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BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON DC 20268-0001

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POSTAL RATE AND FEE CHANGES, 2006

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Docket No. R2006-1

DIRECT TESTIMONY  
OF

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ON BEHALF OF  
PITNEY BOWES INC.

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1 **AUTOBIOGRAPHICAL SKETCH**

2 My name is Lawrence G. Buc. I am the President of SLS Consulting, Inc., a  
3 Washington, D.C., consulting firm specializing in postal economics.

4 I have participated in rate and classification cases of the United States Postal  
5 Service ("Postal Service") for over 30 years. I joined the Revenue and Cost Analysis  
6 Division of the Postal Service in March of 1975 and have analyzed postal issues ever  
7 since. I have also been employed by the United States Postal Rate Commission  
8 ("Commission") and have been retained by private clients for consultations on postal  
9 topics.

10 This is the ninth case in which I have submitted testimony to the Commission. I  
11 have testified previously in four rate cases (R84-1, R90-1, R97-1, and R2000-1), three  
12 mail classification cases (MC76-1, MC77-2, and MC2004-3), and in one complaint case  
13 (C99-4.) I have testified on behalf of the Postal Service, of intervenors, and of the  
14 Office of the Consumer Advocate.

15 I attended Brown University and graduated in 1968 with an A.B. with honors in  
16 mathematics and economics. In 1978, I received an M.A. degree in economics from the  
17 George Washington University of America. While there, I was a member of Omicron  
18 Delta Epsilon, the national honorary economics society. I am a member of the  
19 American Economic Association.

20

1 **I. PURPOSE AND SCOPE**

2 In my testimony, I will show that First-Class Mail Presort Letters are exceedingly  
3 important to the financial well being of the Postal Service, and that it is consequently  
4 very important that they be priced correctly. Next, I will show that the Efficient  
5 Component Pricing Rule (“ECPR”) is the appropriate analytical framework for setting  
6 worksharing discounts. I will also show the importance of accurately measuring cost  
7 avoidances under ECPR. I will then show that the cost avoidance estimates presented  
8 by Postal Service witness Abdirahman for First-Class Mail Automation Letters (USPS-T-  
9 22) are flawed because they consistently understate workshare related cost avoidances  
10 and, thus, are inadequate for ECPR pricing. I will provide better estimates for these  
11 cost avoidances. Finally, based on these improved estimates, I will provide proposed  
12 rates for Automation Letters that balance important policy objectives, better comport  
13 with ECPR, and satisfy the rate-setting factors of the Postal Reorganization Act.<sup>1</sup>

14 **II. FIRST-CLASS MAIL PRESORT LETTERS ARE ESSENTIAL TO THE**  
15 **CONTINUED FINANCIAL VIABILITY OF THE POSTAL SERVICE**  
16

17 First-Class Mail Presort Letters make an enormously valuable contribution to the  
18 Postal Service’s finances; it is very “profitable” mail. With revenues of \$14.95 billion in  
19 the Base Year (FY 2005) and volume variable costs of only \$4.97 billion, First-Class  
20 Mail Presort Letters provided \$9.98 billion in contribution to the Postal Service’s  
21 institutional costs. Thus, while it accounted for about 20 percent of USPS revenues, it  
22 provided almost a third of total contribution.<sup>2</sup>

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<sup>1</sup> See 39 U.S.C. §§ 101 *et. seq.* (2006).

<sup>2</sup> See Summary of Revenue and Cost for Major Service Categories, Fiscal Year 2005 at [http://www.usps.com/financials/\\_xls/FY05CRA.xls](http://www.usps.com/financials/_xls/FY05CRA.xls), tabs Cost1 and Cost2.

1 Several other financial metrics further demonstrate the importance of presort and  
2 automation letters to the continued financial viability of the Postal Service. The unit  
3 contribution and cost coverage for First-Class Mail Presort Letters both exceed those for  
4 First-Class Mail Single-Piece Letters. In fact, in FY 2005 both of these financial metrics  
5 for First-Class Mail Presort Letters were substantially larger than the average for all  
6 mail, as shown in Table 1.

7 **Table 1. Unit Contribution and Cost Coverage**  
8 **for First-Class Mail and All Mail: FY 2005**

	<b>Unit Contribution</b>	<b>Cost Coverage</b>
<b>First-Class Mail Single-Piece Letters</b>	\$0.189	172 %
<b>First-Class Mail Presort Letters</b>	\$0.203	301 %
<b>Total All Mail</b>	\$0.136	176 %

Source: [http://www.usps.com/financials/\\_xls/FY05CRA.xls](http://www.usps.com/financials/_xls/FY05CRA.xls), tabs Cost1 and Cost2

9 Because of the significant financial contribution of First-Class Mail Presort Letters  
10 to the Postal Service, setting rates and discounts for presorted and automation letter  
11 mail to elicit and maintain this contribution is critically important.

12 As shown in Table 2 below, volumes of First-Class Mail Presort Letters continue  
13 to grow, both in absolute terms and as a percentage of First-Class Mail. Consequently,  
14 they have been and will continue to be enormously important to the financial viability of  
15 the Postal Service as a source of both mail volume and revenue. After the mailing  
16 community has fully adapted to worksharing product innovations offered by the Postal  
17 Service, almost 52 percent of First-Class Letter Mail volume and almost 38 percent of  
18 its revenues is generated by mail using these worksharing innovations.<sup>3</sup>

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<sup>3</sup> See *The Effects of Worksharing, Other Product Innovations and the 9/11-Anthrax Attack on U.S. Postal Volumes and Revenues*, Edward S. Pearsall, available on the PRC website, [www.prc.gov](http://www.prc.gov).

1

**Table 2. First-Class Mail Volumes, FY 1995 – FY 2005**

<b>Fiscal Year</b>	<b>Single Piece Volumes (millions)</b>	<b>Workshared Volumes (millions)</b>	<b>Workshared Portion (%)</b>	<b>Workshared Increase (%)</b>
1995	53,527	37,388	41%	9.8%
1996	53,848	37,998	41%	1.6%
1997	54,504	38,648	41%	1.7%
1998	53,936	40,421	43%	4.6%
1999	53,413	42,685	44%	5.6%
2000	52,370	45,676	47%	7.0%
2001	50,946	47,075	48%	3.1%
2002	49,253	47,658	49%	1.2%
2003	46,558	47,288	50%	-0.8%
2004	45,162	47,334	51%	0.1%
2005	43,376	49,066	53%	3.7%

Source: Volumes from USPS-T-7, p. 43

2 **III. THE COMMISSION SHOULD ADHERE TO THE EFFICIENT COMPONENT**  
3 **PRICING RULE TO ESTABLISH APPROPRIATE WORKSHARE DISCOUNTS**

4 Worksharing discounts induce mailers to perform cost saving activities . To  
5 receive these discounts, mailers perform part of the work involved in the end-to-end  
6 mail service and pay less than full price to the Postal Service as a result of performing  
7 this work.

8 The Efficient Component Pricing Rule is the principle that states that the  
9 discounts mailers receive for performing this work should be set at a level *equal* to the  
10 per unit avoided cost of the Postal Service. When discounts are set *equal* to costs  
11 avoided, they induce mailers to perform work if and only if these mailers can perform  
12 the work less expensively than the Postal Service. If discounts are less than the cost  
13 avoided, some mailers who could have performed the work less expensively than the  
14 Postal Service will not undertake the work because of the inaccurate pricing signal.

1 Thus, worksharing discounts that comport with ECPR, i.e. those that are set at a level  
2 equal to the per unit avoided cost, will minimize the total cost of mailing in the economy.

3 **A. The Commission Favors Establishing Worksharing Discounts**  
4 **Consistent With ECPR.**

5 The Commission has long recognized the importance of ECPR for both efficiency  
6 and equity, stating, for example:

7 From the inception of worksharing discounts, the Commission has been  
8 concerned with both equity and economic efficiency. It set the first such  
9 discount at clearly capturable avoided costs. This provided a rate incentive  
10 to mailers which would allow cost-based decisions on whether to engage  
11 in the worksharing activity. In effect, the Commission was setting  
12 discounts in conformity with what later became known as efficient  
13 component pricing. The discount approach led to the lowest cost producer  
14 providing the service. This, in turn, minimized the cost of the workshare  
15 activity to society as a whole.

16  
17 PRC Op. MC95-1, para. 3074.

18  
19 And in addition to recognizing the salutary effects of ECPR on efficiency, the  
20 Commission also has noted that it promotes equity:

21  
22 However, when discounts pass through 100 percent of avoided costs to  
23 the workshare mailer, the contribution made by that mailer to institutional  
24 costs is the same as the mailer would have made without worksharing.  
25 Thus, workshare mailers and non-workshare mailers provide the same  
26 contribution, which is fair and equitable. In this case the Commission has  
27 set the majority of the recommended discounts for First-Class to pass  
28 through 100 percent of the avoided costs. This maximizes the discounts  
29 and effectively reduces the institutional cost burden on workshare mailers  
30 as much as possible.

31  
32 PRC Op. R2000-1, para. 5060.  
33  
34

1           **B.     Dr. Panzar’s Testimony in This Case Also Describes the Benefits of**  
2           **ECPR.**

3  
4           The virtues of ECPR are discussed at length in the companion testimony of Dr.  
5 John C. Panzar. See PB-T-1. As stated by Dr. Panzar, establishing ECPR-based  
6 workshare discounts equal to the per unit avoided costs of the Postal Service benefits  
7 mailers, the Postal Service, and economic efficiency by,

8           lead[ing] mailers to choose to perform work-sharing if and only if doing so  
9 lowers total postal sector costs. . . . If the mailer’s cost is less than the  
10 discount offered, it is profitable for the mailer to do the work – and total  
11 postal sector costs decrease. If the discount is not sufficiently attractive,  
12 the Postal Service continues to provide the service component.

13  
14 PB-T-1 at 18.

15  
16           Dr. Panzar further discusses why ECPR is the *only* discount policy that will allow  
17 mailers to assist the Postal Service in minimizing the total combined costs of the postal  
18 system:

19           This is the case, because, if the worksharing discount is less than the unit  
20 avoided costs of the Postal Service, *some* mailers who could provide the  
21 service more cheaply than the Postal Service will not have an incentive to  
22 engage in worksharing. On the other hand, if the worksharing discount is  
23 greater than the per unit avoided costs of the Postal Service, there will be  
24 mailers who will take advantage of the discount even though they cannot  
25 perform the service as cheaply as the Postal Service. In either case, the  
26 total costs of the end-to-end service will increase.

27  
28 PB-T-1 at 19.

29  
30           **C.     Accurate Cost Estimates are Essential to ECPR.**

31  
32           Accurate measures of cost avoidances are a fundamental requirement of ECPR.  
33 If the cost avoidances are understated, discounts may appear too large to comport with  
34 ECPR even though in reality they are actually too small. As a simple example, suppose  
35 that the cost avoidance between two products is erroneously stated as 1.3 cents, the

1 discount is 1.9 cents, but the accurate cost avoidance is 2.3 cents. Based on the  
2 erroneous cost avoidance, the discount appears to be larger than the appropriate ECPR  
3 discount, but under the accurate cost avoidance, the discount is actually less than the  
4 correct discount under ECPR.

5 This is not an academic distinction. If discounts are lower than they should be  
6 under ECPR, then mailers will not provide as much worksharing as they would under  
7 the correct pricing structure. This, in turn, will result in total mail processing costs that  
8 are higher than they would be otherwise, which is both economically inefficient and  
9 contrary to important public policy goals. Thus, accurate estimates of costs avoided are  
10 critical for ECPR.

11 **IV. THE POSTAL SERVICE'S COST METHODOLOGY CONSISTENTLY**  
12 **UNDERESTIMATES WORKSHARE RELATED COST AVOIDANCES FOR**  
13 **AUTOMATION LETTERS**

14 While the Postal Service has made several improvements to its cost  
15 methodology for First-Class Mail Presort letters in this case (e.g., delinking First-Class  
16 Single Piece and First-Class Presort), the Postal Service has failed to improve its  
17 models in other important respects, and has made one change that seriously degrades  
18 the accuracy of the model (the unexplained and unprecedented exclusion of delivery  
19 costs). The Postal Service's cost methodology remains flawed because it continues to  
20 severely underestimate cost avoidances. To set the context for the subsequent  
21 discussion of improvements, following I briefly describe how the Postal Service model  
22 works.  
23  
24

1           **A.     Postal Service First-Class Mail Presort Letters Cost Methodology.**

2           Because the In-Office Costing System (“IOCS”) does not report costs for the  
3 various rate categories of First-Class Mail Presort Letters, the Postal Service must  
4 estimate, or model, these costs. It does so with a hybrid approach, using a “bottoms-  
5 up” engineering cost model (combining mail flows with costs – derived from productivity  
6 and wage rate data – at each step of the mail flows) to estimate the costs of piece  
7 handling and selected bundle handling activities for letter-shaped mail for each of the  
8 rate categories. Then, using the distribution of mail across the rate categories, the  
9 Postal Service calculates the average weighted cost for letter-shaped Presort Mail. This  
10 cost is next compared to the cost that IOCS shows for letters for those MODS pools that  
11 best map to the modeled activities in the Cost and Revenue Analysis (“CRA”). The ratio  
12 of CRA cost to modeled cost is the “CRA adjustment.” If the ratio is greater than 1,  
13 modeled costs are less than CRA costs; if it is equal to 1, modeled costs equal CRA  
14 costs; and if it is less than 1, modeled costs are greater than CRA costs. Costs for each  
15 rate category are then multiplied by the CRA adjustment to reconcile the modeled costs  
16 to the CRA costs. Finally, the CRA costs for activities that are not modeled – 1.766  
17 cents per piece under the PRC method<sup>4</sup> -- are added to the costs for each of the rate  
18 categories. See USPS-T-22 at 7-8.

19           Under the Postal Service methodology, the activities that are modeled – all piece  
20 handling activities and some bundle handling – are called “proportional,” while all the  
21 remaining activities – container handlings, allied labor, not handling, etc. – are not

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<sup>4</sup> The Postal Service and the Commission use different methods for cost pool formation and for volume variability in Cost Segment 3. These different methods lead to differences in calculated costs in this segment. References to the “PRC method” means that the costs are calculated under the method the Commission uses.

1 modeled and are called “fixed.” This implies that costs for “proportional” cost pool  
2 activities vary across presort levels while the remaining “fixed” cost pool activities are  
3 unaffected by presort level, i.e., they do not vary. But both the Postal Service and its  
4 cost modeling witness Abdirahman have conceded that the classification of cost pools  
5 as “proportional” and “fixed” has only to do with whether the costs have been modeled  
6 and not whether they actually vary with respect to presort level. *See* USPS-T-22 at 7, 8  
7 Tr. 4/509 (PB/USPS-T22-4 (Abdirahman)); Tr. 18D/6587 (PB/USPS-T42-10)(redirected  
8 to USPS)).

9 As described above, under the Postal Service methodology, the average unit  
10 cost of Presort letter-shaped mail derived from the model is constrained to equal the  
11 IOCS unit cost (5.00 cents per piece, using the PRC method). Critical to the  
12 functionality and results of the model, cost avoidances between the rate categories are  
13 determined solely by the piece-handling and bundle costs in the cost pools classified as  
14 proportional by the Postal Service. This is because the same amount of fixed costs are  
15 added to these proportional costs in each rate category. *See* USPS-LR-L-110, CRA  
16 Presort Letters, Table 3 Adjusted Letter Unit Mail Processing Cost, column 6. Thus, the  
17 costs in cost pools designated as fixed costs have *no effect* on the magnitude of the  
18 workshare related cost avoidances. *See* Tr. 4/614-615 (PB/USPS- T22-10(a)  
19 (Abdirahman)). This means that incorrectly classifying costs as fixed with respect to  
20 presort level has the effect of inappropriately compressing the calculated differences in  
21 unit mail processing costs across these presort levels. It understates cost avoidances.

22 Table 3, below, shows how the Postal Service distributes cost pools and cost  
23 between “proportional” and “fixed” and the resulting distribution of unit costs as “fixed”

1 and “proportional.” As the table shows, modeled costs, labeled “proportional,” account  
 2 for only 14 of the 63 cost pools (under the PRC method) and comprise only 3.23 cents  
 3 of the total unit costs of 5.00 cents. Thus, the Postal Service has actually modeled  
 4 slightly more than 20 percent of the cost pools and less than two thirds of the costs.  
 5 Costs that are not modeled, labeled “fixed” costs, comprise the majority of the cost  
 6 pools - 49 under the PRC method - and account for slightly more than one third of the  
 7 total unit costs. Given the large number and percentage of cost pools that are  
 8 characterized as “fixed” and the importance of the distinction between proportional and  
 9 fixed cost pools in accurately determining mail processing costs (and costs avoided)  
 10 across presort levels, careful scrutiny of the USPS classification of cost pools as “fixed”  
 11 or “proportional” is appropriate.

12 **Table 3. USPS Classification of Proportional**  
 13 **and Fixed Cost Pools (PRC Method)**

<b>Pool Classification</b>	<b>Number of Pools</b>	<b>Percent of Pools</b>	<b>Unit Cost</b>	<b>Percent of Unit Cost</b>
<b>Proportional</b>	14	22.2%	3.234	64.7%
<b>Fixed</b>	49	77.8%	1.766	35.3%
<b>Total</b>	63	100.0%	5.000	100.0%

Source: USPS-LR-L-110, PRC FCM.xls, Tab CRA – Presort Letters

14 **B. Improvements to the Postal Service Model.**

15 The Postal Service has made some important improvements to its model in this  
 16 case. Specifically, the Postal Service has improved the model’s handling of estimated  
 17 costs and cost avoidances in three ways: (1) combining Automation with non-  
 18 Automation tallies in the cost pools; (2) changing the classification of three cost pools  
 19 from the fixed to the proportional category; and (3) delinking the Presort letters cost  
 20 avoidances from a single piece benchmark. A short discussion of each follows.  
 21

1                   1. The Postal Service Has Improved Its Model By Combining Automation  
2                   and Non-Automation Tallies.  
3

4                   In R2005-1, the Postal Service used IOCS costs for non-Automation Presort  
5 letter mail and for Automation Presort letter mail separately in the cost estimating  
6 process described above. The Postal Service has now convincingly demonstrated that  
7 IOCS cannot accurately measure the costs for non-Automation Presort mail separate  
8 from those for Automation Presort mail. See Tr. 18D/6603-10 (Response of the United  
9 States Postal Service to P.O. Information Request No. 5, Question 4). Thus, in the  
10 current case, the Postal Service combines the non-Automation and Automation letter  
11 IOCS costs and deaverages the combined First-Class Mail Presort letters cost using the  
12 model described above.

13                   2. The Postal Service Has Improved Its Model by Reclassifying Select  
14                   Cost Pools.  
15

16                   Combining Automation and non-Automation Presort letter tallies in all cost pools  
17 produces an improvement in the classification of certain cost pools. In the Automation  
18 cost model in Docket No. R2005-1, 1OPBULK, 1OPREF, and 1POUCHING were each  
19 classified as worksharing related fixed while in the non-Automation model they were  
20 classified as proportional. Having combined the Automation and non-Automation tallies,  
21 the Postal Service was forced to adopt consistent classifications; each has now been  
22 classified as proportional in this case. As I discuss below, these cost pools should be  
23 classified as proportional and doing so has improved the model.

24                   3. The Postal Service Has Improved Its Model by Delinking Presort Rates  
25                   from Single-Piece Rates.  
26

27                   Delinking Presort letter rates (both Automation and non-Automation) from Single-  
28 Piece rates also represents an improvement in the Postal Service's cost model. As

1 shown in Dr. Panzar's testimony (PB-T-1), the choice of Bulk Metered Mail ("BMM") as  
2 a benchmark is flawed from a theoretical perspective.<sup>5</sup> And once deaveraging occurs  
3 across important cost-causative factors as required for productive efficiency, delinking  
4 naturally follows.<sup>6</sup> From a more practical perspective, delinking also improves the  
5 modeling because *cost avoidances* from the BMM benchmark are implausibly smaller  
6 than *cost differences* given the similarity in weights and shapes of Single-Piece and  
7 Presort Letters mail.<sup>7</sup>

8 **C. The Unexplained Exclusion of Delivery Costs Degrades the Postal**  
9 **Service Cost Model.**

10  
11 Notwithstanding these improvements, the Postal Service has made one change  
12 that substantially degrades the integrity of the cost model: removing the delivery cost  
13 differences. Postal Service witness Taufique attempts to provide a rationale for  
14 excluding delivery cost avoidances in his response to Question 2(c) of P.O.'s  
15 Information Request No. 5.

16 It is my understanding that the differences in delivery costs for the various  
17 presort levels of automation are driven solely by the different Delivery  
18 Point Sequencing (DPS) figures that come from the letter model estimated  
19 by witness Abdirahman, USPS-T-22. Those differences happen because  
20 the less presorted the letters are, the more equipment they go across and  
21 thus, the more opportunities they have to be rejected. However, the reject  
22 rates for the various letter sorting equipment are not unique to class  
23 and/or rate category of the letters in question and reflect all of the letters  
24 worked on that equipment. It is my understanding that DPS percentages  
25 are not an input to the cost models and there are no data indicating that  
26 DPS percentages actually differ among the presort rate categories.

---

<sup>5</sup> Note that even if the Commission were to reject the Postal Service proposal to delink Presorted and Single-Piece Letter Mail, the models should still be corrected as suggested in this testimony to develop the accurate cost avoidance estimates essential to ECP.

<sup>6</sup> See Comments of the Association for Mail Electronic Enhancement, Financial Services Roundtable, National Association of Presort Mailers, National Postal Policy Council, and Pitney Bowes, Inc., in Response to the Third Notice of Inquiry, dated August 17, 2006.

<sup>7</sup> Cost avoidances include only workshare-related mail processing cost differences from a rate setting benchmark, while cost differences include all components of the end-to-end delivery of the mail. Workshare-related cost avoidances are a subset of cost differences.

1 Furthermore, the reject rates that create the differences in the DPS  
2 percentages and resulting different delivery costs for the various presort  
3 levels for letters could be affected by the reject rates for single-piece  
4 letters, which is not a component of the cost models.  
5

6 Tr. 16/4860-61.

7 But this explanation is not compelling, particularly in view of the fact that the  
8 Postal Service's decision to exclude delivery unit costs is inconsistent with the approach  
9 it uses to measure mail processing cost avoidances for the Automation rate categories.  
10 In the mail processing model, the Postal Service explicitly recognizes that part of the  
11 cost differences between Automation rate categories is due to the fact that "the less  
12 presorted the letters are, the more equipment they go across and thus, the more  
13 opportunities they have to be rejected." See USPS-LR-L-110, AUTO MAADC MODEL,  
14 AUTO AADC MODEL, and AUTO 3-DIGIT MODEL. Excluding delivery unit cost  
15 differences is also inconsistent with mail processing operations, because a mail piece  
16 must remain in the automation mailstream to be delivery point sequenced ("DPS"). See  
17 Tr. 11/2795 (APWU/USPS-T-30-4 (Kelley)).

18 **D. The Chief Deficiency in the Postal Service Cost Model is the**  
19 **Improper Classification of Cost Pools.**  
20

21 As shown above, the Postal Service provides no evidence that the cost pools  
22 classified as "fixed" in the cost avoidance model actually are fixed with respect to  
23 presort level. See Tr. 18D/6587 (PB/USPS-T42-10 (redirected to USPS)). Witness  
24 Abdirahman further conceded that he is unaware of econometric, operational, or any  
25 other studies supporting this critical assumption. See Tr. 4/519; Tr. 4/509 (PB/USPS-T-  
26 22-4 (Abdirahman)). In fact, there is no evidence that these cost pools actually are fixed  
27 with respect to presort level. There are, however, substantial and compelling reasons to

1 conclude that the costs in many of these “fixed” cost pools actually do vary between the  
2 presort levels. These cost pools should thus be reclassified as proportional.

3 Thought experiments using Postal Service data, Postal Service attribution and  
4 distribution costing methods, an examination of anomalous cost pools, and operational  
5 analysis prove that most of the costs in cost pools classified as fixed with respect to  
6 presort level actually vary with the presort level. A discussion of this evidence follows.

7 1. A Thought Experiment Demonstrates that Almost all Costs are  
8 Proportional.  
9

10 I start at the highest level of abstraction with a simple thought experiment. At the  
11 most general level, presort may be viewed along a continuum – from less presorted to  
12 more – rather than as a binary event – presorted or not. In this construct, Single-Piece  
13 First Class letter mail is the least presorted while Automation mail is the most presorted.  
14 If “fixed” costs are truly fixed with respect to presort level, then fixed unit costs of  
15 processing Single-Piece and Automation letter mail should be roughly similar on both a  
16 cost pool-by-cost pool basis and on an aggregate basis. And if “fixed” costs are truly  
17 “fixed,” then the ratio of “fixed” to “proportional” costs should be very different in Single-  
18 Piece mail than in Automation mail because, by definition, the proportional costs for  
19 Single-Piece mail are expected to be substantially higher than for Automation mail.

20 Table 4, below, summarizes the results of comparing the fixed pools in Single-  
21 Piece with those in Automation mail (and full results are in PB- LR- L-1, Tab 1). The  
22 table classifies “fixed” cost pools by their ratio of Single-Piece Metered First-Class Letter  
23 Mail unit cost to First-Class Mail Automation Letters unit cost using the PRC method for  
24 mail processing variability. See USPS-LR-L-141. As the table shows, 38 cost pools  
25 with matching non-zero mail processing costs are classified as either “worksharing

1 related fixed” or “nonworksharing related fixed.” In 36 of these fixed pools, the unit cost  
 2 for Single-Piece First-Class Metered Letter Mail exceeds the unit cost for First-Class  
 3 Mail Automation Letters. In 30 of these pools, the unit cost for Single-Piece First-Class  
 4 Letter Mail letters is greater than twice the unit cost for Automation Letters. Finally, in  
 5 ten of these pools, the unit cost of Single-Piece First-Class Metered Letter Mail is more  
 6 than five times greater. In total, the Single-Piece First-Class Metered Letter Mail unit  
 7 cost in the fixed cost pools is 4.525 cents, more than three times the First-Class Mail  
 8 Automation Letters unit cost in these pools, which is 1.479 cents. Thus, the “fixed”  
 9 costs do not appear to be fixed.

10 **Table 4. Number of Fixed Cost Pools and Associated Unit Costs by**  
 11 **Specified Ratios of Single-Piece Metered Letters Unit Cost to Automation**  
 12 **Letters Unit Cost for USPS Designated Fixed Cost Pools**

Ratio Range	Number of Pools with Specified Ratio of Single-Piece Letters to Automation Letters Unit Cost	Unit Costs (cents)	
		Single-Piece Metered Letters	Automation Letters
Less than 1	2	0.012	0.109
Between 1 and 2	6	0.553	0.355
Between 2 and 5	20	2.977	0.932
Over 5	10	0.983	0.082
Total Pools	38	4.525	1.479
Source: PB-LR-1, Tab 1			

13  
 14 Table 5, below, summarizes the results comparing the proportional pools for  
 15 Single-Piece metered and Automation letters, full details are in PB-LR-L-1. As  
 16 expected, the unit cost of Single-Piece metered is much higher than the unit cost of the  
 17 Automation, by a factor of about 3.1.

18

1 **Table 5. Number of Proportional Cost Pools and Associated Unit Costs by**  
 2 **Specified Ratios of Single-Piece Metered Letters Unit Cost to Automation**  
 3 **Letters Unit Cost for USPS Designated Proportional Cost Pools**

Ratio Range	Number of Pools with Specified Ratio of Single-Piece Letters to Automation Letters Unit Cost	Unit Costs (cents)	
		Single-Piece Metered Letters	Automation Letters
Less than 1	1	0.001	0.001
Between 1 and 2	1	0.380	0.205
Between 2 and 5	8	5.215	2.415
Over 5	3	2.978	0.386
Total Pools	13	8.573	2.737
Source: PB-LR-1, Tab 2			

4 Also note that the ratio of Single-Piece unit costs to Automation unit costs is  
 5 about the same in both the fixed and the proportional pools. Finally, drawing from  
 6 Tables 4 and 5, the ratio of proportional to fixed costs is 1.89 for Single-Piece Metered  
 7 Letters and 1.85 for Automation Letters, i.e. the ratio is nearly identical. This is very  
 8 strong evidence that the “fixed” pools are actually not fixed but rather vary across  
 9 presort levels.  
 10

11 Finally, although there may be slight differences between Single-Piece Metered  
 12 and Automation letters with respect to cost causing characteristics like weight<sup>8</sup> and local  
 13 / non-local mix, the most obvious difference is that Single-Piece Metered letters are less  
 14 workshared than Automation letters. No other characteristic can explain such large and  
 15 striking unit cost differences in pools that the USPS classifies as fixed. This suggests  
 16 that, after properly controlling for piece weight, local / non-local mix, and other  
 17 identifiable and measurable cost causing characteristics not related to the degree of

<sup>8</sup> All Single-Piece Letters averaged .8 ounces while all Presort Letters averaged .7 ounces. See Summary of Revenue and Cost for Major Service Categories, Fiscal Year 2005 at [http://www.usps.com/financial/\\_xls/FY05CRA.xls](http://www.usps.com/financial/_xls/FY05CRA.xls), tabs Cost1.

1 worksharing, a statistical analysis would still show significant mail processing cost  
2 differences between Single-Piece and Automation letters. These mail processing cost  
3 differences must then result from the degree of worksharing.

4 2. USPS Attribution and Distribution Costing Methods Imply Almost All  
5 Cost Pools Are Proportional.  
6

7 Postal Service attribution and distribution theory also shows that most of the  
8 costs in the 49 cost pools classified as “fixed” by the Postal Service under the PRC  
9 method actually vary across presort level. Postal Service witness Bozzo (USPS-T-12)  
10 presents testimony on the Postal Service’s methods for estimating the variability of mail  
11 processing costs and Postal Service witness Van-Ty-Smith (USPS-T-11) presents  
12 testimony on the methods for distributing these variable costs to mail classes and  
13 subclasses. Their methods and underlying logic indicate that most volume variable  
14 costs vary with respect to piece-distribution costs.<sup>9</sup>

15 Witness Bozzo explains that total pieces fed (“TPF”) and total pieces handled  
16 (“TPH”) are the correct volume measures of mail processing output. See USPS-T-12 at  
17 23-25 (Bozzo). Thus, the “Postal Service analysis continues to employ MODS TPF and  
18 TPH data to represent ‘outputs’ or ‘cost drivers’ for sorting operations” rather than using  
19 first handled pieces (FHP). See *id.* at 13. Witness Bozzo also confirms that he still  
20 endorses the statement he made in R2005-1,

21 increases in mailer worksharing activities will, in general, substitute for  
22 Postal Service TPF and TPH handlings, but not necessarily for FHP [first  
23 handled pieces]. Compared to an otherwise identical 3-digit presort piece,  
24 for instance, a 5-digit presort piece will avoid the incoming primary TPF  
25 and TPH, but not the incoming FHP count. The mailer’s worksharing  
26 effort has reduced the needed Postal Service effort without being  
27 recognized in FHP.

---

<sup>9</sup> Note that the logic of witness Bozzo’s testimony is independent of his econometric analysis. Therefore, it can be accepted even if the Commission does not accept his econometric estimates of variability.

1  
2 Tr. 10/2551 (PB/USPS-T12-3 (Bozzo)).

3  
4 In his current testimony, witness Bozzo underscores the importance of  
5 TPH noting it captures the “sort stage(s) avoided by the 5-digit piece . . . the  
6 avoidance of certain sort stages, is the basis for presort cost avoidances.”  
7 USPS-T-12 at 25 (Bozzo). Thus, it follows that piece handling costs vary with  
8 presort level and this result is consistent with the Postal Service’s cost avoidance  
9 model for Automation letter-shaped mail.

10 Under Postal Service attribution theory, non-piece handling costs also vary with  
11 TPF, which, according to witness Bozzo, also varies with presort level. Witness Bozzo’s  
12 testimony in pertinent part from R2005-1 states that,

13 Insofar as each piece fed must be brought to and dispatched from the  
14 operation, related container handlings (including handlings to send mail  
15 back through the operation for subsequent sorting passes) will also be  
16 proportional to TPF, as will “overhead” not-handling time that is driven by  
17 the handling workhours. Handling-mail time and associated overheads  
18 account for the vast bulk of workhours in sorting operations, so there is  
19 little in the way of causal avenues for workload measures other than TPF  
20 to enter the relationship between hours and mail processing “outputs.”

21  
22 Docket No. R-2005-1, USPS-T-12 at 14 (Bozzo); *see also* Tr. 10/2549-50 (PB/USPS-  
23 T12-2 (Bozzo))(confirming that witness Bozzo continues to hold this opinion).

24 The Postal Service has, therefore, acknowledged in its attribution theory that  
25 costs of container handlings and overheads vary across presort levels yet it inexplicably  
26 classifies all these costs as “fixed” with respect to presort level in its cost avoidance  
27 modeling. The Postal Service cannot have it both ways: these costs either vary across  
28 presort levels or they do not. They do.

1 Finally, with respect to the volume variability of allied labor and general support  
2 operations, witness Bozzo states:

3 For allied labor and general support operations, it is possible to view cost  
4 causation as following a “piggyback” model, in which the costs in support  
5 operations are viewed as driven by – and thus volume-variable to the  
6 same degree as – the “direct” operations.

7  
8 USPS-T-12 at 84 (Bozzo).

9  
10 Following the logic of the USPS attribution theory, the costs in all of these  
11 cost pools vary across presort levels and should be classified as proportional,  
12 because as Bozzo discusses, these costs vary with TPH and TPH varies across  
13 presort levels.

14 Witness Van-Ty-Smith’s distribution method for support and  
15 miscellaneous cost pools also follows the “piggyback” approach discussed by  
16 witness Bozzo. Specifically, witness Van Ty-Smith states:

17 As was proposed by the Postal Service in Docket No. R2005-1, the two  
18 support cost pools at the plants are consolidated into one “piggyback” cost  
19 pool (see discussion in USPS-T-12, section III E, Docket No. R2005-1).  
20 The two plant support cost pools are quasi-administrative pools  
21 characterized by a high percentage of not-handling-mail activities. The  
22 volume-variable costs for the “piggyback” cost pool are distributed to  
23 subclasses in proportion to the volume-variable costs for subclasses in the  
24 cost pools they support . . . .

25  
26 Docket No. R2005-1, USPS-T11 at 18.

27  
28 Cost distributions for miscellaneous cost pools that are not in the plants  
29 are also based on the distribution of handling tallies.

30 For the miscellaneous cost pool at post-offices, stations, and branches,  
31 the handling tallies are used and the distribution key for the not-handling  
32 tallies is based on all mail processing handling tallies at post-offices,  
33 stations, and branches.

34  
35 Docket No. R2005-1, USPS-T-11 at 19.

36

1           Witness Van-Ty-Smith also confirmed that there is no change in these  
2 distribution keys in this case. See Tr. 10/2460 (PB/USPS-T11-1 (Van-Ty-  
3 Smith)).

4           In summary, Postal Service attribution and distribution methods show that  
5 container handling, allied labor, not handling, and general support costs vary with piece  
6 handling costs. And because piece handling costs vary with presort level, so too must  
7 the container handling, allied labor, not handling, and general support costs. Thus,  
8 according to both the attribution and distribution theory of the Postal Service, *all* of the  
9 cost pools that are classified as “fixed” actually vary with respect to presort level.

10                   3. Classification of Anomalous Cost Pools.

11           Also among the mail processing costs that the Postal Service classifies as “fixed”  
12 are those in cost pools in which costs for First-Class Mail letters are unexpected. Mail  
13 processing costs in these pools may be unexpected because of mail shape, the type of  
14 facility, or the class of mail to which the pool relates. For example, while it would seem  
15 anomalous that First-Class Mail letter mail processing costs would appear in manual  
16 parcel sorting operations, in BMCs, or in Express Mail pools, IOCS actually records  
17 such tallies and the Postal Service uses these tallies to distribute mail processing costs  
18 to mail subclasses and special services.

19           The phenomenon of unexpected costs in cost pools was an issue in Docket No.  
20 R2000-1. In that docket, Postal Service witness Eggleston offered the following  
21 explanation of these costs,

22           IOCS handling tallies record the mail actually being handled by the  
23 employees recorded as working a given mail processing operation (cost  
24 pool), rather than the mail expected to be handled in a given operation.  
25

1 Docket No. R2000-1, Tr. 13/5128-29.

2  
3 From an operational perspective, these tallies generally result from one of two  
4 different circumstances: (1) when a clerk or mailhandler is handling letter -shaped mail in  
5 a non-letter operation; or (2) when a clerk or mailhandler is working in an operation that  
6 is different from the operation into which he or she is clocked. See Tr. 11/2925  
7 (PB/USPS-T42-7 (McCrery)).

8 For example, a First-Class Mail letter tally in a manual flat sorting operation  
9 generally would result from one of two events. The tallied clerk was working in a letter  
10 sorting operation (e.g., manual sorting), but had not clocked out of the flat sorting  
11 operation and into the letter sorting operation. Alternatively, the tallied clerk was, in fact,  
12 sorting that letter in the manual flat sorting operation. In either case, these costs are for  
13 sorting the letter and, like all other piece handling costs, vary with the amount of  
14 worksharing performed.

15 This argument – just like the attribution and distribution argument – holds for  
16 more activities than piece-distribution operations. The costs for many activities – e.g.,  
17 allied, general support, container-handling activities – vary with the amount of  
18 worksharing performed. So, if a mailhandler is clocked into the manual flat sorting  
19 operation, but is, in fact, bringing letters to a piece-distribution operation that cost should  
20 be classified as proportional, not fixed. Sound costing methodology should recognize  
21 that all of these cost pools are proportional costs and they should be so classified.

22 There are 16 anomalous cost pools. Table 6 displays them in three groups:  
23 unexpected facility, unexpected shape, and unexpected class. Table 6 also displays  
24 the associated mail processing unit cost for each group using the PRC method. While

1 unit costs in these pools tend to be small, there are many pools and in aggregate they  
2 comprise 0.079 cents of unit mail processing costs for presort letters. All are improperly  
3 classified as “fixed.” They should be re-classified as “proportional.”

4 **Table 6. Anomalous Cost Pools and Associated CRA**  
5 **BMM Letter and Automation Letter Unit Mail Processing Costs (cents)**

Operations	Number of Non-Zero Cost Pools	Automation Letters
		Unit Cost
Unexpected Facility	3	0.0069
Unexpected Shape	9	0.0634
Unexpected Class	4	0.0084
<b>Total</b>	16	0.079
Source: PB-LR-L-1, Tab 3		

6  
7 **4. Operational Analysis.**

8 An operational analysis of many of the non-modeled activities also shows that  
9 their mail processing costs are not fixed with respect to worksharing, but rather that the  
10 activities vary with presortation and worksharing levels. An overview of current and test  
11 year mail processing operations, and the generalized description of mail flows for First-  
12 Class Mail letters confirmed by Postal Service witness McCrery demonstrate this at a  
13 high level. See Tr. 11/2922 (PB/USPS-T42-5 (McCrery)).

14 Witness McCrery also testified as to how the preparation of certain workshared  
15 First-Class Mail letters cause them to avoid costly operations of the Postal Service. See  
16 PB/USPS-T42-4; Docket No. R2005-1, Tr. 5/1777. This underscores the fact that many  
17 mail processing costs currently classified as fixed do vary directly or indirectly with the  
18 presort level of the letter tray. Therefore, the Postal Service’s classification of many of  
19 these cost pools as “fixed” is wrong. They should be reclassified as proportional.

1 For example, mailers and presort bureaus prepare pallet separations based upon  
2 the presort level of the letter tray, *see* Tr. 11/2918 (PB/USPS-T42-1 (McCrery)). These  
3 separations allow the Postal Service to bypass time-consuming operational activities,  
4 thereby reducing postal service costs. *See* Tr. 11/2921 (PB/USPS-T42-4 (McCrery)).  
5 Pallet separations are related to the size of the mailing, *see* R2005-1, Tr. 5/1776-77,  
6 and the size of the mailing is generally related to the presort level of the letter trays: the  
7 larger the mailing, the greater the depth of presort. Therefore, the presort level of letter  
8 trays is strongly correlated with the ability to perform beneficial pallet separations.

9 Application of PostalOne! technologies provides another example of how the mail  
10 processing costs of non-modeled activities are not fixed with respect to worksharing, but  
11 rather that the costs of these activities vary with presortation and worksharing levels.  
12 The PostalOne! Transportation Management System is integrated into participating  
13 customers' facilities and books air and surface transportation assignments for First-  
14 Class Mail letter trays. The Postal Service concedes that when mailers use PostalOne!  
15 the Postal Service avoids transportation and mail processing costs. *See e.g.*, Tr.  
16 18D/6520 (PB/USPS-T22-11 (redirected to USPS)); Tr. 18D/6518-19 (PB/USPS-1-2  
17 (USPS)). Yet in its classification of cost pools the Postal Service fails to recognize the  
18 relationships among PostalOne!, pallet separations, and the presort level of letter trays.

19 The record evidence in this case establishes that many of the costs avoided by  
20 the Postal Service from pallet separations and PostalOne! correlate with the presort  
21 level of the letter tray. *See* Tr. 11/2918 (PB/USPS-T42-1 (McCrery)); *see also* Docket  
22 No. R2005-1, Tr. 5/1774-76 and 1780-84. Witness McCrery confirmed that mixed  
23 AADC letter trays on pallet separations go through more mail processing, platform,

1 container handling, bullpen and opening unit, tray sorting, piece distribution, allied labor,  
2 and dispatch activities at origin than 5-digit letter trays on pallet separations. See  
3 Docket No. R2005-1, Tr. 5/1780-84. Thus, Postal Service mail processing costs at  
4 origin vary with respect to pallet separations and the presort level of letter trays.

5 Detailed operational analysis of specific operations also demonstrates that  
6 important cost pools currently classified as “fixed” actually vary with presort level and  
7 the amount of worksharing. Correcting these misclassifications of cost pools allows  
8 more accurate estimates of cost avoidance.

9 *Letter Tray Sorting Operations - Mechanical Tray Sorters / Robotics:* The unit  
10 costs for letter tray sorting operations that use mechanical tray sorters and robotics  
11 (cost pools MODS 13 1SACKS, and MODS 13 TRYSORT) total 0.173 cents for First-  
12 Class Mail Automation letters.<sup>10</sup> See USPS-LR-L-110 at 2 (revised 5/3/2006). These  
13 operations perform a similar function as the opening units in separating letter trays.  
14 Originating letters in mixed AADC trays could incur mechanical tray sorting and robotics  
15 costs at an origin plant and at the destinating AADC. Originating letters in 5-digit trays  
16 could incur mechanical tray sorting and robotics costs only at the origin plant as the  
17 Postal Service bypasses the destinating AADC by transporting the mail directly to the  
18 P&DF responsible for destinating processing. Further, letters in 5-digit trays on pallet  
19 separations could bypass the tray sorting costs at the origin plant. See Tr. 11/2922  
20 (PB/USPS-T42-5 (McCrery)).

21 *Dispatch Operations:* Dispatch operations include, among other activities, the  
22 separation, staging, and movement of processed mail for subsequent distribution or

---

<sup>10</sup> I include mechanical and manual sack sorting operations in this discussion because they can sort First-Class Mail letter trays. See Docket No. R2005-1, PRC/USPS-POIR No. 4, Q11(a).

1 outbound transportation and the preparation of strap and sleeve trays. See R2005-1,  
2 Tr. 4/1085-86. Dispatch operations (MODS 17 DISPATCH) unit costs total 0.087 cents  
3 for First-Class Mail Automation letters. See USPS-LR-L-110 at 2 (revised 5/3/2006).  
4 Dispatch costs relate to the number of times mail is processed and the number of times  
5 processed mail is prepared for outbound transportation. Originating letters in mixed  
6 AADC trays can be processed in four sort schemes and require two or three strapping  
7 and/or sleeving activities. Originating letters in 5-digit trays can be processed in only  
8 one sort scheme and require at most one sleeving activity. See Tr. 11/2922 (PB/USPS-  
9 T42-5 (McCrery)). Hence, mixed AADC letters incur greater dispatch costs than 5-digit  
10 letters.

11 *Opening Unit Manual Transport Operations:* Opening unit manual transport  
12 operations (MOD 17 1OPTRANS) include, among other activities, the transportation of  
13 containers of mail between work areas. See Tr. 11/2923-24 (PB/USPS-T42-6  
14 (McCrery)). Their unit costs total 0.032 cents for First-Class Mail Automation letters.  
15 See USPS-LR-L-110 at 2 (revised 5/3/2006). These costs directly relate to the number  
16 of work areas in which mail is processed or handled. The Postal Service processes and  
17 handles originating letters in mixed AADC trays in more opening unit/bullpen operations,  
18 piece distribution operations, and dispatch operations than originating letters in 5-digit  
19 trays. See Tr. 11/2922 (PB/USPS-T42-5 (McCrery)). Hence, mixed AADC letters incur  
20 greater opening unit manual transport costs than 5-digit letters.

21 *Scanning Mail Operations:* Scanning mail operations (MODS 17 1SCAN)  
22 include, among other activities, the loading, scanning, labeling, unloading, sleeving, and  
23 strapping of letter trays. See Tr. 4/610 (PB/USPS-T22-5 (Abdirahman)); Dkt. No.

1 R2005-1, Tr. 5/1678 (PB/USPS-T29-10 (McCrery)) Their unit costs total 0.034 cents  
2 for First-Class Mail Automation letters. See USPS-LR-L-110 at 2 (revised 5/3/2006).  
3 Originating letters in mixed AADC trays incur the costs for scanning mail operations at  
4 an origin plant and sometimes at a destinating AADC that dispatches the letters, after  
5 managed mail program distribution, to another facility for incoming primary and  
6 secondary distribution. Originating letters in 5-digit trays scanned and labeled using  
7 PostalOne! generally do not incur any costs for scanning and labeling mail operations at  
8 an origin plant or at the destinating facility. Even if the Postal Service loads, scans, and  
9 unloads the 5-digit letter tray at an origin plant, it avoids some incremental costs such  
10 as labeling, manual sleeving, and manual strapping costs. Further, destinating letters in  
11 5-digit trays do not incur any scanning costs at all. It is not likely that all letters in mixed  
12 AADC trays destinate within the service area of the entry Postal Service facility, so the  
13 average scanning cost for letters in mixed AADC trays will always be non-zero.

14 *Platform Operations:* Platform operations (MODS 17 1PLATFRM) include the  
15 work of expeditors and, among other activities, loading and unloading trucks, cross  
16 docking containers of mail, and sorting mail during the vehicle unloading process. See  
17 Tr. 4/610 (PB/USPS-T22-5 (Abdirahman)). Their unit costs total 0.433 cents for First-  
18 Class Mail Automation letters. See USPS-LR-L-110 at 2 (revised 5/3/2006). Platform  
19 costs vary not only between workshared and non-workshared letters, but within  
20 presorted letters. For example, originating letters in mixed AADC trays could incur  
21 inbound and outbound platform costs at a destinating AADC prior to dispatch to a  
22 downstream facility for incoming primary and secondary distribution. Originating letters  
23 in 5-digit trays could bypass the platform at the destinating AADC altogether. See Tr.

1 11/2971 (PB/USPS-T22-12 (redirected to McCrery)). Further, the cost of expediting the  
2 distribution and dispatch of processed mail is affected by the number of times mail is  
3 processed in piece distribution operations. And the Postal Service processes  
4 originating letters in mixed AADC trays in more piece distribution operations than  
5 originating letters in 5-digit trays. See Tr. 11/2922 (PB/USPS-T42-5 (McCrery)).  
6 Finally, originating letters in 5-digit trays on pallet separations would bypass the inbound  
7 and outbound platform costs at the origin plant. See Tr. 11/2918 (PB/USPS-T42-1  
8 (McCrery)). Thus, more platform costs are incurred for mixed AADC letters than for 5-  
9 digit letters.

10 *Allied Labor Operations:* Allied labor operations (NON MODS ALLIED) have “two  
11 principal functions – to prepare mail for distribution operations in the plant, and to  
12 process other mail that may not require handling in piece sorting operations.”<sup>11</sup> See  
13 USPS-LR-L-1 at 3-7. Their unit costs in non-MODS facilities total 0.138 cents for First-  
14 Class Mail Automation letters. See USPS-LR-L-110, at 2 (revised 5/3/2006). Although  
15 allied labor overlaps some of the other non-modeled activities, it can be thought of as a  
16 catch-all category that encompasses all mail processing activities “allied” to direct piece  
17 sortation activities. Intuitively, some allied labor activities, like moving mail to/from  
18 sorting operations, have a direct relationship to distribution operations: the greater the  
19 number of distribution operations, the greater the number of allied labor operations. I  
20 have discussed specific allied labor costs, like opening units and dispatch, above.  
21 Thus, the costs of allied labor activities vary to some degree with presort level.

---

<sup>11</sup> Allied labor includes “[p]latform and collection activities, moving mail to/from other operations, separating/breaking down mail, [and] other allied labor activities.” LR-K-1 at 3-11. Further, Witness Smith’s testimony in Docket No. R2005-1 acknowledged that allied labor in non-MODS facilities includes mail preparation, canceling, facing, banding, culling, and separating mail activities. See Docket No. R-2005-1, Tr. 7/2529-30.

1           *Miscellaneous and General Support Operations*: Miscellaneous mail processing  
2 and support operations include the “numerous additional activities” that clerks and  
3 mailhandlers perform in addition to sorting and allied operations. See USPS-LR-L-1, at  
4 3-9. Their unit costs total 0.267 cents for First-Class Mail Automation letters. See  
5 USPS-LR-L-110, Appendix 2 (revised 5/3/2006). These operations are simply “general  
6 mail processing support operations.” See USPS-LR-L-1 at 3-9. The Postal Service  
7 concedes that miscellaneous mail processing costs are “obviously worksharing related.”  
8 See R2005-1, Response to P.O.’s Information Request No. 4, Question 11(a). Further,  
9 it is intuitive that some miscellaneous and support operations are proportional to  
10 distribution operations: the greater the number of distribution operations, the greater the  
11 number of support operations. However, from the operational definitions in USPS-LR-1  
12 and from the detailed descriptions of the activities in certain cost pools provided in  
13 response to interrogatories, see Tr. 11/2929 (PB/USPS-T42-12 (McCreery)), it appears  
14 that costs in LD48OTH, LD48 ADMIN, LD48 48\_SSV and LD49 are truly fixed, while the  
15 costs in 1MISC, 1SUPPORT, 1EEQMT, 1SUPP F1, and NONMODS MISC appear  
16 proportional.

17           The unit costs in the allied labor, general support, and tray sorting pools are  
18 aggregated in Table 7 below. The aggregated data show that these 14 pools account  
19 for 1.2 cents in unit costs for First-Class Mail Automation letters and comprise 68  
20 percent of the total of all costs that the Postal Service classifies as “fixed.”<sup>12</sup> These cost  
21 pools should be reclassified as proportional.

22

---

<sup>12</sup> Note that there is overlap between these pools and those that the thought experiment and the attribution and distribution theory show should be classified as proportional.

1 **Table 7. First-Class Mail Automation Letters Unit Mail**  
 2 **Processing Costs by Select Mail Flow Operations (cents)**

Operations	Number of Cost Pools	Automation Letters
		Unit Cost
Allied Labor*	7	0.765
General Support	5	0.267
Tray Sorting	2	0.173
Total	14	1.206
* Includes the allied cost pool in non-MODS facilities and all LDC 17 cost pools except cancellation, metered mail preparation, flats preparation, opening unit, and pouching.		
Source: PB-LR-L-1, Tab 4		

3  
 4 It also bears noting that the Postal Service's treatment of these costs has been  
 5 discussed in prior cases. In Docket No. MC95-1, Postal Service witness Smith  
 6 acknowledged that some of the same non-modeled activities (e.g., moving mail  
 7 between operations, platform handlings, and unbanding and unsleeving trays) depend  
 8 primarily on or are partly influenced by presort level of the mail. See PRC Op. MC95-1,  
 9 para. 4279. In view of the deficiencies in the classifications and modeling, witness  
 10 Smith stated,

11 it would be better to be able to model the non-modeled activities in  
 12 order to accurately relate these costs to categories. Such an effort  
 13 would be a considerable undertaking and represents a goal to which the  
 14 Postal Service will strive.

15  
 16 PRC Op. MC95-1, para 4277 citing USPS-T-10, at 5.

17 **V. IMPROVED COST ESTIMATES ALLOW 100 PERCENT PASSTHROUGHS**  
 18 **FOR AUTOMATION LETTERS CONSISTENT WITH ECP**

19  
 20 Based on the above analysis, I improved the Postal Service's cost avoidance  
 21 estimates for Automation letters by reclassifying most "fixed" pools as proportional.  
 22 Although the thought experiment described above and the Postal Service's attribution  
 23 and distribution theory for mail processing both strongly suggest that *all* cost pools are  
 24 proportional, for purposes of this testimony I have adopted a more conservative

1 approach. I did not classify all cost pools as proportional but rather classified a cost  
 2 pool as proportional only if (1) the Service classified the pool as proportional, (2) the  
 3 pool is anomalous, or (3) operational and mail flow analysis shows the pool to be  
 4 proportional. I classified a pool as "fixed" if (1) operational analysis did not absolutely  
 5 show it to be fixed, or (2) available data were not sufficient to complete an operational  
 6 analysis.

7 Table 8, below, shows the results of the reclassification; the underlying detail  
 8 appears in PB-LR-L-1 at Tab 5.

9 **Table 8. PB Classification of Cost Pools as**  
 10 **Proportional and Fixed (PRC Method)**

<b>Pool Classification</b>	<b>Number of Pools</b>	<b>Percent of Pools</b>	<b>Unit Cost (cents)</b>	<b>Percent of Unit Cost</b>
<b>Proportional</b>	52	82.5	4.518	90.4
<b>Fixed</b>	11	17.5	.482	9.6
<b>Total</b>	63	100.0%	5.000	100.0%
Source: PB-LR-L-1, Tab 5				

11  
 12  
 13 As the table shows, under my reclassification, 52 pools are proportional, comprising  
 14 82.5 percent of the pools and 90.4 percent of the unit cost using the PRC method.

15 I assumed that the costs of the newly classified proportional pools vary among  
 16 presort levels in exactly the same way as do the modeled pools. The assumption is  
 17 consistent with the attribution and distribution theory of the Postal Service. The  
 18 assumption that non-handling costs are distributed the same as handling costs is  
 19 analogous to the assumption that the distribution of costs by class and subclass for  
 20 supervisors follows the distribution of the costs of the crafts being supervised and, thus,  
 21 is clearly superior to the assumption that the costs of these pools do not vary at all  
 22 across presort levels.

1 I next calculated costs, cost avoidances, and passthroughs for Automation Letter  
 2 Mail using the PRC method for volume variability and delivery unit costs and cost  
 3 avoidances from USPS-LR-L-147. Although I believe that delivery unit cost avoidances  
 4 should be included, I calculated passthroughs both with and without them to test the  
 5 sensitivity of passthroughs to delivery unit cost avoidances. Table 9, below, shows  
 6 passthroughs at USPS-proposed rates when cost avoidances are measured in this  
 7 more accurate manner.

8 **Table 9. Costs, Cost Avoidances, and Passthroughs**  
 9 **for Automation Letters with Corrected Cost Pools**

Rate Category	USPS Proposed Discount (cents)	Avoided Cost with Delivery (cents)	Passthrough with Delivery (percent)	Avoided Cost without Delivery (cents)	Passthrough without Delivery (percent)
MAADC					
AADC	1.1	1.976	56	1.840	60
3-Digit	0.4	0.702	57	0.641	62
5-Digit	1.9	2.345	81	2.092	91

Source: PB-LR-1, Tab 6

10  
 11 As the table shows, in contrast to the estimates of the Postal Service, all passthroughs  
 12 are well below 100 percent even when delivery unit cost avoidances are excluded.

13 **VI. A SET OF PROPOSED RATES FOR AUTOMATION LETTERS THAT**  
 14 **BALANCES IMPORTANT POLICY OBJECTIVES**

15 Given that all passthroughs underlying the Postal Service's proposed rates are  
 16 well below 100 percent with the corrected cost model, that the passthroughs vary widely  
 17 across the rate categories, and the importance of ECPR, I next explored a set of rates  
 18 that would fully comport with ECPR. In doing so, however, I quickly realized that it  
 19 would not be possible to design fully ECPR compliant rates without either causing

1 revenue leakage as compared to the rates proposed by the Postal Service or increasing  
2 some of the proposed rates.

3 Thus, my proposed rate design balances the virtues of ECPR with the evils of  
4 revenue leakage and rate increases. To prevent undue revenue loss, my proposed  
5 rates leave the 3-digit rate unchanged from that proposed by the Postal Service. My  
6 design passes through a uniform 100 percent of the cost avoidances and is thus fully  
7 ECPR-compliant. This results in \$39 million revenue leakage (about one-quarter of one  
8 percent of the revenue from these rate categories) which, I believe, is of both a small  
9 and manageable magnitude and is fully justified by the improved pricing signals that my  
10 rate design will provide to the mailer community. Table 10, below, shows my proposed  
11 rates and compares them to those proposed by the Postal Service.

12 **Table 10. USPS and PB Proposed Rates for Automation Letters**

<b>Rate Category</b>	<b>USPS Proposed Rate (cents)</b>	<b>PB Proposed Rate (cents)</b>	<b>Percentage change from USPS Proposed</b>
<b>MAADC</b>	34.6	35.8	3.4
<b>AADC</b>	33.5	33.8	0.9
<b>3-Digit</b>	33.1	33.1	0
<b>5-Digit</b>	31.2	30.8	-1.4

Source: PB-LR-1, Tab 7

13  
14 This rate design, and its underlying factual basis, are superior to those presented  
15 by the Postal Service. As demonstrated above, the Postal Service's rate design is  
16 predicated in part upon a number of assumptions that are invalid. Using the correct  
17 assumptions, I have shown that the Postal Service's calculated cost avoidances across  
18 the Automation letter rate categories are inappropriately small, and that the true cost  
19 avoidances are substantially larger.

1           Understanding the true magnitude of the avoided costs has then enabled me to  
2 compute rate discounts that are truly compliant with ECPR. Setting these discounts at  
3 the appropriate levels is essential to inducing the optimal amount and mix of  
4 worksharing activity provided by mailers and third-party service providers. Also,  
5 attaining and maintaining this optimal amount and mix of worksharing does and will  
6 continue to fulfill a crucial need in enabling the Postal Service to provide the highest  
7 possible availability and quality of service at the lowest cost. By improving the Postal  
8 Service's proposed rate design by appropriately and uniformly passing through 100  
9 percent of avoided costs, clear and correct price signals enhance overall economic  
10 efficiency.

11           With respect to the application of the ratemaking criteria (39 U.S.C. § 3622) and  
12 classification criteria (39 U.S.C. § 3623) in the Act, I have reviewed the testimony of  
13 witness O'Hara (USPS-T-31) with respect to the application of the former and witness  
14 Taufique (USPS-T-32) with respect to the application of the latter. With respect to the  
15 classification criteria, I propose no changes in the classifications presented by witness  
16 Taufique. With respect to the ratemaking criteria, the cost coverages resulting from my  
17 proposed rate design differ insignificantly from those discussed by witness O'Hara.  
18 Therefore, my proposed rate design conforms to the classification and ratemaking  
19 requirements of the Act to the same extent as the rate design proposed by the Postal  
20 Service.

21           Finally, recognizing that rate increases pose inherently undesirable impacts on  
22 mail customers, I have applied a basis for distributing the rate changes across the  
23 Automation Letter rate categories so as to create minimal disruption and adverse impact

1 to the mailing community, while at the same time creating only very modest loss of  
2 revenue to the Postal Service.

3 The rate design that I propose here offers a complete and accurate synthesis of  
4 all important and appropriate statutory factors, and a reasonable, practical, and  
5 equitable balance among them.

6 **VII. CONCLUSION**

7 For the reasons stated above, the Commission should adhere to ECP in  
8 establishing appropriate workshare discounts for First-Class Mail Automation letters.  
9 Because the Postal Service's cost models systematically understate the true workshare-  
10 related costs avoidances, the Commission should recommend the First-Class Mail  
11 Automation letter rates proposed in this testimony.