

Before the
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Periodic Reporting

Docket No. RM2008-2

PUBLIC REPRESENTATIVE REPLY COMMENTS
CONCERNING TREATMENT OF GROUP-SPECIFIC COSTS

September 15, 2008

In response to the Commission's Notice of Proposed Rulemaking on Costing Methods Used in Periodic Reporting (Order no. 99), several parties have filed comments taking exception to the Postal Service's Proposal One to move a portion of headquarters institutional costs (cost segment 18) to either market dominant or competitive categories, based on results of a new survey. In particular, Robert W. Mitchell claims that the Service's Proposal would fundamentally redefine the notion of institutional costs.¹ He also claims that under the Service's Proposal there would be a "massive" shift of costs from the institutional side that would significantly affect the Service's flexibility in setting rates. Mitchell at 15. Last, he states that attributable costs should be constrained to the volume variable portion of total costs in which case a redefinition of institutional costs is not required. Mitchell at 9. According to Mitchell, preserving this visibility for volume variable costs is essential for efficient rate setting by the Postal Service.

¹ Initial Comments of Robert W. Mitchell on Changes in Costing Methods in Response to Order No. 99, September 8, 2008 at 13 (Mitchell).

VALPAK also takes exception to the Service's Proposal but for different reasons.² They claim that the Service request does not go far enough in determining whether headquarters product-specific and group-specific fixed costs should be assigned to competitive products. VALPAK at 4. In particular, VALPAK would not limit assignment of group-specific costs to competitive products just for those finance numbers (FNs) that the Service considers to fully support competitive product activity. Id. They prefer that the Service also analyze FNs that support both market dominant and competitive categories to determine if any of these costs would be avoided if one or more of the supported competitive products were eliminated. VALPAK at 9. If so, then the avoided costs should be assigned as group-specific to competitive products, according to VALPAK.

However, they are largely silent on whether market dominant products should be subject to similar treatment on these "mixed" FNs, or even whether costs for FNs that support fully market dominant products can be assigned as fully or partially incremental to market dominant products. There only reference to market dominant products is in a footnote where they state "Within CS18, only those Finance Numbers that are group-specific to market-dominant products will not require more detailed inquiry". Id.

In sum, it appears that VALPAK's current proposal could be interpreted as leading to a division of total accrued costs into: a) a competitive incremental portion and a market dominant stand-alone portion or b) a competitive incremental portion, a market dominant volume variable portion, and an institutional cost portion which

² VALPAK Direct Marketing Systems, Inc. and VALPAK Dealers' Association, Inc. Comments Regarding Costing Methods Used in Periodic Reporting, September 8, 2008 (VALPAK).

includes true enterprise-level common costs and product/group-specific fixed costs for market dominant products. The latter would not appear to support an effective rate-setting process. The former fails to consider that the current division of postal products into market dominant and competitive products will undoubtedly change in the future. As liberalization progresses, products or product components now considered as market dominant, but not protected by the postal monopoly, and outside the scope of the USO will be eligible for reclassification as competitive, if competition for markets serviced by these products increases sufficiently. Developing incremental costs for these products for comparison with product revenues will be an essential feature for determining whether reclassification is possible.

The remainder of these comments address Mitchell's concerns in more detail. They demonstrate why the incremental cost concept should eventually be expanded and applied to all postal products, competitive and market dominant, to support effective product profitability analysis and management.

THE LINK BETWEEN INCREMENTAL COSTS AND ECONOMIC EFFICIENCY

As Mitchell recognizes, there is a link between marginal costs and the development of efficient rates. However with scale economies the link is not precise in either a regulated or competitive setting. It is well known that with a regulated multi-product monopoly firm, demand factors and marginal costs both come into play in developing second best or Ramsey rates that are above marginal costs. Likewise in a liberalized postal environment where scale effects exist, strict marginal cost pricing would lead to product/firm losses and therefore is impossible. Instead when active

competition or the threat of competition exists, product prices tend to fall towards unit incremental costs. Further, this tendency for prices to be close to or equal to unit incremental costs is what drives increases in economic efficiency in competitive markets when firms are free to enter and exit such markets and are under no cross-subsidy threat.

As an example, consider two multi-product rivals who compete only in one homogenous (commodity like) product that they both produce. They are market dominant in provision of their other products and can therefore set rates above stand-alone costs for these products (considered as a group) without attracting competition. Suppose rival A has constant marginal costs MC_A and product-specific fixed costs F_A for the competitive product. Similarly, rival B has constant marginal costs MC_B and product-specific fixed costs F_B for the same product. Assume firm A serves the entire market for the product initially at a price yielding zero product profits. The price for the product would then equal firm A's average unit incremental cost at a volume X_A where $P_A = F_A/X_A + MC_A$. The firm has no incentive to increase price to yield positive profits because of the threat of entry by the second firm. However the second firm can evaluate whether profits are possible at the observed price and quantity using its own cost structure.

In particular even without knowledge of the market demand function, the firm can evaluate its unit contribution from the product at the observed price and quantity as $P_A - (F_B/X_A + MC_B)$. If positive, firm B can enter the market by setting its own rate P_B slightly lower than P_A , expand volume and still retain some positive contribution

from the product. In that case, welfare is improved by the increase in consumer surplus yielded by $P_B < P_A$ and the positive contribution retained by firm B.

Although admittedly uncomplicated, the example serves to illustrate the role played by unit incremental costs in serving as a signal for efficiency enhancing market entry. Firm B will enter if its marginal cost MC_B and its unit fixed incremental cost at the observed volume level F_B/X_A or both costs are lower than the corresponding costs for firm A. In fact, even if firm B's marginal cost is highest, entry will occur if savings in unit fixed incremental cost are greater than the difference in marginal costs.³

Furthermore, in this case, neither firm has a strategic incentive to cross-subsidize the competitive product because of the threat of ruinous competition. The market alone ensures that the welfare enhancing solution is achieved. Notice additionally, that although Firm B is the sole provider of the product, its market power is effectively constrained because the market is contestable. It can charge a price that is no higher than P_A without attracting entry.

Now compare this situation with firm A competing against another firm C instead that offers only the competing product. Further assume that the firm has the same cost structure as firm B, $MC_C = MC_B$ and $F_C = F_B$. So if firm A were to price at its unit incremental cost as above, then firm C could price below that and conceivably the same welfare enhancing result could be achieved. However this situation is fundamentally different because firm C has no market dominant position. If Firm C enters the market, Firm A can cross-subsidize its competitive product and set a price which is everywhere lower than Firm C's unit cost curve. Firm C must eventually exit

³ More generally, Firm B would enter if $(MC_A - MC_B) + (F_A - F_B)/X_A > 0$.

and Firm A can then raise its price to the original level or higher to yield a positive contribution. This leads to a stable suboptimal result because Firm A has established a credible cross-subsidy threat.

However a regulator can foreclose this latter possibility and foster efficiency enhancing competition by ensuring that a dominant firm's contribution remains non-negative for individual competitive products, for groups of such products and for the total competitive offering. Therefore a capability to determine incremental costs at the same three levels is required because actual or potential competitors can compete across one or more products offered by the dominant firm. This is already well recognized as an essential feature of a robust incremental costing capability for competitive products. However as suggested previously with respect to the Postal Service, the system should also be flexible enough to include current market dominant products that are potential candidates for reclassification to competitive status. The Appendix highlights how the incremental cost test for competitive products as a whole can be reconstituted flexibly to deal with new product conversions.

CONCLUDING COMMENTS

In summary, the Public Representative supports the Postal Service's conversion of certain institutional costs in cost segments 16, 17, 18 and 20 to group-specific status at this time when the necessary criteria, stated in the initial comments, are met.^{4,5} The cost avoidance principle should be followed and necessary

⁴ Public Representative Comments in Response to Order No. 99, September 8, 2008 at 2-3.

⁵ On September 5, 2008, the Postal Service introduced a Notice to expand the scope of Proposal One described in PRC Order No. 99 to include certain costs in the stated cost segments linked to costs in cost segment 18 Finance

documentation and/or studies should be provided by the Service showing how costs proposed for transfer would be avoided in the stated amounts. Additionally, following the same principle, the Public Representative would support further expansion of the incremental costing process to eventually include all postal cost segments and products. Such an evolution would facilitate effective product management and support further postal liberalization.

Marginal costing will continue to be an important factor in product pricing. Given the Postal Service's added pricing flexibility, knowledge of marginal costs and demand factors will still be an essential ingredient for efficient pricing, particular on the market dominant side. The same factors will also be important in pricing competitive products especially when a residual degree of market power exists. However, revenues and incremental costs will determine absolute profitability and market status for these products and must therefore be considered at least equally important for decision-making purposes.

Numbers. 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.

Respectfully Submitted,

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APPENDIX

OBSERVATIONS ON INCREMENTAL COSTING TO FACILITATE CONVERSION OF MARKET DOMINANT PRODUCTS TO COMPETITIVE STATUS

Consider a regulated market dominant firm with two market dominant products, M_1 and M_2 , and two competitive products, C_1 and C_2 . The total system cost function can then be written as $TC = C(M_1, M_2, C_1, C_2)$. Incremental costs for market dominant and competitive products considered as a group would then be $IC_M = C(M_1, M_2, C_1, C_2) - C(0, 0, C_1, C_2)$ and $IC_C = C(M_1, M_2, C_1, C_2) - C(M_1, M_2, 0, 0)$, respectively. The difference between total costs and the sum of these incremental costs is an absolute measure of scope economies. Call this measure SE. Then as Mitchell mentions, institutional costs could be reconstituted to equal SE from:

$$I = SE = TC - IC_M - IC_C. \quad (1)$$

Now consider that incremental costs for each of the two market dominant products are: $IC_{M1} = C(M_1, M_2, C_1, C_2) - C(0, M_2, C_1, C_2)$ and $IC_{M2} = C(M_1, M_2, C_1, C_2) - C(M_1, 0, C_1, C_2)$, and that similar to the system level measure, a scope economies measure within the market dominant group can be shown as $SE_M = IC_M - IC_{M1} - IC_{M2}$. Similarly, we can establish $SE_C = IC_C - IC_{C1} - IC_{C2}$ for the competitive group. Using the last two to substitute for IC_M and IC_C in (1), we then get: $I + SE_M + SE_C = TC - (IC_{M1} + IC_{M2} + IC_{C1} + IC_{C2})$. The sum of the three scope economy measures is equal to the difference between total costs and the sum of all product-specific incremental costs. As long as one of the three measures is positive, there are scope economies evident somewhere in the system.

Now consider a transfer of the second market dominant product to competitive status. Then the new group incremental cost can be defined as

$$IC_C^* = C(M_1, C_3, C_1, C_2) - C(M_1, 0, 0, 0), \quad (2)$$

where $C_3 = M_2$. By adding and subtracting $C(M_1, C_3, 0, 0)$ from the right hand side of (2), IC_C^* can be rewritten as:

$$IC_C^* = IC_C + C(M_1, C_3, 0, 0) - C(M_1, 0, 0, 0). \quad (3)$$

Next, compare the last two terms on the right of (3) with the incremental cost $IC_{M_2} = C(M_1, M_2, C_1, C_2) - C(M_1, 0, C_1, C_2)$. If the presence of positive volumes for the competitive products does not affect IC_{M_2} , then $C(M_1, C_3, 0, 0) - C(M_1, 0, 0, 0) = IC_{M_2}$ and IC_C^* can be obtained by adding the incremental cost of the product when under the market dominant category to IC_C or $IC_C^* = IC_C + IC_{M_2}$.⁶ However if scope economies were to exist across product types, then $C_1 > 0$ and/or $C_2 > 0$ would lead to $IC_C^* - IC_C > IC_{C_3} = IC_{M_2}$. In those cases, the required adjustment to total incremental costs for competitive products considered as a group would be greater than the addition of the new product-specific incremental cost.⁷

As a first cut, IC_C^* could be calculated as $IC_C^* \approx IC_C + IC_{M_2}$. However the problem with that approach is that IC_C^* would be understated if scope economies exist across products, as just indicated, and therefore total revenue from all competitive products might be less than IC_C^* because of the understatement. That issue can be addressed by instituting a capability to calculate IC_C^* directly from an incremental

⁶ It is also clear that IC_{C_3} , the new product-specific incremental cost, is equal to IC_{M_2} since production for all other products is assumed in both calculations regardless of status.

⁷ In the postal arena, this is easier to see in the context of city carrier costs. In particular, street access costs would be subject to scope economies regardless of mail status (market dominant or competitive) as long as city street carriers deliver both types of mail. In that case, the incremental access costs for C_1 , C_2 and C_3 , considered as a group, would be greater than the sum of the incremental costs for C_1 and C_2 , also considered as a group, and the incremental cost for M_2 alone.

costing model that is already structured for possible transfers from the market dominant side. In that case, IC_C^* could be calculated directly from a quantitative specification for the functional form given in (2).