷ The Commission therefore retained the accepted method of treating these costs as institutional.

The Public Representative supports the Commission’s current treatment. The reason for treating non-volume variable costs for general collection boxes as institutional should be viewed from the same perspective as discussed in the previous section. A rationale may have existed originally to assign all new mail collection fixed costs caused by accessing, opening, and closing mailboxes to First-Class Single-Piece Mail because, as the Service notes, the purpose for installing these boxes was to facilitate collection of such mail. Further, if all single-piece volume were suddenly eliminated from the system and carriers no longer needed to access collection boxes, then all fixed costs would be avoidable and therefore attributable to the single-piece product as the Service states.⁸

However, these collection boxes are now part of the Service’s infrastructure for collection of other types of mail. Once in place, it is difficult to see how these boxes would be left unused just because single-piece mail were eliminated from the system. If other mail collected in boxes, such as express, priority and international, were isolated to a subset of all boxes in the system all the time, then it might be possible to avoid the fixed costs on the remaining boxes from not having to access them. However, because of uncertainty regarding mail distribution among collection boxes, carriers would still be expected to access all or most collection boxes on any particular day. Under these circumstances, it would be difficult to justify assigning any existing

⁷ Annual Compliance Determination, March 27, 2008, at Appendix B-7.

⁸ This situation is analogous to the product-specific support costs caused by initial entry of the competitive product that remain fully avoidable post entry as discussed in the previous section.

non-volume variable costs to the First-Class single-piece product. The current fixed cost level would be largely unavoidable if such mail were removed from the system.

Another option would be to transfer the collection function for remaining mail to a combination of carrier pick up and/or window service. However, in that case, a careful analysis of avoidable costs would be required under particular restructuring assumptions. For example, if all residual mail now collected from blue collection boxes were diverted to carrier pick up, then the total avoided collection cost from eliminating First-Class single-piece volume would be total general collection box costs less the added costs from collecting the residual mail through carrier pick up. Therefore total volume variable and attributable non-volume variable costs should not exceed this amount under this restructuring assumption.

The comparison of this avoidable cost ceiling for attributable costs with the Service's proposal can be made clearer as follows. For simplicity, assume current collection box variable costs for First-Class single-piece letters and cards is VC_{b1} , the sum of variable costs for all other mail deposited in these boxes is VC_{b2} , and fixed costs to access and service these boxes are F_b . Similarly, assume variable costs to service the residual mail through carrier pick up is VC_{c2} and fixed cost associated from accessing added delivery points to pick up such mail is F_c . Then the single-piece total avoidable or incremental cost would be $IC_1 = (VC_{b1} + VC_{b2} + F_b) - (VC_{c2} + F_c)$ or rearranging $IC_1 = VC_{b1} + (VC_{b2} - VC_{c2}) + (F_b - F_c)$.

It is clear that if the Service has system restructuring in mind, then they are proposing that total costs attributed to First-Class single-piece letters and cards be equal to $IC_1 = VC_{b1} + F_b$ under the assumption that variable costs for residual mail be

equal under both options and that there are no added delivery point accesses from carrier pick up of such mail. However, $VC_{b2} - VC_{c2} < 0$ would appear likely because piece handling with carrier pick up would involve customer contact virtually in many instances. Also, not all residual mail would be picked up at already serviced delivery points, so $F_c > 0$ is inevitable.

An interesting possibility would be $(VC_{b2} - VC_{c2}) + (F_b - F_c) = 0$ where $VC_{b2} - VC_{c2} \leq 0$ and $F_b - F_c \geq 0$ in which case $IC_1 = VC_{b1}$. Then the only costs that should be attributed to single-piece letters and cards is the current volume variable portion because differences in variable and fixed costs under the two options offset. However, even if $(VC_{b2} - VC_{c2}) + (F_b - F_c) > 0$, this positive amount is not likely to be large, and therefore IC_1 would be greater than VC_{b1} by a very small amount.

Thus, both under a current and restructured system and without the benefit of additional studies, limiting attributable costs for single-piece letters and cards to current volume-variable costs appears to be a reasonable treatment of the issue. Any deviation from this approach implicitly assumes $(VC_{b2} - VC_{c2}) + (F_b - F_c) \neq 0$ under restructuring. Therefore, any deviations proposed should be based on a quantitative analysis of added costs incurred to collect mail through alternate means.⁹

⁹ The example assumes carrier pick up as the only alternative. However, the approach can be easily expanded to include estimates of added costs from both added carrier pick up and window service.

3. THE DISTRIBUTION KEY FOR VEHICLE SERVICE DRIVER (VSD) VARIABLE COSTS

The Postal Service requests in Proposal Seven to change the distribution key for VSD variable costs from cubic feet of originating mail shown in the Revenue, Pieces and Weight (RPW) statistics to sampled cubic-foot miles of mail on INTRA-SCF routes obtained from the Transportation Cost System (TRACS). Order No. 99 at 17. The Postal Service states that a large portion of originating mail entered at destination delivery units (DDUs) included in the RPW statistics is delivered within the same five digit ZIP Code and therefore do not use VSDs. Therefore, they conclude that the current distribution key is biased. In particular, the Postal Service claims that the proposed distribution key “provides a reasonable proxy” of relative mail flows on VSD runs because highway contractors on INTRA-SCF runs and VSDs cover the same types of routes. Order No. 99 at 18.

The Public Representative agrees in principle that the appropriate distribution key should be limited to mail flows exclusive to INTRA-SCF runs. This would properly exclude mail originating and destinating in the same DDUs from forming part of the distribution key since these volumes are not transported between facilities.

However, there are two other issues that should be noted with respect to the Service's proposal. The Postal Service maintains that using TRACS sampled cubic-foot miles from INTRA-SCF runs can serve as a reasonable substitute for an “ideal” distribution key that would be constructed from sampled VSD mail. However, they note that VSDs usually handle INTRA-SCF runs of less than 25 miles while contractors handle runs of longer distances. Id. This would appear to be a crucial

difference affecting not only particular route costs in total but also the proportions of different mail types that would be handled on short and longer distance INTRA-SCF routes. With respect to the latter, drop-ship incentives by mailers can be expected to vary according to average distances between sectional center facilities (SCFs) and destination delivery units (DDUs). Therefore, one would expect some difference in the distribution of variable costs at the product/rate component level using the Service's distribution key proposal and an ideal constructed from sampled VSD mail.

Second, changing the distribution key from cubic feet to cubic-foot miles of transported mail appears questionable. It might be better to retain the current distribution key because cubic feet of mail appears to be the original VSD cost driver, not cubic-foot miles.¹⁰ However, this is an area that should be explored more fully in a future study, perhaps as an update to the Docket No. R-97 variability study that is still used to determine total VSD variable costs.¹¹

In summary, it would appear useful that any future update to the latest variability study consider using cubic feet of volume transported by VSDs as the cost driver to calculate VSD variable costs. Other suitable control variables from the last study should be retained as necessary. Also, a matching distribution key should be developed and applied using samples from VSD routes. Therefore the Public Representative proposes continued use of the current distribution key until such changes can be made.

¹⁰ For example, a portion of VSD costs are clearly related to loading/unloading mail at vehicle origin/destination points. If trucks have unused capacity, then added volume would affect these costs but not costs related to total route miles traveled necessarily. On the other hand, if trucks are at or near capacity when volume is added, then distance-related costs would probably increase from added vehicle trips. Cubic-foot miles of mail increase in both instances, but cubic feet of volume (converted from the volume composition) is the original cost driver.

¹¹ Direct Testimony of Steven H. Wade on Behalf of United States Postal Service, July 10, 1997 (USPS-T-20).

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APPENDIX

This appendix demonstrates how cost attribution using the cost avoidance principle can be used to evaluate product contributions both over the short and the long term. It requires combining short and long-term attributable costs so that evaluations consider correctly how system profits are affected by a particular product.

First, assume as before that postal management is evaluating whether to enter the competitive market with a single product. To introduce some notation, let R equal annual competitive product revenue, VC equal annual product variable cost, and S equal annual support cost for the product. Then management should enter the market if $\pi = R - (VC + S) > 0$. Assuming this happens, and if all of S continued to be avoidable subsequent to entry, then, of course, $VC + S$ should continue to be attributed to the product so that the annual profit contribution can be correctly evaluated.

However, suppose only (k) fraction of support labor is avoidable in the short-term after entry and the remainder is avoidable in the long-term after (z) years. In that case, a distinction between long and short-term attributable costs needs to be made in order to reach a correct assessment of the product contribution. Therefore, define $VC + S$ as long-term attributable costs and $VC + Sk$ as short-term attributable costs. Management should then continue to evaluate the long-term annual contribution from the product as $\pi_L = R - (VC + S)$ and the short-term annual contribution as $\pi_S = R - (VC + Sk)$. Now, if $\pi_L > 0$, then $\pi_S > 0$ always and the correct decision is always to

continue with the product. At the other extreme, if financials change post entry such that $\pi_L < 0$ and $\pi_S < 0$, then the correct decision is to discontinue the product.

The ambiguous case is $\pi_L < 0$ and $\pi_S > 0$. In this instance, a market exit assessment would involve evaluating a long-term contribution gain of $-\pi_L$ (because the π_L loss is saved when exiting the market) against a short-term contribution loss in the amount of $-\pi_S$. The correct evaluation in this case requires discounting future contributions (cash flows) to the present. The discounted cash flows can be partitioned into long and short-term contribution portions as follows.

If (r) is the discount factor, then the present value in year (z) of perpetual long-term savings beginning in that year from discontinuing the product in the current year is simply $-\pi_L/r$. The present value brought forward to the current year would then be $PV_L = -\pi_L/r(1+r)^z$. Similarly, the present value of the short-term loss from the current year-to-year (z) from market exit can be shown as difference between that loss if it continued perpetually from the present or $-\pi_S/r$ and the loss starting in year (z) , continued perpetually as well, but discounted to the present or $-\pi_S/r(1+r)^z$. Therefore, $PV_S = -\pi_S/r[1 - 1/(1+r)^z]$.

Last, the present value of the change to system profits from market exit can then be expressed as $PV = PV_S + PV_L = -\pi_S/r[1 - 1/(1+r)^z] - \pi_L/r(1+r)^z$. Notice that the terms $-\pi_S/r$ and $-\pi_L/r$ are weighted by the factors $1 - 1/(1+r)^z$ and $1/(1+r)^z$. Also, notice that as (z) increases in value, the short-term contribution is given more weight in the evaluation. In fact, if (z) becomes very large, then $PV \approx -\pi_S/r < 0$ and short-term attributable costs alone give the correct signal against market exit. Of course, if both π_L and π_S have the same sign, then PV is always opposite in sign. In that case, the

correct contribution assessment can always be reached without reference to the discount factor and the intervening time period (z), as mentioned initially.