



## I. Postal Service Proposal One.

As expanded by the Postal Service in a subsequent Notice,<sup>2</sup> Proposal One explains that the finance numbers in certain headquarters-related cost segments may contain some costs, heretofore classified as institutional, that can be identified as “group-specific” (p. 5, single quotes removed) to “either the competitive or market-dominant products” (p. 5).<sup>3</sup> Applied to the competitive products, then, questions would be directed to pools of costs that are inherently fixed and would ask whether the costs in these pools could be avoided if all of the volume of the competitive products were to be withdrawn.

With this understanding, the Postal Service draws on Commission Rule 3015.7(a), which states that “(i)ncremental costs will be used to test for cross-subsidies by market dominant products of competitive products,” to propose that the attributable costs of the competitive products be “supplement[ed]” (p. 7) by any associated group-specific costs *to yield* a new cost figure that is, presumably, a first cut at the incremental cost of the competitive products, and that this new cost figure be used in a test for

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<sup>2</sup> See NOTICE OF THE UNITED STATES POSTAL SERVICE REGARDING EXPANDED SCOPE FOR PROPOSAL ONE OF THE REQUESTED METHODOLOGICAL CHANGES FOR THE FY08 ACR – ERRATA (September 5, 2008).

<sup>3</sup> The Request states: “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.” (p. 5.) This definition would appear to include, if they meet the test, costs in pools that are partially variable as well as costs in pools that are inherently fixed. I believe the Postal Service means to refer only to the latter, and will assume so in these comments. Whether this is the case, however, should be clarified. Volume variability is defined on small volume changes (infinitesimally small in cases where regression results are used), whereas incremental costs are defined on much larger volume changes. Therefore, it is certainly possible that fixed costs in pools that are partially variable could be incremental.

cross-subsidy.<sup>4</sup> Therefore, it appears that if improved estimates of the incremental costs are developed, all candidate cost segments will be examined and the amount by which the attributable costs are supplemented will grow. Also, as explained further below, I see no reason why this growth should be confined to group-specific costs.

Along the way, the Postal Service indicates that (a) the group-specific costs of the *market-dominant* products are “also important, as the value of the institutional cost will be the residual of Postal costs that are not attributed to products and are not group-specific to either group” (pp. 5-6), (b) in addition to covering their incremental costs, the competitive products “also must cover an ‘appropriate share’ of institutional cost” (p. 5), and (c) the institutional-cost figure to which the appropriate-share proportion should be applied is the institutional cost “remaining” (p. 6) after the group-specific costs of both groups of products are removed. These references suggest that the definition of the term *institutional cost* is proposed to be changed and that the Commission-determined appropriate-share proportion should be applied to the newly-defined measure.<sup>5</sup> They also suggest that the revenues from the competitive products should be required to cover the sum of the appropriate share and the associated incremental cost.

On the question of how it is developing group-specific costs, at least for the finance numbers at issue, the Postal Service explains that it “has created a new

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<sup>4</sup> The Postal Service states that “the Commission is currently using competitive products’ attributable costs, supplemented to include causally related, group-specific costs, to test for cross-subsidies” (p. 5).

<sup>5</sup> For example, if the current institutional-cost figure is \$100, and \$20 is group-specific to the competitive products and \$50 is group-specific to the market-dominant products, the new measure of institutional cost would be \$30 (100 - 20 - 50), and it would be the \$30 figure to which the appropriate-share proportion would be applied.

attribute . . . called the *Product Activity Attribute*" (p. 6). If the letters A, B, and C are taken as attribute indicators, the apparent scheme is that (a) finance numbers with an A appended would contain costs that support only or predominantly<sup>6</sup> market-dominant products, (b) finance numbers with a B appended would contain costs that support only or predominantly competitive products, and (c) finance numbers with a C appended would contain costs that support "both groups of products" or support "the Enterprise as a whole" (see pp. 6-7).

## **II. Difficulties with the Scheme Laid Out by the Postal Service.**

The scheme laid out by the Postal Service appears at variance with the principles of efficient ratesetting, and, if adopted, would increase the difficulty of evaluating the compliance of rates with the Postal Accountability and Enhancement Act (hereinafter "Act"). Also, at least for the competitive products, it could reduce the freedom of the Postal Service to compete effectively. In addition, the proposal may not be consistent with associated provisions in the Act.

My comments center primarily on the *ideas* in the proposal. As noted above, I assume that as further improvements in costing are made, similar changes will be made in all candidate cost segments, and efforts to estimate incremental costs will be more inclusive than just costs found to be group-specific.

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<sup>6</sup> At the August 27, 2008 technical conference, the Postal Service indicated that "predominantly" might be enough.

**A. The Volume-variable Costs of Products Should, by Definition, Be Taken as Their Attributable Costs.**

In order to set the stage for the material to follow, I want to clarify that the volume-variable costs of products should, by definition, be taken as their attributable costs, and, therefore, that their attributable costs should not include any other costs, such as fixed costs that are product-specific. Similarly, the attributable costs of a *group* of products should not include any costs that are *group*-specific.

All paths to volume-variable costs are rooted in the marginal-cost concept. A volume-variable cost can be developed as (a) the product of the marginal cost and the volume, (b) the accrued cost multiplied by the quotient of the percent change in cost and the percent change in volume, or (c) the product of the accrued cost and the elasticity of accrued cost with respect to output. These alternatives are mathematically and conceptually equivalent; each is built from a focus on the marginal cost and each yields a unit volume-variable cost that is an estimate of the marginal cost.<sup>7</sup>

Our understanding of the efficiency of any set of rates is tied to the differences between the prices and the marginal costs. The importance of basing attributable costs on volume-variable costs, then, is easy to see: if the attributable costs are not the volume-variable costs, then the unit attributable costs are not estimates of the marginal costs, and the tie to efficiency is lost. Accordingly, the unit attributable costs would not be useful in assessments of the rates. Also, maintaining a tie to marginal cost is

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<sup>7</sup> Unavoidably, this paragraph uses the term *product* in two ways. The first is to refer to a product as defined in the Mail Classification Schedule. The second is to refer to a multiplicative product, the result of multiplying one number by another number. The term *quotient*, of course, refers to the result of *dividing* one number by another number.

important to the effectiveness with which the Postal Service can compete, since competitors, supplying anything from electronic alternatives to private delivery services, tend to charge prices that are equal to *their* marginal costs.<sup>8</sup>

Adding another cost to the volume-variable cost yields a sum with no efficiency properties, as well as one that cannot be interpreted. Suppose, for example, a production process is operating at an output level of 100,000 pieces. If an additional piece can be produced for an additional 10 cents, we know that the marginal cost is 10 cents. If one product-specific cost exists and it is \$500, the unit product-specific cost is 0.5 cents ( $\$500 \div 100,000$ ). But the sum of 10 cents and 0.5 cents is not a figure with meaning, even though it would be the unit attributable cost if the product-specific cost were to be attributed.<sup>9</sup>

Because of their tie to marginal costs, the character of volume-variable costs is that they are reflections of the behavior of associated costs at the margin. They are not

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<sup>8</sup> It is often observed that competing firms, specifically those operating in the private sector, might have fixed costs of their own (just like the Postal Service) and might not be able to exist by charging prices equal to their marginal costs. There can be some truth to such an observation. However, it is also true that such firms would be expected to maintain optimal capacity levels, within which they would find it most profitable to be relatively high on their marginal cost curves, which would lead to relatively high prices, which would be high enough to cover all of their fixed costs and allow a normal level of profit.

<sup>9</sup> Another difficulty associated with adding product-specific costs to volume-variable costs can be seen by thinking about the exercise of comparing the costs of two products. Suppose Product A is produced in operations that are peculiar to Product A, and an analysis of these operations attributes both volume-variable costs and product-specific costs. And suppose Product B is produced in operations servicing *several different* products, and an analysis of these operations attributes volume-variable costs but no product-specific costs. Now, if the unit attributable cost of Product A is compared to the unit attributable cost of Product B, it will tend to appear that Product A is more costly—indeed it has product-specific costs and Product B does not. This is misleading and is unfair to Product A, as well as to any interest the Postal Service has in being competitive. Fundamentally, the problem is a lack of a common denominator, which always makes comparisons anomalous.

a reference to identifiable portions of cost pools that are variable.<sup>10</sup> One implication of their having this character is that they can be larger than the associated accrued costs (as would be the case when, for example, [a] the marginal cost is elevated due to a high rate of utilization of capacity, [b] a 10 percent increase in volume causes a 13 percent increase in cost, or [c] the elasticity of accrued cost with respect to volume is 1.2<sup>11</sup>). An incremental cost, on the other hand, *cannot* be larger than the associated accrued costs (at least not until costs due to reconfiguration are considered). This difference in bounding, by the way, should provide warning that the usefulness of volume-variable costs in estimating incremental costs can be limited, as discussed further below.

**B. It Is True That Commission Rule 3015.7(a) Calls for a Measure of Incremental Cost and an Associated Cross-subsidy Test for the Competitive Products as a Group, but There Is More to Preparing an Estimate of the Incremental Cost than Simply Adding Costs Found to Be Group-specific to Costs Found to Be Volume Variable.**

Quite properly, Commission Rule 3015.7(a) calls for an estimate of the incremental cost of the competitive products as a group, and, consistent with prior Commission positions and the literature, this incremental cost is equal to the reduction in total cost that would be allowed if all of the volume of the competitive products were

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<sup>10</sup> If it is understood that the level of an accrued cost, comprising a cost pool, varies proportionately with volume, it is the case that the accrued cost is volume variable. But such an understanding can be valid only in cases where the marginal cost is equal to the unit accrued cost. Therefore, a finding that a pool of accrued costs is volume variable is anchored in volume-variability being a reflection of the behavior of the costs at the margin, as quantified by the marginal-cost measure.

<sup>11</sup> The elasticity of accrued cost with respect to volume is often a coefficient in a regression equation. There is no reason why such a coefficient cannot be greater than 1.0.

to be withdrawn and the Postal Service were to reconfigure its operations to produce, as efficiently as possible, the products that remain, which, as implied, would be the *market-dominant* products. It seems clear, then, that the Postal Service should develop, present, and defend such an estimate.

Estimating the level of an incremental cost is not a simple exercise. If reality were dominated by marginal cost curves that are horizontal over wide ranges of output, group-specific costs that are well defined, and production processes that do not need to be reconfigured when significant portions of volume of are withdrawn, it might make sense, at least as a first cut, to estimate an incremental cost by adding group-specific costs and volume-variable costs, as the Postal Service proposes. But the behavior of costs is not generally this stylized; thus, it should not be expected that estimates of incremental costs can necessarily be developed with any precision by adding costs in this way.

Marginal costs are associated with small changes in volume, whereas incremental costs are associated with large changes in volume. Also, marginal costs are required to be *ceteris paribus* in character (meaning that the volume of one product is changed while the volumes of all other products remain unchanged), whereas the incremental cost of a group requires that the volumes of all products in the group be changed at once. In addition, marginal cost curves need not have a particular slope or shape. An obvious question, then, more important at the level of a *group* of products than at the level of a *single* product, concerns the extent to which volume-variable costs are useful in estimating incremental costs. If the Postal Service uses them, as it would

be doing if it added group-specific costs to the summation of the associated volume-variable costs, it should justify the usage.

In the Postal Service scheme to attach “product activity attributes” to finance numbers, the C-attribute, as set out above, pertains to costs that support both the market-dominant and the competitive products. But, as is common in exercises in Activity Based Costing, a further question needs to be asked. Specifically, it needs to be asked whether the size of any C-activities could be reduced if the competitive products were to be withdrawn. For example, a group of eight lawyers might work variously on suits relating to both groups of products, and it might be difficult to identify portions of this group that are exclusive to one product group or the other. Nevertheless, the withdrawal of the competitive products in their entirety might allow the size of this group to be reduced to five. This would be a change involving *reconfiguration*. The difference in cost between eight lawyers and five lawyers would become part of the incremental cost of the competitive products.

These considerations and related ones must receive attention when preparing estimates of incremental costs.

**C. The Definition of Institutional Cost Should Not Be Changed. It Makes No Sense to Reduce the Institutional Cost by the Amount of Any Pools of Fixed Costs That Are Found to Be Group-specific.**

Except for issues relating to whether product-specific costs should be attributed, discussed above in section II-A, the term *institutional cost* has been defined heretofore as the total cost (of the Postal Service) minus the sum of all volume-variable costs. It is

thus a *residual* cost, not a cost that can necessarily be identified directly.<sup>12</sup> As a *residual*, it is a measure of the cost that would not be covered if the rates were equal to the marginal costs, a reference point that is widely regarded as the economic ideal. As such (assuming breakeven), the level of the institutional-cost figure is the backdrop guide to the process of selecting the markups of rates over marginal costs. These “markups,” whether expressed on a per-piece basis or on a percentage basis or in some other way, are relevant to issues of resource allocation and the economic efficiency of the rates – they are, clearly and quite specifically, the contributions to covering the institutional cost, the definition of which should not be changed.

Attention to efficiency, including the efficiency of the rates, is clearly expected

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<sup>12</sup> It may seem strange to say that an institutional cost cannot necessarily be identified directly, particularly when there are many examples of pools of costs that do not vary with volume, that are not attributed, and that translate directly into an institutional cost. At the end of the analysis, however, the institutional cost *is* the difference between total cost and the sum of all volume-variable costs, and *is not* necessarily equal to the sum of pools not attributed or the sum of pools found to be fixed.

The problem can be seen with a simple example. Suppose a product is supported by a fixed cost of \$1,000 and a pool of labor costs found in a base period to be \$5,000. And suppose, due to the nature of the production process and how it is being manned, the labor cost is found to have an elasticity of 1.05, meaning that a 10 percent increase in volume would cause a 10.05 percent increase in labor cost. The volume-variable cost is \$5,250 ( $5,000 \times 1.05$ ). The total cost is \$6,000. The institutional cost is \$750, the residual of \$6,000 minus \$5,250. It makes no sense to point to the \$1,000-pool of fixed costs as being part of the institutional cost, and, except that it is part of the accrued cost, knowing about the \$1,000-pool does not help in estimating the institutional cost.

The situation would change somewhat if the elasticity of the labor cost were instead found to be 0.85, in which case we would say that the labor cost is 85 percent variable. Here, the volume-variable cost would be \$4,250 ( $5,000 \times 0.85$ ), the total cost would be \$6,000, as before, and the institutional cost would be \$1,750, the residual of \$6,000 minus \$4,250. Here one could argue that the fixed cost of \$1,000 is “part of” the institutional cost. But another \$750 of institutional cost comes from labor, and there is no way to look at the labor pool and see which \$750 is fixed. The variability of 85 percent does not come from an identifiable (or unidentifiable) portion of labor cost that is fixed. Rather, the \$750 is a reflection of the behavior of the pool of labor costs, at the margin.

under the Act,<sup>13</sup> whether in pre-implementation reviews, annual compliance reviews, or complaints. The Act points to one kind of efficiency or another 24 times. Notably: § 101(a) refers to “prompt, reliable, and efficient services to patrons”; § 3622(b)(1) provides an objective of “maximiz[ing] incentives to reduce costs and increase efficiency”; § 3622(c)(12) points to “the need for the Postal Service to increase its efficiency and reduce costs”; and § 3622(e)(2)(A)(ii) allows that certain constraints on workshare discounts need not be honored if the discounts are “necessary to induce mailer behavior that furthers the economically efficient operations of the Postal Service.” The last three of these sections are from the subchapter containing provisions relating to rates. Because one set of rates instead of another cannot affect

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<sup>13</sup> In a discussion of the need for elasticity measures, in Order No. 104 (August 22, 2008), the Commission pointed specifically to evaluating the efficiency of the rates as being required by the Act, saying:

Further, many of the objectives and factors that the PAEA directs the Commission to consider in establishing a regulatory system for market dominant products involve value of service considerations, either explicitly (see sections 3622(c)(1) and 3622(c)(8)), or implicitly (see sections 3622(c)(3) and 3622(c)(4)). The most objective evidence of a product’s value of service is its price elasticity of demand. Accordingly, demand elasticities provide useful guides for evaluating how well these factors have been recognized in rates. Knowledge of price elasticities of demand is also essential for evaluating the impact of rates on allocative efficiency. Allocative efficiency is a goal embodied in sections 3622(b)(1) and 3622(b)(5).

The PAEA requires the Commission to ensure that the institutional costs of the Postal Service are allocated appropriately between market dominant and competitive products. See sections 3622(b)(9) and 3633(a)(3). Doing so in a way that takes allocative efficiency into account requires the Commission to have knowledge of the relative price elasticities of both market dominant and competitive products.

P. 10, footnote omitted.

the productive efficiency of the Postal Service,<sup>14</sup> these references, to the extent they are applicable to rates, must refer to the economic efficiency of the overall postal sector, including mailers and their objectives, which relative rates can affect. Such a focus is at the heart of the attention given in the past to notions of *lowest combined cost*. But if volume-variable costs and the markups over them (which are the contributions to covering the institutional cost) are not available, these efficiencies cannot be evaluated.

The Postal Service explains that its “analysis of group-specific costs . . . would supplement existing volume-variable and product-specific analys[e]s” (p. 7). It also states: “To the extent costs are group-specific costs, the remaining ‘institutional cost’ will be a smaller amount than it would be otherwise.” (p. 6.) Thus, although it is somewhat unclear whether the definition of attributable cost is proposed to be changed, it is tolerably clear that the definition and meaning of institutional cost is proposed to be changed. A change should not be made.

As a first cut at estimating an incremental cost, to allow a cross-subsidy test, conditions may make it defensible to add measures of group-specific costs to volume-

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<sup>14</sup> One set of rates instead of another can affect relative volumes, but one set of volumes instead of another cannot affect the productive efficiency of the operations involved. It is true that relative volumes can affect the realization of scale economies, but this would be nothing more than a movement along a cost curve, not a movement from one cost curve to a more (or less) efficient one. *Thus, rates cannot affect the Postal Service’s productive efficiency.* This can be seen, for example, by considering that any measure of productive efficiency (or overall productivity) would be found by applying fixed quantity weights to elemental output/input ratios, consistent with the Postal Service’s TFP measure, and that these ratios would be invariant (except for scale effects) to the product mix. In other words, the cost of handling a sack is what the cost of handling a sack is, and changing the number of sacks processed would not change it or any associated efficiency measure. And if no efficiency measure is affected at the disaggregate level, then no efficiency measure can be affected at the aggregate level. Certainly it is desirable for the cost of handling a sack to be low instead of high, but changing rates will not cause such a cost to change.

variable costs (or to functions of volume-variable costs). But it is not necessary to change how the institutional cost is defined or estimated.

Perspective on the meaning and dimensions of the changes at issue can be developed by considering the concepts involved and some actual figures. By definition, the incremental cost of the competitive products is equal to the total cost (of the Postal Service) minus the stand-alone cost of the market-dominant products. Similarly, the incremental cost of the *market-dominant* products is equal to the total cost minus the stand-alone cost of the *competitive products*. And, obviously, the sum of the two stand-alone costs minus the total cost is equal to the economies available by producing the two groups of products jointly. Stated in the converse, these relationships, all of which are definitional, imply that the total cost minus the sum of the two incremental costs is equal to the same economies figure. Therefore, if accurate measures of the incremental costs of the two groups of products were available, reducing the current institutional cost<sup>15</sup> by (a) the *difference* between the incremental cost and the volume-variable costs of the market-dominant products and (b) the *difference* between the incremental cost and the volume-variable costs of the competitive products, which two differences are in the crosshairs of the Postal Service's attention to group-specific costs, *would yield* a new level of institutional cost, which *would be* equal to the economies of joint production. Thus, the Postal Service proposal, if carried out thoroughly, would change substantially the *meaning* of the institutional-cost measure.

The Postal Service proposal would also change the *magnitude* of the

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<sup>15</sup> The Postal Service states: "To the extent costs are group-specific costs, the remaining 'institutional cost' will be a smaller amount than it would be otherwise." (p. 6.)

institutional-cost measure, probably by a considerable amount. A rough estimate of this change in magnitude can be developed by making a few assumptions and drawing on cost figures in the recent Annual Compliance Determination.<sup>16</sup> Specifically, I make three assumptions. (1) When the competitive products are withdrawn, minimal or no reconfiguration is required to continue producing the market-dominant products efficiently. Given that the competitive products account for only 0.77 percent of total volume,<sup>17</sup> this may be a reasonable assumption, at least for rough-estimate purposes. (2) The incremental cost of the competitive products is \$7 billion. Currently, the attributable cost of the competitive products is \$6.1 billion (Compliance Determination, p. 24), so the assumption is that \$0.9 billion beyond the attributable costs could be avoided if the competitive products were withdrawn.<sup>18</sup> (3) The stand-alone cost of the competitive products is \$9 billion.

These assumptions have several implications. First, we know that the economies of joint production are the *difference* between (a) the cost of producing the competitive products in a stand-alone operation (assumed above to be \$9 billion) and (b) the additional cost of producing them along with the market-dominant products (assumed above to be \$7 billion), *which is* \$2 billion. Second, we know from the

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<sup>16</sup> PRC, March 27, 2008 (hereinafter “Compliance Determination”).

<sup>17</sup> The Compliance Determination (p. 24) shows the volume of the competitive products to be 1,630,916,000 and the volume of the market-dominant products to be 210,603,104,000.

<sup>18</sup> The current revenue from the competitive products is \$7.9 billion (Compliance Determination, p. 24). If the incremental cost were *above* \$7.9 billion, one would expect the Postal Service to be contemplating eliminating its competitive products. Since it apparently is not, the incremental cost of the competitive products needs to be between \$6.1 billion (the current attributable cost, Compliance Determination, p. 24) and \$7.9 billion.

definitional relationships that, if reliable estimates were available, the difference between the total cost of the Postal Service and the sum of the two incremental costs would also be equal to the economies of joint production, and thus equal to the same \$2 billion. Therefore, if the sum of the group-specific costs (of the two groups of products) were equal to (a) the sum of the two incremental costs minus (b) the sum of the two attributable costs, which is a necessary condition for the procedure outlined by the Postal Service to yield reliable estimates of the incremental costs, the “remaining” (p. 6) institutional cost under the Postal Service proposal would be \$2 billion. Thus, carried to its logical end point, the proposal would reduce the level of institution cost from \$31.6 billion (Compliance Determination, p. 24) down to \$2 billion.<sup>19</sup>

In short, if the scheme proposed by the Postal Service leads at some point to an accurate measure of the incremental costs, it will reduce the institutional cost from the current level of \$31.6 billion to a new level that I estimate to be \$2 billion, and the Postal Service would apply the Commission-determined appropriate-share proportion to the \$2 billion. This is a massive change. Adjustments could be made to my assumptions, such as increasing the estimate of the stand-alone cost of the competitive products, but the change would remain massive.

There may be one further problem with redefining the institutional-cost term in the way proposed. By my count, the Act refers to institutional costs at least seven

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<sup>19</sup> As a practical matter, note that reaching the result of \$2 billion requires that incremental costs be developed for *both* the market-dominant and the competitive products. If, as recommended further on in the text, incremental costs are not developed for the market-dominant products, or if the incremental-cost estimate for them is less inclusive or less accurate than the estimate for the competitive products, the resulting institutional-cost figure would be unbalanced, unreliable, and likely lopsided. The possibility of having this happen should be considered a supporting reason for not redefining the institutional-cost term.

times. These references bear examination.

1. Section 3622(b)(9) refers to “allocat[ing] the **total institutional costs** of the Postal Service appropriately between market-dominant and competitive products” (emphasis added).
2. In a supporting provision, section 3633(a)(3) requires “that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs.”
3. Section 3633(b) requires an every-five-year review by the Commission to “determine” whether the 3633(a)(3)-provision should be “retained in its current form, modified, or eliminated.” Taken together, these three sections make it clear that the institutional-cost figure is a key element in Congressional thinking, and the focus is on the “total” institutional cost.
4. Section 3622(c)(2) contains a “requirement that each [product] . . . bear the direct and indirect postal costs attributable to [it] . . . plus that portion of all other costs . . . reasonably assignable to [it].” This section is identical to a corresponding section in the Postal Reorganization Act of 1970, which received detailed attention in NAGCP I (569 F.2d 570 [D.C. Cir. 1976]), NAGCP III (607 F.2d 392 [D.C. Cir. 1979]), and NAGCP IV (462 U.S. 810 [Supreme Court 1983]). The latter opinion upheld as a “reasonable construction” the Commission’s “two-tier” approach under which the 1970 Act’s reference to “all other costs” is taken as a reference to the institutional cost, defined on “costs attributable,” meaning that the institutional cost is the difference between total cost and the sum of all

attributable costs. Based on these opinions and Commission practice to date, the “portion of all other costs . . . assignable to” a product has been an influential determinant of its rates.

5. Section 3622(c)(10) states that one justification for “special classifications” is that they “improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs.” At least in so far as rates are concerned, any increase in the “overall contribution,” and thus in net income, would be equal to the increase (or decrease) in revenue minus any increase in (or plus any decrease in) cost, which requires attention to marginal costs. The notion of institutional cost envisioned, then, is linked to volume-variable costs and to marginal costs, not to the level of the incremental cost or to any figure derived from product-specific or group-specific costs.
6. Section 3622(e)(3)(A) allows that workshare discounts need not be reduced if doing so would “lead to a loss of volume in the affected category . . . and reduce the aggregate contribution to the institutional costs of the Postal Service.” For pieces that respond to changes in workshare discounts, reductions in “aggregate contribution” are defined on changes in per-piece revenue and in costs at the margin. Attention to marginal costs cannot be avoided.
7. Section 3652(b)(3) refers to an annual report submitted to the Commission that is required to focus, among other things, on workshare

discounts and their “per-item contribution . . . to institutional costs.” The per-item contribution is equal to the price minus the unit volume-variable cost.

The application of these sections ranges from the assignment of institutional costs to products, to workshare discounts, to special classifications (including NSAs), but they are of one accord. Strained interpretations are not needed. They all point directly to an institutional-cost figure that is (a) a substantial ingredient in ratesetting, (b) defined on total cost and volume-variable costs, and (c) covered by contributions equal to the differences between the prices and the unit volume-variable costs. One has to ask whether Congress contemplated redefining the term institutional cost, particularly in a way that (a) relegates the assignment of the institutional cost to being a near-negligible exercise (at an estimated \$2 billion) and (b) makes these sections either misleading or less than straightforward to interpret. Viewed another way, these sections appear to imply their own definition of the institutional-cost term, and the definition implied is the traditional one.

No redefinition of institutional cost is necessary or warranted. It is simple in theory to test whether the revenues of the competitive products cover the associated incremental cost. It is also simple to test whether these revenues cover the aggregate volume-variable cost plus the Commission-determined share of institutional cost. These tests are separate and independent of one another. If both of them are passed, the law should be satisfied. Group-specific costs may be useful in developing an estimate of the incremental cost, but they should not be subtracted from the current

institutional cost.<sup>20</sup> Similarly, neither volume-variable costs nor attributable costs should be augmented to align with any measure of incremental cost. Incremental costs are a separate concept, designed for cross-subsidy tests.

Finally, there is no justification or logic to support adding the Commission-determined share of institutional cost to the incremental cost and using the sum in a test. Rather, there is a compelling logic to suggest that this should not be done. Based on a range of non-cost considerations (including ones relating to welfare, value of service, marketing factors, profit, and policy), now constrained by a cap at the class level, rates are generally set above marginal costs. The purpose of the incremental cost test is to determine whether the rates are far enough above the marginal costs to cover all costs that could be avoided if the products were to be withdrawn. It is regarded as a *fairness* test, not one based on reasoning that is inherently economic.<sup>21</sup>

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<sup>20</sup> Under the heading of Restricted Institutional Costing, it has been suggested and squelched that there is something to be gained at the level of the product (though never made operational at the level of groups of products) by a two-step process, the first elevating volume-variable costs by the amount of product-specific costs and the second elevating this sum by a portion of the remaining institutional cost. The reason these procedures have been denounced is that they are illusory and potentially distracting. Specifically, what is important is the distances of the rates from the marginal costs, and the number of steps should have no effect.

<sup>21</sup> The fairness character is straightforward. If the competitive products are being tested, the market-dominant products are saying: "It would not be fair for the existence of the competitive products to cause our rates to be higher than they otherwise would be." The test presumes that over the long term, losses by the competitive products must be made up by the market-dominant products. An alternative would be for the competitive products to be subsidized by a Congressional appropriation. Either way, the Act's prohibition against such a cross-subsidy is evidence that Congress does not want the issue to be faced.

The view that the incremental cost test is based on reasoning that is not inherently economic can be puzzling. Two notes may be helpful. First, the incremental cost test is not implied by or connected to the larger economic framework, which includes production theory, consumer theory, and the theory of value. Second, it is widely understood that Ramsey solutions, which *are* inherently economic, can fail the incremental cost test.

It is thus one fact on the question of whether enough of the institutional cost is covered. Viewed in this way, checking to see if the revenues are larger than the attributable costs plus the Commission-determined share is nothing more than another way to approach the same question. Therefore, adding the Commission-determined share to the incremental cost would be double counting. There is no basis for such double counting. It is inconsistent with the notion behind the incremental cost test. It should not be done.

**D. The Incremental Cost of the Market-dominant Products as a Group Does Not Need to Be Developed for Purposes of a Cross-subsidy Test.**

Because the market-dominant products account for such a large proportion (99.23 percent, *ibid.*) of the total volume of the Postal Service, developing an estimate of their incremental cost would be an extremely difficult undertaking. One way of thinking about such an assignment is that it would require, either directly or indirectly, developing an estimate of the *stand-alone* cost of the *competitive* products. That is, the total cost of the Postal Service minus the stand-alone cost of the competitive products is equal to the incremental cost of the market-dominant products.

Based on the assumptions made above about the sizes of the incremental cost and the stand alone cost of the competitive products, then, an estimate of the incremental cost of the market-dominant products can be developed. Specifically, the incremental cost of the market-dominant products equals the total cost of the Postal Service (\$77.2 billion, excluding the escrow payment, Compliance Determination, p. 24) minus the stand-alone cost of the competitive products (assumed above to be \$9 billion), which is \$68.2 billion. The total attributable cost of the market-dominant

products is \$37.5 billion (Compliance Determination, excluding special services, p. 24). If the difference between the incremental cost and the attributable cost were made up of group-specific costs, the rough estimate is that \$30.7 billion (68.2 - 37.5) of group-specific costs for the market-dominant products would need to be found. Of course, as explained above, developing an incremental cost involves more than searching for group-specific costs. Nevertheless, these numbers make it clear that a great deal of analysis would be required.<sup>22</sup>

Although the Postal Service may see reasons for searching for identifiable pools of fixed costs that support only or predominantly the market-dominant products, I see no reason to develop an estimate of the incremental cost of the market-dominant products or to perform an associated cross-subsidy test.<sup>23</sup> The logic of no-such-test is easy to see: in the interest of keeping the rates for the market-dominant products low, if the competitive products, in addition to contributing a profits tax, are able to contribute a portion of their net income as well, they should do so.

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<sup>22</sup> Part of the difficulty of estimating the incremental cost of the market-dominant products is that their withdrawal would undoubtedly bring about a considerable degree of reconfiguration. For example, if only the competitive products remained, many of which are parcels, the Postal Service might see a need for vehicles of a different design and might find flexible routes preferable to its current fixed routes. Also, the number of post offices would be reduced substantially, as would the number of processing facilities.

<sup>23</sup> The question of a cross-subsidy test for a *group* of products is different from the question of whether *individual products* “bear the direct and indirect postal costs attributable to” them, which is the subject of § 3622(c)(2) of the Act, and there is little or no relation between them.

Respectfully submitted,

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