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POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

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POSTAL RATE AND FEE CHANGES, 2006 Docket No. R2006-1

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# DIRECT TESTIMONY
# OF

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PITNEY BOWES INC.

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**AUTOBIOGRAPHICAL SKETCH**

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

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

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

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

## I. PURPOSE AND SCOPE

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

## II. FIRST-CLASS MAIL PRESORT LETTERS ARE ESSENTIAL TO THE CONTINUED FINANCIAL VIABILITY OF THE POSTAL SERVICE

First-Class Mail Presort Letters make an enormously valuable contribution to the Postal Service's finances; it is very "profitable" mail. With revenues of $14.95 billion in the Base Year (FY 2005) and volume variable costs of only $4.97 billion, First-Class Mail Presort Letters provided $9.98 billion in contribution to the Postal Service's institutional costs. Thus, while it accounted for about 20 percent of USPS revenues, it provided almost a third of total contribution.[2]

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[1] *See* 39 U.S.C. §§ 101 *et. seq*. (2006).
[2] *See* Summary of Revenue and Cost for Major Service Categories, Fiscal Year 2005 at http://www.usps.com/financials/_xls/FY05CRA.xls, tabs Cost1 and Cost2.

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

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

| | Unit Contribution | Cost Coverage |
|---|---|---|
| **First-Class Mail Single-Piece Letters** | $0.189 | 172 % |
| **First-Class Mail Presort Letters** | $0.203 | 301 % |
| **Total All Mail** | $0.136 | 176 % |
| Source: http://www.usps.com/financials/_xls/FY05CRA.xls, tabs Cost1 and Cost2 | | |

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

As shown in Table 2 below, volumes of First-Class Mail Presort Letters continue to grow, both in absolute terms and as a percentage of First-Class Mail. Consequently, they have 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. After the mailing community has fully adapted to worksharing product innovations offered by the Postal Service, almost 52 percent of First-Class Letter Mail volume and almost 38 percent of its revenues is generated by mail using these worksharing innovations.[3]

[3] *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.

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

| Fiscal Year | Single Piece Volumes (millions) | Workshared Volumes (millions) | Workshared Porton (%) | Workshared Increase (%) |
|---|---|---|---|---|
| 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

## III. THE COMMISSION SHOULD ADHERE TO THE EFFICIENT COMPONENT PRICING RULE TO ESTABLISH APPROPRIATE WORKSHARE DISCOUNTS

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

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

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

### A. The Commission Favors Establishing Worksharing Discounts Consistent With ECPR.

The Commission has long recognized the importance of ECPR 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.

And in addition to recognizing the salutary effects of ECPR on efficiency, the Commission also has noted that itpromotes equity:

> 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.

### B. Dr. Panzar's Testimony in This Case Also Describes the Benefits of ECPR.

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

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

PB-T-1 at 18.

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

> This is the case, 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.

### C. Accurate Cost Estimates are Essential to ECPR.

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

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

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

## IV. THE POSTAL SERVICE'S COST METHODOLOGY CONSISTENTLY UNDERESTIMATES WORKSHARE RELATED COST AVOIDANCES FOR AUTOMATION LETTERS

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

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

Because the In-Office Costing System ("IOCS") does not report costs for the various rate categories of First-Class Mail Presort Letters, the Postal Service must estimate, or model, these costs. It does so with a hybrid approach, using 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 costs of piece handling and selected bundle handling activities for letter-shaped mail for each of the rate categories. Then, using the distribution of mail across the rate categories, the Postal Service calculates the average weighted cost for letter-shaped Presort Mail. This cost is next compared to the cost that IOCS shows for letters for those MODS pools that best map to the modeled activities in the Cost and Revenue Analysis ("CRA"). The ratio of CRA cost to modeled cost is the "CRA adjustment." If the ratio is greater than 1, modeled costs are less than CRA costs; if it is equal to 1, modeled costs equal CRA costs; and if it is less than 1, modeled costs are greater than CRA costs. Costs for each rate category are then multiplied by the CRA adjustment to reconcile the modeled costs to the CRA costs. Finally, the CRA costs for activities that are not modeled – 1.766 cents per piece under the PRC method[4] -- are added to the costs for each of the rate categories. *See* USPS-T-22 at 7-8.

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

[4] 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.

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

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

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

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

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

| Pool Classification | Number of Pools | Percent of Pools | Unit Cost | Percent of Unit Cost |
|---|---|---|---|---|
| **Proportional** | 14 | 22.2% | 3.234 | 64.7% |
| **Fixed** | 49 | 77.8% | 1.766 | 35.3% |
| **Total** | 63 | 100.0% | 5.000 | 100.0% |
| Source: USPS-LR-L-110, PRC FCM.xls, Tab CRA – Presort Letters | | | | |

### B. Improvements to the Postal Service Model.

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

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

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

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

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

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

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

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

### C. The Unexplained Exclusion of Delivery Costs Degrades the Postal Service Cost Model.

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

> 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.

[5] 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.

[6] *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.

[7] 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.

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

Tr. 16/____.

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

### D. The Chief Deficiency in the Postal Service Cost Model is the Improper Classification of Cost Pools.

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

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

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

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

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

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

related fixed" or "nonworksharing related fixed." In 36 of these fixed pools, the unit cost for Single-Piece First-Class Metered Letter Mail exceeds the unit cost for First-Class Mail Automation Letters. In 30 of these pools, the unit cost for Single-Piece First-Class Letter Mail letters is greater than twice the unit cost for Automation Letters. Finally, in ten of these pools, the unit cost of Single-Piece First-Class Metered Letter Mail is more than five times greater. In total, the Single-Piece First-Class Metered Letter Mail unit cost in the fixed cost pools is 4.556 cents, more than three times the First-Class Mail Automation Letters unit cost in these pools, which is 1.479 cents. Thus, the "fixed" costs do not appear to be fixed.

**Table 4. Number of Fixed Cost Pools and Associated Unit Costs by Specified Ratios of Single-Piece Metered Letters Unit Cost to Automation 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 | | | |

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

**Table 5. Number of Proportional Cost Pools and Associated Unit Costs by Specified Ratios of Single-Piece Metered Letters Unit Cost to Automation 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 | | | |

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

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

[8] 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, tabs Cost1.

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

### 2. USPS Attribution and Distribution Costing Methods Imply Almost All Cost Pools Are Proportional.

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

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

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

[9] 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.

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

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

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

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

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

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

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

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

USPS-T-12 at 84 (Bozzo).

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

Witness Van-Ty-Smith's distribution method for support and miscellaneous cost pools also follows the "piggyback" approach discussed by witness Bozzo. Specifically, witness Van Ty-Smith states:

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

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

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

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

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

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

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

3. Classification of Anomalous Cost Pools.

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

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

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

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

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

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

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

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

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

**Table 6. Anomalous Cost Pools and Associated CRA 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 |
| **Total** | 16 | 0.079 |
| Source: PB-LR-L-1, Tab 3 | | |

4. Operational Analysis.

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

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

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

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

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

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

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

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

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

[10] 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).

outbound transportation and the preparation of strap and sleeve trays. *See* R2005-1, Tr. 4/1085-86. Dispatch operations (MODS 16 DISPATCH) unit costs total 0.087 cents for First-Class Mail Automation letters. *See* USPS-LR-L-110 at 2 (revised 5/3/2006). Dispatch costs relate to the number of times mail is processed and the number of times processed mail is prepared for outbound transportation. Originating letters in mixed AADC trays can be processed in four sort schemes and require two or three strapping and/or sleeving activities. Originating letters in 5-digit trays can be processed in only one sort scheme and require at most one sleeving activity. *See* Tr. 11/2922 (PB/USPS-T42-5 (McCrery)). Hence, mixed AADC letters incur greater dispatch costs than 5-digit letters.

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

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

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

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

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

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

[11] 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.

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

The unit costs in the allied labor, general support, and tray sorting pools are aggregated in Table 7 below. The aggregated data show that these 14 pools account for 1.2 cents in unit costs for First-Class Mail Automation letters and comprise 68 percent of the total of all costs that the Postal Service classifies as "fixed."[12] These cost pools should be reclassified as proportional.

[12] 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.

**Table 7. First-Class Mail Automation Letters Unit Mail 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 | 0.268 |
| 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 5 | | |

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

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

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

## V. IMPROVED COST ESTIMATES ALLOW 100 PERCENT PASSTHROUGHS FOR AUTOMATION LETTERS CONSISTENT WITH ECP

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

approach. 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.

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

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

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

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

I assumed that the costs of the newly classified proportional pools vary among presort levels in exactly the same way as do the modeled pools. The assumption is consistent with the attribution and distribution theory of the Postal Service. The 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.

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

**Table 9. Costs, Cost Avoidances, and Passthroughs 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 | | | | | |

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

## VI. A SET OF PROPOSED RATES FOR AUTOMATION LETTERS THAT BALANCES IMPORTANT POLICY OBJECTIVES

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

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

Thus, my proposed rate design balances the virtues of ECPR with the evils of revenue leakage and rate increases. 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. Table 10, below, shows my proposed rates and compares them to those proposed by the Postal Service.

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

| Rate Category | USPS Proposed Rate (cents) | PB Proposed Rate (cents) | Percentage change from USPS Proposed |
|---|---|---|---|
| **MAADC** | 34.6 | 35.8 | 3.4 |
| **AADC** | 33.5 | 33.8 | 0.9 |
| **3-Digit** | 33.1 | 33.1 | 0 |
| **5-Digit** | 31.2 | 30.8 | -1.4 |
| Source: PB-LR-1, Tab 7 | | | |

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

Understanding the true magnitude of the avoided costs has then enabled me to compute rate discounts that are truly compliant with ECPR. Setting these discounts at the appropriate levels 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. By improving the Postal Service's proposed rate design by appropriately and uniformly passing through 100 percent of avoided costs, clear and correct price signals enhance overall economic efficiency.

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

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

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

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

## VII. CONCLUSION

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