

**BEFORE THE POSTAL RATE COMMISSION  
WASHINGTON, D.C. 20268-0001**

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**Postal Rate and Fee Changes, 2006**

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**Docket No. R2006-1**

**BRIEF OF PITNEY BOWES INC.**

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## I. INTRODUCTION

Pitney Bowes Inc. (“Pitney Bowes”) submits this brief in support of its improved alternative rate proposal for First-Class Mail Automation Letters.<sup>1</sup> Pitney Bowes also submits this brief in support of extending the principles supporting Efficient Component Pricing (“ECP”) to establish intra-subclass rate differences that reflect both workshare-related and non-workshare-related cost differences. That approach also supports the Single Piece First-Class Mail expanded retail access discount proposed by Pitney Bowes.

Pitney Bowes is a leading provider of integrated mail and document management systems, services and solutions. Pitney Bowes helps organizations of all sizes efficiently and effectively manage their mission-critical mail and document flow in physical, digital and hybrid formats. Pitney Bowes solutions range from addressing software and metering systems to print stream management, electronic bill presentment and presort mail services. The company’s 80-plus years of technological leadership have produced many major innovations in the mailing industry, and it is consistently on the Intellectual Property Owners Association’s annual list of top U.S. patent holders. With approximately 35,000 employees worldwide, Pitney Bowes serves more than 2 million businesses through direct and dealer operations.

The improved alternative First-Class Mail Automation Letters proposal advocated in this brief is fully consistent with the principles of ECP, which the Postal Rate Commission (the “Commission”) has long-recognized as the appropriate analytical construct for establishing discounts for workshare-related costs avoided. An alternative First-Class Mail Automation Letters proposal is necessary because the mail processing cost avoidance estimates presented by

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<sup>1</sup> For purposes of this brief, the term “First-Class Mail Automation Letters” comprises what Rate Schedule 221 of Attachment A of the Postal Service’s Request for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services, dated May 3, 2006, lists as First-Class Mail Mixed AADC, AADC, 3-digit, and 5-digit letter mail.

the Postal Service substantially underestimates workshare-related cost avoidances. The alternative First-Class Mail Automation Letters rates submitted by Pitney Bowes are based on improved cost avoidance estimates, better comport with ECP, and satisfy the rate-setting factors of the Postal Reorganization Act.<sup>2</sup>

In response to the Postal Service’s proposal to implement shape-based rates, the Commission invited a broader theoretical discussion of postal pricing below the subclass level (intra-subclass rates). Importantly, this discussion demonstrated that the basic theoretical arguments in support of better reflecting cost-based differences in prices are the same as those for basing worksharing discounts on avoided costs. Viewed in this context, ECP is a specific example of the generalized economic approach to cost-based rates. Pitney Bowes submits this discussion supports an expanded application of the principles underlying ECP such that, to the extent practical, rate differences should be based on both traditional workshare-related and non-workshare-related cost differences. This will better align prices with costs, send correct price “signals,” and promote economic efficiency in the postal sector.

An extended application of the principles of ECP also supports Pitney Bowes’ proposal to deaverage the costs of postage evidencing for Single-Piece First-Class Mail and to provide an incentive in the form of an expanded retail access discount for all mail users that purchase postage through efficient sales channels that reduce the costs of the Postal Service.

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<sup>2</sup> See Postal Reorganization Act, Pub. L. No. 91-375, 84 Stat. 719, (codified as amended in 39 U.S.C. §§ 101 *et. seq.*).

## **II. THE COMMISSION SHOULD RECOMMEND PITNEY BOWES' IMPROVED ALTERNATIVE RATE PROPOSAL FOR FIRST-CLASS MAIL AUTOMATION LETTERS**

### **A. First-Class Mail Workshare Letters Are A Cornerstone of Postal Service Finances.**

The Postal Service acknowledges that the “First-Class Mail rate . . . is a keystone rate which is inextricably tied to the Postal Service’s revenue requirement and policy goals.” Tr. 32/10706. Within First-Class Mail, the importance of First-Class Mail workshare letters deserves particular attention.<sup>3</sup>

First-Class Mail workshare letters is very “profitable” mail. In the Base Year (Fiscal Year 2005) its revenues were \$14.95 billion while its volume variable costs were only \$4.97 billion, yielding \$9.98 billion in contribution to the Postal Service’s institutional cost burden. Thus, while it accounted for about 20 percent of USPS revenues, it provided almost one third of total contribution. *See* PB-T-2 at 2.

Table 1 shows that for more than a decade First-Class workshare letter volume has consistently grown, both in absolute terms and as a percentage of total First-Class Mail. This illustrates why First-Class Mail workshare letters has been and will continue to be enormously important to the financial viability of the Postal Service as a source of both mail volume and revenue. The mailing community has adapted to worksharing product innovations offered by the Postal Service, and today 53 percent of First-Class Letter Mail volume and almost 38 percent of its revenues are generated by mail using these worksharing innovations. *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).

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<sup>3</sup> For purposes of this brief, the term “First-Class Mail workshare letters” comprises what the Rate Schedule lists as presorted letters and automation letters.

**Table 1: First-Class Mail Volumes Since 1995 (in millions)**

<b>Fiscal Year</b>	<b>Single Piece Volumes</b>	<b>Workshared Volumes</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 at 43.

The unit contribution<sup>4</sup> and cost coverage<sup>5</sup> for First-Class Mail workshare letters exceed those for First-Class Mail single-piece letters. In fact, in Fiscal Year 2005 both of these financial metrics for First-Class Mail workshare letters were substantially larger than the average for all mail, as shown in Table 2.

**Table 2: Unit Contribution and Cost Coverage 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 Workshare 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

<sup>4</sup> Unit contribution is the per piece difference between per piece revenue and per piece attributable cost.

<sup>5</sup> Cost coverage is the ratio of total revenue to total attributable cost.

**B. The Commission Should Recommend First-Class Mail Workshare Letter Rates That Are Consistent with the Principles of Efficient Component Pricing.**

As in past cases, the Commission should recommend First-Class Mail workshare letters rates that are consistent with the principles of ECP. In the context of postal pricing, ECP requires that the discount a mailer receives for performing a workshare activity should be set at a level *equal* to the per unit avoided cost of the Postal Service for performing that activity. Discounts set *equal* to costs avoided induce mailers to perform work if and only if mailers can perform the work less expensively than the Postal Service.<sup>6</sup>

As discussed in the testimony of Pitney Bowes witnesses Panzar and Buc, establishing workshare discounts that comport with ECP (i.e., those that are set at a level equal to the per unit avoided cost), will minimize total mail costs. *See* PB-T-1 at 18; PB-T-2 at 6. Panzar discusses why establishing ECP-based workshare discounts equal to per unit avoided costs benefits mailers, the Postal Service, and economic efficiency, stating that ECP is:

the *only* discount policy that will allow the decentralized actions of mailers and consolidators to assist the Postal Service in minimizing the total costs of the postal sector . . . because, if the worksharing discount is less than the unit avoided costs of the Postal Service, *some* mailers who could provide the service more cheaply than the Postal Service will not have an incentive to engage in worksharing. On the other hand, if the worksharing discount is greater than the per unit avoided costs of the Postal Service, there will be mailers who will take advantage of the discount even though they cannot perform the service as cheaply as the Postal Service. In either case, the total costs of the end-to-end service will increase.

PB-T-1 at 19 (emphasis in original).

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<sup>6</sup> A theoretical analysis of worksharing typically assumes that mail of a given category has the same avoided cost to the Postal Service, as discussed in the testimony of witness Panzar, however, “in practice such mail is heterogeneous and would have different unit avoided costs if it were to be handled by the Postal Service.” PB-T-1 at 35. Panzar notes that in the current proceeding, the Postal Service has proposed to abandon the traditional benchmarking methodology for calculating cost avoidances and to “delink” single-piece from workshare First Class Mail. *See id.* Panzar further observes that “the current Postal Service proposal to “de-link” single piece and workshared First Class letters should be viewed as a means of *decreasing* the heterogeneity discussed above.” PB-T-1 at 39.

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

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

PRC Op. MC95-1, para. 3074.

In Docket No. R2000-1 the Commission explained that passing through 100 percent of avoided costs is fair and equitable:

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

PRC Op. R2000-1, para. 5060. This of course, is important under the Act.<sup>7</sup>

In this docket, the Commission twice articulated its support for ECP as a guiding principle:

It is well-established that cost-saving characteristics that are the result of worksharing should be specifically reflected in the rates. The Commission has adhered to the principle that within a subclass, worksharing rate differences should fully reflect the costs that the Postal Service would avoid (or incur) if the mailer were to move from one workshared category of mail to another. Rates that fully reflect avoidable costs (rates that pass 100 percent of the differences in

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<sup>7</sup> Section 101(d) of the Postal Reorganization Act provides that “[p]ostal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis.” 39 U.S.C. § 101(d). Section 3622(b)(1) further provides that the Commission shall make a recommended decision on rate and classification requests that promote the “establishment and maintenance of a fair and equitable schedule.” 39 U.S.C. § 3622(b)(1).

avoidable cost through to the mailer) satisfy the cost recovery and fairness policies of the Postal Reorganization Act.

Second Notice of Inquiry (July 21, 2006) at 1.

Worksharing discounts have been, to the extent practicable, set equal to the costs avoided by worksharing. This practice is intended to send price signals that encourage worksharing by mailers only if the mailer's cost of preparing mail to meet worksharing specifications is less than or equal to the resulting reduction in USPS costs.

Third Notice of Inquiry (July 26, 2006) at 2.

**C. Accurate Per Unit Cost Avoidance Estimates are Critical to Efficient Component Pricing.**

Accurate estimates of the Postal Service's per unit avoided costs are critical to the application of ECP because to establish discounts equal to the per unit costs avoided requires an accurate measure of the avoided costs. Witness Panzar provides both theoretical and empirical reasons why marginal costs, rather than average incremental costs, are the appropriate measure of the Postal Service's costs avoided.<sup>8</sup> As an initial matter, Panzar observes that the Postal Service's Universal Service Obligation means that a portion of its upstream fixed costs are not avoidable. *See* PB-T-1 at 30. Panzar also explains that some of the Postal Service's fixed costs are not avoidable because the relevant market for workshare mailers providing upstream services does not include all of the Postal Service's volumes. *See* PB-T-1 at 30-31. Panzar further explains that marginal costs rather than average incremental costs are the appropriate measure of Postal Service costs avoided because the supply curves for upstream services for workshare mailers will not likely be perfectly elastic and, therefore, workshare mailers will compete for only a portion of the Postal Service's total mail volume. *See* PB-T-1 at 31-33.

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<sup>8</sup> Panzar also discusses the importance of non-modeled cost pools and demonstrates that excluding cost avoidances associated with the non-modeled pools results in inaccurate cost avoidance estimates. *See* PB-T-1 at 40-44.

**D. The Postal Service’s Cost Methodology Substantially Underestimates Workshare-Related Avoided Costs.**

Notwithstanding the importance of accurate cost avoidances estimates to ECP, the record evidence in this docket establishes that the Postal Service’s cost methodology is flawed and does not produce accurate cost estimates. Specifically, the Postal Service’s cost methodology substantially underestimates the cost avoidances for First-Class Mail automation letters. The cost methodology advanced by the Postal Service in this case consistently underestimates workshare-related cost avoidances for First-Class Mail automation letters because it (1) excludes cost avoidances associated with improperly classified and non-modeled cost pools and (2) improperly excludes in-office delivery unit costs from the cost avoidance calculations. Both of these flaws fatally infect the Postal Service’s proposed First-Class Mail Automation Letters rate design.<sup>9</sup>

1. The Postal Service’s Cost Methodology Substantially Underestimates Workshare-Related Costs Avoided Because It Excludes Cost Avoidances Associated With Non-Modeled Cost Pools.

The Postal Service’s cost methodology substantially underestimates workshare-related costs avoided for First-Class Mail Automation Letters because it improperly excludes cost avoidances associated with non-modeled cost pools. As described in witness Buc’s direct testimony, because the Postal Service’s In-Office Costing System (“IOCS”) does not report costs for the various rate categories of First-Class Mail Automation Letters, the Postal Service must estimate, or model, these costs via a hybrid cost model. *See* PB-T-2 at 8-9. First, the Postal Service developed a “bottoms up” engineering cost model (combining mail flows with costs – derived from productivity and wage rate data – at each step of the mail flows) to estimate the

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<sup>9</sup> The alternative First-Class Mail rate proposals advanced by APWU witness Kobe (APWU-T-1) and OCA witness Thompson (OCA-T-4) rely, in whole or in part, on the Postal Service’s cost methodology. Accordingly, the flaws in the First-Class Mail Automation Letters cost avoidance estimates of the Postal Service taint the derivative proposals of witnesses Kobe and Thompson as well.

costs of piece handling and selected bundle handling activities for letter-shaped mail for each of the rate categories. *See id.* Using the distribution of mail across the rate categories, the Postal Service then calculates the average weighted cost for letter-shaped workshare mail. *See id.* These costs are compared to the costs that IOCS shows for letters for those MODS pools that best map to the modeled activities in the Cost and Revenue Analysis (“CRA”). *See id.* Modeled costs for each rate category are then multiplied by the “CRA adjustment” (ratio of CRA costs to modeled costs) to reconcile the modeled costs to the CRA costs. *See id.* The CRA costs for activities that are not modeled – 1.766 cents per piece under the PRC method – are added to the costs for each of the rate categories. *See id.* (citing USPS-T-22 at 7-8). Finally, under the Postal Service’s methodology, the activities that are modeled are classified as “proportional,” while all the remaining activities are classified as “fixed.”

Witness Buc explains why the proper classification of cost pools as either “proportional” or “fixed” is critical to the functionality and results of the Postal Service estimating model. Cost avoidances between the rate categories are determined solely by the piece-handling and bundle costs in the cost pools classified as “proportional” by the Postal Service. *See* PB-T-2 at 9. Because the same amount of fixed costs is added to the proportional costs in each rate category the costs in cost pools designated as “fixed” have *no effect* on the magnitude of the workshare related cost avoidances between rate categories. *See id.*; USPS-LR-L-110, CRA Presort Letters, Table 3 Adjusted Letter Unit Mail Processing Cost, column 6. The Postal Service’s First-Class Mail costing witness, witnessAbdirahman, confirms that only proportional costs can affect the differences between automation rate categories. *See* Tr. 4/614-15 (PB/USPS-T22-10(a) (Abdirahman)); *see also* Tr. 4/661, 670, and 675-76.

Notwithstanding the critical importance of these classifications in estimating the cost avoidances between the rate categories, the Postal Service provides no evidence that the costs in the pools it classified as “fixed” in its cost avoidance model are, in fact, fixed with respect to presort level. *See* Tr. 18D/6587 (PB/USPS-T42-10 (redirected to USPS)); *see also* Tr. 4/619.

Witness Abdirahman concedes that he knows of no econometric, operational, or other study supporting his assertions as to which costs are truly fixed and not just classified as such. *See* Tr. 4/661; Tr. 4/609 (PB/USPS-T-22-4 (Abdirahman)). In fact, Abdirahman concedes that the classification of any particular cost pool as “fixed” or “proportional” turns not on whether he actually determined whether the costs within the cost pool actually vary among automation rate categories, but rather on whether he had occasion to study or model the costs involved: “the things I have modeled, is in the proportional cost pool. Anything that’s in the fixed cost pool is what I have not modeled.” Tr. 4/619. Abdirahman further concedes that “it’s possible that some costs would in those costs pools vary for mail of different presort levels, but I have not studied them.” Tr. 4/670; *see also* Tr. 4/618-19; Tr. 35/12048. Stated another way, the Postal Service simply assumed that all costs which it did not take the time to model were “fixed” and, therefore, would not be taken into account in developing cost differences between rate categories within First-Class Mail Automation Letters.

Table 3 compares the Postal Service’s cost avoidance estimates with Pitney Bowes’ costs avoidance estimates for First-Class Mail Automation Letters rate categories.<sup>10</sup>

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<sup>10</sup> Note that the Pitney Bowes cost avoidance estimates shown in Table 3 do not include the in-office delivery costs discussed below. *See infra* pp. 11-14.

**Table 3: Effects of Excluding Cost Avoidances Associated with Non-Modeled Cost Pools**

<b>Rate Category</b>	<b>USPS Avoided Costs (cents)</b>	<b>Pitney Bowes Avoided Costs (Excluding In-Office Delivery Costs) (cents)</b>
<b>MAADC</b>	N/A	N/A
<b>AADC</b>	1.317	1.840
<b>3-Digit</b>	0.459	0.641
<b>5-Digit</b>	1.497	2.092
Source: Derived from USPS-T-22 at 23; PB-T-2 at 31.		

As the Table 3 shows, the Postal Service’s cost methodology substantially underestimates workshare-related costs avoided for First-Class Mail Automation Letters because it improperly excludes cost avoidances associated with non-modeled cost pools.

2. The Postal Service’s Cost Methodology Substantially Underestimates Workshare-Related Costs Avoided Because It Excludes Cost Avoidances Associated With The In-Office Delivery Costs.

In a departure from past practices, in this case the Postal Service presents a model for estimating First-Class Mail Automation Letters unit costs and cost differences that excludes in their entirety the in-office delivery unit costs. As a result, the Postal Service’s cost methodology substantially underestimates workshare-related costs avoided for First-Class Mail Automation Letters.

The Postal Service attempts to offer a justification for its departure from past practices, but never reconciles how it can selectively disown one of the two outputs, the Delivery Point Sequence percentages, of the main mail flow model that serves as the basis for its mail processing unit cost estimates. In response to an inquiry from the Commission asking why the Postal Service excluded delivery cost estimates in this case, Postal Service witness Taufique offered the following *post hoc* rationale:

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

Tr. 16/4860-61 (Response to P.O. Information Request No. 5 (June 29, 2006) at 4-5.

Witness Abdirahman echoed this rationale by stating that “[s]eparate delivery unit cost estimates by rate category are no longer provided because there is no conclusive evidence to suggest that the DPS percentages actually vary among the machinable rate categories.” Tr. 35/11953.

The arguments presented by the Postal Service are completely unavailing. Varied DPS percentages by rate category – the basis of delivery unit cost differences for the various levels of automation – are an output of the same cost model that the Postal Service uses to estimate cost avoidances for First-Class Mail Automation Letters. *See* Tr. 35/12036. Therefore, in an attempt to explain away the exclusion of the delivery cost estimates, the Postal Service invites the Commission to believe that its model produces valid outputs for mail processing unit costs by rate category, but that the same model does not produce valid outputs for the number of pieces requiring manual sorting in delivery units. *See* Tr. 35/12036-40. This is not a tenable position where, as here, the mail processing unit costs are a function of the same mail flows (among other factors) that produce the estimates of the percentage of First-Class Mail Automation Letters that

are successfully DPS processed and the percentage that are not and thus require manual sortation to carrier route walk sequence in the delivery unit by the carriers.<sup>11</sup>

The decision to completely exclude delivery costs from the calculation of cost differences must be rejected because it would lead to incomplete cost and cost avoidance estimates. Implicit in Postal Service's decision to exclude the delivery costs is the assumption that the DPS percentages for all automation rate categories are exactly the same. This assumption is inconsistent with Postal Service's own model and testimony.

The Postal Service's mail flow model and testimony confirms, at least directionally, that because a higher percentage of more finely presorted mail (e.g., 5-Digit Auto Letters) is successfully DPS processed in the automation stream, a smaller percentage of this mail requires manual sorts to carrier route walk sequence in the delivery unit. *See* Tr. 35/12032-33. The mail flow model and testimony also establish, at least directionally, that because a higher percentage of less finely presorted mail (e.g., MAADC Auto Letters) is not successfully DPS processed in the automation stream, a larger percentage of less finely presorted mail requires expensive manual sorting in the delivery unit. *See id.* Assuming the unit costs of the manual sort to carrier walk sequence performed in the delivery unit is the same for each rate category – and there is no reason for them to be different – the costs of these manual sorts will increase the Postal Services estimated cost differences between the rate categories of First-Class Mail Automation Letters. Thus, a complete and accurate cost accounting of the cost avoidance estimates for First-Class Mail Automation Letters requires the addition of the missing delivery unit costs and cost differences.

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<sup>11</sup> The Postal Service acknowledged that letters that are not DPS processed in an automated stream must be manually sorted to carrier walk sequence either by clerks or carriers in the delivery unit. *See* Tr. 35/12027-28.

Table 4 compares the Postal Service’s cost avoidance estimates with Pitney Bowes’ costs avoidance estimates for First-Class Mail Automation Letters rate categories including the costs avoided associated with the in-office delivery costs.

**Table 4: Effects of Excluding Cost Avoidances Associated with Non-Modeled Cost Pools and In-Office Delivery Costs**

<b>Rate Category</b>	<b>USPS Avoided Costs (cents)</b>	<b>Pitney Bowes Avoided Costs (Including In-Office Delivery Costs) (cents)</b>
<b>MAADC</b>	N/A	N/A
<b>AADC</b>	1.317	1.976
<b>3-Digit</b>	0.459	0.702
<b>5-Digit</b>	1.497	2.345
Source: Derived from USPS-T-22 at 23; PB-T-2 at 31.		

As Table 4 shows, the Postal Service’s cost methodology substantially underestimates workshare-related costs avoided for First-Class Mail Automation Letters because it improperly excludes cost avoidances associated with in-office delivery costs.

**E. Pitney Bowes Provides Improved Cost Avoidance Estimates For First-Class Mail Automation Letters.**

Pitney Bowes witness Buc’s testimony provides a comprehensive analysis of the Postal Service’s cost pool classifications and concludes that many of the non-modeled cost pools classified as “fixed” by the Postal Service do in fact contain costs that vary with presort level and, therefore, should be classified as “proportional.” The Postal Service failed to advance a meaningful critique of Buc’s analysis.

Buc presents four independent analyses of the relevant cost pools by applying (1) a thought experiment using Postal Service data, *see* PB-T-2 at 14-17, (2) a review of the Postal Service’s attribution and distribution costing methods, *see id.* at 17-20, (3) a review of the

classification of “anomalous” cost pools, *see id.* at 20-22, and (4) an operational analysis, *see id.* at 22-29.

Following these analyses, Buc summarizes his decision rule for cost pool classifications, as follows:

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

PB-T-2 at 30.

A summary of witness Buc’s analysis of the improved cost pool classifications is provided as Tab 5 to Library Reference PB-LR-L-1. It provides a comparative analysis of the Postal Service’s classification of each pool with the classification resulting from Buc’s four separate analyses. The analysis also provides the attributable cost for each cost pool. Finally, the analysis shows how Buc classifies each pool after applying his conservative decision rule.

Neither witness Abdirahman nor any other Postal Service witness presents a substantive rebuttal to Buc’s comprehensive analysis. Abdirahman is content to note that “PB witness Buc proposes cost pool classifications in PB-LR-L-1 that differ from those relied upon by the Postal Service and the Commission in past dockets,” Tr. 35/11957, and to rhetorically assail Buc’s approach as “arbitrary.” *Id.*

Abdirahman also attempts to criticize Buc for his choice to “use the costs that are modeled as distribution keys for the costs he has not modeled.” Tr. 35/11957. This appears to be an attempt to critique Buc’s analysis of the Postal Service attribution and distribution methodology which shows that container handlings, allied labor, not handling, and general support costs all vary with piece handling costs. But Buc’s analysis cites to the prior testimony

of Postal Service witnesses Bozzo and Van-Ty-Smith regarding Postal Service attribution and distribution models to establish that because piece handling costs vary with presort level, so too must the associated container handling, allied labor, not handling, and general support costs. *See* PB-T-2 at 18-20.

Buc's testimony also discusses why the costs in those cost pools reclassified by Pitney Bowes as "proportional" can be assumed to vary among presort levels in exactly the same way as do the modeled pools. Specifically, Buc explained,

[t]he assumption that non-handling costs are distributed the same as handling costs is analogous to the assumption that the distribution of costs by class and subclass for supervisors follows the distribution of the costs of the crafts being supervised and, thus, is clearly superior to the assumption that the costs of these pools do not vary at all across presort levels.

PB-T-2 at 30. Again, the Postal Service's rebuttal testimony failed to substantively engage Buc on this point.

**F. Pitney Bowes' Improved Cost Pool Classifications Fully Reflect Workshare-Related Costs Avoided for First-Class Mail Automation Letters.**

Using improved cost pool classifications and delivery cost differences excluded by the Postal Service, Pitney Bowes calculated the workshare-related cost avoidances for First-Class Mail Automation Letters and produced an alternative rate proposal. Using Buc's analysis, the passthroughs resulting from the Postal Service's requested rates are much less than 100 percent and vary widely across rate categories. Accordingly, Pitney Bowes proposes a rate design that is consistent with the principles of ECP and minimizes revenue leakage:

To prevent undue revenue loss, my proposed rates leave the 3-digit rate unchanged from that proposed by the Postal Service. My design passes through a uniform 100 percent of the cost avoidances and is thus fully ECPR-compliant. This results in \$39 million revenue leakage (about one-quarter of one percent of the revenue from these rate categories) which, I believe, is of both a small and manageable magnitude and is fully justified by the improved pricing signals that my rate design will provide to the mailer community.

PB-T-2 at 32.

The rates proposed by Pitney Bowes are as follows:

**USPS and PB Proposed Rates for Automation Letter Mail**

<b>Rate Category</b>	<b>USPS Proposed Rate (cents)</b>	<b>PB Proposed Rate (cents)</b>	<b>PB Proposed Passthrough (percent)</b>	<b>Percentage change from USPS Proposed</b>
<b>MAADC</b>	34.6	35.8		3.4
<b>AADC</b>	33.5	33.8	100	0.9
<b>3-Digit</b>	33.1	33.1	100	0
<b>5-Digit</b>	31.2	30.8	100	-1.4

Source: PB-LR-1, Tab 7.

This rate design is superior to that requested by the Postal Service because it accurately estimates the true workshare-related avoided costs for First -Class Mail Automation Letters and because it more fully comports with ECP. See PB-T-2 at 32-33. Establishing the correct rate relationships and workshare discounts is essential to inducing the optimal amount and mix of worksharing activity provided by mailers and third-party service providers. Also, attaining and maintaining this optimal amount and mix of worksharing does and will continue to fulfill a crucial need in enabling the Postal Service to provide the highest possible availability and quality of service at the lowest cost. Finally, the revenue leakage from this proposal is small relative to its benefits and will not comprise the break-even mandate of the Act given the Postal Service's request which results in a surplus.

Pitney Bowes' improved rate design appropriately and uniformly passes through 100 percent of the workshare-related avoided costs and, thus, sends clear and correct price signals to enhance overall economic efficiency.

Pitney Bowes' improved rate design also fully complies with the rate and classification provisions of the Postal Reorganization Act. *See* PB-T-2 at 33. The cost coverages resulting from Pitney Bowes' proposed rate design differ insignificantly from those requested by the Postal Service. *See* USPS-T-31 at 30. Accordingly, the Pitney Bowes rate design conforms to the classification and ratemaking requirements of the Act to the same extent as the rate design requested by the Postal Service.

### **III. THE COMMISSION SHOULD EMBRACE AN EXPANDED APPLICATION OF THE PRINCIPLES UNDERLYING EFFICIENT COMPONENT PRICING TO BETTER ALIGN PRICES WITH COSTS**

In many ways, R2006-1 is a landmark case: the Postal Service's proposal to implement shape-based rates has generated a broader, more elemental discussion about appropriate pricing principles for postal products. Much of this discussion explored how prices for postal products within a subclass should reflect cost differences. Importantly, this discussion demonstrated that the basic theoretical arguments in support of better reflecting cost-based differences in prices are the same as those underlying worksharing discounts based on avoided costs. Pitney Bowes submits this discussion supports an expanded application of ECP such that, to the extent practical, postal prices will reflect all cost differences, not just costs avoided as a result of "traditional" worksharing activities. This will better align prices with costs, send correct price "signals," and promote economic efficiency.

This discussion was substantially advanced by the Commission's issuance of two Notices of Inquiry bearing on the issue of how prices should reflect all cost causative factors, not just workshare-related cost differences. *See* Second Notice of Inquiry (July 21, 2006) and Third Notice of Inquiry (July 26, 2006). Through the issuance of these NOI's the Commission framed the discussion as follows:

The second aspect of rate design highlighted by the Postal Service's proposed rates involves cost-causing characteristics that do not result from worksharing, such as weight and shape. Here, too, there is a presumption that rates within a subclass should fully reflect cost differences that are caused by such differences. This process is less exact, as it is often difficult to separate the cost effects of shape from weight. However, to the extent feasible, cost-causing characteristics are evaluated and rate distinctions are implemented to recognize those characteristics. Here, too, policies such as rate simplification, the need for rational rate relationships, and avoidance of rate shock have often caused the Commission to recommend rates that did not perfectly reflect cost differences.

Second Notice of Inquiry (July 21, 2006) at 2.

The Commission also invited all participants to provide their views on whether the principles of ECP require that "the difference between any two rates within a subclass equal the difference in avoidable cost between the two rate categories," and how the principles of ECP apply to worksharing, shape, and "other cost causing characteristics." Third Notice of Inquiry (July 26, 2006) at 6-7.

For the reasons discussed below, Pitney Bowes urges the Commission to embrace an expanded application of the principles underlying ECP to better align rate differences with costs differences below the subclass level.

**A. An Organizing Construct for the Extension of the Principles Underlying Efficient Component Pricing to Non-Workshare-Related As Well as Workshare-Related Cost Differences.**

The discussion and record evidence in this case has generated a set of organizing principles for establishing prices for workshare-related *and* non-workshare-related cost differences within a subclass:

- Institutional costs should be allocated to class and subclass based on the factors of the Act. *See* USPS-T-31 at 8-16.
- Within a subclass, pricing in accordance with the principles supporting ECP is the default presumption. *See* PB-T-1 at 45-50; NOI Response of Association for Mail Enhancement, Financial Services Roundtable, National Association of Presort Mailers, National Postal Policy Council, and Pitney Bowes Inc., at 11-20.

- Mailers can and will respond to these pricing signals and will therefore make mailing decisions reflective of the costs that they impose on the Postal Service. *See* PB-T-1 at 45-47; USPS-T-31 at 4-5.
- Deviations from ECP may be necessary to prevent rate shock, to prevent crossovers between classes or other anomalies, or in the instance where different products within the same subclass display very different price elasticities of demand. *See* Tr. 26/9303; 35/11808-09.
- Accurate cost estimates of workshare and non-workshare-related cost differences within a subclass must be developed to support ECP. *See* PB-T-2 at 6-7.

**B. An Argument for Extending the Principles Supporting Efficient Component Pricing To Non-Workshare-Related Cost Differences.**

Responsive to the Commission’s request for guidance on these issues, Pitney Bowes witness Panzar’s direct testimony states:

In two recent Notices of Inquiry, the Commission asked for guidance on the general subject of basing rate differences – other than worksharing discounts - on cost differences for mail within a subclass. This section addresses that issue and explains why the principles supporting the ECPR apply to these situations as well.

PB-T-1 at 45 (footnote omitted).

Witness Panzar shows why the same principles that support ECP for traditional worksharing also are applicable to setting rates that reflect all cost differences within a subclass:

More so than in most markets, mailers have the opportunity to “design their own service.” That is, they can choose many of the intrinsic properties of their mailing: its *size* (one ounce or several); its *shape* (letter or flat), the time of day at which it enters the mail stream, the location at which it enters the Postal Service network – and many other of their mail’s characteristics. Two aspects of this flexibility are important for rate making purposes. First, and most importantly, differences in these characteristics may have important impacts on the costs that the mail imposes on the Postal Service. Second, while mailers may have preferences over these characteristics (e.g., a flat may better serve their purposes than a letter), the relative value of shifting from one alternative to another may be dramatically different than the difference in Postal Service costs. Just as with traditional worksharing, an effective way to induce changes in mailer behaviour is through rate differences that reflect cost differences. The basic economic argument in support of cost-based rate differentials is the same as that for avoided cost worksharing discounts. Mailers can act to minimize end to-end costs only if the

difference in rates for mail with differing characteristics reflects differences in the costs incurred by the Postal Service.

PB-T-1 at 46.

**C. The Debate.**

Not all participants agree. Various parties object to extending the principles of ECP to non-worksharing related characteristics and their attendant costs. Some argue that mailers do not have control over these characteristics or those characteristics like shape and weight are not traditionally viewed as worksharing. *See* Tr. 33/11131-34 (Kiefer); NAA-T-1 at 11-12 (Sidak). Other parties assert the primacy of Ramsey pricing or subclass average mark-ups for setting rates for non-workshare-related cost differences. *See* Tr. 35/11907 (Mitchell); Tr. 33/11132-33 (Kiefer). Following, we discuss these objections, showing that they are incorrect.

On rebuttal the Postal Service challenged Panzar's theoretical extension of ECP by rejecting the notion of "mailer choice." Postal Service witness Kiefer asserts:

Witness Panzar bases his argument for extending the ECP rule on two premises, both of which are unproven, and likely wrong. The first premise is that mailers choose the characteristics of the mail they send, such as the shape of the mail pieces, and that their choices are highly flexible and largely susceptible to influence by the relative prices set by the Postal Service.

Tr. 33/11131.

In his cross-examination, however, witness Kiefer was forced to concede that this position was little more than sophistry: acknowledging that the Postal Service supports the view that shape-based pricing can change mailer behavior, *see* Tr. 33/11210, and that Postal Service witness O'Hara – the Postal Service's rate design witness – developed the Postal Service's rate design in this case on the explicit expectation of "mailer choice" in response to appropriate pricing signals:

In this case, we continue the process of developing appropriate price signals by focusing on the effect of shape on postal costs. In re-examining the relationship between costs and prices, it became clear that the current rate structures did not adequately reflect the greater costs of handling a flat or parcel as compared to a letter.

Because the costs of handling a flat, for example, are greater than the costs of handling a letter, customers sending light-weight First-Class Mail flats could face larger than average price increases. I expect this may cause some customers to re-evaluate their choices. In some instances, a customer could pay lower prices by simply folding a mailpiece and reconfiguring it as a letter; in other cases, a customer may determine that the aesthetics of a flat-shaped piece better communicates their message to the recipient. In both cases, the customer can make a choice as to the value of “shape” vs. “postage expense” and, thereby the implicit costs of the Postal Service handling a mail piece that is not letter-shaped.

USPS-T-31 at 4-5.

ADVO witness Crowder’s testimony further confirmed that many cost causative characteristics of mail not traditionally recognized as workshare attributes could be modified with appropriate pricing signals:

It depends on what you mean by “workshare” because mailers do all sorts of worksharing that are maybe not entirely obvious . . . You may have mailers that are now mailing flats who will do certain things to those flats, maybe fold them or quarter-fold them or tab them or do whatever, and that makes them a letter. It's at their expense, and it saves the Postal Service money, and, to me, that would be a form of worksharing, although it's not the kind of worksharing that's been discussed in this proceeding.

Tr. 35/11816-17.

Witness Kiefer’s critique of “mailer choice” is also incorrect as a matter of economic theory. The notion of “mailer choice” does not require that it be feasible to convert every 70 pound parcel to a 1 ounce letter: economic analysis is concerned with changes at the margin. Thus, if there are flats which will convert to letters under price signals which reflect the underlying costs, if there are heavier parcels which will convert to slightly lighter parcels under these price signals, and if there are parcels of high cube that will convert to parcels of slightly

lesser cube under these price signals, then ECP based prices will promote productive efficiency. See PB-T-1 at 45-47.

Valpak witness Mitchell argues that non-workshared cost differences within a sub-class should not be priced at cost differences, but should be “marked up” either with Ramsey markups or with subclass cost coverage markups. However, many of the theoretical benefits of Ramsey pricing are lost where, as here, the pricing is constrained within a sub-class. See PRC Op. R87-1, paras. 5149-5151. With respect to Ramsey markups generally, witness Pazar’s objections to Ramsey pricing for worksharing are equally applicable when applied to non-worksharing-related cost differences:

First, Ramsey Pricing requires precise information about production costs and consumer demands. ECPR requires only information about cost differences at the margin. Thus a system of prices that provide incentives for efficient worksharing can be put in place using only the costing systems of the Postal Service. Estimates of demand elasticities are not required.

Second, Ramsey Pricing does not automatically ensure that prices are free of cross-subsidization. That is, it must be verified that the prices of each product are at least as large as the associated average incremental costs. This is much less likely to be a problem for worksharing discounts set in accordance with ECPR. Intuitively, as long as the base, non work-shared price covers its average incremental cost, application of ECPR will ensure that all of the associated discounted prices are also free of cross subsidy.

Third, Ramsey Pricing weighs surplus dollars equally. While appealing to economists, this neutrality does not allow for the Commission to exercise independent judgment with respect to the non cost factors specified by the Postal Reorganization Act. It is true that Ramsey Pricing principles could be applied using unequal welfare weights. However, ECPR facilitates the application of non cost factors on a subclass by subclass basis while maintaining incentives for efficient worksharing within a subclass.

Finally, and most importantly, the use of ECPR is much better suited to a constantly changing and evolving postal industry. In particular, it allows relatively straightforward adjustments to reflect changing worksharing technology without the need to obtain information on changing demand elasticities.

PB-T-1 at 50 (footnote omitted).

As identified in Panzar's first objection, a significant practical limitation on Ramsey pricing is that it requires a large amount of information regarding price elasticities that is simply unavailable below the subclass level. *See* Tr. 35/11219-20.

In Docket No. MC 95-1 the Commission addressed the issue of marking-up cost differences with subclass markups, finding that differences in demand elasticities play no role in setting rate differentials between categories. *See* PRC Op. MC95-1, para. 2073. Given that this approach does not maximize consumer surplus (as would an unconstrained Ramsey approach) nor minimize end-to-end costs (as would an ECP approach), it seems to have little to recommend it from a theoretical perspective.

The Postal Service also raises the concern that the extension of the principles underlying ECP should not be applied "dogmatically." *See* Tr. 33/11133; Tr. 32/10704-05. While this is a sound observation, it is an inappropriate critique of witness Panzar's position. Witness Panzar does not advocate a rigid application of ECP for non-workshare-related cost differences and, in fact, acknowledged as much when presented with a situation where elasticities varied substantially within a sub-class (parcel post). *See* Tr. 26/9262 (stating "absent any direct information that demand elasticities are significantly different, my testimony recommends following the ECPR logic within a subclass.").

Developing rate differentials to recognize what have traditionally been considered non-workshare-related costs differences would provide an additional means through which the Postal Service could achieve its goals of generating additional revenue, reducing costs, and improving service. There are many cost-causative characteristics of First-Class Mail that are not explicitly recognized under the current pricing regime but which could be deaveraged and priced to reflect actual costs incurred or avoided by the Postal Service. For example, currently, First-Class Mail

rates do not include either destination-entry discounts or distance based rate zones and, thus, do not recognize the cost effects of the distance between the entry point and the addressee. First-Class Mail rates also fail to recognize any of the unit cost differences caused by the sales channel or postage evidencing methods used by the mailer. Similarly, First-Class Mail rates fail to recognize mail piece hygiene or to reflect the relative costs of the wide variations in the correctness, completeness, and legibility of addresses. An extension of the principles supporting ECP to both workshare-related and non-workshare-related cost differences within a subclass would result in prices that more accurately reflect costs avoided or incurred.

Pitney Bowes understands that rate making is an evolutionary process and that the Commission is not presented with a clean slate, but rather must evaluate new proposals in the context of existing rate relationships. Accordingly, it may be difficult to implement rates which fully comport with a theoretical extension of the principles supporting ECP. Nevertheless, Pitney Bowes urges the Commission to move toward such rates as expeditiously as possible so postal prices reflect, to the extent practical, (1) costs avoided by traditional workshare-related activities, (2) costs avoided by additional workshare-related activities such as the expanded retail access discount proposed by witness Buc and discussed in Part IV of this brief, below, and (3) all other cost differences resulting from cost causing characteristics.

**IV. THE COMMISSION SHOULD RECOMMEND THAT THE POSTAL SERVICE DEAVERAGE THE COST OF POSTAGE EVIDENCING FOR FIRST-CLASS MAIL AND PROVIDE A DISCOUNT FOR POSTAGE EVIDENCING METHODS THAT AVOID POSTAL SERVICE COSTS**

The Commission should recommend the Pitney Bowes' proposal for a discount for Single-Piece First-Class Letter Mail first-ounce postage evidencing purchased through retail sales channels that avoid the transaction costs incurred by stamps sold directly by Postal Service employees at USPS owned or leased facilities (i.e., stamps sold across USPS retail windows or counters). Deaveraging the cost of postage evidencing for all retail sales channels would promote economic efficiency and would assist the Postal Service in realizing its ambitious goal of moving expensive transactions away from the Postal Service retail window.

It bears noting that for International Mail retail products the Postal Service itself has proposed a discount for customers who purchase postage through on-line sales channels that avoid the transaction costs incurred at a Postal Service retail window.<sup>12</sup> See 71 Fed. Reg. 76231 (2006). The Commission should recommend and the Postal Service should adopt a similar discount for postage evidencing sold through less expensive sales channels, as proposed by Pitney Bowes, for Single-Piece First-Class Mail letters in the domestic mail stream.

Pitney Bowes witnesses Panzar and Buc both invite the Commission to adopt a broader conception of "worksharing" in which the Postal Service uses pricing to incent any private sector activity, including activities of individual mailers, that reduces the costs of the Postal Service. See PB-T-1 at 7; PB-T-3 at 3. Specifically, witness Panzar's testimony states, "I do not limit the

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<sup>12</sup> Specifically, the Federal Register Notice for International Product and Pricing Initiatives states, in part,

Customers who purchase postage using Click-N-Ship, at <http://www.usps.com>, or through an authorized online provider, will receive discounts of 10 percent on Global Express Guaranteed shipments, 8 percent on Express Mail International shipments, and 5 percent on Priority Mail International shipments.

71 Fed. Reg. 76231 (2006).

discussion to activities performed by mailers that currently entitle them to official worksharing discounts. Rather, I offer the following more inclusive definition: *Worksharing* refers to any private sector *activity* which *reduces the costs* of the Postal Service.” (emphasis in original).

PB-T-1 at 7.

Witness Panzar explains that this definition would encompass new activities and recognize new cost savings opportunities:

a number of types of Postal Service cost savings, not merely the operational costs recognized in the current discount structure. For example, a mailer that dispensed with stamps would save the Postal Service the transactions costs associated with selling stamps at the post office window or stamp machine.

*Id.* at 7.

Witness Panzar notes that providing discounts to move transactions away from the window is an economic approach that would provide strong incentives to induce customers to change their behavior as a means to reduce costs and improve service. *See* PB-T-1 at 13.

Pitney Bowes witness Buc elaborates on the potential efficiency gains of an expanded retail access discount. Specifically, Buc discusses the fact that in the Base Year, the Postal Service sold almost 20 billion stamps for Single-Piece First-Class Mail at the window while selling less than 4 billion in other channels. *See* PB-T-3 at 5. Thus, to provide incentives for more efficient behavior Buc proposes a discount for postage evidencing sold in less expensive channels.

Witness Buc acknowledges that although the logical extension of the arguments presented would compel the establishment of a discount for all postage evidencing other than retail window sales, due to the lack of data produced by the Postal Service the rate design proposed is limited to postage evidencing via permits, postage meters, and PC Postage – sales

channels in which it is certain that the Postal Service incurs minimal transaction costs. *See* PB-T-3 at 7-8.

Importantly, an expanded retail access discount as proposed would be the first “workshare” discount to apply to mail users with small mail volumes and, thus, would help democratize worksharing discounts. Unlike all other worksharing discounts that require substantial volumes of mail (500 pieces, 20 pounds, etc.), these discounts would be available to mailers of small volumes of mail so long as the postage evidencing did not take the form of stamps purchased at USPS windows. Small mailers as well as large ones could be given incentives to purchase and evidence postage via the internet, through the mail, or other sales channels that are less expensive than the Postal Service window.

As an interim measure until more data are collected allowing a full deaveraging across all channels, Pitney Bowes proposes a discount of .1 cents per piece for postage evidencing via permit, PC Postage, and postage meters for Single-Piece First-Class Mail. Pitney Bowes proposes an initial discount that is clearly less than costs avoided to minimize revenue leakage. *See* PB-T-3 at 8.

No party filed rebuttal testimony opposing Pitney Bowes’ expanded retail access proposal. Accordingly, Pitney Bowes urges the Commission to recommend the establishment of its proposed expanded retail access discount and asks the Commission to encourage the Postal Service to collect data to allow the discount to be expanded to all efficient sales channels in the future.

