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ORDER NO. 115

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

Before Commissioners: Dan G. Blair, Chairman;
Mark Acton, Vice Chairman;
Ruth Y. Goldway;
Tony L. Hammond; and
Nanci E. Langley

Periodic Reporting — Docket No. RM2008-2

ORDER ACCEPTING CERTAIN ANALYTICAL PRINCIPLES FOR USE IN THE POSTAL SERVICE'S PERIODIC REPORTS

Washington, D.C. 20268

October 10, 2008

Table of Contents

I. INTRODUCTION

Section 3652 of the Postal Accountability and Enhancement Act (PAEA) requires the Postal Service to file a report at the conclusion of each fiscal year analyzing the degree to which its finances and operations complied with the standards of the PAEA. Section 3652(a)(1) gives the Commission the responsibility to prescribe the methods that will be used to produce the information on which the Postal Service's annual report is based. This order authorizes the Postal Service to make a number of changes in the methods it uses to categorize costs when it prepares its Annual Compliance Report for fiscal year 2008.

The Postal Service initially proposed making eight changes in the analytical principles by which it would compile the FY 2008 version of its Annual Compliance Report.[1] The Postal Service describes each proposed change, gives its background, objectives, rationale, and, in most instances, estimates its impact on classes of mail.

On August 18, 2008, the Commission issued Order No. 99 initiating this docket for the purpose of evaluating the eight proposed methodological changes.[2] The Commission chose the informal rulemaking approach for evaluating costing changes that it outlined in its FY 2007 Annual Compliance Determination. Essentially, the Commission interpreted the Postal Service's August 11, 2008 Request as a petition for an informal rulemaking to accept eight new analytical principles for use in the Postal Service's periodic reports. On the same day that the Commission issued Order No. 99, the Postal Service filed a motion to supplement the list with Proposal Nine, which sought to update the distribution key for Postal Automation Redirection System (PARS)-related costs.[3]

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[1] 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 at 2-3 (Request).

[2] PRC Order No. 99, Notice of Proposed Rulemaking on Costing Methods Used in Periodic Reporting, August 18, 2008 (Order No. 99).

[3] 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. That motion was granted on August 21, 2008 in Order No. 102.

Order No. 99 scheduled an informal technical conference for August 27, 2008 to allow the public to ask Postal Service experts to elaborate on the rationale for the nine proposals. Order No. 99 at 4. On August 29, 2008, the Postal Service filed supporting materials requested at the technical conference.[4] On September 5, 2008, the Postal Service filed a notice expanding the scope of its proposal to quantify group-specific costs (Proposal One) beyond Cost Segment 18.[5]

A lead time of several months is necessary for the Postal Service to prepare a Cost and Revenue Analysis (CRA) and related reports that will feed into its Annual Compliance Report, which is due 90 days after the close of each fiscal year. The purpose of this docket is to evaluate the Postal Service's proposals in time for it to incorporate them in its FY 2008 CRA. Accordingly, the Commission must limit the issues addressed in this docket to those raised by the Postal Service's proposals in order to complete the requested review expeditiously. For this reason, the Commission will defer consideration of the independent issues raised by Time Warner Inc. concerning Periodicals costs and rates, and by the Major Mailers Association concerning the use of actual data rather than modeled data to estimate Delivery Point Sequencing rates.[6]

The Commission appreciates the efforts that these commenters have made to bring these issues to its attention. As a practical matter, however, the near-term regulatory workload of the Commission and the Postal Service makes it difficult to evaluate these issues adequately at this time. Those seeking to have the Commission address costing issues in the future should make proposals as concrete and specific as is practical and frame them as petitions for informal rulemakings. Although there are no

[4] Notice of the United States Postal Service Regarding Materials Distributed or Requested at the August 27, 2008 Technical Conference, August 29, 2008 (Notice Regarding Technical Conference Materials).

[5] 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 (Notice Regarding Expanded Scope).

[6] *See* Initial Comments of Major Mailers Association, September 8, 2008, and Initial Comments of Time Warner Inc. in Response to Order No. 99, September 8, 2008 (Time Warner Comments).

restrictions on the timing of such petitions, it will be difficult to give substantial proposals thorough consideration until after the end of April 2009. After that time, the Commission expects to focus on these comments and any other petitions to modify the analytical principles used in preparing the Postal Service’s annual compliance and other periodic reports. If petitions presenting potentially promising concepts have been received at that time, the Commission may consolidate them in an omnibus cost methodology rulemaking.

II. PROPOSAL ONE—Procedures for Identifying and Applying Group-Specific Costs

According to the Postal Service, group-specific costs are "those costs which cannot be attributed to individual products, but which are caused by either the competitive or market-dominant product as a group." Request at 5. Proposal One would identify group-specific costs by finding a causal relationship between the labor cost of particular administrative units in Cost Segment 18 and one of two product groups—market dominant or competitive. Proposal One does not analyze what product group causes the activity of any particular headquarters unit in Cost Segment 18. It only describes a general approach that it seeks to have approved.

As the Postal Service describes it, the approach it proposes seems to have three basic steps. In the first step, the Cost Attribution unit in the Postal Service's Corporate Finance Planning department sends questionnaires to various headquarter's offices (identified by Finance Number) and asks whether that office's activity "only supports" market dominant products, "only supports" competitive products, or "supports both groups of products." *Id.* at 6-7. If either the first or second response is received, the cost review team would treat the cost of that activity as a "candidate" for categorization as a group-specific cost.[7]

A response that an activity "supports both groups of products" leads to an additional step. The cost review team analyzes the cost pool to determine whether it should be categorized as a cost that is specific to the product group that it primarily supports, even though it provides some support for products of the other group. The Postal Service says that the cost review team would "conduct further research as necessary" to decide whether to recategorize a mixed activity as specific to one of the two groups. It says that the review team would recategorize a mixed activity as specific

[7] The Postal Service describes this process as assigning a "Product Activity Attribute" for each Finance Number in the "Finance Number Control Master File." It says that designating a Finance Number as supporting only one of the two product groups would "help identify" that activity as a group-specific cost. It does not say what further analysis, if any, would be performed before an activity that is self reported as group specific would be confirmed as group specific. *Id.*

to a product group if it concluded that the activity would not be undertaken "but for" the existence of that product group. Once it categorizes the cost of a headquarter's unit bearing a particular Finance Number as group specific, the Postal Service proposes to examine expenses in other cost segments authorized by that headquarter's unit, such as contractor, research and development, and depreciation expenses, to determine if the Product Activity Attribute assigned to the headquarter's unit should be imputed to the expenses that it has authorized.[8]

The Postal Service proposes to use the result of its identification of group-specific costs to estimate the incremental cost of the competitive product group to see if that group is being cross-subsidized by the market dominant group. It proposes to go further, however, and identify group-specific costs for market dominant products. It would then subtract attributable costs and both kinds of group-specific costs from total costs to calculate institutional costs. It assumes that the Commission would use the resulting reduced institutional cost estimate to calculate an appropriate institutional cost share for competitive products, pursuant to section 3633(a)(3).

A. Comments

The Public Representative supports calculating group-specific costs as a way of estimating incremental costs and testing the competitive product group for cross-subsidy.[9] To identify group-specific costs, he would support use of an exclusivity decision rule, *i.e.*, costs that exclusively benefit one product group would be categorized as group specific. He would also support use of a decision rule that would categorize a cost as group specific if it primarily benefits one product group and only "incidentally"

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[8] *See* Notice of Expanded Scope.

[9] At an individual product level, he argues that the incremental cost of a competitive product can be a useful guide to the economic efficiency of that product's price serving as a price ceiling above which there is incentive for competitors to enter the market for that product. Public Representative Reply Comments Concerning Treatment of Group-Specific Costs, September 15, 2008, at 5 (Public Representative Reply Comments).

benefits the other.[10] He argues that circumstances can change the manner in which costs would be avoided under the "but for" causation test. Therefore, the categorization of costs as group specific should be redone when such changes occur. (Changed circumstances might include changes in headquarter's organization or changes in the classification of products in the Mail Classification Schedule as market dominant or competitive.) *Id.* at 3. He recommends calculating group-specific costs for market dominant products in order to be able to readily deal with such changes. Public Representative Reply Comments at 3.

Parcel Shippers Association (PSA) argues that the only reliable test of "but for" cost causation for a product group is the exclusivity test. It appears willing to allow the Postal Service to apply such a decision rule without prior review by the Commission and the public. For a cost that benefits both product groups, but benefits one in greater measure than the other, PSA asserts that the Postal Service is proposing to use a "much broader and murkier" causality test. It does not want the Postal Service to identify such costs as group specific unless the decision rules to be applied are clearly articulated in advance.[11] The Association of Postal Commerce, Direct Marketing Association, Mail Order Association of America, Magazine Publishers of America, Inc., and the Alliance of Nonprofit Mailers concur. They assert that with respect to finding mixed group costs to be product specific, "the Postal Service is proposing to move too far, too fast, while providing too little information."[12]

In his comments, Robert Mitchell focuses on the uses that should be made of estimates of group-specific costs rather than on how strict or lenient the decision rule

[10] Public Representative Comments in Response to Order No. 99, September 8, 2008, at 2 (Public Representative Comments).

[11] Initial Comments of Parcel Shippers Association to PRC Notice and Order No. 99 (Supplemented by Order No. 102) (ISSUED August 18, 2008), August 8, 2008, at 3-5 (PSA Comments).

[12] Reply Comments of Parcel Shippers Association, the Association for Postal Commerce, Direct Marketing Association, Mail Order Association of America, Magazine Publishers of America, Inc., and the Alliance of Nonprofit Mailers to PRC Notice and Order No. 99 (Supplemented by Order No. 102), September 15, 2008, at 3 (PSA, et al. Reply Comments).

detecting causality should be.[13] He asserts that it is not the decision rule, but the quality of the data and analysis, that should determine whether a finding of group causality is accepted. He argues that the use of group-specific costs should be limited to fashioning an incremental cost with which to test the competitive product group for cross-subsidy. Mitchell Comments at 2-3. Mitchell argues that if both costs attributable to specific classes of mail and group-specific costs are summed, the result would be an aggregation of incompatibly defined costs that would be useless as a guide to the economic efficiency of rates. Deducting that sum from institutional costs, as the Postal Service contemplates, he contends, would not provide a meaningful measure of any economic quantity, and would have little relation to the established concept of institutional costs upon which the PAEA heavily relies. *Id.* at 5-6.

He argues that the only use for institutional costs, as the Postal Service would redefine them, would be as a starting point for the Commission's section 3633(a)(3) determination of the appropriate share of overhead costs to be borne by competitive products. *Id.* at 10-11. He characterizes this as a fairness test for the competitive product group that would compete with the familiar incremental-cost-based cross-subsidy test. He argues that as a fairness test, it is inferior to the traditional incremental-cost-based test because it would require a realistic estimate of the incremental costs of the market dominant product group. *Id.* at 18. He contends that estimating the incremental costs of that group would be a difficult, ambitious, and uncertain undertaking because of the highly subjective assumptions upon which it would have to rely. *Id.* at 19-21.

He asserts that, as a practical matter, it would be easy to categorize almost all institutional costs as specific to the market dominant product group so that only a trivial amount of institutional costs would remain. He suggests that the Commission's determination under section 3633(a)(3) that competitive products bear a particular

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

percentage of institutional costs would not provide the meaningful safeguard that Congress envisioned if it were applied to a miniscule pool of costs. *Id.* at 14-15.

Valpak notes, as did Mitchell, that determining group-specific costs is necessary, but not sufficient, to estimate incremental costs.[14] In addition to finding all costs that exclusively support one group, they recommend comprehensively examining costs that do not support a single group to determine whether they would partially vary with group volume. Valpak Comments at 10. Valpak notes that if a large amount of costs were identified as incremental to the competitive product group, that amount might exceed the 5.5 percent share of institutional costs that the Commission has determined is appropriate. In that event, they suggest that the Commission re-examine its conclusion that the appropriate share of institutional costs (traditionally defined) is 5.5 percent. *Id*. at 11-12.

The Postal Service attempts to allay the concerns of Valpak and PSA regarding the effect on the competitive products' appropriate share of institutional costs. It notes that while redefining a portion of institutional costs as group specific will reduce institutional costs, it will increase the incremental cost revenue floor. The net effect, it says, cannot be predicted. It agrees, however, that the Commission might need to re-evaluate its conclusion that 5.5 percent is an appropriate institutional cost share for the competitive group depending on the amount of group-specific costs that are ultimately identified.[15]

Pitney Bowes Inc. comments that it is premature to decide what standards should be used to estimate group-specific and incremental costs.[16] It notes that this issue is discussed by the Department of Treasury in its report on the accounting rules to

[14] Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments Regarding Costing Methods Used in Periodic Reporting, September 8, 2008, at 8 (Valpak Comments).

[15] Reply Comments of the United States Postal Service Regarding Proposals One through Nine, September 15, 2008, at 3-4 (Postal Service Reply Comments).

[16] Reply Comments of Pitney Bowes Inc., September 15, 2008 (Pitney Bowes Reply Comments).

be followed in operating the competitive products fund[17] and is an issue that Docket No. RM2008-5 will address. Pitney Bowes Reply Comments at 2-3. It notes that the Commission has not yet adopted clear guidelines regarding the type and amount of data and analysis required to support changes in costing principles. It anticipates that some will be provided in Docket No. RM2008-5. *Id.* at 3.

United Parcel Service encourages the Postal Service to press ahead with its effort to identify group-specific costs.[18] It says that the proposal is designed to improve the Commission's ability to test for cross-subsidies and that approval of the Postal Service's approach will be an important step toward that goal. UPS Reply Comments at 3.

B. Commission Analysis

To analyze the Postal Service's proposal to identify and measure group-specific costs, it is necessary to carefully distinguish between issues raised by the cost causation analysis that it proposes to apply to a group of products, the uses that will be made of the cost estimate that results from that analysis, and the manner in which those results should be presented and reported.

Analyzing causation. As noted, Proposal One seeks to identify causal relationships between the labor cost of particular administrative units in Cost Segment 18 and either the market dominant or the competitive product group. The Postal Service only describes a general approach that it seeks to have approved. Proposal One does not trace the cause of specific headquarters activities in Cost Segment 18 to either product group. After the headquarters survey assigns a Product Activity Attribute to each Cost Segment 18 activity, activities that support a mix of market dominant and

[17] *See Report of the U.S. Department of the Treasury on Accounting Principles and Practices for the Operation of the United States Postal Service's Competitive Products Fund*, December 19, 2007.

[18] Reply Comments of United Parcel Service on Notice of Proposed Rulemaking on Costing Methods Used in Periodic Reporting, September 15, 2008 (UPS Reply Comments).

competitive products are further analyzed by the Cost Review team to determine if that activity would be eliminated "but for" the existence of one or the other group.

The "but for" test proposed by the Postal Service is "the familiar incremental cost inquiry—if the product or group of products were eliminated, would the cost likely still be incurred."[19] The "but for" test requires the Postal Service to formulate a hypothesis about what activities would or would not be eliminated, reduced, expanded, or reconfigured if one of the two product groups were discontinued. This test can involve a good deal of subjective judgment, especially as applied to the market dominant product group, which makes up 99 percent of postal volume. Speculating what the postal system would consist of if the vast majority of its volume were removed ventures into highly uncertain analytical territory. *See* Mitchell Comments at 7-9; and Valpak Comments at 8-10.

Many commenters are concerned that in the approach that the Postal Service proposes, it does not articulate any decision rules that it would apply to determine whether a given activity would cease if a product group were discontinued. They note that the Postal Service has discussed basing its conclusion on a finding that the activity would "solely" benefit one group or "predominantly" benefit one group. It has also discussed basing its conclusion on a finding that a "preponderance" or a "substantial preponderance" of the activity would benefit one group, or a finding that the activity would benefit one of the groups only "incidentally."[20] Even if the Postal Service had proposed to follow specific decision rules, these commenters worry that it would not apply them consistently across activities, or apply them comprehensively to all non-attributed cost pools.[21] Because there is so much uncertainty as to how the Postal

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[19] Notice Regarding Technical Conference Materials at 5.

[20] *See* Notice Regarding Technical Conference Materials at 5; Mitchell Comments at 4; PSA Comments at 3-5; PSA, et al. Reply Comments at 3; and Public Representative Comments at 2-3.

[21] Mitchell Comments at 7-9; Valpak Comments at 8-10; Valpak Reply Comments at 3; and PSA, et al. Reply Comments at 3.

Service would apply its "but for" hypotheses, they argue, the Commission should not give advance approval of such a vaguely defined process. PSA Comments at 3-5.

The Postal Service argues that it can consistently apply a "but for" analysis despite its inherent subjectivity. It does not articulate any decision rules that it would apply generally. It asserts, however, that it will augment the Product Activity Attribute survey results with other information—in some instances referring to program descriptions in the Postal Service's budget for an indication that a program is group specific; in others, looking at the categorization of the headquarter's unit that authorized an investment as an indication that the investment itself is group specific. Postal Service Reply Comments at 4-6.

There are contexts in which applying the "but for" hypothesis to some activities can be an objective, straightforward exercise with a reasonably predictable result. One such context is where an activity supports only one product group. In that context, causal analysis would be analogous to that which the Commission has applied when it attributes product-specific costs. For attribution purposes, the Commission has historically found activities to be product specific where an activity supports a single product. This finding has been based on the criterion of exclusivity—*i.e.*, an activity unambiguously supports only one product. *See* PRC Op. R94-1, ¶ 3139.

In identifying the group-specific costs that are to be used in estimating incremental costs, the Commission authorizes the Postal Service in advance to categorize an activity as group specific if it unambiguously supports only one product group. This decision rule is simple and its application is relatively straightforward as applied to a headquarter's unit in Cost Segment 18. The Commission delegates application of this decision rule to the Postal Service to the extent that it applies the rule to Cost Segment 18. If, however, the exclusivity test is self-applied by a headquarter's unit, as occurs in the Product Activity Attribute survey, the Postal Service's finance department must review and confirm that the exclusivity test was validly applied before incorporating the result in its Incremental Cost Report to the Commission.

The Commission does not give the Postal Service advance authorization to impute a group-specific Product Activity Attribute in Cost Segment 18 to non-administrative activities in other cost segments. From the sparse record in this rulemaking, it has not been shown that a causal link detected between a headquarter's unit and a specific product group can safely be imputed to a non-administrative activity that shares the same Finance Number. Much depends upon legitimacy of the criteria by which the administrative and the non-administrative activity were grouped under the same Finance Number. The record does not indicate what criteria are used to define the boundaries of Finance Numbers, although the Commission presumes that Finance Numbers are defined to implement budgetary rather than economic concepts. Nor does the record indicate how rigidly a Finance Number's boundaries are observed. For example, one could conceive of situations in which a headquarter's unit that only has responsibility for competitive products according to the flow chart is asked to oversee a particular project that supports both product groups.[22] Under those circumstances, the Product Activity Attribute assigned to headquarter's unit could not reliably be imputed to the non-administrative activity, even though it has the same Finance Number.

Similarly, the Commission does not give the Postal Service advance authorization to apply the group-specific "but for" causality test to Finance Number activities that support both the market dominant and the competitive product groups. "But for" causation analysis that is applied to an activity that supports both the market dominant and competitive product groups necessarily involves decision rules that are more subjective than the "exclusivity" test. The Commission will not approve in advance the results of a process that applies unidentified criteria or decision rules to mixed

[22] Suppose, for example, that there were a headquarter's unit in the "Shipping" division whose Product Activity Attribute categorized it as group specific to competitive products. And suppose that, because of its expertise in the area, the headquarters unit developed a program by which all parcels (competitive and market dominant) could be given a radio frequency (RF) tag that could be read by a sensor on the addressee's mailbox, which would then relay a message to the addressee's mobile phone that a parcel had been delivered. The fact that the Product Activity Attribute for that headquarters unit categorized it as group specific to competitive products would not be a valid basis for imputing the unit's Product Activity Attribute to the costs of the RF notification program that it developed.

product group activities. The Commission agrees with numerous comments that it has received that analyzing activities that benefit mixed product groups for causation is much more complicated and subjective than analyzing causation where the activity benefits only one product group.

To the extent that the Postal Service is looking for general guidance concerning its proposed approach to analyzing the cause of activities that support both product groups, the Commission encourages the Postal Service to proceed with its analysis of group-specific costs in the manner it describes, as it pursues the goal of producing a comprehensive analysis of the incremental costs of the competitive product group. But because the decision rules to be applied are not known in advance, and a plan is not in place to analyze all relevant activities for group causation in a balanced way, the Commission cannot approve the results of such analyses before it, and the public, have had a chance to review the process, including the standards used and the manner in which they were applied. To do so would be to accept analytical principles, as the Commission's proposed periodic reporting rules would define them,[23] before knowing what the analytical principles are. Before the Commission will accept as an analytical principle a conclusion that the cost of a particular mixed group activity is incremental to only one of the two product groups benefiting from that activity, the Postal Service must give the Commission and the public an opportunity, in an informal rulemaking, to review the analysis that led to that conclusion.

Appropriate uses of group-specific cost estimates. The Postal Service characterizes Proposal One as an initiative intended to implement rule 3015.7(a) of the Commission's competitive product rules. Request at 5. That rule states:

> Incremental costs will be used to test for cross-subsidies by market dominant products of competitive products. To the extent that incremental cost data are unavailable, the Commission will use competitive products' attributable costs supplemented to include causally related, group-specific costs to test for cross-subsidies.

[23] *See* Order No. 104 at 26.

Rule 7(a) requires that the Postal Service provide the Commission with estimates of group-specific costs. These estimates are to be used as one component of an interim measure of the incremental costs of the competitive product group until a systematic and comprehensive estimate of those costs can be developed. The ultimate purpose of obtaining an estimate of the incremental cost of the competitive product group is to test for cross-subsidy of that group by market dominant products. This test is meant to satisfy section 3633(a)(1), which prohibits "the subsidization of competitive products by market-dominant products[.]" The Postal Service, however, goes beyond the purpose of rule 7(a) to assert that

> [T]he identification of market-dominant group-specific costs is also important, as the value of the institutional cost will be the residual of Postal costs that are not attributable to products and are not group-specific to either group. To the extent costs are group-specific costs, the remaining 'institutional cost' will be a smaller amount than it would be otherwise.

Id. at 5-6.

Incremental cost has value primarily as a tool for testing the fairness of rates rather than as a tool for applying economic theory. Mitchell Comments at 19. In adopting rule 7(a), the Commission did not intend to use group-specific costs to do anything more than produce an estimate to test for cross-subsidy of competitive products. The Commission did not contemplate altering the long-established meaning of institutional costs in the context of postal regulation because the cross-subsidy test for competitive products does not involve institutional costs. Therefore, the Commission does not authorize subtracting both attributable costs and group-specific costs from total costs to arrive at a new definition of costs that are to be considered institutional.

There are several reasons for this. In postal regulation, institutional costs have historically been defined as the difference between total costs and attributable costs.

They are the residue remaining after the attributable costs of individual products[24] have been identified. Attributable costs are a close proxy for marginal costs.[25] Separating total costs into the sum of the marginal costs of individual classes of mail and all other costs is economically meaningful because it allows one to identify the distance between revenues for a particular product and its marginal costs (its "markup" over marginal costs). This allows rates to be evaluated for their allocative efficiency effects (*e.g.*, Ramsey rates) and their productive efficiency effects (on the broader postal market). Mitchell Comments at 9-12.

In terms of the economic analysis of rates, the Commission concludes that the confusion that would be caused by subtracting group-specific costs from institutional costs would outweigh any benefits that the exercise would provide. The Postal Service envisions subtracting the sum of attributable costs for individual products and the sum of group-specific costs from total costs to yield what will be referred to hereafter as "reduced institutional costs." As commenter Mitchell notes, attributable costs for individual products and group-specific costs are isolated using different causality tests.[26] As a result, the costs identified by these tests are not necessarily mutually exclusive and may overlap. It is difficult to confidently place an economic interpretation on the residue that remains when group-specific costs are deducted from institutional costs in

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[24] Product is the relevant point of reference when analyzing the economic properties of rates since rates are applied and markups evaluated on a product-by-product basis. Under the Postal Reorganization Act (PRA), they were designed on a subclass-by-subclass basis. Under the PAEA, "class of mail or type of mail service" is a second point of reference that is most relevant to the implementation of the rate cap.

[25] Attributable costs are those that can be reliably traced to a class of mail. In the language of section 3622(c)(2) of the PAEA, they are "direct and indirect postal costs attributable to each class or type of mail[.]" In the postal context, they are volume variable costs. Therefore, they are a close proxy for marginal costs, even though they include a minor amount of product-specific costs.

[26] One is a test involving infinitely small changes in class volume holding all other volumes constant. The other is a test involving withdrawal of total group volume and hypothesizing direct effects on some activities and side effects on others. Attributable and group-specific costs would not be additive if institutional costs include costs that are partially variable with volume, or class-specific attributable costs are more than 100 percent variable with volume. *Id.* at 2, 5-8, and 10. Considering the current state of postal costing, neither possibility can be ruled out.

a piecemeal fashion, focusing on certain cost segments in one year, and adding others the next.

The Commission sees value in gradually uncovering group-specific costs from year to year to the extent that this would provide stepping stones to estimating the true incremental cost of the competitive product group.[27] No harm is likely to result from using partial estimates of incremental costs as the basis of a fairness test of the competitive product group's overall revenue burden. As long as the analysis remains incomplete, the bar may be set too low, but it is preferable to not applying the fairness test at all.

The Commission, however, sees little present value in using group-specific costs to calculate "reduced institutional costs" to be used as the basis of a fairness test. This is particularly true if the process of identifying group-specific costs is not balanced and complete. If group-specific costs were to be used to calculate "reduced institutional costs" for use in a fairness test, the relationship of costs identified as specific to the market dominant group and costs identified as specific to the competitive group would become critical. For example, the Postal Service envisions the Commission using "reduced institutional costs" as the starting point for its determination of the competitive product group's appropriate share of "institutional costs" under section 3633(a)(3).[28] If the group causality test were to be applied only to the "low hanging fruit" in the Postal Service's administrative units (those offices that are dedicated to competitive products on the flow chart), it would not identify the subtler burden-reducing effects on mixed-

[27] If the incremental costs of both groups were comprehensively and reliably identified, the sum of group incremental costs could then be compared to total costs. The difference would represent the economies of joint production of market dominant and competitive products.

[28] Postal Service Reply Comments at 4, n.4. Section 3633(a) reads

> In general.--The Postal Regulatory Commission shall …
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> * * * * *
>
> > (3) ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.

purpose offices of eliminating competitive products. Ignoring such effects would understate group-specific costs for competitive products because they would not reflect the costs that they impose on mixed-purpose offices that are partially volume variable. Ignoring such effects would also overstate “reduced institutional costs.” *See* Mitchell Comments at 9.

Similarly, applying the group causality test to certain cost segments and not others could bias the results. For example, Cost Segments 7 and 10 include almost $11 billion of fixed costs reflecting the cost of delivering mail on fixed routes to essentially all addresses. In applying the “but for” group causality test to Cost Segments 7 and 10, it is possible to argue that the market dominant group causes these fixed costs since the competitive group has too little volume to support serving fixed routes. If such an argument were accepted, the decision to analyze or not analyze Cost Segments 7 and 10 in a given year could have a huge impact on the ratio of “reduced institutional costs” to group-specific costs for both product groups.

Another downside of immediately using “reduced institutional costs” as the starting point of a fairness test is the instability and unpredictability of the outcome of such a test due to the inherent subjectivity of the “but for” causality test. If a strict standard (such as exclusivity) were to guide the “but for” causality test, there might be only a small set of group-specific costs identified, and only a small reduction in institutional costs. If a very liberal standard (such as “substantial predominance”) were applied, institutional costs could be quickly reduced to a very small amount because market dominant products account for the overwhelming majority of system volume. The conservative end of the continuum could lead to a fairness test so easy to pass that it would be rather meaningless. The liberal end of the continuum could lead to a rather meaningless fairness test as well because the pool of institutional costs to which it would be applied would be too small to matter. The potential instability and unpredictability of a fairness test based on “reduced institutional costs” tends to undermine the legitimacy of the approach.

Testing fairness through the "reduced institutional cost" mechanism also does not fit well with the PAEA. A volatile and possibly insignificant pool of institutional costs is unlikely to be something that Congress anticipated when it adopted the PAEA. Congress made institutional costs a key measuring stick throughout the PAEA. *See* section 3622(b)(9), 3633(a)(3), 3622(c)(10), 3622(e)(3)(A) and 3622(c)(2).[29]

The first two of these provisions assign the Commission the task of striking an "appropriate" balance between the institutional costs borne by market dominant products and those borne by competitive products. There is reason to believe that Congress wanted the Commission to strike this balance by considering the broad set of policy considerations listed in chapter 36 of the PAEA.

For this reason, using "reduced institutional costs" as a starting point for applying a fairness test does not mesh well with key provisions of the PAEA. The PAEA provides postal management with an incentive to maximize the share of institutional costs identified as specific to the market dominant group. This is because the revenue burden allocated to market dominant products is largely determined by the price cap, rather than any estimate of costs, including group-specific costs. Loading up the market dominant group with group-specific costs would have little effect on market dominant rates, but it could leave an insignificant amount of "reduced institutional costs" from which the Commission would (under the Postal Service's approach) allocate an appropriate share to the competitive product group under section 3633(a)(3). The Commission's duty under section 3633(a)(3) would become essentially irrelevant under

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[29] Section 3622(c)(2) requires

> that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type[.]

This section of the PAEA is essentially a codification of the Supreme Court's interpretation of the virtually identical provision in the PRA. In language almost identical to section 3622(c)(2), the court validated the Commission's decision to divide costs into two tiers—class-specific attributable costs and institutional costs. *See National Association of Greeting Card Publishers v. USPS*, 462 U.S. 810, 833-34 (1983) (NAGCP IV). The language of section 3622(c)(2) implies that Congress shared the prevailing conception that responsibility for postal costs should take the form of class-specific attributable costs and institutional costs.

these circumstances—a result that Congress would not likely have envisioned when it included these provisions.

For the reasons described, the Commission concludes that it is not useful, and probably not consistent with the PAEA, to apply the concept of "reduced institutional costs" to the economic analysis of postal rates at this time.

Reporting and presentation. The Commission will use the group-specific costs of competitive products to estimate incremental costs and test for cross-subsidy of competitive products, consistent with rule 3015.7(a).[30] It will not use group-specific costs to calculate "reduced institutional costs" for purposes of applying a fairness test to competitive product revenues, such as the one mandated by section 3633(a)(3). To maintain clarity in the role that is appropriate for group-specific costs, incremental costs, and institutional costs to play in analyzing the Postal Service's compliance with the PAEA, the Postal Service is directed to report group-specific costs as an element of an Incremental Cost Report to be filed separately from, but at the same time as, its Cost and Revenue Analysis report.

[30] Identifying group specific costs has implications for calculating an assumed Federal income tax for competitive products. These will be addressed in Docket No. RM2008-5.

III. PROPOSAL TWO—Treating Click-N-Ship and Carrier Pickup Advertising as a Group-Specific Cost

Proposal Two assigns the advertising costs of Click-N-Ship and Carrier Pickup service as group-specific costs of competitive products. In prior years, these costs were treated as institutional because the costs of these services supported Priority Mail, Express Mail, International packages, International Express Mail, and International Priority Mail, all of which are competitive products. The Postal Service states that about $40 million was spent on advertising for these two services in FY 2007 and that a similar amount would be spent in FY 2008.

During the technical conference held on August 27, 2008, a question was raised as to whether Merchandise Return Service, a market dominant service, was included in the Carrier Pickup program. The Postal Service confirmed that the Carrier Pickup program was expanded in FY 2008 to include Merchandise Return Service.

This proposal raises two issues. First, what is the appropriate standard by which group-specific cost causality should be judged, *e.g.*, must an activity support one product group exclusively, or is it sufficient that a preponderance of that activity supports one product group? Second, if a support activity is extended to benefit other products, does this change the economic purpose or business motive for incurring these costs?

The Postal Service claims that given the small size of Merchandise Return Service relative to the competitive products supported by Clink-N-Ship and Carrier Pickup, it is unlikely that the addition of this market dominant product will change the basic economic rationale for the program. The Postal Service argues that the fact that advertising costs for Carrier Pickup were incurred before it was available to Merchandise Return Service demonstrates that the advertising costs should be group specific to the competitive products. The Postal Service states that the advertising costs for Carrier Pickup would not be incurred if all of the competitive products were eliminated. Notice Regarding Technical Conference at 3-6.

A. Comments

PSA contends that the proposal should not be approved because the costs support a mix of competitive and market dominant products. It downplays the Postal Service's argument that Merchandise Return Service is a very small portion of the Carrier Pickup service because evidence of relative volumes has not been provided. PSA questions the Postal Service's assumption that because there were advertising costs for Carrier Pickup before Merchandise Return Service was included, the costs would be eliminated if the competitive products were eliminated. PSA Comments at 6. It also notes that even though Click-N-Ship can only be used by competitive products, it is not clear that Click-N-Ship does not promote other online solutions, such as the eBay online postage solution, that support market dominant products. *Id*. at 7.

Valpak comments that the Postal Service proposal for advertising costs seems reasonable. However, it asserts that acceptance of a conclusion that a particular cost is group specific should turn not on the standard applied to "but for" analysis, but on whether credible evidence and careful analysis supports the proposal. Valpak Comments at 14. It says that any analysis of incremental costs must recognize that whenever a product or group of products are eliminated several things can happen. A credible analysis would examine each of the possibilities and determine the possible effects of each. *Id.* at 3.

United Parcel Service does not take a position on the issue of what "but for" causality standard should be applied. It argues that it is clear that the competitive products should be assigned the largest share of the advertising costs. UPS Reply Comments at 3.

The Postal Service concedes that it cannot definitively prove the causal link between the advertising costs of Carrier Pickup and Click-N-Ship and the competitive product group. It argues, nevertheless, that it is likely that these costs would not be incurred if the competitive product group were eliminated since competitive products remain the main beneficiaries of the advertising campaign.

B. Commission Analysis

In evaluating Proposal One, the Commission authorized the Postal Service in advance to categorize a Segment 18 cost as group specific if it exclusively benefits one product group. However, the Commission did not give the Postal Service advance authorization to apply the group specific “but for” causality test to activities that benefit both the market dominant and the competitive product groups. In this instance, the advertising costs were incurred for two services, Click-N-Ship and Carrier Pickup. The Postal Service asserts that the preponderance of the mail that uses these services is competitive and that the advertising costs would not be incurred if the relevant competitive services were discontinued.

Merchandise Return Service is a market dominant product that is eligible for Carrier Pickup. Whether the cost of advertising Carrier Pickup service would be reduced or eliminated if Merchandise Return Service were ineligible for it is a factual determination. The Commission would be in a better position to review the Postal Service’s causality finding if the relevant facts were clearer. As PSA points out, a relevant question is whether Carrier Pickup advertising promotes that service generally, or names particular products that can use it. PSA Comments at 6. The Postal Service would have a stronger case if specific competitive products were mentioned and Merchandise Return Service was not. There are similar ambiguities with respect to Click-N-Ship, and whether it promotes other online services that support market dominant products. Ideally, the advertising itself would be made available for review to help resolve these ambiguities.

Where the cause of an activity that supports both product groups is being analyzed, it is relevant to ask not only whether the initial business motive for that activity is to support both product groups, but whether the decision to continue that activity is influenced by the fact that it supports two product groups. It is also relevant to ask whether eliminating the product group receiving the lesser benefit of that activity would cause the level of that activity to drop even if it would not disappear. If it would cause the level of that activity to drop, the residual activity level would be the proper measure of group-specific costs to the product group receiving the greater benefit from that activity. This is an example of Valpak's observation that proper incremental cost analysis would take into account all of the possible cost consequences of eliminating a particular product group.

Proposal Two is a first cut by the Postal Service at supporting a proposal to treat a particular advertising cost as group specific. Under this circumstance, the Commission is inclined to be more lenient than it would otherwise be with respect to the strength of the factual record required to support a finding of group causality. The Postal Service asserts that the Carrier Pickup advertising program was instituted before Merchandise Return Service was eligible to use it. That would seem to corroborate the Postal Service's assertion that the volume of Merchandise Return Service taking advantage of Carrier Pickup service is small relative to that of competitive products. On the strength of these two assertions, the Commission will accept the Postal Service's proposal to treat advertising costs for Carrier Pickup service as group specific to competitive products in FY 2008 periodic reporting. It will do the same for the cost of advertising Click-N-Ship. Due to the strength of the factual support provided, however, the Commission will not treat the conclusion that these costs are group specific as a settled issue for reports covering periods after FY 2008. The nature of advertising campaigns can be expected to change from year to year, which may warrant a change in the characterization of those costs as group specific.

As discussed in its disposition of Proposal One at pages 13-19, the use of group-specific costs, once identified, is to calculate the incremental cost of competitive products. Group-specific costs will not be used to adjust total institutional costs.

IV. PROPOSAL THREE—Using the In-Office Cost System Shape Information to Distribute Allied Mail Processing Costs

The In-Office Cost System (IOCS) is a probability sample that provides data on the activities of the Postal Service's supervisors, clerks, mail handlers, and city delivery carriers. IOCS data identifies the characteristics of the mail handled by clerks, mail handlers, and city carriers in the course of various in-office work activities. The information is used to form subclass distribution keys for the associated cost components or cost pools. Generally, "allied labor" is labor incurred when workers are not performing mail sorting operations. Proposal Three would alter the coding of IOCS tallies for allied activities to better reflect mail shape.

Currently in allied operations, mixed mail tallies and the associated costs are allocated to all shapes and classes. If those tallies can be reasonably identified and assigned solely to letters, flats, or parcels, then the costs should be assigned to the correct shape and to classes that only include that shape. At present, approximately 88 percent of the allied cost pool tallies are coded as mixed mail and are subsequently allocated back to letters, flats, and parcels. By using additional information collected from IOCS surveys regarding the contents in a wheeled container or pallet, Proposal Three would reduce the number of mixed mail and empty wheeled container tallies in allied operations by assigning them to letter, flat, and parcel mail shapes as appropriate. For example, if the contents of a container are loose letters, the IOCS tally is assigned to letters. The associated costs would be assigned only to classes of mail that contain letters.[31]

FY 2007 allied cost pool tallies had the following profile: 3 percent letters, 2 percent flats, 2 percent irregular parcels and pieces (ipp)/parcels, 88 percent mixed mail (all shapes), and 6 percent empty non-wheeled containers. After the Postal Service's proposed changes, the tallies will likely have the following profile: 30 percent letters, 25 percent flats, 16 percent ipp/parcels, 26 percent mixed mail tallies, and

[31] Small discrepancies can still arise, even from this procedure.

2 percent empty non-wheeled containers. The Postal Service was unable to provide the cost impact on the classes of mail.

There were no comments received concerning Proposal Three. Proposal Three properly exploits information about the shape profile of mail served by wheeled and non-wheeled containers. The added precision in assigning costs to shapes and through shapes to products is a substantial improvement in the attribution of allied mail processing costs. The Commission accepts this proposed change to the analytical principles used in the Postal Service’s periodic reports.

V. PROPOSAL FOUR—Attributing the Non-Volume Variable Collection Costs of Blue Collection Boxes

In its FY 2007 Annual Compliance Report (ACR2007), the Postal Service proposed attributing approximately $60 million in non-volume-variable costs associated with collecting mail from blue collection boxes to First-Class single-piece letters. The Commission rejected attribution of these costs to First-Class single-piece letters in its FY 2007 ACD because it was the conscious policy of the Postal Service to allow products other than First-Class single-piece letters to be served by blue collection boxes. FY 2007 ACD, Appendix B, at 7.

The Postal Service makes the "but for" argument that the network of blue collection boxes was deployed in order to serve First-Class single-piece letters, "though a small amount of other products are sometimes deposited there."[32] Request at 13. The Postal Service emphasizes that competitive products, such as Priority Mail and Express Mail, have an alternative to using blue collection boxes as they are eligible for Carrier Pickup at the door. *Id.* It argues that over 90 percent of mail collected from blue collection boxes is First-Class single-piece letters, and this percent will be higher now that First-Class single-piece letters is comprised of single-piece letters and cards. *Id.* at 12. Finally, the Postal Service notes that since July 2007, stamped mail over 13 ounces has been barred from blue collection boxes for security reasons. Therefore, it argues, some mail previously deposited in blue collection boxes is now excluded. *Id*. at 13.

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[32] The other products include First-Class Mail flats, First-Class Mail parcels, Priority Mail, Express Mail, Parcels Zoned Rate US Postal Service Mail, Free Mail and International Mail. *See* Notice Regarding Technical Conference Materials at 6. In addition, Merchandise Return Service, Bulk Parcel Return Service, and Parcel Return Service may also be deposited in blue collection boxes. *See* Domestic Mail Manual (DMM) 126 and DMM 507.

A. Comments

Three commenters oppose Proposal Four—the Public Representative, the Greeting Card Association (GCA),[33] and the American Postal Workers Union (APWU).[34] The Public Representative questions the relevance of the historical perspective the Postal Service uses to analyze avoided costs. While blue collection boxes may have been installed decades ago in order to collect First-Class single-piece letters, he argues that what is relevant is the current uses of blue collection boxes.[35] Public Representative Comments at 6.

The Public Representative discusses two scenarios. In the first scenario, the Postal Service eliminates First-Class single-piece letter service, and several remaining products such as Priority and Express Mail continue to be collected from blue collection boxes. In this case, the Public Representative concludes that the boxes would not be removed, although the frequency of emptying them might be reduced. In the second scenario, First-Class single-piece letter service is eliminated and the blue collection boxes are removed. In this case, according to the Public Representative, the Postal Service would incur additional costs providing alternate collection mechanisms for the products that were once deposited in blue collection boxes. *Id.* at 7. In both scenarios, he argues, the Postal Service would not completely avoid the costs associated with sweeping blue collection boxes if it were to stop providing First-Class single-piece letters. Therefore, he concludes, the costs of blue collection boxes do not pass the avoidable cost test, which requires that the entire cost be eliminated if the product is eliminated. The Public Representative asks the Commission to reject Proposal Four.

[33] Initial Comments of Greeting Card Association, September 8, 2008 (GCA Comments).

[34] Comments of the American Postal Workers Union, AFL-CIO on Rulemaking on Costing Methods Used in Periodic Reporting, September 8, 2008 (APWU Comments).

[35] The Postal Service strengthens this point in its reply comments by noting that blue collection boxes were installed 150 years ago in order to collect letters and only later were they used to collect other products. Postal Service Reply Comments at 8, n.7.

The APWU notes that Priority Mail, Express Mail, Priority Mail International and International Express Mail are swept from blue collection boxes, according to the data used by the Postal Service. This data comes from a special study submitted in Docket No. R84-1, 24 years ago. APWU notes that the City Carrier Cost System (CCCS) has current data on the volume of products swept from blue collection boxes. Because the Postal Service has failed to provide reasonably current data from which a sound decision may be made, they recommend that the Commission reject this proposal. *Id.* at 2-3.

GCA also recommends that the Commission reject this proposal. It argues that even though large commercial mailers may not deposit mail in blue collection boxes and may send their own mail as a bulk presort product, the viability of their enterprises depends on First-Class single-piece letters remittance mail which may be deposited in blue collection boxes. GCA concludes that the security provided by blue collection boxes benefits the entire mailing community. Therefore, non-volume-variable costs associated with blue collection boxes should not be attributed to a single product. GCA Comments at 2.

The Postal Service notes that current data on the distribution of mail volumes swept from blue collection boxes shows that First-Class single-piece letters comprise over 99 percent of the volume of mail swept from blue collection boxes. Postal Service Reply Comments at 8. It dismisses GCA's argument that more than First-Class single-piece letters benefit from the mail security provided by blue collection boxes as off-point because it does not allow one to determine whether blue collection boxes would be retained if First-Class single-piece letters were eliminated. *Id.* at 9.

Responding to the Public Representative, the Postal Service asserts that if First-Class single-piece letters were eliminated, it would remove all blue collection boxes. Therefore, other products could not be deposited in them, contrary to the Public Representative's first scenario. *Id*. It next agrees with the Public Representative that one must consider the attributable costs for all products in a cost pool when determining whether one or several products are responsible for causing an institutional cost to arise, but dismisses this analysis as pertaining solely to the measurement of incremental, not group-specific, costs. *Id.* Finally, the Postal Service contends that removing First-Class single-piece letters and sweeping remaining mail from blue collection boxes would not increase the collection costs of the remaining products. It offers two reasons for this conclusion: (1) other products would already be stamped and so would only have to be put through a slot in the lobby of a post office. Since mail is already swept from post office lobbies, no additional cost would be incurred to accommodate this additional mail; and (2) if door collection were used by the remaining products, additional door collection costs would be more than offset by the reduction in non-collection costs in other operations or cost segments, especially since the additional door collection costs would be *de minimus* due to low volume of these products currently deposited in blue collection boxes. *Id.* at 10.

B. Commission Analysis

Proposal Four would attribute the non-volume-variable portion of the costs of sweeping blue collection boxes to First-Class single-piece letters, even though the DMM allows the boxes to be used by mailers of other products. To support Proposal Four, the Postal Service relies on the kind of "but for" causation analysis that it applies elsewhere in this docket to determine if costs are group specific or incremental. As with advertising costs (Proposal Two), it argues that the original purpose of the blue collection boxes was to serve a certain product even though it now serves other products. And, as with advertising costs, it argues that the degree of support that blue box collection provides to the secondary products is small relative to the support it provides to the primary product. It argues that both of these factors justify ignoring the secondary products when determining which product is ultimately responsible for the activity's costs.[36] The Postal Service, nevertheless, asks the Commission to disregard the criticisms of the Public Representative and PSA because they are based on

[36] Notice Regarding Technical Conference Materials at 5; Postal Service Reply Comments at 9.

incremental cost-style causation analysis that should not be applied to cost attribution. Postal Service Reply Comments at 10.

As the Postal Service suggests, the standards for finding cost causation when attributing costs to individual products are different from the standards that are used to find the cause of incremental costs. The former is empirical, focusing on marginal effects identified by econometric or operational analysis. The latter requires inherently subjective hypothesizing how postal operations might be reconfigured if the entire volume of a product or group were eliminated. When attributing costs to individual products, the Commission limits itself to objective and reliable inferences of causation. By adhering to this conservative approach, attributable costs depart from marginal costs only to the minimum degree necessary to remain faithful to the definition of marginal costs in the PAEA. *See, e.g.*, 39 U.S.C. 3622(c)(2).

For this reason, the Commission attributes a non-volume-variable cost to an individual product only when it exclusively supports that product.[37] If an activity has volume-variable and fixed costs, and the volume-variable portion must be distributed to more than one product using a distribution key, the fixed-cost portion of that activity is not suitable for treatment as product specific. If the presence of products other than First-Class single-piece letters in the blue collection boxes were *de minimus* and accidental, their presence could be overlooked in attribution analysis. Where, as here, it is the conscious policy of the Postal Service that an activity support more than one product, the cost of that activity may not be treated as an attributable product-specific cost.

It is the policy of the Postal Service to allow blue collection boxes to serve not just First-Class single-piece letters (which now includes cards), but First-Class Mail flats, First-Class Mail parcels, Priority Mail, Express Mail, Merchandise Return Service, Bulk Parcel Return Service, and Parcel Return Service. *See* DMM 126 and DMM 507. In the area of attribution, causation standards are more objective and more rigorous

[37] The seminal case is Docket No. R87-1, where the Commission "attribute[ed] all accrued access costs at stops whose delivered mail is of the same subclass." See PRC Op. R90-1, ¶¶ 3093, 3124.

than the standards applied in the area of group-specific or incremental cost analysis. For attribution purposes, only volume-variable and single-product costs (fixed or variable) qualify. Non-volume-variable blue collection box costs are not single-product costs. For that reason, the Commission again rejects Proposal Four for use in the Postal Service’s periodic reports.

VI. PROPOSAL FIVE—Cost of Delivery of Express Mail by Clerks

Proposal Five has two parts, both involving the cost of street delivery of Express Mail by mail clerks. Part (a) is a proposal to change the distribution key for the attributable portion of those costs. Part (b) is a proposal to treat the non-attributed portion of those costs as group specific to the competitive product group.

A. Distribution Key

The key currently used to distribute the attributable costs of the mail processing activity called "out of office, delivering Express Mail"[38] is the product shares of the attributable cost of mail processing activities by those clerks when they are in the office. This results in, respectively, a 96 percent to 4 percent division between domestic and International Express Mail. *See* Docket No. R2006-1, USPS-LR-L-55. In the Commission's FY 2007 ACD, it questioned the basis of the 96/4 percent split, noting that the split would be 79/21 percent if it were based on Revenue, Pieces, and Weight System (RPW) volumes. The Commission suggests that the distribution key should be re-evaluated in light of the wide difference between these two methods. Proposal Five would apply the RPW-based distribution key. Using FY 2007 costs, the Postal Service estimates that changing the 96/4 percent distribution key to a 79/21 percent distribution key would shift about $4.346 million from domestic Express Mail to International Express Mail. *Id.* at 15.

No comments were received opposing part (a) of Proposal Five.

The Commission accepts part (a) of Proposal Five. The Commission approves the Postal Service's proposed use of RPW volumes of domestic and International Express Mail as the key for distributing attributing out of office, delivering Express Mail costs. However, further study of the reasons for the discrepancy between the In-Office Cost System-based key and the RPW-based key is warranted.

[38] Request at 14.

B. Comments

The non-volume-variable portion of the costs of "out of office, delivering Express Mail" activity is 57 percent and is treated as institutional. In the Commission's FY 2007 ACD, the Commission suggested that the Postal Service review this variability factor. FY 2007 ACD, Appendix B, at 2. The Postal Service proposes to continue to use the 43 percent variability factor. It also proposes treating the 57 percent non-volume-variable amount as group specific to competitive products on the assumption that these costs solely support domestic and International Express Mail, both of which are competitive products.

Using FY 2007 costs, the Postal Service estimates that treating the 57 percent non-volume-variable costs as group specific to competitive products shifts about $34 million from institutional costs to competitive group-specific costs. Request at 15.

PSA expresses concern that the Postal Service is proposing to categorize all non-volume-variable "out of office, delivering Express Mail" costs as group specific based on the name of the activity. It states:

> There is nothing on this record to show that Express Mail is the only mail delivered by postal employees in this activity. While it is tempting based upon the activity's name to assume that only Express Mail is delivered in this activity, this may not be the case. … The classification of 'Out of Office, Delivery Express Mail' costs is based on a single question about 'off premises activity' (Q18A07)[.] … Express Mail is the only class of mail explicitly identified for pickup or delivery and it is listed as the first option, possibly leading to errors or bias in responses in cases where the answer may be unclear. … [T]here is no use of the extensive set of IOCS questions about the mailpiece itself that are used to make sure that the mail class is correctly identified.

PSA Comments at 7-8. PSA does not feel that the Postal Service has properly assessed whether there exists the required exclusive causal relationship to conclude that these costs would go away if competitive products were no longer offered.

The Postal Service denies that IOCS Question 18A07, the "Off Premises Activity" question, is prone to errors or bias. It argues that options A and B offered in the question are clearly contrasting choices that allow the data collector to differentiate between Express Mail Delivery and some other delivery of non-Express Mail. The

Postal Service says it does not believe this proposal should be controversial since it uses clear-cut IOCS questions in a way that is consistent with the general use of IOCS questions to identify the activities of postal employees and assign costs on the basis of that identification. Postal Service Reply Comments at 11-12.

The Postal Service does not address PSA's contention that IOCS information on mailpiece identification should be used to supplement the Off Premises Activity IOCS question to confirm that "out of office, delivering Express Mail" costs are confined to Express Mail.

The Commission agrees with the Postal Service that the IOCS questions supporting its conclusion that "out of office, delivering Express Mail" is an activity that is confined to Express Mail clearly distinguishes between the delivery of Express Mail and other mail. In the Commission's view, it is reasonable to assume that the responses to these questions are unbiased. Therefore, treating these non-volume-variable costs as group specific to competitive products is appropriate. The Commission accepts the proposed change in analytical principles in Proposal Five, part (b) for use in the Postal Service's Incremental Cost Report and the Competitive Products Income Statement.

Examination of IOCS data on mailpiece identification, however, would provide assurance that the Commission's assumption is correct that the IOCS data is unbiased. To validate the Postal Service's categorization of these costs as group specific to competitive products, the Commission requests the Postal Service to make a preliminary examination of IOCS data that help identify the mailpiece and report the results in its FY 2008 annual report.[39]

[39] IOCS questions Q18H03 and Q23G01 might be particularly relevant.

VII. PROPOSAL SIX—Excluding Non-transportation Costs from the Key that Distributes the Cost of Transporting Empty Equipment

Currently, after the empty equipment component of attributable highway and rail purchased transportation costs is calculated, it is distributed to products using a key that consists of the product shares of all other Segment 14 attributable costs. One of the products included in the product share profile is International Mail. Proposal Six would exclude from that key certain costs that the Postal Service argues are not transportation-related costs. These it identifies as terminal dues and internal conveyance charges. The Postal Service states these costs "are largely the result of settling foreign postal transactions[.]" Request at 18. Excluding these costs from the distribution key will distribute fewer empty equipment costs to International Mail and increase the amount distributed to First-Class Mail and Priority Mail.

Only Time Warner Inc. (Time Warner) commented on this proposal. Time Warner is concerned distribution keys based on all other Segment 14 costs are imperfect because of mail brought directly to the destination delivery units (DDU) by mailers in various containers. These containers, once emptied by the Postal Service, must be returned to the mailers. Time Warner Comments at 6-7. However, empty equipment costs are not attributed to these mail volumes because they are not observed on any purchased transportation. Time Warner believes that Proposal Six results in a more accurate distribution key, but suggests that the Postal Service try to account for the cost of transporting empty equipment resulting from mail dropped at the DDU.

The Commission agrees that these terminal dues and internal conveyance charges are not transportation related, and thus should not be included in the key which distributes highway and rail empty equipment costs.

No commenters oppose the proposal. The Commission accepts this proposed change in analytical principles. At the same time, it urges the Postal Service to look for a remedy to the defect in the new distribution key identified by Time Warner.

VIII. PROPOSAL SEVEN—Changing the Key that Distributes Attributable Vehicle Service Driver Costs

Proposal Seven would change the key used to distribute attributable Vehicle Service Driver (VSD) costs (Cost Segment 8) to products. The Postal Service does not have data that directly measures product shares of attributable VSD costs. The proxy distribution key that it currently uses is the cubic feet of originating mail obtained from the RPW system. The Postal Service argues that this proxy inappropriately distributes VSD costs to mail that originates at the DDU. Instead, it proposes to use estimated cubic-foot miles of mail sampled on intra-sectional center facility (intra-SCF) routes as a more accurate proxy. It believes that this proxy will better reflect VSD mail than the current RPW proxy because intra-SCF routes do not handle mail that originates at the DDU. Request at 20-23.

Proposal Seven would increase the amount of VSD costs attributed to First-Class Mail, Priority Mail, Express Mail, and Periodicals and decrease the amount attributed to Standard Mail and Package Services.[40] The Postal Service argues that these effects are to be expected because First-Class, Periodical, Priority, and Express Mail are rarely entered at the DDU, and these pieces often incur VSD transportation from the origin and to the destination. Postal Service Reply Comments at 17-18.

A. Comments

Five parties filed comments that criticize Proposal Seven.[41] They consider it inappropriate to replace one imperfect proxy with another imperfect proxy when data on relative product use of VSD services could be directly measured. They encourage the Postal Service to do a study to collect the appropriate data. In its reply comments, the

[40] The FY 2007 CRA does not distinguish between single-piece Parcel Post, Parcel Select, and Parcel Return Service; therefore, the impact on the individual products is unknown at this time.

[41] Reply Comments of Magazine Publishers of America, Inc., September 15, 2008, at 1-3; Public Representative Comments at 10; Valpak Comments at 15-18; APWU Comments at 3-4; and Time Warner Comments at 7-9.

Postal Service acknowledges that the intra-SCF proxy is imperfect, but believes it is an improvement over the current proxy. Postal Service Reply Comments at 17.

The Public Representative believes that the intra-SCF proxy is an appropriate distribution key because it excludes mail originating and destinating in the same DDU. Public Representative Comments at 9. However, he notes two issues that should be considered before accepting the Postal Service's proposal. First, he expects "some difference in the distribution of variable costs at the product/rate level" using the method proposed by the Postal Service, compared to actual VSD sampled mail. *Id.* at 10. This difference is expected because intra-SCF runs are handled by contractors if runs are longer than 25 miles, and VSDs usually handle the routes less than 25 miles. Second, the Public Representative believes it might be better to keep the distribution key as cubic feet of mail because that appears to be the original cost driver. *Id*. at 9-10.

The Postal Service agrees that the fact that intra-SCF trips are longer than VSD trips could make its proposed proxy biased by over-representing products that are transported further. It argues, however, that the proposed proxy is still a significant improvement over the current one. Postal Service Reply Comments at 16. It also rebuts the Public Representative's assertion that the cost driver should be cubic feet rather than cubic-feet miles. It cites the testimony of Steve H. Wade in Docket No. R97-1, which identifies cubic-foot miles as the VSD cost driver.

In its initial comments, APWU asserts that there are specific data, such as data for Highway Contract Routes (HCR), from which a distribution key for VSD costs could be derived, obviating the need to use proxies. APWU Comments at 4. The Postal Service contends that APWU is incorrect, and the distribution factors, specifically data on HCRs, do not exist. Postal Service Reply Comments at 16. Time Warner notes that VSDs perform non-driving duties, and urges the Postal Service to take an inventory of the activities performed by VSDs and the products they handle. Time Warner Comments at 8. The Postal Service argues that these duties are reflected in the variability estimate, and are not relevant to the distribution of the volume-variable costs of VSDs. Postal Service Reply Comments at 17.

Valpak believes the Postal Service should be required to explain why the proposed proxy is better than the existing distribution key, and why it cannot collect data that measures the VSD product profile directly. Valpak Comments at 17-18. In its reply comments, the Postal Service argues that the current distribution key has both methodological and conceptual deficiencies, which Proposal Seven would cure. Postal Service Reply Comments at 14. It argues that highway transportation data is a better proxy than RPW data because transportation operations have changed over the years with increasing dropshipping directly to the DDU. *Id*. at 13. It also asserts that using cubic-foot miles rather than a cubic-foot distribution key is consistent with the cost driver used in the variability model that estimates attributable VSD costs. *Id*. at 14. The Postal Service believes the underlying justification for the RPW-based distribution key is no longer applicable because at the time the RPW was selected as the proxy, most mail needed to be transported by truck from the destination sectional center facility (DSCF) to the DDU. The Postal Service also contends that development of a distribution key that directly estimates VSD cubic-foot mile proportions would be too expensive and time consuming to develop at this time. *Id*. at 15.

B. Commission Analysis

The Commission agrees that there is potentially significant distance-related bias in the new VSD proxy that the Postal Service proposes. The Postal Service is encouraged to collect data that directly measures the product profile for VSD costs. Nevertheless, the Commission agrees with the Postal Service that using intra-SCF cubic-foot miles to distribute VSD attributable costs to products is likely to be less biased than the current proxy, both because DDU dropshipped mail will be excluded from the new key, and the new key will be consistent with the modeled driver of attributable VSD cost. Accordingly, the Commission accepts the change in the analytical principle proposed in Proposal Seven for use in the Postal Service's FY 2008 periodic reports. The Commission, however, intends to revisit the analytical method for distributing VSD attributable costs as part of the FY 2009 Annual Compliance

Determination. The Postal Service must demonstrate a good faith effort to directly measure how these costs are distributed to products before the Commission will accept the use of a proxy after the FY 2008 reporting period.

All of the numerous commenters addressing Proposal Seven are opposed to it. They object to the Postal Service's continued reliance on proxies that the Postal Service concedes are flawed, rather than obtaining data that directly measures products' relative use of VSD transportation. The Commission notes that nearly $400 million of attributable costs are distributed by the method at issue in Proposal Seven and the change in the proxies used results in wide swings in product shares of these costs. *See* Request at 22-23. The Commission agrees with the commenters that the Postal Service should not be satisfied with the use of flawed proxies for distributing this very substantial pool of costs.

IX. PROPOSAL EIGHT—Proposed Changes to First-Class Mail Automation Flats Mapping

The Postal Service proposes to change the mapping of automation flats to rate categories in the model that estimates worksharing-related cost avoidance for First-Class Mail flats. The purpose of mapping volumes to rate categories is to identify for each rate category how many bundles and pieces are entered into the system and at what point in the system they enter. The current methodology uses the presort level of the container (or tub) to determine the rate category, and the proposal is to use the presort level of the bundle (or package) instead.

In its Request, the Postal Service explains that container-based mapping was originally incorporated into the model because it anticipated a container-based rate structure. That structure was never adopted; instead, pieces are assessed postage based on the presort level of the bundle. Through an oversight, the Postal Service did not change its container-based mapping scheme to a bundle-based mapping scheme in the versions of the model that it submitted in Docket Nos. R2005-1 and R2006-1 or in the FY 2007 annual report. Request at 24.

In support of its proposal, the Postal Service filed supplemental materials that make it possible to estimate the impact that the proposed change would have had on the FY 2007 cost avoidances for First-Class Mail automation flats. The table below presents a comparison of the avoidable costs and corresponding worksharing cost avoidances using the current method and the proposed method.

Table IX-1

Effect of Proposal Eight on First-Class Mail Flats Cost Avoidances

Rate Category	**ACR 2007 WS Related Unit Cost (1)**	**RM2008-2 WS Related Unit Cost (2)**	**Difference (3)**
Nonauto Presort	53.38	46.00	-7.38
Mixed ADC Auto Presort	54.15	50.89	-3.26
(Cost Avoidance)	**(13.83)**	**(10.35)**	**-3.48**
ADC Auto Presort	40.32	40.54	0.22
(Cost Avoidance)	**(9.56)**	**(5.40)**	**-4.16**
3-Digit Auto Presort	30.75	35.13	4.38
(Cost Avoidance)	**(11.88)**	**(15.96)**	**4.08**
5-Digit Auto Presort	18.87	19.17	0.30

Sources: col (1) PRC-ACR2007-LR3, FCM flat costs.xls; col (2) Prop.8.Supplemental.xls, filed with Notice of United States Postal Service Regarding Materials Distributed or Requested at the August 27, 2008 Technical Conference (August 29, 2008)

As the table shows, the worksharing cost avoidances for area distribution center (ADC) automation and 3-digit automation flats decrease by 3.48 cents and 4.16 cents, respectively. The revised estimate of avoided cost for each of these categories is less than the current corresponding discount.[42] In contrast, the worksharing cost avoidance for 5-digit automation flats would increase by 4.08 cents. In planning its next rate adjustment, the Postal Service should be aware of these effects when designing discounts to comply with the statutory restrictions on worksharing discounts.

None of the comments filed in this docket address Proposal Eight. The Commission finds the proposal to be an improvement for the reasons identified by the Postal Service and accepts the changed analytical principle in Proposal Eight for use in the Postal Service's periodic reports.

[42] The current First-Class Mail automation flats discounts are 13.2 cents for ADC, 9.1 cents for 3-digit, and 11.5 cents for 5-digit. *See* Docket No. R2008-1, United States Postal Service Notice of Market-Dominant Price Adjustment, February 11, 2008, Appendix B.

X. PROPOSAL NINE—Basing the Distribution Key for Postal Automated Redirection System Costs on In-Office Cost System Tallies

Postal Automated Redirection System (PARS) equipment automates the handling of machinable undeliverable-as-addressed letters. It intercepts the forwarding and return-to-sender operations for letters at the originating processing facility level, and either forwards, returns to the sender, or wastes the letters in question. This process reduces downstream letter handlings, and thus, reduces the costs for processing, transporting, and delivering letters at the originating processing facilities. PARS attributable costs include depreciation, maintenance labor, and parts and supplies. These costs are nearly 100 percent volume variable.

Currently, the attributable costs of PARS are distributed to products using the distribution key for the Computer Forwarding System (CFS), which PARS is in the process of replacing. The current CFS proxy incorrectly distributes a large portion of the PARS equipment costs to classes and subclasses that benefit very little from PARS, particularly (because of shape) Periodicals. The IOCS was recently redesigned to include tallies of PARS operations. Proposal Nine would construct a distribution key for the attributable costs of PARS based on IOCS tallies. This will distribute PARS costs to those classes of mail that are processed with the aid of PARS equipment.

Time Warner comments that Proposal Nine is a clear improvement. It agrees with the Postal Service that the "current method has the effect of assigning a large portion of the PARS equipment costs to flats mail, particularly to Periodicals, even though PARS is used only for letters and not for flats." Time Warner Comments at 9-10. Time Warner notes that this new distribution key should reduce PARS-related costs that are distributed to Periodicals by almost $17 million. *Id.*

The Commission agrees that since PARS tallies are currently available from the IOCS, it is appropriate to construct a distribution key that reflects the relative usage of PARS from the IOCS data. Accordingly, the Commission accepts the proposed change in analytical principles in Proposal Nine for use in the Postal Service's periodic reports.

It is Ordered:

The 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, filed August 11, 2008, is disposed of as described below:

1. Proposal One is granted to the extent that the Postal Service is delegated the authority to categorize the cost of an activity in Cost Segment 18 as group specific if it demonstrates at the time that it files its FY 2008 Incremental Cost Report that the relevant activity supports only one competitive product group. The Postal Service is authorized to use the group-specific costs identified in this manner in its Incremental Cost Report.

2. Proposal One is denied to the extent that it requests that the Postal Service be delegated the authority to categorize the cost of an activity that supports both market dominant and competitive products as group specific. The Postal Service may, however, submit a proposed change in how the cost of such an activity will be categorized to the Commission for review. If the Commission accepts the change, it may be included in the Postal Service's Incremental Cost Report.

3. Proposal Two is granted to the extent that the Postal Service is authorized to use the group-specific advertising cost identified to prepare its FY 2008 Incremental Cost Report.

4. Proposal Three is accepted.

5. Proposal Four is rejected.

6. Proposal Five is accepted.

7. Proposal Six is accepted.

8. Proposal Seven is accepted.

9. Proposal Eight is accepted.

10. Proposal Nine is accepted.

By the Commission.

Steven W. Williams
Secretary