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BEFORE THE
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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ON BEHALF OF
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.

1 **I. PURPOSE AND SCOPE**

2 In my testimony, I will show that First-Class Mail Presort Letters are exceedingly

3 important to the financial well being of the Postal Service, and that it is consequently

4 very important that they be priced correctly. Next, I will show that the Efficient

5 Component Pricing Rule ("ECPR") is the appropriate analytical framework for setting

6 worksharing discounts. I will also show the importance of accurately measuring cost

7 avoidances under ECPR. I will then show that the cost avoidance estimates presented

8 by Postal Service witness Abdirahman for First-Class Mail Automation Letters (USPS-T-

9 22) are flawed because they consistently understate workshare related cost avoidances

10 and, thus, are inadequate for ECPR pricing. I will provide better estimates for these

11 cost avoidances. Finally, based on these improved estimates, I will provide proposed

12 rates for Automation Letters that balance important policy objectives, better comport

13 with ECPR, and satisfy the rate-setting factors of the Postal Reorganization Act.[1]

14 **II. FIRST-CLASS MAIL PRESORT LETTERS ARE ESSENTIAL TO THE**
15 **CONTINUED FINANCIAL VIABILITY OF THE POSTAL SERVICE**
16
17 First-Class Mail Presort Letters make an enormously valuable contribution to the

18 Postal Service's finances; it is very "profitable" mail. With revenues of $14.95 billion in

19 the Base Year (FY 2005) and volume variable costs of only $4.97 billion, First-Class

20 Mail Presort Letters provided $9.98 billion in contribution to the Postal Service's

21 institutional costs. Thus, while it accounted for about 20 percent of USPS revenues, it

22 provided almost a third of total contribution.[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.

1    Several other financial metrics further demonstrate the importance of presort and

2    automation letters to the continued financial viability of the Postal Service.  The unit

3    contribution and cost coverage for First-Class Mail Presort Letters both exceed those for

4    First-Class Mail Single-Piece Letters.  In fact, in FY 2005 both of these financial metrics

5    for First-Class Mail Presort Letters were substantially larger than the average for all

6    mail, as shown in Table 1.

7
8

**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 | | |

9    Because of the significant financial contribution of First-Class Mail Presort Letters

10   to the Postal Service, setting rates and discounts for presorted and automation letter

11   mail to elicit and maintain this contribution is critically important.

12   As shown in Table 2 below, volumes of First-Class Mail Presort Letters continue

13   to grow, both in absolute terms and as a percentage of First-Class Mail.  Consequently,

14   they have been and will continue to be enormously important to the financial viability of

15   the Postal Service as a source of both mail volume and revenue.  After the mailing

16   community has fully adapted to worksharing product innovations offered by the Postal

17   Service, almost 52 percent of First-Class Letter Mail volume and almost 38 percent of

18   its revenues is generated by mail using these worksharing innovations.[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.

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

| Fiscal Year | Single Piece Volumes (millions) | Workshared Volumes (millions) | Workshared Portion (%) | 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 | | | | |

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

4        Worksharing discounts induce mailers to perform cost saving activities  .  To

5  receive these discounts, mailers perform part of the work involved in the end-to-end

6  mail service and pay less than full price to the Postal Service as a result of performing

7  this work.

8        The Efficient Component Pricing Rule is the principle that states that the

9  discounts mailers receive for performing this work should be set at a level *equal* to the

10  per unit avoided cost of the Postal Service.  When discounts are set *equal* to costs

11  avoided, they induce mailers to perform work if and only if these mailers can perform

12  the work less expensively than the Postal Service.  If discounts are less than the cost

13  avoided, some mailers who could have performed the work less expensively than the

14  Postal Service will not undertake the work because of the inaccurate pricing signal.

1    Thus, worksharing discounts that comport with ECPR, i.e. those that are set at a level

2    equal to the per unit avoided cost, will minimize the total cost of mailing in the economy.

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

5    The Commission has long recognized the importance of ECPR for both efficiency

6    and equity, stating, for example:

7        From the inception of worksharing discounts, the Commission has been
8        concerned with both equity and economic efficiency. It set the first such
9        discount at clearly capturable avoided costs. This provided a rate incentive
10       to mailers which would allow cost-based decisions on whether to engage
11       in the worksharing activity. In effect, the Commission was setting
12       discounts in conformity with what later became known as efficient
13       component pricing. The discount approach led to the lowest cost producer
14       providing the service. This, in turn, minimized the cost of the workshare
15       activity to society as a whole.
16
17   PRC Op. MC95-1, para. 3074.
18
19       And in addition to recognizing the salutary effects of ECPR on efficiency, the

20   Commission also has noted that it promotes  equity:
21
22       However, when discounts pass through 100 percent of avoided costs to
23       the workshare mailer, the contribution made by that mailer to institutional
24       costs is the same as the mailer would have made without worksharing.
25       Thus, workshare mailers and non-workshare mailers provide the same
26       contribution, which is fair and equitable.  In this case the Commission has
27       set the majority of the recommended discounts for First-Class to pass
28       through 100 percent of the avoided costs.  This maximizes the discounts
29       and effectively reduces the institutional cost burden on workshare mailers
30       as much as possible.
31
32   PRC Op. R2000-1, para. 5060.
33
34

**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

1   discount is 1.9 cents, but the accurate cost avoidance is 2.3 cents.  Based on the

2   erroneous cost avoidance, the discount appears to be larger than the appropriate ECPR

3   discount, but under the accurate cost avoidance, the discount is actually less than the

4   correct discount under ECPR.

5        This is not an academic distinction.  If discounts are lower than they should be

6   under ECPR, then mailers will not provide as much worksharing as they would under

7   the correct pricing structure.  This, in turn, will result in total mail processing costs that

8   are higher than they would be otherwise, which is both economically inefficient and

9   contrary to important public policy goals. Thus, accurate estimates of costs avoided are

10  critical for ECPR.

11  **IV.     THE POSTAL SERVICE'S COST METHODOLOGY CONSISTENTLY**
12  **         UNDERESTIMATES WORKSHARE RELATED COST AVOIDANCES FOR**
13  **         AUTOMATION LETTERS**
14
15       While the Postal Service has made several improvements to its cost

16  methodology for First-Class Mail Presort letters in this case (e.g., delinking First-Class

17  Single Piece and First-Class Presort), the Postal Service has failed to improve its

18  models in other important respects, and has made one change that seriously degrades

19  the accuracy of the model (the unexplained and unprecedented exclusion of delivery

20  costs).  The Postal Service's cost methodology remains flawed because itcontinues to

21  severely underestimate cost avoidances.  To set the context for the subsequent

22  discussion of improvements, following I briefly describe how the Postal Service model

23  works.

24

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

2    Because the In-Office Costing System ("IOCS") does not report costs for the

3    various rate categories of First-Class Mail Presort Letters, the Postal Service must

4    estimate, or model, these costs.  It does so with a hybrid approach, using a "bottoms-

5    up" engineering cost model (combining mail flows with costs – derived from productivity

6    and wage rate data – at each step of the mail flows) to estimate the costs of piece

7    handling and selected bundle handling activities for letter-shaped mail for each of the

8    rate categories.  Then, using the distribution of mail across the rate categories, the

9    Postal Service calculates the average weighted cost for letter-shaped Presort Mail.  This

10   cost is next compared to the cost that IOCS shows for letters for those MODS pools that

11   best map to the modeled activities in the Cost and Revenue Analysis ("CRA").  The ratio

12   of CRA cost to modeled cost is the "CRA adjustment."  If the ratio is greater than 1,

13   modeled costs are less than CRA costs; if it is equal to 1, modeled costs equal CRA

14   costs; and if it is less than 1, modeled costs are greater than CRA costs.  Costs for each

15   rate category are then multiplied by the CRA adjustment to reconcile the modeled costs

16   to the CRA costs.  Finally, the CRA costs for activities that are not modeled – 1.766

17   cents per piece under the PRC method[4] -- are added to the costs for each of the rate

18   categories.  *See* USPS-T-22 at 7-8.

19   Under the Postal Service methodology, the activities that are modeled – all piece

20   handling activities and some bundle handling – are called "proportional," while all the

21   remaining activities – container handlings, allied labor, not handling, etc. – are not

---

[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.

1    modeled and are called "fixed."  This implies that costs for "proportional" cost pool

2    activities vary across presort levels while the remaining "fixed" cost pool activities are

3    unaffected by presort level, i.e., they do not vary.  But both the Postal Service and its

4    cost modeling witness Abdirahman have conceded that the classification of cost pools

5    as "proportional" and "fixed" has only to do with whether the costs have been modeled

6    and not whether they actually vary with respect to presort level.  *See* USPS-T-22 at 7, 8

7    Tr. 4/509 (PB/USPS-T22-4 (Abdirahman)); Tr. 18D/6587 (PB/USPS-T42-10)(redirected

8    to USPS)).

9            As described above, under the Postal Service methodology, the average unit

10   cost of Presort letter-shaped mail derived from the model is constrained to equal the

11   IOCS unit cost (5.00 cents per piece, using the PRC method).  Critical to the

12   functionality and results of the model, cost avoidances between the rate categories are

13   determined solely by the piece-handling and bundle costs in the cost pools classified as

14   proportional by the Postal Service.  This is because the same amount of fixed costs are

15   added to these proportional costs in each rate category.  *See* USPS-LR-L-110, CRA

16   Presort Letters, Table 3 Adjusted Letter Unit Mail Processing Cost, column 6.  Thus, the

17   costs in cost pools designated as fixed costs have *no effect* on the magnitude of the

18   workshare related cost avoidances.  *See* Tr. 4/614-615 (PB/USPS- T22-10(a)

19   (Abdirahman)).  This means that incorrectly classifying costs as fixed with respect to

20   presort level has the effect of inappropriately compressing the calculated differences in

21   unit mail processing costs across these presort levels. It understates cost avoidances.

22           Table 3, below, shows how the Postal Service distributes cost pools and cost

23   between "proportional" and "fixed" and the resulting distribution of unit costs as "fixed"

1    and "proportional."  As the table shows, modeled costs, labeled "proportional," account

2    for only 14 of the 63 cost pools (under the PRC method) and comprise only 3.23 cents

3    of the total unit costs of 5.00 cents.  Thus, the Postal Service has actually modeled

4    slightly more than 20 percent of the cost pools and less than two thirds of the costs.

5    Costs that are not modeled, labeled "fixed" costs, comprise the majority of the cost

6    pools - 49 under the PRC method - and account for slightly more than one third of the

7    total unit costs.  Given the large number and percentage of cost pools that are

8    characterized as "fixed" and the importance of the distinction between proportional and

9    fixed cost pools in accurately determining mail processing costs (and costs avoided)

10   across presort levels, careful scrutiny of the USPS classification of cost pools as "fixed"

11   or "proportional" is appropriate.

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

| 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 | | | | |

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

16          The Postal Service has made some important improvements to its model in this

17   case.  Specifically, the Postal Service has improved the model's handling of estimated

18   costs and cost avoidances in three ways: (1) combining Automation with non-

19   Automation tallies in the cost pools; (2) changing the classification of three cost pools

20   from the fixed to the proportional category; and (3) delinking the Presort letters cost

21   avoidances from a single piece benchmark.  A short discussion of each follows.

1       1.   The Postal Service Has Improved Its Model By Combining Automation
2            and Non-Automation Tallies.
3
4       In R2005-1, the Postal Service used IOCS costs for non-Automation Presort

5  letter mail and for Automation Presort letter mail separately in the cost estimating

6  process described above.  The Postal Service has now convincingly demonstrated that

7  IOCS cannot accurately measure the costs for non-Automation Presort mail separate

8  from those for Automation Presort mail.  *See* Tr. 18D/6603-10 (Response of the United

9  States Postal Service to P.O. Information Request No. 5, Question 4).  Thus, in the

10  current case, the Postal Service combines the non-Automation and Automation letter

11  IOCS costs and deaverages the combined First-Class Mail Presort letters cost using the

12  model described above.

13      2.   The Postal Service Has Improved Its Model by Reclassifying Select
14           Cost Pools.
15
16      Combining Automation and non-Automation Presort letter tallies in all cost pools

17  produces an improvement in the classification of certain cost pools.  In the Automation

18  cost model in Docket No. R2005-1, 1OPBULK, 1OPPREF, and 1POUCHING were each

19  classified as worksharing related fixed while in the non-Automation model they were

20  classified as proportional.  Having combined the Automation and non-Automation tallies,

21  the Postal Service was forced to adopt consistent classifications; each has now been

22  classified as proportional in this case.  As I discuss below, these cost pools should be

23  classified as proportional and doing so has improved the model.

24      3.   The Postal Service Has Improved Its Model by Delinking Presort Rates
25           from Single-Piece Rates.
26
27      Delinking Presort letter rates (both Automation and non-Automation) from Single-

28  Piece rates also represents an improvement in the Postal Service's cost model.  As

1    shown in Dr. Panzar's testimony (PB-T-1), the choice of Bulk Metered Mail ("BMM") as

2    a benchmark is flawed from a theoretical perspective.[5]  And once deaveraging occurs

3    across important cost-causative factors as required for productive efficiency, delinking

4    naturally follows.[6]  From a more practical perspective, delinking also improves the

5    modeling because *cost avoidances* from the BMM benchmark are implausibly smaller

6    than *cost differences* given the similarity in weights and shapes of Single-Piece and

7    Presort Letters mail.[7]

8    **C.    The Unexplained Exclusion of Delivery Costs Degrades the Postal**
9    **Service Cost Model.**
10
11    Notwithstanding these improvements, the Postal Service has made one change

12    that substantially degrades the integrity of the cost model: removing the delivery cost

13    differences.  Postal Service witness Taufique attempts to provide a rationale for

14    excluding delivery cost avoidances in his response to Question 2(c) of P.O.'s

15    Information Request No. 5.

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

---

[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.

1        Furthermore, the reject rates that create the differences in the DPS
2        percentages and resulting different delivery costs for the various presort
3        levels for letters could be affected by the reject rates for single-piece
4        letters, which is not a component of the cost models.
5
6 Tr. 16/4860-61.

7        But this explanation is not compelling, particularly in view of the fact that the

8 Postal Service's decision to exclude delivery unit costs is inconsistent with the approach

9 it uses to measure mail processing cost avoidances for the Automation rate categories.

10 In the mail processing model, the Postal Service explicitly recognizes that part of the

11 cost differences between Automation rate categories is due to the fact that "the less

12 presorted the letters are, the more equipment they go across and thus, the more

13 opportunities they have to be rejected." *See* USPS-LR-L-110, AUTO MAADC MODEL,

14 AUTO AADC MODEL, and AUTO 3-DIGIT MODEL.  Excluding delivery unit cost

15 differences is also inconsistent with mail processing operations, because a mail piece

16 must remain in the automation mailstream to be delivery point sequenced ("DPS").  *See*

17 Tr. 11/2795 (APWU/USPS-T-30-4 (Kelley)).

18      **D.**     **The Chief Deficiency in the Postal Service Cost Model is the**
19                 **Improper Classification of Cost Pools.**
20
21        As shown above, t he Postal Service provides no evidence that the cost pools

22 classified as "fixed" in the cost avoidance model actually are fixed with respect to

23 presort level.  *See* Tr. 18D/6587 (PB/USPS-T42-10 (redirected to USPS)).  Witness

24 Abdirahman further conceded that he is unaware of econometric, operational, or any

25 other studies supporting this critical assumption.  *See* Tr. 4/519; Tr. 4/509 (PB/USPS-T-

26 22-4 (Abdirahman)).  In fact, there is no evidence that these cost pools actually are fixed

27 with respect to presort level.  There are, however, substantial and compelling reasons to

1     conclude that the costs in many of these "fixed" cost pools actually do vary between the

2     presort levels.  These cost pools should thus be reclassified as proportional.

3        Thought experiments using Postal Service data, Postal Service attribution and

4     distribution costing methods, an examination of anomalous cost pools, and operational

5     analysis prove that most of the costs in cost pools classified as fixed with respect to

6     presort level actually vary with the presort level.  A discussion of this evidence follows.

7                   1. <u>A Thought Experiment Demonstrates that Almost all Costs are</u>
8                          <u>Proportional</u>.
9
10        I start at the highest level of abstraction with a simple thought experiment.  At the

11     most general level, presort may be viewed along a continuum – from less presorted to

12     more – rather than as a binary event – presorted or not.  In this construct, Single-Piece

13     First Class letter mail is the least presorted while Automation mail is the most presorted.

14     If "fixed' costs are truly fixed with respect to presort level, then fixed unit costs of

15     processing Single-Piece and Automation letter mail should be roughly similar on both a

16     cost pool-by-cost pool basis and on an aggregate basis.  And if "fixed" costs are truly

17     "fixed," then the ratio of "fixed" to "proportional" costs should be very different in Single-

18     Piece mail than in Automation mail because, by definition, the proportional costs for

19     Single-Piece mail are expected to be substantially higher than for Automation mail.

20        Table 4, below, summarizes the results of comparing the fixed pools in Single-

21     Piece with those in Automation mail (and full results are in PB- LR- L-1, Tab 1).  The

22     table classifies "fixed" cost pools by their ratio of Single-Piece Metered First-Class Letter

23     Mail unit cost to First-Class Mail Automation Letters unit cost using the PRC method for

24     mail processing variability.  *See* USPS-LR-L-141.  As the table shows, 38 cost pools

25     with matching non-zero mail processing costs are classified as either "worksharing

1    related fixed" or "nonworksharing related fixed."  In 36 of these fixed pools, the unit cost

2    for Single-Piece First-Class Metered Letter Mail exceeds the unit cost for First-Class

3    Mail Automation Letters.  In 30 of these pools, the unit cost for Single-Piece First-Class

4    Letter Mail letters is greater than twice the unit cost for Automation Letters.  Finally, in

5    ten of these pools, the unit cost of Single-Piece First-Class Metered Letter Mail is more

6    than five times greater.  In total, the Single-Piece First-Class Metered Letter Mail unit

7    cost in the fixed cost pools is 4.525 cents, more than three times the First-Class Mail

8    Automation Letters unit cost in these pools, which is 1.479 cents.  Thus, the "fixed"

9    costs do not appear to be fixed.

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

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

13
14        Table 5, below, summarizes the results comparing the proportional pools for

15   Single-Piece metered and Automation letters, full details are in PB-LR-L-1.  As

16   expected, the unit cost of Single-Piece metered is much higher than the unit cost of the

17   Automation, by a factor of about 3.1.

18

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

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

4
5       Also note that the ratio of Single-Piece unit costs to Automation unit costs is

6  about the same in both the fixed and the proportional pools.  Finally, drawing from

7  Tables 4 and 5, the ratio of proportional to fixed costs is 1.89 for Single-Piece Metered

8  Letters and 1.85 for Automation Letters, i.e. the ratio is nearly identical.  This is very

9  strong evidence that the "fixed" pools are actually not fixed but rather vary across

10  presort levels.

11       Finally, although there may be slight differences between Single-Piece Metered

12  and Automation letters with respect to cost causing characteristics like weight[8] and local

13  / non-local mix, the most obvious difference is that Single-Piece Metered letters are less

14  workshared than Automation letters.  No other characteristic can explain such large and

15  striking unit cost differences in pools that the USPS classifies as fixed.  This suggests

16  that, after properly controlling for piece weight, local / non-local mix, and other

17  identifiable and measurable cost causing characteristics not related to the degree of

---

[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.

1    worksharing, a statistical analysis would still show significant mail processing cost

2    differences between Single-Piece and Automation letters.  These mail processing cost

3    differences must then result from the degree of worksharing.

4            2. <u>USPS Attribution and Distribution Costing Methods Imply Almost All</u>
5               <u>Cost Pools Are Proportional.</u>
6
7            Postal Service attribution and distribution theory also shows that most of the

8    costs in the 49 cost pools classified as "fixed" by the Postal Service under the PRC

9    method actually vary across presort level.  Postal Service witness Bozzo (USPS-T-12)

10   presents testimony on the Postal Service's methods for estimating the variability of mail

11   processing costs and Postal Service witness Van-Ty-Smith (USPS-T-11) presents

12   testimony on the methods for distributing these variable costs to mail classes and

13   subclasses.  Their methods and underlying logic indicate that most volume variable

14   costs vary with respect to piece-distribution costs.[9]

15           Witness Bozzo explains that total pieces fed ("TPF") and total pieces handled

16   ("TPH") are the correct volume measures of mail processing output.  *See* USPS-T-12 at

17   23-25 (Bozzo).  Thus, the "Postal Service analysis continues to employ MODS TPF and

18   TPH data to represent 'outputs' or 'cost drivers' for sorting operations" rather than using

19   first handled pieces (FHP).  *See id.* at 13.  Witness Bozzo also confirms that he still

20   endorses the statement he made in R2005-1,

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

---

[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.

1
2 Tr. 10/2551 (PB/USPS-T12-3 (Bozzo)).
3
4    In his current testimony, witness Bozzo underscores the importance of

5 TPH noting it captures the "sort stage(s) avoided by the 5-digit piece . . . the

6 avoidance of certain sort stages, is the basis for presort cost avoidances."

7 USPS-T-12 at 25 (Bozzo).  Thus, it follows that piece handling costs vary with

8 presort level and this result is consistent with the Postal Service's cost avoidance

9 model for Automation letter-shaped mail.

10    Under Postal Service attribution theory, non-piece handling costs also vary with

11 TPF, which, according to witness Bozzo, also varies with presort level.  Witness Bozzo's

12 testimony in pertinent part from R2005-1 states that,

13       Insofar as each piece fed must be brought to and dispatched from the
14       operation, related container handlings (including handlings to send mail
15       back through the operation for subsequent sorting passes) will also be
16       proportional to TPF, as will "overhead" not-handling time that is driven by
17       the handling workhours.  Handling-mail time and associated overheads
18       account for the vast bulk of workhours in sorting operations, so there is
19       little in the way of causal avenues for workload measures other than TPF
20       to enter the relationship between hours and mail processing "outputs."
21
22 Docket No. R-2005-1, USPS-T-12 at 14 (Bozzo); *see also* Tr. 10/2549-50 (PB/USPS-

23 T12-2 (Bozzo))(confirming that witness Bozzo continues to hold this opinion).

24    The Postal Service has, therefore, acknowledged in its attribution theory that

25 costs of container handlings and overheads vary across presort levels yet it inexplicably

26 classifies all these costs as "fixed" with respect to presort level in its cost avoidance

27 modeling.  The Postal Service cannot have it both ways: these costs either vary across

28 presort levels or they do not.  They do.

1    Finally, with respect to the volume variability of allied labor and general support

2    operations, witness Bozzo states:

3        For allied labor and general support operations, it is possible to view cost
4        causation as following a "piggyback" model, in which the costs in support
5        operations are viewed as driven by – and thus volume-variable to the
6        same degree as – the "direct" operations.
7
8    USPS-T-12 at 84 (Bozzo).
9
10    Following the logic of the USPS attribution theory, the costs in all of these

11    cost pools vary across presort levels and should be classified as proportional,

12    because as Bozzo discusses, these costs vary with TPH and TPH varies across

13    presort levels.

14    Witness    Van-Ty-Smith's    distribution    method    for    support    and

15    miscellaneous cost pools also follows the "piggyback" approach discussed by

16    witness Bozzo.  Specifically, witness Van Ty-Smith states:

17        As was proposed by the Postal Service in Docket No. R2005-1, the two
18        support cost pools at the plants are consolidated into one "piggyback" cost
19        pool (see discussion in USPS-T-12, section III E, Docket No. R2005-1).
20        The two plant support cost pools are quasi-administrative pools
21        characterized by a high percentage of not-handling-mail activities.  The
22        volume-variable costs for the "piggyback" cost pool are distributed to
23        subclasses in proportion to the volume-variable costs for subclasses in the
24        cost pools they support . . . .
25
26    Docket No. R2005-1, USPS-T11 at 18.
27
28    Cost distributions for miscellaneous cost pools that are not in the plants

29    are also based on the distribution of handling tallies.

30        For the miscellaneous cost pool at post-offices, stations, and branches,
31        the handling tallies are used and the distribution key for the not-handling
32        tallies is based on all mail processing handling tallies at post-offices,
33        stations, and branches.
34
35    Docket No. R2005-1, USPS-T-11 at 19.
36

1    Witness Van-Ty-Smith also confirmed that there is no change in these

2   distribution keys in this case.  *See* Tr. 10/2460 (PB/USPS-T11-1 (Van-Ty-

3   Smith)).

4    In summary, Postal Service attribution and distribution methods show that

5   container handling, allied labor, not handling, and general support costs vary with piece

6   handling costs.  And because piece handling costs vary with presort level, so too must

7   the container handling, allied labor, not handling, and general support costs.  Thus,

8   according to both the attribution and distribution theory of the Postal Service, *all* of the

9   cost pools that are classified as "fixed" actually vary with respect to presort level.

10    3. Classification of Anomalous Cost Pools.

11    Also among the mail processing costs that the Postal Service classifies as "fixed"

12   are those in cost pools in which costs for First-Class Mail letters are unexpected.  Mail

13   processing costs in these pools may be unexpected because of mail shape, the type of

14   facility, or the class of mail to which the pool relates.  For example, while it would seem

15   anomalous that First-Class Mail letter mail processing costs would appear in manual

16   parcel sorting operations, in BMCs, or in Express Mail pools, IOCS actually records

17   such tallies and the Postal Service uses these tallies to distribute mail processing costs

18   to mail subclasses and special services.

19    The phenomenon of unexpected costs in cost pools was an issue in Docket No.

20   R2000-1.  In that docket, Postal Service witness Eggleston offered the following

21   explanation of these costs,

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

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

3       From an operational perspective, these tallies generally result from one of two

4  different circumstances: (1) when a clerk or mailhandler is handling letter -shaped mail in

5  a non-letter operation; or (2) when a clerk or mailhandler is working in an operation that

6  is different from the operation into which he or she is clocked.  *See* Tr. 11/2925

7  (PB/USPS-T42-7 (McCrery)).

8       For example, a First-Class Mail letter tally in a manual flat sorting operation

9  generally would result from one of two events.  The tallied clerk was working in a letter

10  sorting operation (e.g., manual sorting), but had not clocked out of the flat sorting

11  operation and into the letter sorting operation.  Alternatively, the tallied clerk was, in fact,

12  sorting that letter in the manual flat sorting operation.  In either case, these costs are for

13  sorting the letter and, like all other piece handling costs, vary with the amount of

14  worksharing performed.

15       This argument – just like the attribution and distribution argument – holds for

16  more activities than piece-distribution operations.  The costs for many activities – e.g.,

17  allied, general support, container-handling activities – vary with the amount of

18  worksharing performed.  So, if a mailhandler is clocked into the manual flat sorting

19  operation, but is, in fact, bringing letters to a piece-distribution operation that cost should

20  be classified as proportional, not fixed.  Sound costing methodology should recognize

21  that all of these cost pools are proportional costs and they should be so classified.

22       There are 16 anomalous cost pools.  Table 6 displays them in three groups:

23  unexpected facility, unexpected shape, and unexpected class.  Table 6 also displays

24  the associated mail processing unit cost for each group using the PRC method.  While

1 unit costs in these pools tend to be small, there are many pools and in aggregate they

2 comprise 0.079 cents of unit mail processing costs for presort letters. All are improperly

3 classified as "fixed." They should be re-classified as "proportional."

**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 | | |

7     4. <u>Operational Analysis</u>.

8     An operational analysis of many of the non-modeled activities also shows that

9 their mail processing costs are not fixed with respect to worksharing, but rather that the

10 activities vary with presortation and worksharing levels. An overview of current and test

11 year mail processing operations, and the generalized description of mail flows for First-

12 Class Mail letters confirmed by Postal Service witness McCrery demonstrate this at a

13 high level. *See* Tr. 11/2922 (PB/USPS-T42-5 (McCrery)).

14     Witness McCrery also testified as to how the preparation of certain workshared

15 First-Class Mail letters cause them to avoid costly operations of the Postal Service. *See*

16 PB/USPS-T42-4; Docket No. R2005-1, Tr. 5/1777. This underscores the fact that many

17 mail processing costs currently classified as fixed do vary directly or indirectly with the

18 presort level of the letter tray. Therefore, the Postal Service's classification of many of

19 these cost pools as "fixed" is wrong. They should be reclassified as proportional.

1  For example, mailers and presort bureaus prepare pallet separations based upon

2  the presort level of the letter tray, *see* Tr. 11/2918 (PB/USPS-T42-1 (McCrery)).  These

3  separations allow the Postal Service to bypass time-consuming operational activities,

4  thereby reducing postal service costs.  *See* Tr. 11/2921 (PB/USPS-T42-4 (McCrery)).

5  Pallet separations are related to the size of the mailing, *see* R2005-1, Tr. 5/1776-77,

6  and the size of the mailing is generally related to the presort level of the letter trays: the

7  larger the mailing, the greater the depth of presort.  Therefore, the presort level of letter

8  trays is strongly correlated with the ability to perform beneficial pallet separations.

9  Application of PostalOne! technologies provides another example of how the mail

10  processing costs of non-modeled activities are not fixed with respect to worksharing, but

11  rather that the costs of these activities vary with presortation and worksharing levels.

12  The PostalOne! Transportation Management System is integrated into participating

13  customers' facilities and books air and surface transportation assignments for First-

14  Class Mail letter trays.  The Postal Service concedes that when mailers use PostalOne!

15  the Postal Service avoids transportation and mail processing costs.  *See e.g.*, Tr.

16  18D/6520 (PB/USPS-T22-11 (redirected to USPS)); Tr. 18D/6518-19 (PB/USPS-1-2

17  (USPS)).  Yet in its classification of cost pools the Postal Service fails to recognize the

18  relationships among PostalOne!, pallet separations, and the presort level of letter trays.

19  The record evidence in this case establishes that many of the costs avoided by

20  the Postal Service from pallet separations and PostalOne! correlate with the presort

21  level of the letter tray.  *See* Tr. 11/2918 (PB/USPS-T42-1 (McCrery)); *see also* Docket

22  No. R2005-1, Tr. 5/1774-76 and 1780-84.  Witness McCrery confirmed that mixed

23  AADC letter trays on pallet separations go through more mail processing, platform,

1     container handling, bullpen and opening unit, tray sorting, piece distribution, allied labor,

2     and dispatch activities at origin than 5-digit letter trays on pallet separations. *See*

3     Docket No. R2005-1, Tr. 5/1780-84. Thus, Postal Service mail processing costs at

4     origin vary with respect to pallet separations and the presort level of letter trays.

5          Detailed operational analysis of specific operations also demonstrates that

6     important cost pools currently classified as "fixed" actually vary with presort level and

7     the amount of worksharing. Correcting these misclassifications of cost pools allows

8     more accurate estimates of cost avoidance.

9          *Letter Tray Sorting Operations - Mechanical Tray Sorters / Robotics:* The unit

10    costs for letter tray sorting operations that use mechanical tray sorters and robotics

11    (cost pools MODS 13 1SACKS, and MODS 13 TRYSORT) total 0.173 cents for First-

12    Class Mail Automation letters.[10] *See* USPS-LR-L-110 at 2 (revised 5/3/2006). These

13    operations perform a similar function as the opening units in separating letter trays.

14    Originating letters in mixed AADC trays could incur mechanical tray sorting and robotics

15    costs at an origin plant and at the destinating AADC. Originating letters in 5-digit trays

16    could incur mechanical tray sorting and robotics costs only at the origin plant as the

17    Postal Service bypasses the destinating AADC by transporting the mail directly to the

18    P&DF responsible for destinating processing. Further, letters in 5-digit trays on pallet

19    separations could bypass the tray sorting costs at the origin plant. *See* Tr. 11/2922

20    (PB/USPS-T42-5 (McCrery)).

21         *Dispatch Operations*: Dispatch operations include, among other activities, the

22    separation, staging, and movement of processed mail for subsequent distribution or

---

[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).

1     outbound transportation and the preparation of strap and sleeve trays. *See* R2005-1,

2     Tr. 4/1085-86. Dispatch operations (MODS 17 DISPATCH) unit costs total 0.087 cents

3     for First-Class Mail Automation letters. *See* USPS-LR-L-110 at 2 (revised 5/3/2006).

4     Dispatch costs relate to the number of times mail is processed and the number of times

5     processed mail is prepared for outbound transportation. Originating letters in mixed

6     AADC trays can be processed in four sort schemes and require two or three strapping

7     and/or sleeving activities. Originating letters in 5-digit trays can be processed in only

8     one sort scheme and require at most one sleeving activity. *See* Tr. 11/2922 (PB/USPS-

9     T42-5 (McCrery)). Hence, mixed AADC letters incur greater dispatch costs than 5-digit

10     letters.

11     *Opening Unit Manual Transport Operations*: Opening unit manual transport

12     operations (MOD 17 1OPTRANS) include, among other activities, the transportation of

13     containers of mail between work areas. *See* Tr. 11/2923-24 (PB/USPS-T42-6

14     (McCrery)). Their unit costs total 0.032 cents for First-Class Mail Automation letters.

15     *See* USPS-LR-L-110 at 2 (revised 5/3/2006). These costs directly relate to the number

16     of work areas in whichmail is processed or handled. The Postal Service processes a nd

17     handles originating letters in mixed AADC trays in more opening unit/bullpen operations,

18     piece distribution operations, and dispatch operations than originating letters in 5-digit

19     trays. *See* Tr. 11/2922 (PB/USPS-T42-5 (McCrery)). Hence, mixed AADC letters incur

20     greater opening unit manual transport costs than 5-digit letters.

21     *Scanning Mail Operations*: Scanning mail operations (MODS 17 1SCAN)

22     include, among other activities, the loading, scanning, labeling, unloading, sleeving, and

23     strapping of letter trays. *See* Tr. 4/610 (PB/USPS-T22-5 (Abdirahman)); Dkt. No.

1    R2005-1, Tr. 5/1678 (PB/USPS-T29-10 (McCrery))   Their unit costs total 0.034 cents

2    for First-Class Mail Automation letters.  *See* USPS-LR-L-110 at 2 (revised 5/3/2006).

3    Originating letters in mixed AADC trays incur the costs for scanning mail operations at

4    an origin plant and sometimes at a destinating AADC that dispatches the letters, after

5    managed mail program distribution, to another facility for incoming primary and

6    secondary distribution.  Originating letters in 5-digit trays scanned and labeled using

7    PostalOne! generally do not incur any costs for scanning and labeling mail operations at

8    an origin plant or at the destinating facility.  Even if the Postal Service loads, scans, and

9    unloads the 5-digit letter tray at an origin plant, it avoids some incremental costs such

10   as labeling, manual sleeving, and manual strapping costs.  Further, destinating letters in

11   5-digit trays do not incur any scanning costs at all.  It is not likely that all letters in mixed

12   AADC trays destinate within the service area of the entry Postal Service facility, so the

13   average scanning cost for letters in mixed AADC trays will always be non-zero.

14       *Platform Operations*:  Platform operations (MODS 17 1PLATFRM) include the

15   work of expeditors and, among other activities, loading and unloading trucks, cross

16   docking containers of mail, and sorting mail during the vehicle unloading process.  *See*

17   Tr. 4/610 (PB/USPS-T22-5 (Abdirahman)).  Their unit costs total 0.433 cents for First-

18   Class Mail Automation letters.  *See* USPS-LR-L-110 at 2 (revised 5/3/2006).  Platform

19   costs vary not only between workshared and non-workshared letters, but within

20   presorted letters.  For example, originating letters in mixed AADC trays could incur

21   inbound and outbound platform costs at a destinating AADC prior to dispatch to a

22   downstream facility for incoming primary and secondary distribution.  Originating letters

23   in 5-digit trays could bypass the platform at the destinating AADC altogether.  *See* Tr.

1    11/2971 (PB/USPS-T22-12 (redirected to McCrery)).  Further, the cost of expediting the

2    distribution and dispatch of processed mail is affected by the number of times mail is

3    processed in piece distribution operations.  And the Postal Service processes

4    originating letters in mixed AADC trays in more piece distribution operations than

5    originating letters in 5-digit trays.  *See* Tr. 11/2922 (PB/USPS-T42-5 (McCrery)).

6    Finally, originating letters in 5-digit trays on pallet separations would bypass the inbound

7    and outbound platform costs at the origin plant.  *See* Tr. 11/2918 (PB/USPS-T42-1

8    (McCrery)).  Thus, more platform costs are incurred for mixed AADC letters than for 5-

9    digit letters.

10         *Allied Labor Operations*:  Allied labor operations (NON MODS ALLIED) have "two

11    principal functions – to prepare mail for distribution operations in the plant, and to

12    process other mail that may not require handling in piece sorting operations."[11]  *See*

13    USPS-LR-L-1 at 3-7.  Their unit costs in non-MODS facilities total 0.138 cents for First-

14    Class Mail Automation letters.  *See* USPS-LR-L-110, at 2 (revised 5/3/2006).  Although

15    allied labor overlaps some of the other non-modeled activities, it can be thought of as a

16    catch-all category that encompasses all mail processing activities "allied" to direct piece

17    sortation activities.  Intuitively, some allied labor activities, like moving mail to/from

18    sorting operations, have a direct relationship to distribution operations: the greater the

19    number of distribution operations, the greater the number of allied labor operations.  I

20    have discussed specific allied labor costs, like opening units and dispatch, above.

21    Thus, the costs of allied labor activities vary to some degree with presort level.

---

[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.

1     *Miscellaneous and General Support Operations*:  Miscellaneous mail processing

2     and support operations include the "numerous additional activities" that clerks and

3     mailhandlers perform in addition to sorting and allied operations.  *See* USPS-LR-L-1, at

4     3-9.  Their unit costs total 0.267 cents for First-Class MailAutomation  letters.  *See*

5     USPS-LR-L-110, Appendix 2 (revised 5/3/2006).  These operations are simply "general

6     mail processing support operations."  *See* USPS-LR-L-1 at 3-9.  The Postal Service

7     concedes that miscellaneous mail processing costs are "obviously worksharing related."

8     *See* R2005-1, Response to P.O.'s Information Request No. 4, Question 11(a).  Further,

9     it is intuitive that some miscellaneous and support operations are proportional to

10    distribution operations: the greater the number of distribution operations, the greater the

11    number of support operations.  However, from the operational definitions in USPS-LR-1

12    and from the detailed descriptions of the activities in certain cost pools provided in

13    response to interrogatories, *see* Tr. 11/2929 (PB/USPS-T42-12 (McCrery)), it appears

14    that costs in LD48OTH, LD48 ADMIN, LD48 48_SSV and LD49 are truly fixed, while the

15    costs in 1MISC, 1SUPPORT, 1EEQMT, 1SUPP F1, and NONMODS MISC appear

16    proportional.

17          The unit costs in the allied labor, general support, and tray sorting pools are

18    aggregated in Table 7 below.  The aggregated data show that these 14 pools account

19    for 1.2 cents in unit costs for First-Class Mail Automation letters and comprise 68

20    percent of the total of all costs that the Postal Service classifies as "fixed."[12]  These cost

21    pools should be reclassified as proportional.

22

---

[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.

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

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

3
4     It also bears noting that the Postal Service's treatment of these costs has been

5  discussed in prior cases. In Docket No. MC95-1, Postal Service witness Smith

6  acknowledged that some of the same non-modeled activities (e.g., moving mail

7  between operations, platform handlings, and unbanding and unsleeving trays) depend

8  primarily on or are partly influenced by presort level of the mail. *See* PRC Op. MC95-1,

9  para. 4279. In view of the deficiencies in the classifications and modeling, witness

10  Smith stated,

11     it would be better to be able to model the non-modeled activities in
12     order to accurately relate these costs to categories. Such an effort
13     would be a considerable undertaking and represents a goal to which the
14     Postal Service will strive.
15
16   PRC Op. MC95-1, para 4277 citing USPS-T-10, at 5.

17  **V.     IMPROVED COST ESTIMATES ALLOW 100 PERCENT PASSTHROUGHS**
18  **       FOR AUTOMATION LETTERS CONSISTENT WITH ECP**
19
20     Based on the above analysis, I improved the Postal Service's cost avoidance

21  estimates for Automation letters by reclassifyingmo st "fixed" pools as proportional.

22  Although the thought experiment described above and the Postal Service's attribution

23  and distribution theory for mail processing both strongly suggest that *all*cost pools are

24  proportional, for purposes of this testimony I have adopted a more conservative

1  approach.  I did not classify all cost pools as proportional but rather classified a cost

2  pool as proportional only if (1) the Service classified the pool as proportional, (2) the

3  pool is anomalous, or (3) operational and mail flow analysis shows the pool to be

4  proportional.  I classified a pool as "fixed" if (1) operational analysis did not absolutely

5  show it to be fixed, or (2) available data were not sufficient to complete an operational

6  analysis.

7        Table 8, below, shows the results of the reclassification; the underlying detail

8  appears in  PB-LR-L-1 at Tab 5.

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

| 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 | | | | |

11
12
13  As the table shows, under my reclassification, 52 pools are proportional, comprising

14  82.5 percent of the pools and 90.4 percent of the unit cost using the PRC method.

15        I assumed that the costs of the newly classified proportional pools vary among

16  presort levels in exactly the same way as do the modeled pools.  The assumption is

17  consistent with the attribution and distribution theory of the Postal Service.  The

18  assumption that non-handling costs are distributed the same as handling costs is

19  analogous to the assumption that the distribution of costs by class and subclass for

20  supervisors follows the distribution of the costs of the crafts being supervised and, thus,

21  is clearly superior to the assumption that the costs of these pools do not vary at all

22  across presort levels.

1    I next calculated costs, cost avoidances, and passthroughs for Automation Letter

2    Mail using the PRC method for volume variability and delivery unit costs and cost

3    avoidances from USPS-LR-L-147.  Although I believe that delivery unit cost avoidances

4    should be included, I calculated passthroughs both with and without them to test the

5    sensitivity of passthroughs to delivery unit cost avoidances.  Table 9, below, shows

6    passthroughs at USPS-proposed rates when cost avoidances are measured in this

7    more accurate manner.

**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 | | | | | |

11    As the table shows, in contrast to the estimates of the Postal Service, all passthroughs

12    are well below 100 percent even when delivery unit cost avoidances are excluded.

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

15    Given that all passthroughs underlying the Postal Service's proposed rates are

16    well below 100 percent with the corrected cost model, that the passthroughs vary widely

17    across the rate categories, and the importance of ECPR, I next explored a set of rates

18    that would fully comport with ECPR.  In doing so, however, I quickly realized that it

19    would not be possible to design fully ECPR compliant rates without either causing

1    revenue leakage as compared to the rates proposed by the Postal Service or increasing

2    some of the proposed rates.

3        Thus, my proposed rate design balances the virtues of ECPR with the evils of

4    revenue leakage and rate increases.  To prevent undue revenue loss, my proposed

5    rates leave the 3-digit rate unchanged from that proposed by the Postal Service.  My

6    design passes through a uniform 100 percent of the cost avoidances and is thus fully

7    ECPR-compliant.  This results in $39 million revenue leakage (about one-quarter of one

8    percent of the revenue from these rate categories) which, I believe, is of both a small

9    and manageable magnitude and is fully justified by the improved pricing signals that my

10   rate design will provide to the mailer community.  Table 10, below, shows my proposed

11   rates and compares them to those proposed by the Postal Service.

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

| 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 | | | |

13

14       This rate design, and its underlying factual basis, are superior to those presented

15   by the Postal Service.  As demonstrated above, the Postal Service's rate design is

16   predicated in part upon a number of assumptions that are invalid.  Using the correct

17   assumptions, I have shown that the Postal Service's calculated cost avoidances across

18   the Automation letter rate categories are inappropriately small, and that the true cost

19   avoidances are substantially larger.

1    Understanding the true magnitude of the avoided costs has then enabled me to

2    compute rate discounts that are truly compliant with ECPR.  Setting these discounts at

3    the appropriate levels is essential to inducing the optimal amount and mix of

4    worksharing activity provided by mailers and third-party service providers.  Also,

5    attaining and maintaining this optimal amount and mix of worksharing does and will

6    continue to fulfill a crucial need in enabling the Postal Service to provide the highest

7    possible availability and quality of service at the lowest cost.  By improving the Postal

8    Service's proposed rate design by appropriately and uniformly passing through 100

9    percent of avoided costs, clear and correct price signals enhance overall economic

10   efficiency.

11       With respect to the application of the ratemaking criteria (39 U.S.C. § 3622) and

12   classification criteria (39 U.S.C. § 3623) in the Act, I have reviewed the testimony of

13   witness O'Hara (USPS-T-31) with respect to the application of the former and witness

14   Taufique (USPS-T-32) with respect to the application of the latter.  With respect to the

15   classification criteria, I propose no changes in the classifications presented by witness

16   Taufique.  With respect to the ratemaking criteria, the cost coverages resulting from my

17   proposed rate design differ insignificantly from those discussed by witness O'Hara.

18   Therefore, my proposed rate design conforms to the classification and ratemaking

19   requirements of the Act to the same extent as the rate design proposed by the Postal

20   Service.

21       Finally, recognizing that rate increases pose inherently undesirable impacts on

22   mail customers, I have applied a basis for distributing the rate changes across the

23   Automation Letter rate categories so as to create minimal disruption and adverse impact

1   to the mailing community, while at the same time creating only very modest loss of

2   revenue to the Postal Service.

3         The rate design that I propose here offers a complete and accurate synthesis of

4   all important and appropriate statutory factors, and a reasonable, practical, and

5   equitable balance among them.

6   **VII.   CONCLUSION**

7         For the reasons stated above, the Commission should adhere to ECP in

8   establishing appropriate workshare discounts for First-Class Mail Automation letters.

9   Because the Postal Service's cost models systematically understate the true workshare-

10   related costs avoidances, the Commission should recommend the First-Class Mail

11   Automation letter rates proposed in this testimony.