

ORIGINAL

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

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Mailing Online Service )

Docket No. MC98-1

OFFICE OF THE CONSUMER ADVOCATE RESPONSE TO  
ISSUE NO. 5 OF NOTICE OF INQUIRY NO. 1  
(February 8, 1999)

Notice of Inquiry No. 1 ("NOI") was issued by the Commission on October 16, 1998, for the purpose of seeking input from the participants on six issues requiring further development during the experimental phase of Docket No. MC98-1. The Office of the Consumer Advocate ("OCA") hereby presents its views on Issue No. 5 of the NOI.

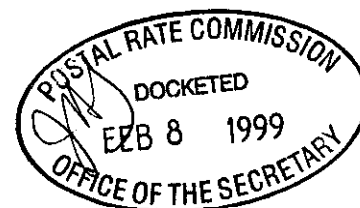
Issue No. 5 was posited by the Commission as follows:<sup>1</sup>

The Postal Service identifies no marketing costs that are specific to Mailing Online. Mailing Online, however, is expected to benefit from marketing programs planned for PostOffice Online, which will jointly promote Mailing Online, and other postal products. The Service argues that no portion of joint marketing costs should be attributed to Mailing Online. Other parties have requested that joint marketing costs be tracked and provided so that their relevance to Mailing Online costs and rates could be addressed during consideration of the experiment phase. The Commission concurred. *Participants are requested to discuss whether joint marketing costs that promote Mailing Online should be attributed to Mailing Online, and how any such cost attribution should be quantified.*

At the outset, the Commission must be commended for its foresight in requiring the Postal Service to collect and report the marketing costs of PostOffice Online

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<sup>1</sup> Citations omitted, emphasis added.



("POL"), even though, at the time it formulated its opinion on the market test, the Commission apparently had not yet reached a firm conclusion on whether such costs ought to be attributed to Mailing Online ("MOL").<sup>2</sup> This farsightedness was not limited to the marketing costs of MOL, but extended to other common costs, such as POL Help Desk costs, Processing Center costs, Communications, and Printer Site costs.<sup>3</sup>

OCA understands the Postal Service's position on the treatment of POL marketing costs to be the following: first, in pricing MOL, the Postal Service believes it appropriate to mark up only the volume variable costs of the service.<sup>4</sup> Second, the Postal Service maintains that an incremental cost test should be performed only to ensure that MOL is not being cross-subsidized by other classes and services.<sup>5</sup>

With respect to the first principle, the Postal Service's position is that advertising costs of a service are not volume variable. For example, in Docket No. R97-1, Postal Service witness Takis testified that the advertising costs of Priority and Express Mail are specific fixed, not volume variable,<sup>6</sup> and, therefore, not subject to being "marked up."<sup>7</sup> The conclusion that advertising costs are fixed is the product of a set of shallow, self-serving assumptions. The Service does not acknowledge the true nature of advertising expenses—they are marginal costs because each extra unit of advertising cost is expended to induce a purchase by an additional buyer. This insight was articulated in a

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<sup>2</sup> This is evidenced by the inclusion of Issue No. 5 in the NOI.

<sup>3</sup> PRC Op. MC98-1 (Market Test) at 51.

<sup>4</sup> Response of witness Plunkett to item 1, Presiding Officer's Information Request ("POIR") No. 2, Tr. 5/1115.

<sup>5</sup> Response of the Postal Service to NOI, Issue 5.

<sup>6</sup> USPS-T-41 at 25-26.

<sup>7</sup> See discussion, *infra*.

speech by Jonathan Baker, Director, Bureau of Economics, Federal Trade Commission:<sup>8</sup>

Accounting measures of average variable cost that exclude all expenditures on advertising and other promotion may underestimate marginal cost. . . . The marginal cost relevant to pricing includes those advertising and promotional expenditures that would change were the firm to adopt a different pricing strategy over a full promotion and inventory cycle. Hence, an estimator of marginal cost that excludes all promotional expenditures on the ground that they are predetermined in the very short run may systematically understate the incremental cost related to the intermediate-term pricing decision . . . .

In short, advertising costs *are* volume variable.

A cynical inconsistency in the Postal Service's view of the volume variability of Express Mail advertising is exposed when the method employed by Postal Service witness Musgrave to estimate Express Mail volumes in the Docket No. R90-1 test year is examined. He testified that:<sup>9</sup>

The Postal Service engages in promotional activities on behalf of Express Mail. In constructing the model we assumed that the impact of these expenditures on volume would occur over more than one quarter. . . .

Our results are consistent with this view. The coefficients of the Express Mail advertising variable are positive and statistically significant. They show an immediate impact that is strong and continues for six months. . . . Over our sample, the growth in real advertising accounted for an increase of 116 percent in Express Mail volume.

This demonstrates a keen awareness by the Postal Service that advertising costs are indeed incurred in order to generate volume growth; witness Musgrave

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<sup>8</sup> "Antitrust in the Information Revolution: New Economic Approaches for Analyzing Antitrust Issues," October 11, 1996 (revised February 7, 1997), published in 5 Geo. Mason U. L. Rev. 347, 358 (citations omitted).

<sup>9</sup> USPS-T- 3 at 27-28. Witness Musgrave was unable to include Express Mail advertising in the volume estimation procedure in Docket No. R94-1 because of the unavailability of data. USPS-T-3, WP D-4.

proved with econometric tools what is well-known even to the average layperson—the more that is spent prudently on advertising, the greater the volume response induced. Therefore, even under the theory of attribution endorsed by the Postal Service, advertising costs, including those of POL, must be considered volume variable. As with other volume variable costs, a distribution key must be selected that most closely reflects the nature of the cost causation. Whatever the distribution key finally selected, it cannot be disputed that the only candidates for cost responsibility are those services obtained at the POL website, where POL acts as the gateway to MOL, Shipping Online (“SOL”), Express Mail tracking, and Priority Mail delivery confirmation.<sup>10</sup>

Even if the Commission cannot conclude categorically that advertising costs are volume variable, they are attributable nonetheless. At para. 4016 of PRC Op. R97-1, the Commission framed the issue “whether it is reasonable to limit the concept of attributable cost to marginal cost.” While conceding that marginal costs are the “most important element of attributable cost,”<sup>11</sup> the Commission has “also included specific

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<sup>10</sup> At Tr. 5/1072, l. 4-5, Chairman Gleiman characterized POL as “the gateway to getting to Mailing Online.” When questioned about the Chairman’s statement, Postal Service witness Lim generally indicated his agreement:

... POL is ... sort of the first step towards entering the MOL area, which is, I guess, in web terms, you would go to the POL web page first, which would then have a link to subparts which are specific to MOL, or have specific information about MOL, or related to the MOL program. So, in that sense, I would say I would agree with that statement.

Tr. 8/1954, l. 11-17.

<sup>11</sup> PRC Op. R97-1, para. 4016.

fixed costs under the rubric of attributable. . . . [and] has analyzed costs caused by the classes of mail and found other nonvariable costs to be attributable . . . ."<sup>12</sup>

Significantly, the Commission held that:<sup>13</sup>

Marginal costs are an important subset of attributable costs, but the Commission cannot agree that marginal cost is all that is meant by the term "attributable. . . ." In interpreting th[e] language [of the Act] the Commission continues to believe that the authors of the Act intended "attributable" to mean more than just marginal cost. . . .

Marking up attributable cost is the means by which the Commission makes its determination of a reasonable contribution to all other costs. All other costs are the difference between total cost and attributable costs. All other costs are not the difference between total cost and marginal cost. When the Commission determines the reasonableness of a subclass' contribution to all other costs, it must use attributable cost as a base and *mark-up*.

The Postal Service's view (as expressed by witness Plunkett in his Response to POIR No. 2), that fixed costs should not be included in the attributable cost base and marked up to set rates for MOL, is plainly at variance with the Commission's. There is no reason to believe that the Commission would wish to retreat from the policy outlined in Docket No. R97-1. Consequently, even if advertising costs are considered non-volume variable, the only remaining questions to be resolved are: 1) whether marketing costs that are common to other classes and services can properly be considered "attributable" to MOL, and 2) what method can be used to allocate such common costs to the classes and services that benefit from them.

One important determination made by the Commission in its R97-1 opinion was that:<sup>14</sup>

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<sup>12</sup> Id.

<sup>13</sup> Id. at paras. 4017-4018. (Emphasis in original).

<sup>14</sup> Id. at para. 4024. (Emphasis added).

The Commission's calculation of attributable costs by subclass and service does not precisely conform to witness Panzar's definitions of either marginal cost or incremental cost. However, *they come closest to being the incremental costs associated with the subclasses and services taken one at a time.*

Once the premise is established that incremental costs essentially constitute the attributable costs that must be marked up for ratesetting purposes, it is necessary to determine whether a pool of common costs enjoyed by only a few classes and services, but by no means most or all services, should be viewed as attributable.

Professor Baumol, testifying on behalf of the Postal Service in Docket No. R87-1 on the subject of common fixed costs, stated that:<sup>15</sup>

The incremental cost concept can also be extended to two or more services. If a fixed outlay simultaneously benefits consumers of services A and B but not customers of service C, then none of that outlay is included in the incremental cost of service C, for obvious reasons. Moreover, none of that outlay is included in the incremental cost of service A by itself, or the incremental cost of service B by itself, if the outlay could not have been escaped if only (either) one of those services had been provided. That is so because, say, if service A were provided initially, then the subsequent launching of service B would in this case not increase the fixed outlay in question. However, though it is excluded from the incremental cost of either A or B alone, in this case the fixed outlay must be included in the (combined) incremental cost of A and B . . . .

OCA witness Sherman made the same observation in Docket No. R97-1:<sup>16</sup>

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<sup>15</sup> USPS-T-3 at 22-23. *Accord, In the Matter of Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 94-54, Notice of Proposed Rulemaking, FCC 95-505, January 11, 1996, para. 54: ". . . [T]he Commission has repeatedly expressed concern about preventing cross-subsidies. Some economists have defined the following alternative tests for cross-subsidy . . . the revenue from each service *and from all subsets of services* must exceed the incremental cost of the service or *the subset of services*." [citing William J. Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure* 351-56 (1982) (emphasis added)].

<sup>16</sup> OCA-T-300 at 52-53. It must be conceded that witnesses Baumol and Sherman did not testify that common fixed costs ought to be included in the cost base of a class and

In his testimony (USPS-T-41), Witness Takis gives little attention to the imputation of fixed costs when they are caused by more than one service. If a fixed cost is shared by, say, two services, an incremental cost for those two services together can be estimated. Then a test for cross subsidy can be carried out for that two-service group, to determine whether the two services are being subsidized.

. . . . .

[A]re the Bulk Mail Centers necessary for two mail classes? For three? Answers to these questions determine the level at which cross-subsidy tests should be carried out. In some cases, incremental costs should be estimated for combinations of classes, and then tests for cross subsidy should be conducted for that combination of classes. The present effort seems essentially to focus on incremental cost estimates for only one class at a time. It is possible that when fixed costs that are shared by services are imputed to those services, a larger portion of total costs would be identified as incremental . . . .

The Federal Communications Commission has also recognized that equity and economic efficiency dictate that costs common to only a subset of services must be allocated only to those services. In the *First Report & Order In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*,<sup>17</sup> an order that provides for "opening the local exchange and exchange access

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marked up (as they would advocate for marginal costs). Rather, the traditional approach of economists would be to apply the incremental cost test to the two classes of mail benefiting from the fixed cost expended, and assure that neither class is being cross-subsidized by any other class. However, these costs would be excluded from the pool of costs to be marked up, as that pool is traditionally limited to marginal costs. If one looks at the overarching meaning of their remarks, it becomes clear that the most equitable treatment for fixed costs incurred by only a small subset of classes is to make that cost part of the attributable cost base and mark it up. If one merely applies the incremental cost test and stops there, in most cases the rate imposed will indeed cover the marginal cost of the class (and will have been proven to cover the incremental fixed costs of the class), but in many cases, very little will be left over to make a meaningful contribution to the institutional costs of the entity. A meaningful contribution to institutional costs can only be ensured by marking up the specific fixed cost (or joint fixed costs) of the small subset of classes.

<sup>17</sup> FCC 96-325, sec. VII, para. 694.

markets to competitive entry,"<sup>18</sup> and "reforming . . . the current subsidy system" for provision of local telephone service,<sup>19</sup> the FCC articulated this policy:

Forward-Looking Common Costs. Certain common costs are incurred in the provision of network elements . . . . [S]ome of these costs are common to only a subset of the elements or services provided by incumbent LECs. Such costs shall be allocated to that subset, and should then be allocated among the individual elements of services in that subset, to the greatest possible extent.

In Docket No. R87-1, the Postal Rate Commission reached a similar conclusion. The Commission treated the fixed costs of Cost Segment IX (Special Delivery Messengers) as attributable costs to be marked up. In its opinion, the Commission framed one of two principal issues involved in the attribution of Special Delivery Messenger costs as follows: "whether the nonvariable portion should be treated as institutional or distributed to a subset of classes on a causal basis."<sup>20</sup> Summarizing its decision in Docket No. R84-1, the Commission stated that it had recognized the unique entitlement of Express Mail and Special Delivery to the services of a messenger when needed to effect delivery within service standards by refusing to allocate these costs as institutional. Equity dictated that "other mail" should not have to "pay for a service characteristic they did not receive."<sup>21</sup>

In order to distinguish the justified attribution of fixed common costs from fully distributed costs (an approach rejected by the Commission), the Commission held that "specifically justifiable causal connections" must be established.<sup>22</sup> There must be a

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<sup>18</sup> Id., sec. I, para. 3.

<sup>19</sup> Id., para. 5.

<sup>20</sup> PRC Op. R87-1, Appendix J, [CS IX], para. 003.

<sup>21</sup> Id.

<sup>22</sup> Id., paras. 019-020.



finding that such costs are the “result of providing a mail characteristic that distinguishes some classes from the rest.”<sup>23</sup> One operative fact in determining the “uniqueness” of Express Mail’s and Special Delivery mail’s use of Special Delivery messengers was that “no other classes play[ed] a part in” the scheduling of Special Delivery runs. Further, the evidence adduced in Docket No. R87-1 failed to indicate that any classes or services, aside from Express Mail and Special Delivery, were “responsible for any of the fixed portion of Segment IX.”<sup>24</sup> The Commission articulated the general standard it would apply in future cases: whether the classes found responsible for the fixed costs by virtue of their special entitlement are, in fact, the only deliberately intended beneficiaries of those outlays.<sup>25</sup>

From the scant evidence furnished by the Postal Service in the instant proceeding, marketing costs for MOL would appear to meet every condition established by the Commission in Docket No. R87-1. The Postal Service defends its exclusion of advertising costs for MOL by characterizing them as “fixed and common to projects other than Mailing Online, such as advertising costs for PostOffice Online.”<sup>26</sup> However, advertising costs of POL clearly fall within the ambit of costs that must be attributed under the principles of Docket No. R87-1—they are incurred solely for the benefit of a subset of classes and services, i.e., MOL, SOL, Express Mail tracking, and Priority Mail Delivery Confirmation. Only those services that are facilitated or purchased at the POL website benefit from the marketing of POL. Fairness under the Postal Reorganization

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<sup>23</sup> Id., para. 020.

<sup>24</sup> Id., para. 022.

<sup>25</sup> Id., para. 023.

<sup>26</sup> Postal Service Reply Brief, [Market Test], Docket No. MC98-1 at 15.

Act, as interpreted by the Commission, dictates that the particular subset of classes and services facilitated by POL be made solely responsible for such costs.

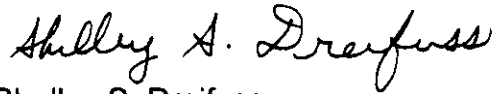
The final question to be resolved is: what distribution key would be most appropriate for allocating these marketing costs? In Docket No. R87-1, the Commission elected pieces as the appropriate distribution key for the fixed costs of Special Delivery Messengers. The Commission reasoned that: "Since we had identified a particular entitlement to expedition as the cause, and since expedition is essentially a characteristic of pieces, we were able to establish the relative responsibility of Express Mail and Special Delivery for the fixed costs."<sup>27</sup>

Advertising and promotion of PostOffice Online is undoubtedly for the purpose of increasing public awareness of MOL, which, in turn, is intended to stimulate MOL usage. Increasing Express Mail and Priority Mail usage is part of the same goal. Consequently, the relative usage of POL for access to the various services available at the site is the logical distribution key. Specifically, OCA proposes that the relative number of transactions conducted at the website for each individual service available there be used as the basis for determining MOL's proper share of advertising costs.

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<sup>27</sup> The quoted language was a description of the Commission's distribution of fixed costs in the previous rate case, Docket No. R84-1. The Commission distributed fixed costs on the basis of pieces in R87-1 as well. PRC Op. R87-1, Appendix J [CS IX], para. 024.

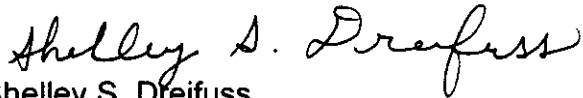
Respectfully submitted,

A handwritten signature in cursive script that reads "Shelley S. Dreifuss".

Shelley S. Dreifuss  
Attorney  
Office of the Consumer Advocate

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

A handwritten signature in cursive script that reads "Shelley S. Dreifuss".

Shelley S. Dreifuss  
Attorney

Washington, D.C. 20268-0001  
February 8, 1999