

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**



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Introduction

The 2006 Postal Accountability and Enhancement Act (PAEA or the Act, enacted on December 20, 2006), among other things, includes a number of provisions and requirements for separate accounting and funding for United States Postal Service (USPS) class and subclass products that compete with similar products offered by commercial entities or “competitive products.” Specifically, PAEA directs that¹:

The Secretary of the Treasury, in consultation with the Postal Service and an independent, certified public accounting firm and other advisors as the Secretary considers appropriate, shall develop recommendations regarding—

- (i) the accounting practices and principles that should be followed by the Postal Service with the objectives of—
 - (I) identifying and valuing the assets and liabilities of the Postal Service associated with providing competitive products, including the capital and operating costs incurred by the Postal Service in providing such competitive products; and
 - (II) subject to subsection (e)(5), preventing the subsidization of such products by market-dominant products; and
- (ii) the substantive and procedural rules that should be followed in determining the assumed Federal income tax on competitive products income of the Postal Service for any year (within the meaning of section 3634²).

Treasury is required to present these recommendations to the Postal Regulatory Commission (PRC) no later than December 20, 2007. The PRC, in turn, is required under PAEA to provide all interested parties (the USPS, users of the mails, and a member of the PRC who is required to represent the interests of the general public) an opportunity to present their written views on the Treasury recommendations or in whatever manner the PRC deems is appropriate.³ In addition, within 12 months of the date that Treasury submits its recommendations to the PRC, or a later date agreed upon by the PRC and the USPS, the PRC is required to issue regulations establishing the accounting practices and principles that the PRC has determined will govern the operation of the Competitive Products Fund (CPF) and the determination of the assumed federal income tax to be transferred from the CPF to the existing Postal Service Fund (PSF).

The purpose of this report is to present to the PRC Treasury’s recommended accounting principles and practices. This report first discusses specific PAEA accounting and CPF income taxation requirements and then provides an accounting approach with regard to the CPF that Treasury believes will best meet these requirements, including identifying and valuing the assets and liabilities for the CPF and determining the assumed federal income tax on the income of the CPF. Under Treasury’s recommended accounting approach, the rate determination and calculation of the assumed income tax would necessarily be simplified. Ultimately, however, the PRC will need to determine the optimum accounting approaches that USPS should implement. The accounting and income tax approaches described in this report should serve as the starting points for such future discussions and decisions. Given the size and scope of the USPS’s

¹ PAEA, Title IV, SEC. 401(a)(1), ‘Sec. 2011(h)(1).

² PAEA, Title IV, SEC. 402, ‘Sec. 3634. Under Section 3634, the USPS shall compute an assumed Federal income tax based on the assumed taxable income from competitive products and transfer the amount of that assumed tax from the Competitive Products Fund to the Postal Service Fund.

³ PAEA, Title IV, SEC. 401(a)(1), ‘Sec. 2011(h)(2)(A).

operations as well as the complexity involved in meeting the PAEA accounting and other requirements, Treasury believes that any necessary changes to the existing USPS costing and other systems should be made incrementally and notes that some may need to be implemented over the long term.

Section 1

PAEA Accounting Requirements for Competitive Products

PAEA contains a number of provisions and requirements concerning the accounting and funding for USPS competitive products. This section provides an overview of the current USPS cost systems and addresses the PAEA cost accounting requirements for competitive products.

1.1 Current USPS Cost System

USPS currently uses an Activity Based Costing (ABC) system⁴ that aims to generate economic costs. Employing statistical methods and applied economic theory to generate various measures of cost as outputs, it follows the distinction of economic theory between fixed and variable costs.⁵ In 2006 USPS assigned approximately 59 percent of cost to products (about \$42 billion); the remaining costs are placed in a cost pool known as “institutional costs.” These institutional costs correspond, in effect, to fixed costs in economic theory. To achieve break-even operations, as required prior to PAEA, these fixed costs must be recovered by price mark-ups over the volume-variable costs of operations.

The primary objectives of the USPS economic costing system are to report (1) the marginal cost of each class of product and (2) the incremental cost of each class of product compared to all of the other classes of products serviced. Marginal cost is the change in total variable cost that results from producing an additional unit of output of a given product. In a multi-product firm like USPS, incremental cost is the amount of cost avoided by eliminating a given product. The average incremental cost is this dollar figure divided by the number of units that are no longer produced.⁶

USPS approximates marginal cost by computing average (or unit) volume-variable cost. These costs are derived using its aforementioned ABC system, which links the variability of cost pools in activity centers to the various products that use these activities. USPS uses the system to generate incremental costs. As noted above, the system does not assign all costs to product classes and subclasses and any costs that are considered non-attributable are called institutional costs, treated as period costs, and essentially ignored for product costing purposes.

⁴ Activity Based Costing, or ABC, is an accounting method of assigning costs to activities based on their use of resources. Cost pools are created for groups of activities that can be assigned together. Cost drivers are identified for each activity. The variability of the costs for that activity is calculated as a function of the volumes of each product or service using the activity. Then the results are applied to the respective cost drivers to determine the amount of each cost pool and each activity to be assigned to each product or service.

⁵ The basis for economic costing is opportunity cost, which is the cost of the alternatives foregone. Economic costs are forward-looking whereas accounting costs and revenues are based on dollars derived from accounts of historical activities. Accounting costs are not intended to be forward-looking, but to render a transactional picture of actual expenditures and revenues for some past period (e.g., fiscal year).

⁶ It is also possible to compute incremental cost by looking at the additional cost of adding a given number of units of a new product to the product line. However, the standard incremental cost calculation is based on the total cost that would be avoided if the current output of a product were reduced to zero and all associated costs with producing the product were eliminated.

One outcome of USPS's use of an economic costing approach is that its pricing is supported by marginal cost analysis. Another is that USPS seeks to avoid the cross-subsidization of competitive products by market-dominant products by ensuring that its prices on its competitive products exceed their average incremental costs.

1.2 PAEA Cost Accounting Requirements

Among the PAEA statutory cost accounting requirements for competitive products, the following are of particular note in Title II, Section 202, subsection 3633(a):

IN GENERAL — the Postal Regulatory Commission shall ...promulgate regulations to —

- (1) prohibit the subsidization of competitive products by market-dominant products;
- (2) ensure that each competitive product covers its costs attributable; and
- (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. (emphasis added)

Based on these three statutory requirements, augmented by other PAEA provisions, Treasury has concluded that the only viable method to begin to address the PAEA requirements for competitive products is to establish a theoretical, regulatory reporting construct under which the USPS would “on paper only” analytically segregate and identify the revenue and costs associated with the competitive products — that is, to treat competitive products as if they were sold by a separate, theoretical enterprise or corporation that shares economies of scale and scope with the market-dominant products.⁷ To accomplish this, Treasury recommends that USPS modify its current cost system to attribute costs consistent with the PRC definition of USPS competitive products. This modification in itself, however, is not sufficient to calculate a PAEA-compliant, corporate-like income statement or impute an assumed income tax. In addition, this initial modification, in Treasury's assessment, does not satisfy other PAEA competitive products requirements concerning cross-subsidy tests and assignment of an appropriate share of institutional costs. To achieve these additional PAEA compliance requirements, the USPS cost system will need to be augmented to provide for the additional assignment of competitive products' costs.

It should be noted that the once the competitive products are theoretically segregated for PAEA compliance demands, when added back to the market-dominant products, the USPS entity is intact (i.e., the parts equal the whole). In addition, it is important to emphasize at the outset of this report that Treasury deliberately does not address the issue of USPS competitive products pricing (rate-making in USPS terminology). Pricing by private industry as well as by the USPS for competitive products must necessarily be a separate activity from costing. Pricing is typically market-driven and frequently reflects decisions that encompass more than just costs (e.g., strategic considerations, competition, and supply and demand).

In Treasury's view, PAEA establishes five requirements for the USPS cost attribution system,⁸ which include the three PAEA statutory cost accounting requirements discussed at the beginning of this section. In order to meet the five requirements, the modified USPS cost system must have the capability to:

⁷ PAEA Title IV, SEC. 402, “Sec.3634(a)(2)(A): “...the term ‘assumed taxable income from competitive products’, with respect to a year, refers to the amount representing what would be the taxable income of a corporation under the Internal Revenue Code of 1986 for the year, if— (A) the only activities of such corporation were the activities of the Postal Service allocable under section 2011(h) to competitive products;...” (emphasis added)

⁸ Specific PAEA references for each of these requirements can be found in subsequent subsections of this section.

1. Report the costs for competitive products at a more granular⁹ level than they are currently¹⁰;
2. Demonstrate that each competitive product (as defined under PAEA) covers its attributable costs by pricing each competitive product above its volume-variable or marginal cost;
3. Demonstrate that competitive products are not individually cross-subsidized by the market-dominant products¹¹ by showing that each competitive product's revenues exceed its incremental costs;
4. Ensure that the combined revenues of the competitive products cover an appropriate share of the USPS institutional costs; and
5. Enable computation of an assumed federal income tax on the income of the theoretical USPS Competitive enterprise.

The first three of the PAEA costing requirements would require only minor, if any, modifications to the current USPS cost system. However, the last two could require more substantive changes to the current system. The purpose of this section is to describe Treasury's proposed modifications to the current USPS cost system and to demonstrate that the resulting system would meet the above five requirements.

1.3 Key Foundational Costing Recommendations

Before discussing the details of the proposed solutions, Treasury would like to make some key foundational recommendations that address requirements needed to: (1) perform competitive products' cost assignment and cross-subsidy and institutional costs "appropriate coverage" tests, (2) calculate income before taxes, and (3) provide financial reporting for the USPS competitive products.

The first of these recommendations deals with the definition of products. PAEA defines product as "a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be applied."¹² The USPS postal services, as currently defined by class and subclass, do not meet this definition.

The PRC, in its recent Docket No. RM2007-1, Order No. 26, addresses this situation — at least from a product-definition standpoint. In its Order, the PRC states that "the term 'product' has greater significance for competitive products than for market-dominant products. Section 3633(a)(2) requires each competitive product to cover its attributable costs. Each competitive product is identified following the process outlined in Section 3631." First, Section 3631(a) lists four types of mail (priority mail, expedited mail, bulk parcel post and bulk international mail) as being within the competitive category of mail. Second, Section 3631(c) instructs that the "mail matter" comprising each of these types of mail have "the meaning given to such mail matter under the mail classification schedule" and "The Commission is charged with the responsibility of determining what mail matter comprises each of these types of mail, and that mail matter is what competitive products initially are."¹³

⁹ The terms "granular" and "granularity" are used in this report to describe the level of detail that is reported by a cost system. The level of granularity in financial reporting is often used to assess the reporting transparency.

¹⁰ A number of PAEA provisions relate to increasing financial data granularity and improving transparency. For example, see Title II, SEC. 201(a), 'Sec. 3621 Market-Dominant Products Applicability and Title II, SEC. 202, 'Sec. 3631(a).

¹¹ PAEA, Title II, SEC. 202, 'Sec. 3633(a)(1) and Sec 2011(h)(1)(A)(II).

¹² PAEA, Title I, SEC. 101, 'Sec. 102(6).

¹³ PRC Docket No. RM2007-1, Order No. 26, Chapter III, Subsection E4, Paragraph [3072].

The PRC recently “identified 11 products that initially comprise the competitive products category:

- Priority mail, consisting of Domestic Priority Mail (1) and International Priority Mail (2);
- Expedited mail, consisting of Domestic Express Mail (3) and International Express Mail (4);
- Bulk parcel post, consisting of Parcel Select (5), Parcel Return Service (6), and parcel post qualifying for BMC, OBMC, and barcode discounts (7);
- Bulk international mail, consisting of IPA (8), ISAL (9), and M-bags (10); and
- Negotiated service agreements (11), which includes ICMs.

These products not only form the basis for the mail classification schedule, but also comprise the initial competitive product list required by section 3642.”¹⁴

Based on the above, Treasury assumes that USPS will have to redefine and reclassify its current postal-class and subclass services consistent with PAEA direction and PRC definitions. Consistent with this assumption, and unless specifically noted otherwise, the term “product” as used in this section is assumed to be consistent with the PRC definition, and “competitive products” refer to the products and product categories, including associated services, noted above. All other products and services are, by default, considered in this section to comprise the USPS market-dominant products.

As part of the USPS competitive product reclassification effort, Treasury makes the following recommendation in support of the cost-system modification requirements.

Recommendation 1: The current USPS economic cost attribution system should be modified so that the currently estimated class and subclass costs are remapped and attributed to the competitive products as defined by the PRC. Once remapped, product cost assignment should then be made consistent with the current USPS attribution rules and processes for marginal and incremental costs.

The second recommendation deals with sharing the economies of scale and scope between the market-dominant and competitive products. The competitive products “business” is defined in PAEA in Title IV, SEC. 402, ‘Sec. 3634(a)(2) as if it were a stand-alone corporation that sold solely competitive products:

(A) the only activities of such **corporation** were the activities of the Postal Service allocable under section 2011(h) to competitive products; (emphasis added) and

(B) the only assets held by such corporation were the assets of the Postal Service allocable under section 2011(h) to such activities.’

Clearly, there is no USPS stand-alone corporation that sells competitive products only and PAEA does not change this. However, in order to meet PAEA’s specific provisions for separate accounting for USPS competitive products, Treasury believes that a theoretical or “on paper only” corporation or enterprise should be analytically created for the competitive products. If this assumption were not made, then sophisticated cost modeling of a true stand-alone enterprise would be required. However, such modeling would require a number of assumptions that would be difficult to subject to third-party validation, since they would significantly depend upon the approaches to service delivery built into the model. Moreover, such modeling would likely be very costly and take many years for the USPS to develop with little-to-no corresponding benefits.

¹⁴ Ibid., Paragraph [3073]. Note: Treasury added individual product numbering for product identification clarity.

Recommendation 2: To enable a practical solution to be developed that could be validated by third parties, a theoretical or “on paper only” enterprise — USPS Competitive — should be analytically created by assigning to it an appropriate share of all USPS costs.

Consistent with this recommendation, as noted above, Treasury assumes that the competitive products would share the economies of scale and scope with the market-dominant products and that the USPS costs would be assigned to the theoretical USPS Competitive enterprise without any attempt to determine the costs of a true stand-alone competitive products entity.

The third recommendation relates to the derivation of marginal and incremental costs. PAEA Title II, Section 202, subsection 3631(b) provides the following definition:

For purposes of this subchapter, the term ‘costs attributable,’ as used with respect to a product, means the direct and indirect postal costs attributable to such product through reliably identified causal relationships.

This definition is consistent with the economic costing approach of the current USPS cost system. Consequently, Treasury assumes that compliance with this PAEA definition would require no modification to the current USPS cost system beyond those recommended to accommodate the newly defined competitive products. Treasury also assumes that the product costs reported by the modified USPS product cost system would be attributable costs and would form the appropriate basis for determining the marginal and incremental costs of the competitive products.

Recommendation 3: The volume-variable or marginal product costs reported by the USPS cost system should be used — after the product definition modification required by PAEA— to ensure that the competitive products cover their attributable costs. The reported incremental costs should be used to ensure that cross-subsidization of the competitive products by the market-dominant products is not occurring.

The fourth recommendation deals with the treatment of the postal Universal Service Obligation (USO) costs. The USO represents a demand by society via the federal government to provide a level of mail service different from that which would be justified on purely commercial grounds. That is, if USPS were driven by profit motives, some aspects of the obligations inherent in the USO would not be fulfilled. Since price-cap regulation under PAEA is interpreted to instill incentives for USPS to operate in a more commercial manner, it is logical as well that the costs of the USO and its source of funding should be identified. The perceived main elements of the USO in postal services are uniformity of price for single-piece mail and ubiquity of collection and delivery. Other elements of the USO include a defined frequency of delivery to all addresses and constraints on accessibility to postal services, including the maintenance of post offices in low population areas. Some of these obligations impose additional costs on the USPS that it would not incur were it not for the USO. Since there is no charge-back of the costs of this additional burden to the federal government, the costs are borne by USPS and, via the rate-setting process, postal customers.

Currently, the USPS cost system does not explicitly distinguish the costs of the USO from common variable costs. Determining the USO’s incremental costs would be a complex undertaking. Theoretically, it would require modeling the costs of USPS as if there were no USO and the USPS were operating as a purely profit-driven entity. Such modeling would require numerous assumptions about the service delivery approaches adopted under such a regimen and would be difficult to subject to meaningful third-party validation.

Treasury notes that PAEA requires the PRC to report on the estimated costs of the USO.¹⁵ The PRC report on this matter will provide the specifics on how the scope of the USO should be defined and what approach should be used to cost the USO. This study should also identify the costs and benefits of the USO for competitive products and make recommendations concerning what portion of the cost of the USO, if any, should be borne by the competitive products and USPS Competitive.

It should be noted that the usual starting point in practice in other postal operators has been that the cost of the USO is borne solely by the market-dominant products. This starting point derives both from historical reasons as well as from the fact that locations giving rise to significant revenues from competitive products tend also to be high-revenue locations for market-dominant products. Thus, a commercially oriented operator would specify service levels in high-revenue locations at levels at or above those required by the USO. Under these circumstances, the presence of competitive products does not impose any additional burden as a result of the USO. Note, however, that competitive products typically will contribute to the support of the USO network based on economies of scope between competitive and market-dominant products so that the cost of the USO will be lower with competitive products than it would be without these products.

Until the PRC report on the USO is completed, Treasury makes the following recommendation regarding the interim assignment of the costs of the USO to competitive products.

Recommendation 4: When the costs of the USO have been reliably determined and subjected to third-party validation, then the PRC should make any adjustments it deems necessary to the institutional cost assignment approach described in the following recommendation.

The fifth recommendation deals with the aforementioned PAEA requirement in Title II, Section 202, subsection 3633(a)(3) that competitive products collectively cover an *appropriate* share of the USPS institutional costs, as defined by the PRC. Treasury notes that this requirement is reinforced by the following language from Title II, Section 201, subsection 3622(b)(9) that provides that the USPS rate-setting process is: “[t]o allocate the **total** institutional costs of the Postal Service **appropriately** between market-dominant and competitive products....” (emphasis added)

Treasury notes that the recent PRC Final Rule set the “appropriate share of institutional costs” test in subsection 3633 (a)(3) at 5.5 percent, based upon the historical performance of the competitive products.¹⁶ Thus, the test requires that the competitive products retain their current level of contribution. The derivation of the 5.5 percent is based upon the current definition of institutional costs as being beyond marginal product costs. As long as the USPS cost system continues to report marginal and product-specific fixed costs, then institutional costs (as currently defined) could still be derived and the 5.5 percent contribution test, or other PRC-defined test,¹⁷ could still be applied.

Based on discussions with the USPS, Treasury understands that USPS is moving apace to modify its cost accounting system to attribute costs, using its existing procedures, to the greatest extent possible to competitive products as defined by PAEA, which is in accordance with Treasury’s first and third cost accounting recommendations. In addition, the USPS is working to develop and implement cost system modifications whereby the costs of its two lines of business¹⁸ (LoBs), the Market-dominant and the Competitive, will be assigned using cost drivers that capture the causal relationship between these LoBs and their applicable business costs.

¹⁵ PAEA, Title VII, Section 702(b)(2)(A).

¹⁶ PRC Docket No. RM2007-1, Order No. 43, Chapter V, Section 3015.7(c).

¹⁷ PAEA, Title II, SEC. 202, ‘Sec. 3633(b).

¹⁸ Lines of business (LoBs) are meaningful collections of products that have activities associated with them.

The costs attributable to the USPS Competitive LoB are those costs that are specific to the competitive products collectively, but cannot be assigned meaningfully at the product level. An example is the cost of a manager in charge of some aspect of competitive products, who would not be required if all competitive products were discontinued. However, that individual would still be required if a single competitive product was discontinued. Hence, the associated costs would not be part of the USPS volume-variable costs reported at the individual product level. Since these costs are specific to the LoB, they could be directly assigned to the LoB cost objects.

After assigning applicable costs to the two LoBs, the remaining unassigned costs would be considered institutional costs. The theoretical Competitive enterprise would then be required to cover the competitive products' attributable costs, the applicable LoB costs, and whatever the PRC has prescribed by regulation as the competitive products' "appropriate share" of the institutional costs, which may or may not be the currently established 5.5 percent depending on the PRC's analysis of the costs and other factors involved.

Recommendation 5: The current USPS cost accounting system should be modified so that all of the costs for USPS's two lines of business (Market-Dominant and Competitive) can be assigned using cost drivers that capture the causal relationship between the lines of business and their applicable business costs. The remaining unassigned costs should be treated as institutional costs and an appropriate percentage of these institutional costs, which should be defined by the PRC by regulation, should be covered by the theoretical Competitive enterprise.

Furthermore, PAEA indicates that revenues should be sufficiently measured. Title II, Section 204(b), subsection 3652(e)(2)(A) authorizes the PRC to initiate proceedings to improve the quality of data if "... the attribution of costs or **revenues** to products has become significantly inaccurate or can be significantly improved" (emphasis added) Fortunately, the existing revenue tracking systems at USPS appear to be adequate for this purpose. No further work or system modification appears necessary in this area unless the reclassification of postal classes and subclasses to the newly defined competitive products warrants them.

Recommendation 6: Subject to USPS system modifications to accommodate the new product definitions, the revenue numbers from the existing USPS financial systems should be used as a basis for both reporting the financial income and the taxable net income of the USPS Competitive theoretical enterprise. [Note: The revenues used to determine the assumed federal income tax might have to be adjusted, as appropriate, to conform to tax code treatment.]

With both revenues and costs for the theoretical Competitive enterprise separated from those of the market-dominant products, it should be possible to develop an income statement for the USPS Competitive enterprise. This statement is needed in order to calculate the required federal income tax on competitive products.

Recommendation 7: A theoretical USPS Competitive enterprise income statement, or statement of operations along the lines of the 2007 statement of the operations shown in Figure 1, should be developed. The revenues should be derived from the current USPS revenue system and process as modified to reflect the new definitions of competitive products. The costs should be the outcome of applying Treasury's above-proposed cost accounting approaches.

USPS 2007 Statement of Operations

USPS Statement of Operations

(from United States Postal Service Annual Report 2007)

September 30,	2007	2006	2005	2004
(Dollars in millions)				
Operating Revenue	74,778	72,650	69,907	68,996
Operating Expenses:				
Compensation and benefits*	54,186	54,665	52,449	50,821
Retiree health benefits*	10,084	1,637	1,495	1,313
Other	15,835	15,379	14,337	13,717
Total operating expenses*	80,105	71,681	68,281	65,851
Income from Operations	(5,327)	969	1,626	3,145
Interest and investment income	195	167	86	33
Interest expense on deferred retirement obligations	-	(231)	(263)	(103)
Other interest expense	(10)	(5)	(4)	(10)
Net (Loss) Income	(5,142)	900	1,445	3,065

* The net impact of P.L. 109-435 legislation was \$6.8 billion of additional expense in 2007 (\$8.4 billion in additional Retiree health benefits less \$1.6 billion in CSRS savings).

Figure 1: USPS 2007 Statement of Operations

It should be noted that the time and resources required to undertake and implement the proposed recommendations reflect both the need to collect the data and develop the software needed to report the new cost information. The timing and duration of implementing these tasks can only be determined through consultation with USPS.

Section 2

Assumed Federal Income Tax

PAEA directs USPS to calculate an assumed federal income tax on its income from competitive activities as defined in PAEA, Title IV, SEC. 402, ‘Sec 3634, Assumed Federal income tax on competitive products income:

(a) DEFINITIONS—

For purposes of this section—

(1) the term ‘assumed Federal income tax on competitive products income’ means the net income tax that would be imposed by chapter 1 of the Internal Revenue Code of 1986 on the Postal Service’s assumed taxable income from competitive products for the year; and

(2) the term ‘assumed taxable income from competitive products’, with respect to a year, refers to the amount representing what would be the taxable income of a corporation under the Internal Revenue Code of 1986 for the year, if—

(A) the only activities of such corporation were the activities of the Postal Service allocable under section 2011(h) to competitive products; and

(B) the only assets held by such corporation were the assets of the Postal Service allocable under section 2011(h) to such activities.

(b) COMPUTATION AND TRANSFER REQUIREMENTS—The Postal Service shall, for each year beginning with the year in which occurs the deadline for the Postal Service’s first report to the Postal Regulatory Commission under section 3652(a)—

(1) compute its assumed Federal income tax on competitive products income for such year; and

‘(2) transfer from the Competitive Products Fund to the Postal Service Fund the amount of that assumed tax.

(c) DEADLINE FOR TRANSFERS- Any transfer required to be made under this section for a year shall be due on or before the January 15th next occurring after the close of such year.

The normal starting points for determining corporate tax liability are an income statement and balance sheet prepared under GAAP. The income statement recommended in Section 1 should be an acceptable starting point for the assumed tax computation.

2.1 Accounting Methodology and Guidelines

Unlike the computation of an individual’s taxable income, under which income is taxable when received and expenses are deductible when paid, the calculation of a corporation’s taxable income generally begins with its Financial Statement Income¹⁹ calculated in accordance with GAAP. There are fundamental

¹⁹ Financial statement income is the net income reflected in the Statement of Operations contained in the USPS 2007 Financial Statement. Reference United States Postal Service Annual Report 2007.

differences between the calculation of financial statement income and taxable income²⁰ that arise from the natural bias of each. To determine a corporation's assumed tax burden requires adjusting accounting income developed under GAAP to develop the income that would be subject to federal tax under current tax law. However, it should be noted that the income statement for competitive products would not be on a GAAP basis.

The primary differences between GAAP income and taxable income relate to timing differences. For GAAP purposes, an expense is recognized when a liability for the expense has been created. Under GAAP, a liability is created when there is a "probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."²¹ For tax purposes, a liability is generally not recognized until satisfaction of the All Events test.²² In general, income is recognized as the underlying earning activity is completed for both GAAP and tax purposes. However, tax law may accelerate the recognition of income when payments are received prior to the completion of the underlying earning activity.

In addition to the general timing differences that distinguish the calculation of Financial Statement Income from taxable income, the tax law also provides special rules with respect to certain items that may result in a different treatment of an item for tax purposes. The following discussion highlights certain of these differences and provides suggestions on how the calculation of an assumed USPS federal income tax on the competitive products income might be effected.

Revenue Recognition

USPS currently recognizes revenue (financial statement income) when services are rendered.²³ In the case of parcel delivery, presumably revenue is recognized upon delivery. On the balance sheet date (the end of the fiscal year), a portion of the revenues from shipments in transit may also be recognized as income for financial statement purposes. In general, income for tax purposes is recognized as the underlying service is provided similar to the financial statement recognition of income. However, tax law may accelerate the recognition of income where payments are received prior to the performance of the underlying earning activity. ²⁴ Thus, where payment is received in advance of the services that USPS provides — for example, prepaid postage, prepaid box rent, outstanding postal money orders and the like — the recognition of revenue for tax purposes may be earlier than the recognition of revenue for GAAP purposes.

It is unclear what portion of income attributable to competitive products may relate to pre-payments for delivery services. In the context of USPS competitive products, it is likely that a portion of the payments received shortly before year-end would relate to parcel deliveries that are not completed until after year-

²⁰ Taxable income refers to income calculated in accordance with the tax law.

²¹ FASB Concept Statement 6, Paragraph 35.

²² The All Events test, until the Tax Reform Act of 1984, PL 98-369, required only that (1) all events have occurred that establish a liability and (2) that the liability can be measured with reasonable accuracy. The Tax Reform Act of 1984, P L 98-369, introduced a third requirement: economic performance. The economic performance leg of the All Events test delays deduction of certain expenses until services are rendered for the taxpayer or to the taxpayer and, with respect to certain other expenses, until such expenses are paid. See Income Tax Regulations Section 1.461-4. Those liabilities as to which payment is required for deduction are referred to as Payment Liabilities.

²³ See Note 4 of 2006 USPS Financial Statement.

²⁴ As a general rule, accrual method corporations such as USPS recognize income at the earlier of receipt of payment or the performance of the underlying earning activity. (See Section 451 of the Internal Revenue Code and Income Tax Regulations, Section 1.451-5(b)(1).) Certain specific exceptions in the area of prepaid services (see Revenue Procedure 2004-34), prepaid subscriptions (see Section 455 of the Internal Revenue Code), prepaid dues of certain membership organizations (Section 456 of the Internal Revenue Code) and advance payment for goods and long term contracts under certain circumstances (Income Tax Regulations, Section.1-451-5). None of the current exceptions to the general rule would appear to apply to any competitive business, with the exception of advance revenues (which appear to be minimal) received for services as described in Revenue Procedure 2004-34.

end. This could result in a difference in the recognition of such payments for tax purposes. However, Revenue Procedure 2004-34, Internal Revenue Bulletin 2004-22, 991 allows taxpayers to defer the recognition of income under certain circumstances until it is earned or if earlier, to the end of the next succeeding tax year. It is likely that USPS would qualify to use the tax accounting method provided in the Revenue Procedure 2004-34 if it so requested. Under this method of accounting, a taxpayer is permitted to follow its financial statement income recognition policies for qualifying prepayments. Under the revenue procedure, qualifying taxpayers receive automatic consent to change to this method of accounting. Therefore, for purposes of calculating taxable income it is appropriate to assume that USPS is permitted to use this method of accounting.²⁵ Accordingly, any financial statement deferred income related to the receipt of prepayments would also be deferred for purposes of calculating taxable income.

The USPS financial statements contain a liability for deferred appropriations revenue, representing amounts given to USPS by Congress in 2001 and again in 2004 for the purpose of rebuilding or repairing facilities destroyed or damaged on 9/11 and for the purchase of biodetection equipment and ventilation and filtration systems. USPS relieves this account as equipment is purchased and increases financial statement income accordingly. Under the principles discussed above, had USPS been required to calculate an assumed income tax for the year the appropriation was received, and had the amount been taxable, such an amount would have been included in taxable income at that time because the funds were not segregated and were generally available to USPS.²⁶ Any amounts of this deferred revenue that are included in financial statement income in any year after receipt as a consequence of the purchase of assets used in a competitive business would not be included in taxable income for the year of the purchase even though it may have been included in financial statement income for such year.²⁷

Revenue Forgone

Under the Revenue Forgone Reform Act of 1993, Congress authorized a total of \$1.218 billion to be paid at the rate of \$29 million per year through 2035 (42 years). This appropriation is to reimburse USPS for the revenue that it has forgone in providing mandated free or reduced fee mail for designated mailers. Further, there is an annual estimate, appropriation and true-up²⁸ for the services provided since 1998. It does not appear that any of the forgone revenue is attributable to any competitive service or product;²⁹ therefore neither the payment on the receivable nor the interest imputed on such receivable would be assumed included in the competitive products enterprise taxable income. It should be noted that in the event that certain of the forgone revenue were used to pay expenses attributed to the competitive products, lines of business or enterprise and was not considered taxable income, no deductions would be allowed for the related expenses. USPS must review this source of income — and any similar future sources of income — on an annual basis to assure that it benefits market-dominant products, lines of business or enterprise.

²⁵ It is understood that the assumed USPS federal income tax would not actually be paid to the IRS. However, USPS tax code applications would probably need to be addressed as part of the PAEA provision implementation.

²⁶ If such funds had been segregated and restricted so that they were not available for any other purpose, an argument might be available that tax should be deferred until the funds were spent. That argument does not appear to be available under the facts.

²⁷ The above is only illustrative of the concept of the differences in the GAAP and tax law treatment of deferred revenue. For tax law purposes, if the receipt of the revenue was considered to be a nontaxable capital contribution by a non-shareholder, the basis of any asset purchased with the revenue within 12 months is reduced by the amount of such contribution. Any remaining nontaxable capital contribution reduces the basis of other depreciable property (Sections 118 and 362(c)(2) of the Internal Revenue Code). The effect of the operation of these rules is to deny depreciation deductions for assets purchased (or considered purchased) with cash contributed to capital by a non-shareholder.

²⁸ A true-up represents the reconciliation of the amounts appropriated during the year based upon estimates with the actual amounts that should have been appropriated, determined after the close of the fiscal year when all information is available.

²⁹ Treasury's assumption is that this appropriation was in support of the postal USO and is therefore part of the market-dominant products line of business.

Deduction of Expenses

The All Events test is the standard for recognizing liabilities and measuring deductions under the tax law. The economic performance³⁰ leg of the All Events test generally defers deductions of liabilities to pay for services until the services are rendered and defers deductions for the cost of providing services until such costs are incurred. The effect of the economic performance requirement may be to defer the deduction of certain items to a later point than would have been the case under GAAP.

There are certain liabilities for which economic performance can only occur through payment — for example, Payment Liabilities.³¹ Key among these liabilities is resolution of workers' compensation claims, settlement of other claims or other litigation. Just as the tax law provided a tightening of the operation of the All Events test by imposing an economic performance requirement, the Internal Revenue Code also provides modification to the operation of the economic performance test in the form of a recurring item exception.³² This applies to certain recurring immaterial items that have met the All Events test by the end of the fiscal year but to which economic performance has not yet occurred, or to certain material items where allowing deduction would result in a better matching of income and expense. In such cases, a deduction is permitted if economic performance occurs on or before the earlier of the timely filing of an entity's tax return for the year (including extensions) or by the 15th day of the ninth calendar month after the close of the tax year.

The recurring item exception does not apply to many payment liabilities. It is a method of accounting that must be elected and must be consistently applied.

Property and Equipment

In the case of property with an estimated useful life, the tax law provides depreciation elections, schedules and methods that almost assure that annual depreciation for purposes of calculating taxable income will be different from depreciation calculated for purposes of determining financial statement income. As a general rule, the tax law provides for more rapid recovery of costs than GAAP does.

The tax law divides property into classes or groups and then assigns a recovery period to all the property in each of the classes or groups, based on a class life assigned to each class or group. Some asset recovery periods are assigned directly by statute. A heavy, general-purpose truck, for example, would have a recovery period of five years because, with a class life of six years, it falls among those assets that have a class life of more than four years, but less than ten years, which are assigned by the Internal Revenue Code a five-year recovery period.³³ A taxpayer (the term includes corporations or entities like USPS) would, with respect to each purchase made during the tax year of the same kind of property, recover the cost (without regard to salvage value) using certain designated methods that accelerate depreciation deductions relative to GAAP-permitted deductions.³⁴ A taxpayer may elect to depreciate these assets using a less accelerated declining balance method or the straight-line method over a period equal to the recovery period.³⁵

³⁰ Economic performance refers to the requirement that must be met under the tax law in order to satisfy the test for deduction of expenses, notwithstanding that the expense may have been accrued for financial statement purposes. There are certain expenses as to which economic performance will not be considered to have occurred until the expense is paid.

³¹ There are certain liabilities as to which economic performance occurs only when, and to the extent, payment is made to the person to which the liability is owed. (Income Tax Regulations § 1.461-4(g).)

³² Recurring item exception is the exception to the general economic performance rules that allows economic performance to be considered to have been met for a taxable year if (1) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (2) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year or (b) the 15th day of the ninth calendar month after the close of the taxable year; (3) the liability is recurring in nature; and (4) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs.

³³ Internal Revenue Code, SEC. 168(e)(1).

³⁴ *Ibid.*, SEC. 168(b).

³⁵ *Id.*

The concept of impairment³⁶ as defined for GAAP does not exist in the tax law. While deductions are permitted for the abandonment of depreciable assets when they are no longer used in the business and are withdrawn from service or as a result of casualty, no deduction is permitted for the mere diminution in the value of property or the unavailability of property for its intended use.

In general, the GAAP and tax characterization of leases are similar. However, there are situations where a lease may be characterized as an operating lease for tax purposes and a capital lease for GAAP purposes. A difference in the characterization of a lease for GAAP and tax purposes generally will result in a difference in the timing and character of the related deductions. In general, an operating lease for tax purposes results in rent expense related to the use of property while a capital lease is treated as the a purchase of property resulting in depreciation deductions.³⁷ Existing USPS leases allocable to the USPS Competitive enterprise would need to be analyzed to determine their proper classification under the tax law.

The treatment of purchased intangible property under the tax law also differs from its treatment under GAAP. When acquired as part of an ongoing business, property such as goodwill and customer-based intangibles are generally amortized over 15 years for tax purposes.³⁸ Under GAAP, good will is evaluated on an annual basis and written down only when such annual valuation suggests impairment or a decline in value. Customer-based intangibles such as customer lists may be amortized for GAAP over a period of time, subject to a more accelerated write-off if their values decline below carrying values. Therefore, intangible assets allocable to the USPS Competitive enterprise would need to be analyzed to determine the proper tax treatment of such items.

USPS currently amortizes leasehold improvements over the term of the applicable lease or useful life of the property under GAAP, whichever is shorter.³⁹ The Internal Revenue Code, however, assigns a 39-year recovery period to leasehold improvements of nonresidential real property, regardless of the lease period, except a temporary provision shortens this recovery period to 15 years if the property is placed in service before January 1, 2008. Such leasehold improvements are depreciated using the straight-line method. Any remaining basis⁴⁰ in the improvement at the termination of a lease is deductible at that time by the lessor under Section 168(i)(8)(B), provided the improvement is abandoned. If the leasehold improvements are constructed and owned by the lessee, any remaining basis of such improvements may be written off at the termination of the lease, provided such leasehold improvements are permanently removed from service.⁴¹

The tax law generally will allow deduction of a repair without regard to cost, provided the repair neither materially adds to the value of the property nor appreciably prolongs its life.⁴² USPS policy has been to capitalize repair expenses that exceed \$3,000 and extend the useful life of the subject property for more than one year. USPS may, in view of the FedEx tax case discussed in Section 2.2, wish to review the application of that policy under certain circumstances when applied to certain assets eventually assigned to the competitive products LoB or USPS Competitive enterprise.

³⁶ Impairment generally refers to a situation where the value of an asset has been permanently reduced to a level below that at which it is carried on the GAAP financial statements.

³⁷ The criteria for treatment of a lease as a capital lease for GAAP and the tax law criteria for treating a lease as a purchase are similar in many respects, but are not identical.

³⁸ IRC, SEC. 197.

³⁹ See Note 4, Financial Statements.

⁴⁰ "Basis" as used in this report generally refers to the cost of property reduced by allowable depreciation or amortization. See IRC SEC. 1012 and 1016.

⁴¹ Income Tax Regulations, SEC. 1.167(a)-(8).

⁴² Ibid., SEC. 1.162-4.

Contingent Liabilities and Other Reserves

GAAP requires an entity to establish a contingent liability when a liability becomes probable and may be reasonably estimated.⁴³ These contingent liabilities or reserves are generally considered to be deductible expenses for purposes of calculation of financial statement income. When the liability is finally determined and paid, the amount is offset against the applicable reserve.

In general, the establishment of a contingent liability or reserve is not recognized as an incurred liability for tax purposes. Many contingent liabilities or reserves relate to potential litigation. For tax purposes, a liability arising out of any tort, breach of contract or violation of law cannot be recognized as a deduction until payment is made. In other words, if a financial contingency reserve was established as a result of a lawsuit filed against USPS, no tax deduction would be permitted until the judgment was actually paid.

Allowance for Doubtful Accounts

USPS current policy provides for an allowance for doubtful accounts based on their outstanding receivables, collection history and estimate of uncollectible accounts.⁴⁴ The tax law generally requires that taxpayers use the specific charge-off method to deduct bad debts — a method based not on estimates but on actual worthlessness. The tax law also permits a deduction for the partial worthlessness of business debts.

Self Insurance

USPS self-insures against risks associated with the operation of its entire business, including general liability and workers' compensation. Self-insurance reserves established for purposes of preparation of the financial statements (financial statement income), even though prepared using sound actuarial principles, would not be deductible in the calculation of taxable income. This is because, generally speaking, a liability to a third party arising out of acts or events that might otherwise be covered by workers compensation insurance is a Payment Liability.⁴⁵ Furthermore, a liability arising out of settlement of a dispute in which a tort, breach of contract or violation of law is alleged is also a Payment Liability.⁴⁶ Were USPS to elect to insure its risks with an unrelated insurance company, its premiums would generally be deductible to the extent they relate to insurance coverage for the current taxable year, regardless of when the claimant was ultimately paid.

Workers Compensation Costs and Accumulated Leave

USPS currently determines an annual accrual for anticipated workers compensation costs (wage continuation, medical expenses, etc.) by using estimates of the present value of the claims filed by its employees through the end of the fiscal year. This annual accrual is treated as a deduction in the calculation of the USPS financial statement income and as an adjustment to the non-current liabilities in the balance sheet.⁴⁷ For purposes of calculating taxable income, however, the deduction of worker's compensation costs is a Payment Liability. Accordingly, the annual accrual of such costs for financial statement purposes would not be deductible when determining taxable income. The actual payments of such costs made during the year, without regard to when they were accrued, would be deductible.

Accumulated employee leave earned during any tax year but not paid (used) on or before two and a half months after the end of the fiscal year is considered to be deferred compensation, deductible for purposes

⁴³ Statement of Financial Accounting Standards No. 5. The SFAS establishes a continuum for accounting for loss contingencies ranging from not disclosed to footnote disclosure to possible accrual to full accrual.

⁴⁴ See Note 4 to the Financial Statement.

⁴⁵ A Payment Liability is a liability as to which economic performance (and therefore, the All Events test) is considered to be satisfied only by payment. See ITR, SEC. 1.461-4 (g)(2).

⁴⁶ ITR, SEC. 1.461.4 (g)(2)(ii).

⁴⁷ See Note 11 to the Financial Statement.

of calculating taxable income only when it is included in the employee's income.⁴⁸ Accordingly, any annual accrued additions to the liability for accumulated employee leave would not be deductible as such in the calculation of taxable income. What would be deductible is (1) any leave accrued during the year with respect to which payment is made to employees within two and a half months of the close of year and (2) any other payments to employees during the tax year for accumulated leave without regard to when it was earned (other than payments made during the first two and a half months of the year for leave accrued during the preceding year).

2.2 Industry Practices

In general, companies that participate in the USPS competitive products marketplace prepare GAAP financial statements and provide notes related to their reported income tax expense. Unlike financial statements of public companies that are disclosed to the investing public and regulators such as the Securities Exchange Commission as a matter of law, income tax returns of for-profit entities are private and not subject to public scrutiny and analysis.

It should also be noted that income tax expense as shown on a corporation's financial statement is not the same as the income tax liability shown on the corporation's income tax return. One is calculated in accordance with GAAP and the other according to the tax law. Most of the differences arise as a matter of timing of items of income and deductions and are reflected in GAAP financial statements as either deferred tax assets or deferred tax liabilities. A deferred tax asset generally arises from tax attributes that may be carried to future years, such as operating loss carry-overs. Deferred tax liabilities generally reflect tax deductions that were more accelerated than GAAP, such as depreciation. A sale of an asset that has been depreciated more rapidly for tax than for GAAP will result in more taxable gain (and more tax) in the year of sale because its basis was lower. GAAP tracks the depreciation differences from the date of purchase, and calculates and records a deferred tax on the relevant asset to reflect the additional tax that will be owed when the asset is sold. Deferred tax assets and liabilities change on an annual basis. Permanent differences between GAAP and the tax law relating to the treatment of specific items are not reflected in deferred taxes because they do not involve a timing difference. Two of the most common permanent differences are the treatment of (1) fines and penalties and (2) meals and entertainment. While each is fully deductible for GAAP, tax law does not permit a deduction for fines and penalties and limits the deduction for meals and entertainment.⁴⁹

FASB Interpretation No. 48

In June 2006, FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)." One of the factors that prompted the adoption of FIN 48 was FASB's view that corporations were understating their financial statement tax liabilities by giving effect to transactions and tax positions that, while meeting the criteria for inclusion in a tax return, were nonetheless not "more likely than not" the correct tax position. ("More likely than not" in the context of a tax position has generally been viewed as a position that has a greater than 50 percent likelihood of being sustained on the merits.)

This interpretation provides clarification to the accounting for uncertainty in income taxes recognized in financial statements. It prescribes a recognition threshold and measurement attribute for tax positions taken, or expected to be taken, in a tax return. The interpretation provides guidance on recognition, financial statement classification, tax related interest and penalties and additional disclosure requirements.

⁴⁸ IRC, SEC. 404 (a)(5), 404 (a)(11); ITR, SEC.1.404(b)-IT.

⁴⁹ IRC, SEC. 162(f) and 274(n).

FIN 48 will be adopted by FedEx in the first quarter of 2008. UPS is required to adopt FIN 48 effective January 1, 2007.

The adoption of FIN 48 requires a taxpayer to complete an inventory of “all income tax positions taken or expected to be taken in a tax return.” In general, this inventory of positions can be determined by analyzing the company trial balance account by account to document the income tax treatment of each account in the income tax return. FedEx reported within its 2006 annual report that the adoption of FIN 48 would not have a material effect on its financial statements. UPS reported within its 2006 annual report that the company is currently in the process of evaluating the impact on the financial statements.

The overall effect of FIN 48’s adoption would likely be to reduce the number of overly aggressive positions taken on corporate tax returns. The degree to which its adoption would impact the tax returns of FedEx and UPS is still to be determined. The impact on USPS is assumed to be negligible, because no separate financial statements are expected to be filed for the competitive products enterprise and the calculation of an assumed income tax expense for financial statement purposes is the driver behind the adoption of FIN 48.

The American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 was enacted by Congress and signed by the president to promote full employment in the U.S. Included within this Act were a number of income tax benefits to corporate America. This legislation introduced tax incentives for biodiesel and modified the tax incentives for ethanol; these incentives can be claimed as an income tax credit, an excise tax credit or a refundable payment.⁵⁰

USPS should evaluate the impact of the American Jobs Creation Act of 2004 to determine the value of biodiesel tax incentives, if any, on its imputed income tax return. This credit has provided significant tax benefits to FedEx and UPS.

“Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005”

On Aug. 10, 2005, President George W. Bush signed the “Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users” (SAFETEA-LU). This legislation provided substantial changes directed toward improving the safe operation of trucks and tractors on the highways and also provided a number of tax incentives to companies operating transportation equipment using alternative fuels. USPS should determine whether the transportation assets used or (cost) assigned to the competitive products enterprise could obtain the alternative fuel tax incentives provided in SAFETEA-LU. These tax incentives are also widely used by USPS competitors.

***FedEx Corporation v. United States*, No. 01-2200 Ma/A (W.D. Tenn. 8/27/2003), affirmed, 412 F.3d 617 (6th Cir. 2005)**

Aircraft owners in the industry have argued on behalf of taking an immediate deduction for engine overhauls and repairs, as opposed to capitalizing and depreciating the repairs as a new depreciable asset. In FedEx Corporation v. United States, the court ruled that the costs of aircraft engine overhauls are allowable deductions. The court ruled that off-wing engine maintenance and auxiliary power unit maintenance costs are currently deductible as ordinary and necessary business expenses.⁵¹ The essence of the case was that the inspections and overhauls, even though in some instances resulting in replacement of some component parts, did not appreciably prolong the anticipated lives of the engines, measured from when the engines were when first placed in service, and did not appreciably increase the value. The court’s

⁵⁰ Biodiesel tax incentives were created to encourage the production and use of biodiesel fuels (IRC, SEC. 40A(d)). The incentives may be claimed for the fuels produced and sold until December 31, 2008.

⁵¹ IRC, SEC. 162.

ruling also enables aircraft owners to take a similar position on transactions to deduct other repairs by arguing for immediate write-off of items such as paint, compliance with airworthiness directives or service bulletins, terrain awareness and warning system maintenance costs, and other airframe repairs.

This treatment would accelerate deductions to the current period and allow income taxes to be reduced for that period. While Treasury understands that USPS does not currently own any aircraft, it is possible that the rationale expressed in the case could be equally applicable to programmed maintenance of vehicles used in supporting the USPS Competitive enterprise.

These types of issues are the hot topics in the competitive products' market and the transportation industry in general, and should be carefully considered when USPS computes the USPS Competitive income taxes in accordance with PAEA.

2.3 Other Considerations

While not specifically addressed above, the items mentioned below may affect the calculation of an imputed assumed income tax for the USPS competitive products. Alternatively, they may require that other policy judgments be made so as to arrive at a result consistent with the provisions and/or intent of PAEA.

Net Operating Losses and Capital Losses

A taxable corporation that suffers an operating loss may generally carry back such loss to the second preceding year and file amended returns for that year, generally offsetting that year's taxable income and recovering taxes previously paid. Losses in excess of the taxable income for such year are carried to the first preceding year, while remaining unused losses may be carried forward for up to 20 years. The effect of these provisions is to allow corporations a form of income averaging over the loss year and the periods to which the losses are carried. Capital losses may be carried back for three years and forward for five years. GAAP does not recognize the concept of loss carry-backs or carry-overs (whether ordinary or capital) in the context of the calculations of its pretax financial statement income.

Pensions

Employees of USPS—including employees working for or assigned to the competitive products enterprise—are covered under one of three pension programs, depending on the start date of employment. The programs are administered by the Office of Personnel Management and are accounted for under multiemployer plan accounting rules. The plans generally provide a basic annuity and Social Security. The Federal Employees Retirement System, the largest of the three plans—it currently covers more than 76 percent of USPS employees—also has a thrift savings plan to which USPS is required to contribute a minimum of 1 percent of basic pay. USPS also matches employees' voluntary contributions up to 3 percent of basic pay and matches 50 percent of employees' voluntary contributions of 3 percent to 5 percent of basic pay.

The Postal Civil Service Retirement System Funding Reform Act of 2003 imposed additional requirements upon USPS. It required USPS to begin to fund its obligations based upon dynamic assumptions, including the full value of future benefits to employees related to military or voluntary service that had previously been funded by the Treasury.

While both FedEx and UPS have defined benefit and other plans, to Treasury's knowledge neither had a matching plan such as the USPS Thrift Savings Plan, and neither corporation is required to account and pay for periods of service performed elsewhere.

Domestic Production Activities

If the competitive products' income were to include income from certain specified activities, then additional tax deductions are allowed under Section 199 of the Internal Revenue Code for a percentage of its income derived from such activities. The activities encompassed by this special deduction generally include the lease, sale or other disposition of tangible personal property, construction performed in the United States or engineering or architectural services performed in the U.S. for projects located there. It does not appear that any of the competitive products' income would currently qualify for these additional deductions.

Research and Experimentation Credit

A credit is available under Section 41 of the Internal Revenue Code equal to 20 percent of the qualified research expenses paid or incurred for a tax year in excess of the taxpayer's base amount for that year plus 20 percent of the basic research payments to certain research organizations. USPS activities in this regard should be analyzed to determine whether they qualify, and whether any of such activities are attributable to the USPS Competitive enterprise. The credit currently does not apply to expenditures made after December 31, 2007, but is likely to be extended. If it were determined that certain of the expenditures incurred by USPS qualified and were attributable to competitive products activities, certain assumptions would need to be made for purposes of determining the base amount so that a computation of the credit could be made.

2.4 Observations

One issue not specifically addressed by PAEA that could have an impact on the amount of assumed income tax imputed, and potentially a significant impact on the cost to impute it, is the hypothetical opening balances in certain accounts — that is, the competitive products' assumed beginning account balances as of the first day of the first period for which an imputed tax is to be calculated for Competitive Products.

To illustrate, under the tax law, for an entity switching from non-taxed to taxable status, the basis of depreciable assets upon conversion to taxable status is the lesser of the asset's fair market value or its adjusted depreciable basis at the time of conversion.⁵² The adjustment to basis (i.e., to historical cost) is determined as the sum of amounts that would have been allowable as deductions if the taxpayer had been taxable, where depreciation was determined using the straight-line method.⁵³ The resulting basis does not correspond to the corresponding GAAP value, however, because the tax depreciation recovery periods and other depreciation rules are unlikely to correspond to those under GAAP. There remains, however, the issue of whether requiring such calculations is cost effective within the current exercise in which the USPS is not actually being taxed.

A policy decision regarding the transition is beyond the scope of this report. However, because the imputed income tax is merely transferred between funds of USPS, it does not appear that the cost and effort of a valuing, or revaluing, all the attributed competitive products' assets may be warranted. One consideration might be that the competitive products' assets should be deemed to have been transferred to the theoretical enterprise at the current USPS basis and holding period, assuming for this purpose that there were no differences in book basis and tax basis.

The USPS is a very large (currently, \$75 billion) and complex operations entity. The size of the USPS' competitive products revenues and costs may eventually prove to be a relatively small percentage of the

⁵² See Reg. 1.168(i)-4(b)(1).

⁵³ See Reg. 1.1016-4.

total USPS revenues and costs in comparison to the market-dominant products. However, the rigor (i.e., resources and expenses) that would be required to impute and report a competitive products income tax is assumed to be conceptually consistent with the rigor employed by commercial competitors. That said, it is likely that the amount of rigor employed by commercial competitors is often motivated as much by the desire to legally minimize the payment of taxes as by tax law compliance. While the importance and benefits for competitive products income tax payments are addressed in PAEA, the motivation to legally minimize payment of income taxes for USPS is not exactly the same as for its competitors.

For example, if a commercial company spent \$100,000 to legally avoid \$110,000 in tax payments, the tax savings and net \$10,000 positive cash flow would probably be considered to be a good cost-benefit investment. Should USPS make that same investment, however, Treasury's reading of PAEA is that this same cost-benefit would not be realized. The resultant tax payment would be made from the USPS CPF to the USPS PSF—in effect, never leaving the USPS entity—and USPS would have a real negative cash-flow impact related to the cost of the tax-avoidance effort.

Alternative Assumed Tax Calculation Approach

There is a potential PAEA compliance conflict between tax law treatment for balance sheet (e.g., accrued or deferred revenues, expenses and liabilities and asset depreciation) items and the assignment of USPS assets and liabilities to the CPF. The essence of the problem is that full application of tax law would require asset-by-asset assessment and utilization assignment to the competitive products. Once this substantive and complex effort was completed, the USPS current balance sheet treatment for each asset under GAAP (e.g., depreciation) could be adjusted for appropriate tax law treatment and application. However, PAEA describes a high-level asset assignment method⁵⁴ that would satisfy the initial quantification of the CPF, but would not provide the asset detail needed for precise income tax treatment and computation.

. . . For purposes of this subsection, the total assets of the Competitive Products Fund shall be the greater of—

(A) the assets related to the provision of competitive products as calculated under subsection (h); *or*

(B) *the percentage of total Postal Service revenues and receipts from competitive products times the total assets of the Postal Service.* (emphasis added)

If a detailed asset assignment approach is used to satisfy tax law application, there is no guarantee that the eventual output from that effort would satisfy the PAEA “the greater of” asset quantification test for the CPF, thus requiring two different asset-assignment exercises: one for tax law treatment and the other for PAEA compliance for CPF asset valuation.

An approach to address this potentially mutually exclusive conflict might be to use the pretax income from the USPS competitive products income statement for the computation of the assumed income tax. Similar to the approach used by the PRC in establishing the initial contribution to the USPS institutional costs at 5.5 percent,⁵⁵ an initial set tax rate could be established. Using a set tax rate would also address cost-benefit concerns with efforts to perform a detailed USPS CPF asset assignment versus the desire to minimize tax computation costs in order to maximize CPF and PSF income. Three potential options for determining an appropriate assumed set tax rate could be:

⁵⁴ PAEA, Title IV, SEC. 401, ‘Sec. 2011, 5 (A) and (B).

⁵⁵ PRC Docket No. RM2007-1, Order No. 26, Chapter III, Section 3, paragraphs [3049-3061] and 10/29/2007, PRC Docket No. RM2007-1, Order No. 43, Chapter V, § 3015.7(c).

1. Apply the effective C corporations' tax rate (currently 35 percent⁵⁶) to the USPS Competitive pretax income. While this may be a potentially viable approach, it puts the enterprise at an income disadvantage, as the Congressional Research Service reports that very few C corporations actually pay the effective tax rate.
2. Select a set of competitive firms in the private sector that publish their effective tax rates and determine the weighted average tax rate that they pay. This average rate could then be used to determine the assumed set tax rate that could be applied to the USPS Competitive pretax income.

This effective tax rate is a financial statement figure (GAAP-derived) that calculates the tax expense for reporting and can be found in the corporation's 10k report. There is not, however, a correlation between that number and tax actually paid during that year or the current year tax liability. The effective reported tax rate is derived using reported income plus permanent differences and certain other adjustments. Permanent differences may include tax credits, fines and penalties, changes to valuation allowances, officer's life insurance, and meals and entertainment, to name a few. This could significantly affect the effective tax rate. Also embedded in the effective rate of competitive companies is a state tax component. If a weighted average set rate is used, consideration should be given to reducing it by the appropriate state tax component.

Careful thought would need to be given to the set of competitive corporations used for the computation to ensure that they are reasonably similar in business to the USPS Competitive enterprise, and thus are subject to approximately the same types of tax liabilities. In addition, potential adjustments may be appropriate for competitive corporations with international operations. The effective tax rate of these corporations may be skewed, as they will include the impact of foreign taxes paid, and USPS is a domestic entity with no foreign subsidiaries.

3. Use as an assumed set tax rate the most current CRS-reported average effective tax rate (e.g., 26.3 percent for 1993-2002) for C corporation, non-financial entities, or another publicly available average effective corporate tax rate, preferably updated annually.

The use of any of the above set rates — or something similar — would have to assume that:

- Accrued or deferred revenues and expenses are (dollar) immaterial and, as period-related transactions, will be included in the next period's tax calculation;
- Tax law depreciation is (dollar) immaterial to the cost-benefit requirements of individual-asset identification for accelerated depreciation treatment;
- Appropriate adjustments to the effective tax rate to exclude state taxes could be made; and
- Neither the creation nor the release of a valuation allowance (a mechanism that annually adjusts financial statement income to account for the likelihood of the realization of future tax benefits from the utilization of tax loss and tax credit carryovers) would have a material affect on the effective tax rate.

Recommendation 8: The USPS should calculate the competitive products' assumed federal income tax using a simplified approach, preferably using a published, regularly updated, tax rate.

This alternative assumed tax rate computation approach may not be precisely tax law compliant, but it may sufficiently satisfy the PAEA intent of paying an assumed income tax to the PSF without having to

⁵⁶ While the current maximum C corporation tax rate is 39 percent, the effective rate is 35 percent. The maximum 39 percent rate is to adjust for the lower tax rates used at the lower brackets. This surtax at the highest bracket effectively flattens the tax rate to 35 percent.

perform a cost-intensive, asset-by-asset identification and assignment that still might not meet the total asset “shall be the greater of” asset assignment quantification test for the CPF.

2.5 USPS Tax Elections and Assumptions

There are two general approaches — complex and simplified — that USPS could use to calculate the assumed federal income tax for the USPS Competitive enterprise. The complex approach would enable precise tax law application, but would require a detailed asset and liability assessment and assignment. Under this approach, the following assumptions could be used:

- USPS is a domestic U.S. corporation with no domestic or foreign subsidiaries.
- USPS does business in no foreign jurisdictions and pays no foreign taxes.
- USPS would elect the depreciation methods that maximize its depreciation deductions.
- USPS would elect the recurring item exception to the economic performance rules.
- USPS would initially elect or change to the method of accounting that would allow it to defer recognition of advance payments received for services as discussed in Revenue Procedure 2004-34, 2004-22 IRB 991. It is anticipated that this election or change would be made applicable to payments received before year-end for services rendered (deliveries) after year-end.

While it is assumed that USPS could create an imputed federal income tax using standard corporate tax forms, it is also assumed that USPS would not actually submit these forms to the IRS. Whether or not these forms should be subject to a tax audit review by independent auditors is something that may need to be addressed prior to initiating the assumed income tax computation effort. In addition, the potential need to establish a forum and process to review and approve USPS-requested tax elections, as applicable, may also need to be addressed.

Under the simplified approach, a set effective income tax rate would be determined for application and computation on the USPS Competitive enterprise income. The intent of this approach is to satisfy PAEA requirements for financial fairness in the competitive marketplace without the cost — and potential CPF asset compliance conflict — of a detailed USPS balance sheet assignment effort. For this method, the following USPS tax treatment elections’ assumptions could be used:

- USPS is a domestic U.S. corporation with no domestic or foreign subsidiaries.
- USPS does business in no foreign jurisdictions and pays no foreign taxes.
- The asset and liability adjustments for precise tax law treatment are not material when compared to the cost-benefit of individual asset or liability assignment to the USPS Competitive enterprise.

While computation work sheets would be required for oversight inspection, this approach assumes that no tax forms or independent tax audit review would be needed.

2.6 Summary and Conclusions

While deceptively simple in its mandate to impute an assumed federal income tax on the income from the USPS Competitive enterprise, compliance with the applicable PAEA provisions could be very complex. This assumes that an analytically derived competitive products financial income statement could be created to determine GAAP financial income to begin the income tax computation. However, a complementary derived competitive products balance sheet with sufficient detail — particularly with regard to the applicable assets’ basis and calculation of allowable depreciation of fixed assets — would be

a substantial undertaking. Both of these financial statements — or some acceptable derivation of them — would be needed for the computation of an assumed federal income tax on the income generated by USPS Competitive products.

There are, however, two approaches — complex and simplified — that could be used by USPS to calculate the USPS Competitive income tax, which differ from each other greatly in the cost, effort, and method of application. Adoption of either of these approaches, particularly the simple approach, would require some level of PAEA intent interpretation and scope determination by the appropriate governance bodies.

The complex approach assumes that the cost assignment method would be implemented prior to the tax computation effort. It assumes that financial statement income for the USPS Competitive would be created using GAAP. It also assumes that the appropriate asset and liability assignment to the competitive products would be performed at a sufficiently detailed level to enable tax law elections, adjustments and treatment in the income tax calculation.

The simplified approach also assumes that a financial statement of income would be derived for the USPS Competitive enterprise. However without the asset and liability detail needed for precise tax law elections and treatment, it assumes that a set effective tax rate would be used to calculate the required assumed federal income tax solely using income reported in financial statements.

Section 3

Identifying and Valuing the Assets and Liabilities of the Competitive Products Fund

This section reviews the PAEA provisions regarding identifying and valuing the assets and liabilities of the CPF and reporting for this fund.

3.1 Assets

As noted previously, PAEA requires Treasury to recommend to the PRC accounting practices and principles regarding, among other things, identifying and valuing the assets and liabilities associated with providing competitive products.⁵⁷ While the term “assets” is used in this and other PAEA provisions as well, it is not specifically defined in the Act. The closest reference Treasury found was in Title IV, Sec. 401, ‘Sec. 2011(e)(5)(A) and (B) relating to the “payments of principal, or interest, or both on obligations issued under this section out of revenues and receipts from competitive products and assets related to the provision of competitive products”:

... For purposes of this subsection, the total assets of the Competitive Products Fund shall be the greater of—

- (A) the assets related to the provision of competitive products as calculated under subsection (h); or
- (B) the percentage of total Postal Service revenues and receipts from competitive products times the **total assets** of the Postal Service. (emphasis added)

The phrase “total assets” could potentially refer to the total assets as financially represented in the USPS 2007 annual report balance sheet (see Figure 3 at the end of this section). There are several possible assumptions that could be made if this term has been correctly interpreted:

1. The assets calculated under (B) above would represent net assets, which would include depreciation and amortization for property and equipment. The depreciation method currently used by USPS would also be the method used for tax law analysis and appropriate treatment.
2. The value-basis for the net assets would be the net book value at the time that the CPF was created.
3. If the “shall be the greater of” CPF asset assignment quantification test is against total assets, then it might be reasonably assumed that the “assets related to the provision of competitive products” should also be assigned on a (net) total assets basis.

Using a percentage test would suggest that any theoretical USPS Competitive enterprise assets or total assets assignment would, when added to the market-dominant products’ assets, equal the total consolidated USPS assets as currently reported in the annual report balance sheet (i.e., “the parts equal the whole”).

⁵⁷ PAEA, Title IV, SEC. 401(a)(1), ‘Sec. 2011 (h)(1).

Efforts to analyze each USPS asset to determine its theoretical enterprise origin and usage could be a significant undertaking. The results might be less than satisfying in that, in Treasury's assessment, a number of the USPS individual assets are being used to support, to varying degrees, both competitive and market-dominant products. The assumptions and methods required to assign percentage utilization for each shared asset to each of the product sets, and track that assignment over the life of the shared asset, could be substantial.

Other potential assignment treatments, described in Section 3.3 below, might be used to achieve the PAEA intent. These treatments could be deployed without incurring the cost, time, and complexity requirements of individual asset assignment to the competitive products.

3.2 Liabilities

In reviewing PAEA, Treasury found only the previously cited reference to the word "liabilities" with respect to competitive products in Title II, SEC. 401(a)(1), 'Sec 2011 (h)(1). If it is determined that liabilities, or total liabilities (see Figure 3), should be included in the CPF, then many of the same assessment and assignment assumptions and methods used for the competitive products' assets could be used. In fact, it would probably be preferable that similar methods are used for both assets and liabilities for process and approach consistency. At the same time, however, Treasury notes that the separation of the liabilities would be more problematic than it would be for assets, because many of the liabilities could reflect many years of activities, and across those years the ratio of market-dominant to competitive products (however measured) could vary dramatically.

3.3 Observations

Treasury believes that the separation of the assets could be achieved with the same cost drivers currently used for depreciation and other expenses in the USPS postal classes and subclasses costing system. However, an analysis of how depreciation expenses are accumulated would probably be required to determine if they are sufficiently granular to allow effective separation for tax law treatment.

Without the benefit of additional research and analysis, Treasury believes that there are at least four potential methods to analytically derive and assign assets to a theoretical USPS Competitive enterprise. These four possible methods are:

1. Analyze each USPS asset and assign it to the CPF using an appropriate usage and/or application factor. This would identify the appropriate percentage of each asset used to support the theoretical USPS Competitive enterprise. There would also be the need to establish a set of accounting books to monitor and track the assignment for ongoing CPF maintenance, including new asset additions and/or reductions.
2. Analyze each USPS asset and assign it to the CPF using the "predominate use"⁵⁸ concept. This concept and method would wholly (100 percent) assign an asset to the theoretical enterprise that uses 50+ percent of the asset. There would also be the need to establish a set of accounting books to monitor and track the assignment for ongoing CPF maintenance, including new asset additions and/or reductions.

⁵⁸ The concept of "predominant use" can be found in Federal Accounting Standards Board statements #8 and #29. In addition, the concept of "predominate use" used is used in IRS Publication 946 for "listed property rules" and the associated tests for "predominant use". Similar assignment concepts can be found in FASAB #7 (predominant revenue source) and FASAB #8 (predominant expenses incurred application). http://www.fasab.gov/pdffiles/codification_report2007.pdf

3. Assign the total assets using the competitive products' cost of revenue as a percentage of the total USPS cost of revenue. By using cost of revenue versus revenue, potential pricing (cost of revenue plus mark-up) impacts would be taken out of the equation. This method would probably not provide sufficient granularity in costs to fully assess tax law treatment. Additional tax law computation assumptions would have to be made (e.g., use GAAP depreciation costs versus the accelerated depreciation that tax law allows) to fully accommodate this method. Alternatively, if it is determined to be acceptable under PAEA, the assumed federal income tax could be computed on the theoretical USPS Competitive enterprise income using a predetermined, effective set tax rate. (See Section 2.4.)
4. Assign the total assets using the competitive products' revenue as a percentage of the total USPS revenues. By using revenues, however, potential pricing (cost of revenue plus mark-up) could impact the assignment percentage. This method would probably not provide sufficient granularity in costs to fully assess tax law treatment. Additional tax law computation assumptions would have to be made (e.g., GAAP depreciation costs versus the accelerated depreciation that tax law allows) to fully accommodate this method. Alternatively, if it is determined to be acceptable under PAEA, the assumed federal income tax could be computed on the theoretical USPS Competitive enterprise income using a predetermined effective set tax rate. (See Section 2.4.)

It should be noted that PAEA already provides the following alternative approach to valuing the competitive products' assets in Title IV, Section 401, subsection 2011(e)(5) (A) and (B):

... For purposes of this subsection, the total assets of the Competitive Products Fund shall be the greater of—

(A) the assets related to the provision of competitive products as calculated under subsection (h); or

(B) **the percentage of total Postal Service revenues and receipts from competitive products times the total assets of the Postal Service.** (emphasis added)

The PAEA approach in (B) is essentially the same as Option 4 above. This approach highlights the potential granularity issues with USPS's ability to assess current asset depreciation methods versus tax law treatment using a high-level revenues assignment method.

Per the provisions in PAEA Title IV, Section 401, subsections 2011(e)(5)(A) and (B), if any one of the above options, with the exception of Option 4, were used for CPF asset assignment, it would need to be tested for asset quantification compliance (i.e., (B) "shall be the greater of ..."). For assignment Options 1 and 2, it would be highly advisable to perform a preliminary analysis to determine if the "shall be the greater of" CPF asset quantification test could be successfully met before actually conducting a detailed asset-by-asset usage exercise. The simplicity of options 3 and 4 make them attractive options for this test.

There is a significant conflict between the use of a high-level asset assignment method (Options 3 and 4 above) and the need for asset detail for tax law analysis and treatment. Tax law requires detailed accounting data for revenue and cost accruals/deferrals and asset-type specific depreciation methods in order to determine their applicability for tax treatment. This level of detail would probably only be available using Option 1, and possibly Option 2. However, performing asset-by-asset analysis and assignment could have a substantial cost-benefit impact. There is also no guarantee that the eventual output from that effort would satisfy the PAEA "shall be the greater of" CPF asset quantification test, thus requiring two different assignment exercises: one for tax law treatment and a second one for PAEA compliance for CPF asset valuation.

One approach to address this problem is to use pretax income from the theoretical USPS Competitive enterprise income statement as a basis for computing the assumed income tax. In addition, the USPS

could use a set effective tax rate in order to make the required income tax calculation. Using such a rate would be comparable to the approach the PRC recently took when it established 5.5 percent as USPS's initial institutional costs contribution level. Using this approach would minimize the costs of the tax computation and thereby, maximize CPF and also PSF income. (See Section 2.4.)

3.4 Reporting for the Competitive Products Fund

Title IV, Sec. 401, Section 2011(h)(2)(B)(i)(III) of PAEA requires the PRC to provide by regulation for the submission by USPS to the PRC of annual and periodic reports setting forth such information as the PRC may require. In addition, Section 2011(h)(2)(D)(i)(1) requires USPS to submit an annual report to the Secretary of the Treasury concerning the operation of the CPF. This report must address such matters as risk limitations, reserve balances, allocation or distribution of moneys, liquidity requirements, and measures to safeguard against losses. Treasury notes that under Section 2011(h)(2)(D)(i)(2), USPS is required to provide to the PRC the most recent copy of its CPF report to Treasury.

While PAEA includes provisions in Title II, Section 204 for additional financial reporting requirements⁵⁹ for USPS in total, the specific competitive products' reports to be provided and the necessary "audit" documentation to support them is somewhat open to interpretation.

Sec. 204, 'Sec 3651, Annual reports by the Commission

(a) IN GENERAL - The Postal Regulatory Commission shall submit an annual report to the President and the Congress concerning the operations of the Commission under this title, including the extent to which regulations are achieving the objectives under sections 3622 and 3633, respectively.

Section 3633 of PAEA contains the key provisions applicable to the major competitive products tests for cross-subsidization, costs attributable, and appropriate share allocation of the institutional costs. However, it is not clear to what degree USPS should include this information in its quarterly reports, 10k reports, annual reports,⁶⁰ etc., or prepare separate CPF reports.

As demonstrated below, PAEA does make clear that any USPS-reported information on the CPF will be subject to audit and that the PRC will have access to the audit documentation and be able to request additional supporting documentation or improved documentation, as required (emphasis added):

Title II, Sec. 204, 'Sec 3654:

(c) TREATMENT- For purposes of the reports required by subsection (a)(1)(B), the Postal Service **shall obtain an opinion from an independent auditor** on whether the information listed in subsection (b) is fairly stated in all material respects, either in relation to the basic financial statements as a whole or on a stand-alone basis.

(d) SUPPORTING MATTER- The **Postal Regulatory Commission shall have access to the audit documentation** and any other supporting matter of the Postal Service and its independent auditor in connection with any information submitted under this section.

(e) REVISED REQUIREMENTS- The Postal Regulatory Commission may, on its own motion or on request of interested party, initiate proceedings (to be conducted in accordance with regulations that the Commission shall prescribe) **to improve the quality, accuracy, or completeness of Postal Service data** required under this section . . . (emphasis added)

⁵⁹ PAEA, Title II, SEC. 204, 'Sec. 3651 '(a).

⁶⁰ PAEA, Title II, SEC. 204, 'Sec. 3654 Additional financial reporting, '(a).

Based on the above PAEA provisions, Treasury recommends that some level of competitive products' reporting (e.g., an income statement and the assumed federal income tax calculation) be required to ensure that the economic and accounting cost treatments are consistent with whatever approaches the PRC eventually establishes to implement the PAEA requirements for competitive products. In addition, the reporting should be subject to a reasonable level of oversight and inspection (e.g., an audit).

Recommendation 9: To ensure compliance with PAEA provisions and subsequent PRC clarification and direction for their implementation, USPS should provide sufficient accounting and financial statements of operations reporting and supporting information for the theoretical USPS Competitive enterprise. The information prepared and reported should be subject to sufficient independent review to ensure that it is fairly stated in all material respects, either in relation to the basic financial statements as a whole or on a stand-alone basis.

3.5 Summary

PAEA provides a test that “the total assets of the Competitive Products Fund shall be the greater of [the deployment of one of the recommended or other options] . . . or the percentage of total Postal Service revenues and receipts from competitive products times the total assets of the Postal Service.” The Act does not, however, provide a similar test for liabilities. In fact, the definition for liabilities would need further clarification for PAEA compliance vis-à-vis a CPF assignment method adoption. A clearer definition of assets or total assets would also greatly facilitate the eventual CPF assignment treatment.

As part of the final CPF asset-assignment approach and method determination, evaluation and tax law treatment considerations should be addressed for asset depreciation, amortization, and write-offs. A high-level cost of revenue or revenue asset-assignment (options 3 and 4 above), while intuitively cost-implementation effective, would probably not provide sufficient depreciation granularity for full tax law compliance and/or for USPS to take advantage of the accelerated cost applications tax law affords. A possible approach to simplifying the assumed tax calculation to maximize net income after taxes and still meet the PAEA “shall be the greater of” total assets CPF quantification test, is to use the theoretical USPS Competitive enterprise income before taxes and apply an appropriate, set effective tax rate.

The segregation and maintenance of the USPS CPF should require a reasonable level of management and oversight reporting. This reporting should be subject to sufficient independent review to ensure that it is fairly stated in all material respects, either in relation to the basic financial and accounting statements as a whole or on a stand-alone basis.

USPS 2007 Annual Report Balance Sheet

USPS Balance Sheets Assets

(from United States Postal Service Annual Report 2007)

	September 30, 2007	2006
(Dollars in millions)		
Assets		
Current Assets		
Cash and cash equivalents	899	997
Receivables:		
Foreign countries	425	527
U.S. government	155	150
Other	223	210
Receivables before allowances	803	887
Less allowances	44	48
Total receivables, net	759	839
Supplies, advances and prepayments	201	205
Total Current Assets	1,859	2,041

Cash - Restricted	-	2,958
Appropriations Receivable - Revenue	392	394
Forgone		
Property and Equipment, at Cost:		
Buildings	21,591	21,083
Equipment	21,060	19,729
Land	2,914	2,887
Leasehold improvements	842	1,232
	46,407	44,931
Less allowances for depreciation and amortization	24,688	23,951
Construction in progress	1,877	2,115
Total Property and Equipment, Net	23,596	23,095
Total Assets	25,847	28,488

USPS Balance Sheets Liabilities and Net Capital

(from United States Postal Service Annual Report 2007)

	September 30, 2007	2006
(Dollars in millions)		
Liabilities and Net Capital		
Current Liabilities:		
Compensation and benefits	3,571	3,224
Payables and accrued expenses:		
Trade payables and accrued expenses	1,523	1,481
Foreign countries	452	567
U.S. government	111	111
Total payables and accrued expenses	2,086	2,159
Customer deposit accounts	1,499	1,647
Deferred revenue - prepaid postage	1,142	1,187
Outstanding postal money orders	847	885
Prepaid box rent and other deferred revenue	434	411
Debt	4,200	2,100
Total Current Liabilities	13,779	11,613
Non-Current Liabilities		
Workers' compensation costs	6,800	6,869
Employees' accumulated leave	2,129	2,116
Deferred appropriations revenue	591	674
Long-term portion capital lease obligations	618	637
Deferred gains on sales of property	341	123
Contingent liabilities and other	455	180
Total Non-Current Liabilities	10,934	10,599
Total Liabilities	24,713	22,212
Net Capital		
Capital contributions of the U.S. government	3,034	3,034
Retained (deficit) earnings since reorganization	(1,900)	3,242
Total Net Capital	1,134	6,276
Total Liabilities and Net Capital	25,847	28,488

Figure 3: USPS 2007 Annual Report Balance Sheet

Section 4

Summary and Conclusions

PAEA contains a number of provisions and requirements for separate accounting and funding for the USPS CPF. It also requires the Secretary of the Treasury to do the following⁶¹:

The Secretary of the Treasury, in consultation with the Postal Service and an independent, certified public accounting firm and other advisors as the Secretary considers appropriate, shall develop recommendations regarding --

(i) the accounting practices and principles that should be followed by the Postal Service with the objectives of--

(I) identifying and valuing the assets and liabilities of the Postal Service associated with providing competitive products, including the capital and operating costs incurred by the Postal Service in providing such competitive products; and

(II) subject to subsection (e)(5), preventing the subsidization of such products by market-dominant products; and

(ii) the substantive and procedural rules that should be followed in determining the assumed federal income tax on competitive products income of the Postal Service for any year (within the meaning of section 3634).

The purpose of this report is to address the above statutory requirements.

4.1 PAEA Requirements for Competitive Products

PAEA contains the following five requirements regarding competitive products:

1. Subsidization of competitive products by market-dominant products is prohibited.⁶²
2. Each competitive product shall cover its costs attributable.⁶³
3. All competitive products shall collectively cover what the PRC determines to be an appropriate share of the institutional costs of USPS.⁶⁴
4. An assumed federal income tax on competitive products' income shall be annually computed.⁶⁵
5. The total assets of the CPF shall be at least as great as the percentage of total USPS revenues and receipts from competitive products times the total assets of USPS.⁶⁶

⁶¹ PAEA, Title IV, Sec. 401(a)(1), 'Sec 2011 (h)(1).

⁶² PAEA, Title IV, Sec. 202, 'Sec. 3633(a)(1) and Sec 2011(h)(1)(A)(II).

⁶³ Ibid., 'Sec. 3633(a)(2).

⁶⁴ Ibid., 'Sec. 3633(a)(3).

⁶⁵ PAEA, Title IV, SEC. 402, 'Sec. 3634(b)(1).

⁶⁶ Ibid., SEC. 401, 'Sec. 2011(e)(5).

In order to address the first four of these requirements, Treasury believes that the current USPS cost system must be modified in order to meet the following accounting cost requirements:

1. Report the costs for competitive products at a more granular⁶⁷ level than they are currently;
2. Demonstrate that each competitive product (as defined under PAEA) covers its attributable costs by pricing each competitive product above its volume-variable or marginal cost;
3. Demonstrate that competitive products are not individually cross-subsidized by the market-dominant products by showing that each competitive product's revenues exceed its incremental costs;
4. Ensure that the combined revenues of the competitive products cover an appropriate share of the USPS institutional costs; and
5. Enable computation of an assumed federal income tax on the income of the theoretical USPS Competitive enterprise.

Based on Treasury's analysis of the PAEA accounting, taxation and other provisions and requirements for competitive products, Treasury has developed nine recommendations to the PRC. These recommendations are as follows.

4.2 Treasury Recommendations

Treasury recommends that the PRC implement the following recommendations in order to meet the various PAEA provisions and requirements concerning USPS competitive products:

Recommendation 1: The current USPS economic cost attribution system should be modified so that the currently estimated class and subclass costs are remapped and attributed to the competitive products as defined by the PRC. Once remapped, product cost assignment should then be made consistent with the current USPS attribution rules and processes for marginal and incremental costs.

Recommendation 2: To enable a practical solution to be developed that could be validated by third parties, a theoretical or "on paper only" enterprise — USPS Competitive — should be analytically created by assigning to it an appropriate share of all USPS costs.

Recommendation 3: The volume-variable or marginal product costs currently reported by the USPS cost system should be used — after the product definition modification required by PAEA— to ensure that the competitive products cover their attributable costs. The reported incremental costs should be used to ensure that cross-subsidization of the competitive products by the market-dominant products is not occurring.

Recommendation 4: When the costs of the USO have been reliably determined and subjected to third-party validation, then the PRC should make any adjustments it deems necessary to the institutional cost assignment approach described in the following recommendation.

⁶⁷ The terms "granular" and "granularity" are used in this report to describe the level of detail that is reported by a cost system. The level of granularity in financial reporting is often used to assess the reporting transparency.

Recommendation 5: The current USPS cost accounting system should be modified so that all of the costs for USPS's two lines of business (Market-Dominant and Competitive) can be assigned using cost drivers that capture the causal relationship between the lines of business and their applicable business costs. The remaining unassigned costs should be treated as institutional costs and an appropriate percentage of these institutional costs, which should be defined by the PRC by regulation, should be covered by the theoretical Competitive enterprise.

Recommendation 6: Subject to USPS system modifications to accommodate the new product definitions, the revenue numbers from the existing USPS financial systems should be used as a basis for both reporting the financial profits and the taxable profits of the USPS Competitive theoretical enterprise. [Note: The revenues used to determine the assumed federal income tax might have to be adjusted, as appropriate, to conform to tax code treatment.]

Recommendation 7: A theoretical USPS Competitive enterprise income statement should be developed. The revenues should be derived from the current USPS revenue system and process as modified to reflect the new definitions of competitive products. The costs should be the outcome of applying the above-proposed cost accounting approaches.

Recommendation 8: The USPS should calculate the competitive products' assumed federal income tax using a simplified approach, preferably using a published, regularly updated, tax rate.

Recommendation 9: To ensure compliance with PAEA provisions and subsequent PRC clarification and direction for their implementation, USPS should provide sufficient accounting and financial statements of operations reporting and supporting information for the theoretical USPS Competitive enterprise. The information prepared and reported should be subject to sufficient independent review to ensure that it is fairly stated in all material respects, either in relation to the basic financial statements as a whole or on a stand-alone basis.

4.3 Conclusions

The proposed Treasury accounting and taxation approaches should enable USPS to satisfy the above-cited PAEA competitive products costing and reporting requirements. Refining the product cost object should allow the existing cost system to report competitive products' marginal and incremental costs. The marginal costs should allow USPS to analyze competitive products' pricing for appropriate pricing actions. The incremental costs should enable USPS to demonstrate that the market-dominant products are not cross-subsidizing the competitive products.

The proposed assignment of the institutional costs to competitive products, which is detailed in Recommendation 5, should provide greater transparency to the cause and magnitude of institutional costs. In addition, this proposed approach should provide a basis for the computation of the assumed federal income tax on the USPS Competitive enterprise.

While several PAEA provisions are fairly specific in their requirements, there are several areas that are potentially open to interpretation and intent (e.g., "appropriate share" of institutional costs) and/or further clarification (e.g., the term "liabilities"). For example, individual asset identification and usage assignment may enable tax law depreciation treatment, but this assignment method may not meet the CPF "shall be the greater of" asset quantification assignment test (see Section 2.4). The significant challenge in implementing all of the relevant PAEA competitive products provisions lies in identifying that set of integrated options that would successfully satisfy all of the provisions.

Ultimately, the PRC will need to determine the optimum set of integrated options that should be implemented by USPS. As noted earlier, given the size and scope of the USPS's operations as well as the complexity involved in meeting the PAEA accounting and other requirements, Treasury believes that any necessary changes to the existing USPS cost and other systems should be made incrementally.

With respect to implementation of Treasury's specific recommended accounting and taxation approaches, Treasury proposes the following phases:

1. Deploy the proposed cost assignment approach and methods — or some close variation — as described in this report. The output from these approaches should yield the following:
 - a. Revenues consistent with the PRC-defined competitive products;
 - b. Competitive products' costs to perform the individual product cross-subsidy and collective competitive products' "appropriate share" of institutional costs tests; and
 - c. Competitive products' income before taxes.
2. Use a USPS total asset assignment to the CPF using the competitive products' proportional cost of revenue as the assignment percentage. Using cost of revenues⁶⁸ versus revenues would avoid skewing the assignment for pricing mark-ups. The output from this approach should yield the competitive products' total assets to perform the "shall be the greater of" PAEA test for initial asset assignment quantification. (If this approach does not satisfy the test, the default should be revenue percentage assignment.)
3. Calculate an assumed federal income tax on competitive products' income using the most current Congressional Research Service reported average effective tax rate (e.g., 26.3 percent for 1993-2002 for C-corporation, non-financial entities.) This approach contains two key assumptions. First, it assumes that accrued or deferred revenues and expenses are (dollar) immaterial and, as period-related transactions, will be included in the next period's tax calculation. Second, it assumes that the tax law depreciation is (dollar) immaterial to the cost-benefit requirements of individual-asset identification for accelerated depreciation treatment. The output from this set effective tax rate approach should yield:
 - a. An assumed competitive products' federal income tax;
 - b. Competitive products' income after tax for CPF inclusion; and
 - c. An assumed income tax amount to be transferred to the PSF.
4. Using the outputs from the above proposed approaches, create the required competitive products' reporting documents (e.g., statements of operations) consistent with PAEA provisions and governance requirements.
5. Prior to the release of the competitive products' reporting documents, sufficient independent review should be conducted to ensure that the documents and any supporting information are consistent with PAEA requirements and PRC direction, and fairly stated in all material respects, either in relation to the basic financial and accounting statements as a whole or on a stand-alone basis.

Treasury has recommended that a simplified method of calculating the assumed tax be used instead of a detailed tax law calculation. Tax law requires a level of revenue, cost, and balance sheet detail for treatment assessment and application that might only be achieved through the creation of entirely separate, stand-alone Competitive Products enterprise and supporting documentation for it. However,

⁶⁸ Cost of revenue is the cumulative costs of products and/or services before selling, general, administration —SG&A — and other expenses. Revenues less cost of revenue will yield gross profits and gross revenue margins.

this is clearly not required by PAEA and it would entail great expense with no concomitant benefit. Thus, Treasury has recommended a simplified method of determining the assumed tax.

Treasury also notes that the intention of PAEA in charging an assumed income tax to the USPS Competitive enterprise is presumably to induce competitive fairness and equal treatment vis-à-vis private industry. Yet, another key objective of PAEA is to permit competitive products to make a positive contribution to market-dominant products' business. In fact, PAEA requires the USPS to transfer the assumed tax to the PSF. The PAEA objective of having competitive products contribute to the market-dominant products' business would not be met to the extent USPS chose to use competitive products' revenue to minimize the tax it would be required to pay per a tax law calculation.

Glossary of Key Terms

2006 Postal Accountability and Enhancement Act (PAEA). Signed into law Dec. 20, 2006, PAEA directs the Department of the Treasury to resume funding of military pensions for postal employees, returning the USPS to the same status as the majority of other agencies. PAEA also abolishes a legally mandated escrow requirement. In addition, it reconstitutes the former Postal Rate Commission into the Postal Regulatory Commission, and grants it greater authority and responsibility. The Act also provides for the separation of product categories into market-dominant and competitive products as well as compliance to many provisions of Sarbanes-Oxley.

Activity Based Costing is an accounting method of assigning costs to activities based on their use of resources. Cost pools are created for groups of activities that can be assigned together. Cost drivers are identified for each activity. The variability of the costs for that activity is calculated as a function of the volumes of each product or service using the activity. The results are then applied to the respective cost drivers to determine the amount of each cost pool and each activity to be assigned to each product or service.

All Events Test. Until the Tax [Law] Reform Act of 1984, P.L. 98-369, the All Events test required only that (1) all events have occurred that establish a liability and (2) that the liability can be measured with reasonable accuracy. The Tax Reform Act of 1984, P. L. 98-369, introduced a third requirement: economic performance. The economic performance leg of the All Events test delays deduction of certain expenses until services are rendered for the taxpayer or to the taxpayer and, with respect to certain other expenses, until such expenses are paid. See Income Tax Regulations Section 1.461-4. Those liabilities as to which payment is required for deduction are referred to as payment liabilities.

Attributable costs are defined in PAEA Section 3631(b) as “the direct and indirect postal costs attributable to such product through reliably identified causal relationships.” This standard codifies the Postal Regulatory Commission’s long-standing method of attribution under the Postal Reorganization Act. (See, e.g., PRC Op. R97-1, ¶ 4017: “The Commission is not prepared to depart from the position that attributable cost means costs which can be said to be reliably caused by a subclass of mail or service.”). For purposes of initially implementing regulations pursuant to subsection 3633, the PRC intends to employ this long-established attribution method to determine compliance with subsection 3633(a)(2). – 8/15/2007, PRC Docket No. RM2007-1, Order No. 26, Chapter III, Section E, subsection 2, paragraph [3045].

Class and subclass are terms used to define and describe the current products and services provided by USPS. PAEA requires that these classes and subclasses be reclassified to the new definitions of market-dominant and competitive products and services.

Common costs. A cost that is common to a number of cost objects (e.g., products or services), but cannot be directly attributed to any one cost object.

Competitive products. The PRC identified 11 products that initially comprise the competitive products' category:

- Priority mail, consisting of Domestic Priority Mail (1) and International Priority Mail (2);
- Expedited mail, consisting of Domestic Express Mail (3) and International Express Mail (4);
- Bulk parcel post, consisting of Parcel Select (5), Parcel Return Service (6), and parcel post qualifying for BMC, OBMC, and barcode discounts (7);
- Bulk international mail, consisting of IPA (8), ISAL (9), and M-bags (10); and
- Negotiated service agreements (11), which includes ICMs.

These products not only form the basis for the mail classification schedule, but also comprise the initial competitive product list required by section 3642.” – 8/15/2007, PRC Docket No. RM2007-1, Order No. 26, Chapter III, Section E, subsection 4, paragraph [3073] (Note: Treasury added the individual product numbering for product identification clarity.)

Competitive Products Fund, or CPF. A USPS revolving fund in the Treasury into which will be deposited: (1) the revenues from competitive products, (2) amounts received from competitive products' obligations issued by the USPS, (3) interest and dividends earned on investments of the CPF and (4) any other receipts of the USPS (including from the sale of assets), to the extent allocable to competitive products. This revolving fund is available to USPS for the payment of: (1) costs attributable to competitive products and (2) all other costs incurred by USPS, to the extent allocable to competitive products.

Cost assignment is a process that identifies costs with activities, outputs or other cost objects. In a broad sense, costs can be assigned to processes, activities, organizational divisions, products and services. FASAB Standard #4 states that “cost assignments should be performed using the following methods listed in order of preference: (a) directly tracing* costs wherever feasible and economically practicable; (b) assigning costs on a cause-and-effect basis; or (c) allocating costs on a reasonable and consistent basis.”

* Direct tracing applies to resources that are directly used in the production of an output. It also applies to specific resources that are dedicated to particular outputs.

Cost driver identifies the cause of the cost object and its cost. A cost driver is any factor that causes the increase or decrease in the occurrence of the activity or the level of effort required to perform the activity. There are often several cost drivers for a single activity. Management typically uses the results of cost driver analysis in continuous improvement programs to help reduce throughput time, improve quality, and reduce cost.

Cost object. An activity, output or item whose cost is to be measured. In a broad sense, a cost object can be an organizational division, a line of business, and a function, task, product, service or customer objective whose cost is measured by an ABC accounting system.

Cost of revenues. The cumulative costs of products and/or services before applying a market-driven pricing product or service mark-up and before selling, general, administration and other expenses. Cost of revenue is generally a better high-level, gross-assignment method, as it represents costs before SG&A and other expenses. Revenues are cumulative prices. Pricing is typically market-driven and will frequently reflect decisions that reflect more than just costs (e.g., strategic considerations, competition, and supply and demand) that could potentially distort the assignment.

Cross-subsidy (product). A product cross-subsidy, as used in this report, occurs when the revenue generated by that product is less than that product's incremental costs.

Economic Performance is a tax law term that refers to the third requirement that must be met under the tax law in order to satisfy the **All Events test** for deduction of expenses. There are certain expenses as to which **economic performance** will not be considered to have occurred until the expense is paid. The rationale of the requirement, which was added in 1984, is that many business liabilities do not require actual payment until a distant point in the future, and many such liabilities can be easily overstated to reduce (or eliminate) tax liability. Under Tax Code Section 461, economic performance occurs when property or services are provided or used, or when payments are made in the case of workers' compensation and tort claims.

Economic versus Managerial Cost Accounting systems. The basis of the economic approach to costing is opportunity cost, which is the cost of the alternatives foregone. Economic costs are forward-looking; accounting costs and revenues are based on dollars derived from accounts of historical activities. Accounting costs are not intended to be forward-looking, but to render a transactional picture of actual expenditures and revenues for some past period (e.g., fiscal year).

Economists make an important distinction between fixed and variable costs and between marginal and average costs. Fixed costs do not change with output (over some given period), while variable costs do vary with output. The cost of an increase in output of one unit is known as marginal cost, while average cost is defined as total costs divided by total output (for a given period). Marginal cost of a product is the opportunity cost of increasing output by one unit. Fixed costs play no role in marginal costs. Cost accountants also recognize distinctions between fixed and variable costs, but attempt to assign all costs of an activity to the products — or combinations of like-products — produced or to the customers served by the activity.

Economies of scale refer to the reduction of per-unit costs through an increase in production volume. They arise from spreading the fixed costs of a given activity or technology over a greater volume of units.

An economy of scope refers to the reduction of per-unit costs through the production of a wider variety of products or services. This is often the result of using a process or technology that is capable of producing multiple products or services — versus setting up separate processes or technologies for each product or service.

Financial statement income is the net income reflected on an entity's financial reports for statements of operations or income statement using generally accepted accounting principles, or GAAP.

Generally Accepted Accounting Principles, or GAAP, is a widely accepted set of rules, conventions, standards and procedures for reporting financial information, as established by the Financial Accounting Standards Board, or FASB.

Granular and granularity are terms used in this report to describe the level of detail that is reported by a cost system. For example, if the definition of a cost object is changed so that there are more objects whose costs are being reported, the resulting system is said to be more granular.

Impairment. A Financial Accounting Standards Board concept that generally refers to a situation where the value of an asset has been permanently reduced to a level below that at which it is carried on the GAAP-derived financial statements. The concept is not generally applicable under tax law.

Incremental cost. In a multi-product firm like USPS, incremental cost is the amount of cost avoided by eliminating a given product. The average incremental cost is this dollar figure divided by the number of units that are no longer produced. It is also possible to compute incremental cost by looking at the additional cost of adding a given number of units of a new product to the product line. However, the standard incremental cost calculation is based on the total cost that would be avoided if the current output of a product were reduced to zero and all associated costs with producing the product were eliminated.

Institutional costs. An economic concept for a group of costs, referred to as shared, joint or common that cannot be reliably assigned on causal grounds to any particular product or service in the group. These costs are shared by the group in question and consequently, they must be assigned to the corresponding group of products or services as a whole. When such common costs are not volume-variable and not attributable to a particular product or service or set of products or services, these shared (or non-attributable) costs are classified by USPS as institutional costs. Thus, institutional costs are the residual after volume-variable and service-specific fixed costs are subtracted from total costs. Since the service-specific fixed costs, as identified by USPS, are quite small for most services, institutional costs are roughly equal to total costs minus volume-variable costs.

Managerial Cost Accounting. Managerial cost accounting, or MCA, principles and methods are widely accepted and documented in books aimed at educating executives and students, and in professional and government statements of accounting practice. For specific standards and sources see: *Cost and Effect*, Robert S. Kaplan and Robin Cooper, Harvard Business School Press, Boston, 1997; *Management Accounting*, fifth edition, Anthony A. Atkinson, Robert S. Kaplan, S. Mark Young and Ella Mae Matsumura, Prentice Hall, 2007; *Statements on Management Accounting: Strategic Cost Management*, Institute of Management Accountants, 2006; and OMB FASAB Statement #4 – *Managerial Cost Accounting Concepts and Standards for the Federal Government*, Federal Accounting Standards Advisory Board, 1995.

Marginal cost is the cost of producing an additional unit of a given product or service, or the rate of change in total cost as output changes.

Market-dominant products. PAEA [Title II, Section 201, subsection 3621 (a)(1-10)] defines the following 10 USPS products as market-dominant:

- first-class mail letters and sealed parcel
- first-class mail cards
- periodicals
- standard mail
- single-piece parcel post
- media mail
- bound printed matter
- library mail
- special services
- single-piece international mail, subject to any changes the Postal Regulatory Commission may make under section 3642.

Opportunity cost is the cost of passing up the next best choice when making a decision. For example, if an asset such as capital is used for one purpose, the opportunity cost is the value of the next best purpose the asset could have been used for. Opportunity cost analysis is an important part

of a company's decision-making processes, but is not treated as an actual cost in any financial statement.

Payment Liabilities. A tax law term for those liabilities as to which payment is required as a condition to economic performance and deduction for purposes of calculating taxable income. Liabilities are defined as any deduction item, expense or cost that is allowable for the purposes of federal income taxes. The IRS issued proposed regulations on June 7, 1990, that established six types of liabilities for which payment must be made to establish economic performance: breach of contract of violation of law; rebates and refunds; awards, prizes, or jackpots; insurance premiums, warranty, or service contract payments; liabilities arising from taxes; and other liabilities not specifically delineated.

Postal Service Fund, or PSF. A USPS revolving fund in the Treasury (which shall be available to the USPS without fiscal limitation) into which will be deposited: (1) the revenues from postal and nonpostal services, (2) amounts received from obligations issued by the USPS, (3) amounts appropriated for the use of the USPS, (4) interest earned on investments, (5) any other receipts of the USPS (including from the sale of assets), and (6) the balance in the Post Office Department Fund as of the commencement of operations of the USPS. This revolving fund is available to USPS for the payment of all costs incurred by USPS and the PRC.

Tax law is the U.S. Government law applicable to calculation of taxable income as set forth in the Internal Revenue Code of 1986, as amended, Treasury Regulations promulgated there under, and other revenue rulings, procedures and notices issued by the IRS and applicable case law interpreting same.

Taxable income is the net income calculated in accordance with tax law of the theoretical USPS Competitive enterprise.

Theoretical or “On Paper Only” USPS Competitive Enterprise is a term used in this report to describe a USPS competitive products enterprise that is analytically created (on paper) in the format of financial and accounting information as if it were a separate USPS business enterprise that shares the economies of scale and scope with the USPS market-dominant products. This theoretical or analytically derived USPS Competitive enterprise is deemed necessary to comply with the PAEA enactment requirements for competitive products’ financial reporting and assumed federal income tax computation.

True-up is a tax law term that represents the reconciliation of the amounts appropriated during the year based upon estimates with the actual amounts that should have been appropriated. It is determined after the close of the fiscal year when all information is available.

Universal Service Obligation, or USO. The postal USO is a fundamental feature of postal services in advanced economies. It is the requirement that postal operators provide service to every address within their countries, and in the case of letters, at a uniform price. The government monopoly in postal delivery and restrictions on private industry entry has traditionally been the means of assuring that postal operators can pay the costs of their USOs.

Volume-variable costs are the costs that vary with the volume of output. The volume-variable costs that USPS currently reports are mathematically equivalent to marginal costs.