

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

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

REPLY BRIEF OF PITNEY BOWES INC.

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I. INTRODUCTION

Pitney Bowes Inc. (“Pitney Bowes”) hereby replies to the arguments, assertions, and comments of several participants in this docket. In its direct case and brief, Pitney Bowes stated its position. Pitney Bowes urges the Postal Regulatory Commission (the “Commission”) to: (1) adopt an improved methodology for estimating cost avoidances for First-Class Mail Automation Letters and recommend a rate schedule that better reflects those cost avoidances than that requested by the Postal Service, (2) recommend an expanded retail access discount for efficient postage evidencing of Single-Piece First-Class Mail, and (3) extend the principles supporting Efficient Component Pricing (“ECP”) to establish intra-subclass rate differences that reflect both workshare-related and non-workshare-related cost differences. No participant, including the Postal Service, has effectively countered Pitney Bowes’ position.

Pitney Bowes has demonstrated, on this record, that the Postal Service’s cost methodology substantially underestimates workshare-related cost avoidances by improperly excluding workshare-related cost avoidances associated with (1) non-modeled cost pools and (2) in-office delivery costs. Pitney Bowes witness Buc explains how to correct these underestimates. The Postal Service’s opposition to this proposal, set forth in its rebuttal testimony and brief, fails to effectively defend its own proposal or to present a persuasive critique of Pitney Bowes’ proposed changes. No other participant opposes the changes proposed by Pitney Bowes and two specifically endorse them. *See* MMA Brief at 33 (“the Commission should adopt MMA’s and Pitney Bowes’ position regarding the classification of cost pools.”); NAPM Brief at 28 (“By contrast, the presort cost avoidance estimates of Pitney Bowes witness Buc and MMA witness Bentley are well supported.”).

Pitney Bowes also presents a proposal to deaverage the costs of postage evidencing for Single-Piece First-Class Mail and to provide an incentive in the form of an expanded retail access discount for all mail users who purchase postage through efficient sales channels. This will reduce the costs of the Postal Service, which opposes this proposal on the grounds that it is premature and would be difficult to implement. But the Postal Service itself has proposed a similar discount for customers who purchase postage on-line for international retail products and there is no reason to limit such postage evidencing discounts to the international market only. The Commission should recommend, and the Postal Service Governors should adopt, a similar discount for Single-Piece First-Class Mail letters.

Finally, the Commission invited discussion of and, in testimony and on brief, several participants commented upon the application of ECP in setting postal rates. *See* Second Notice of Inquiry (July 21, 2006) at 7; Third Notice of Inquiry (July 26, 2006) at 6-7; *see e.g.*, ABA Brief at 16-18; GCA Brief at 14-18; NAPM Brief at 4-28; Postal Service Brief at 169-178. In reply, Pitney Bowes again urges the Commission to apply the principles underlying ECP such that, to the extent practical, intra-subclass rate differences are based on both traditional workshare-related and non-workshare-related cost differences. This expanded recognition of cost differences below the subclass level will better align prices with costs, send better price “signals,” and promote economic efficiency in the postal sector. Of course, any theoretical approach must admit exceptions and must allow the Commission to recommend rates that reflect the full consideration of the rate-setting factors of the Postal Reorganization Act (the “Act”). *See* Pub. L. No. 91-375, 84 Stat. 719, 39 U.S.C. §§101 *et. seq.* In its brief, Pitney Bowes offered a set of organizing principles for such an expanded application of the principles underlying ECP.

No other party has offered a better approach for developing cost-based rates below the subclass level.

II. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE ARGUMENTS AND ADOPT THE IMPROVED METHODOLOGY FOR ESTIMATING COST AVOIDANCES FOR FIRST-CLASS AUTOMATION LETTERS AND THE RATES PROPOSED BY PITNEY BOWES.

In this docket Pitney Bowes offers an alternative rate design for First-Class Mail Automation Letters that is based on improved cost avoidance estimates, better adheres to ECP, and is consistent with the rate-setting criteria of the Act. It did so after demonstrating, on the record, that the Postal Service's cost methodology substantially underestimates workshare-related cost avoidances for First-Class Mail Automation Letters. Pitney Bowes showed the Postal Service methodology (1) erroneously excludes workshare-related costs avoided associated with improperly classified and non-modeled cost pools, and (2) improperly excludes workshare-related costs avoided associated with in-office delivery unit costs.

Although the Postal Service nominally opposes the alternative rate design Pitney Bowes proposed, it has provided no basis for its opposition – as evidenced by the fact that the Postal Service devotes barely a page and a half of its initial brief in defense of its approach and in response to Pitney Bowes' alternative proposal. *See* Postal Service Brief at 250-51. To the extent the Postal Service has attempted to defend its position its arguments are contradicted by record evidence and testimony of its own witnesses.

A. The Postal Service Has Failed to Meaningfully Respond to the Demonstration That Its Cost Methodology Substantially Underestimates Workshare-Related Cost Avoidance Estimates Because it Improperly Excludes Workshare-Related Cost Avoidances Associated with Non-Modeled Cost Pools.

Pitney Bowes and other participants have argued that the Postal Service's cost methodology substantially underestimates workshare-related costs avoided for First-Class Mail

Automation Letters because it improperly excludes cost avoidances associated with non-modeled cost pools. *See* Pitney Bowes Brief at 8-11; MMA Brief at 31-38; NAPM Brief at 26-28.

The response of the Postal Service is as follows:

the Postal Service classifies cost pools as either proportional or fixed, with the distinction being that the proportional costs are the ones that are modeled, and fixed costs are the ones *beyond the scope* of witness Abdirahman's USPS-T-22 model. The Postal Service classifies cost pools as proportional because the activities, and the costs thereof, captured within those cost pools are understood to vary in known ways with the presort level, i.e., the more finely presorted a piece is, the less the cost of processing a piece in a given cost pool.

Postal Service Brief at 250 (citation omitted) (emphasis added). As detailed below, this response adds nothing to the record; it is tautological and is contradicted by record evidence including the Postal Service's own testimony.

The Postal Service provides no evidence that the costs in the non-modeled pools it classified as "fixed" are, in fact, fixed with respect to presort level. *See* Tr. 18D/6587 (PB/USPS-T42-10 (redirected to USPS)); *see also* Tr. 4/619. Moreover, the Postal Service's cost witness, witness Abdirahman, conceded that he knows of no econometric, operational, or other study supporting his assignment and exclusion of non-modeled "fixed" cost pools. *See* Tr. 4/661; Tr. 4/609 (PB/USPS-T-22-4 (Abdirahman)). Witness Abdirahman further conceded that his decision to classify and exclude non-modeled "fixed" cost pools from his cost estimates amounted to little more than whether he took the time to model the costs involved: "the things I have modeled, is in the proportional cost pool. Anything that's in the fixed cost pool is what I have not modeled." Tr. 4/619. Presumably, this is what the Postal Service describes as "beyond the scope" of his model. Postal Service Brief at 250. Witness Abdirahman also conceded that "it's possible that some costs would in those costs pools vary for mail of different presort levels, but I have not studied them." Tr. 4/670; *see also* Tr. 4/618-19; Tr. 35/12048. Thus, the Postal

Service essentially admits in testimony and concedes on brief that it simply assumed that all costs which it did not take the time to model were “fixed.”

Furthermore, the Postal Service’s assertion that the costs in the non-modeled pools are not “understood to vary in known ways with the presort level” is meaningless. Postal Service Brief at 251. The Postal Service does not understand anything about the costs in these non-modeled cost pools because it did not take the time to model them, although its own costing witness acknowledges that many of these non-modeled cost pools could contain costs that vary with respect to presort level. Ideally, the Postal Service would have modeled every cost pool to determine the relationship of the costs among presort levels. Because the Postal Service failed to model all the cost pools, Pitney Bowes witness Buc undertook a comprehensive analysis.

In its rebuttal testimony and in its brief, the Postal Service criticizes Buc’s testimony by mischaracterizing his analysis and asserting, without factual support, that his approach is “arbitrary” or “flawed.” Postal Service Brief at 251. For example, the Postal Service’s discussion of Buc’s analysis begins with the statement that Buc’s “arbitrary classifications of the majority of the cost pools as modeled/proportional lack any supporting basis.” Postal Service Brief at 251. This statement is demonstrably false. Buc provides nearly 15 pages of analysis of the non-modeled cost pools in his direct testimony, *see* PB-T-2 at 14-29, and also borrows in part from the discussion in Pitney Bowes witness Panzar’s testimony on the importance of non-modeled cost pools, *see* PB-T-1 at 40-44.

Buc provided a comprehensive examination of the Postal Service’s cost pool classifications, on the record, using four separate analyses: (1) a thought experiment using Postal Service data, *see* PB-T-2 at 14-17, (2) an examination of the Postal Service’s attribution and distribution costing methods, *see id.* at 17-20, (3) a review of the classification of “anomalous”

cost pools, *see id.* at 20-22, and (4) an operational analysis, *see id.* at 22-29. Each of the four analyses demonstrates the flaw in the Postal Service’s cost methodology. Employing the results of his analyses, Buc developed different and more accurate cost avoidance estimates than did the Postal Service.

1. Witness Buc’s Thought Experiment.

Buc performed a “thought experiment,” an abstract exercise in which he compared the ratio of “fixed” to “proportional” costs between Single-Piece and Automation letter mail. *See* PB-T-2 at 14.¹ Buc demonstrated that for 38 non-modeled cost pools classified as “fixed” by the Postal Service, the unit costs were actually smaller for more finely presorted mail than they were for less finely presorted mail, a very strong indication that these costs are not really fixed. The same analysis demonstrated that for the proportional pools, the ratio of costs in the more presorted pools to the costs in the less presorted pools was approximately the same as the ratio in the non-modeled “fixed” pools. *See* PB-T-2 at 14-18. The Postal Service has offered nothing to disprove or even bring into question this analysis.

2. Witness Buc’s Examination of Attribution and Distribution Costing Methods.

Buc’s examination of the mail processing attribution and distribution costing methods of Postal Service witnesses Bozzo and Van-Ty-Smith demonstrate that the costs in the container handling, allied labor, not handling, and general support cost pools vary with presort level. Thus, these pools should be classified as “proportional.” Because the Postal Service did not bother to model these pools, or apparently investigate their costs in any other way, it classified the pools as

¹ The Postal Service either believes, or wants the Commission to believe, that Buc’s analysis of the deficiencies in its cost avoidance estimates relies exclusively on his thought experiment. *See* USPS-RT-7 at 10; Postal Service Brief at 251. As has been made clear repeatedly, the “thought experiment” was just one of four separate and independent analyses performed by Buc to demonstrate that the Postal Service’s cost methodology underestimates workshare-related costs avoided. *See, e.g.,* PB-T-2 at 14; Tr. 35/12042-47.

“fixed.” *See* PB-T-2 at 17-20. On brief, the Postal Service offers no specific response to the merits of Buc’s analysis, but instead mischaracterizes his testimony and suggests that Buc has “conceded” the analysis was “inappropriate.” Postal Service Brief at 251. Buc did not “concede” this. Rather, Buc’s oral testimony states, in pertinent part, that he “improved the portions that weren’t modeled that the Postal Service assumed didn’t vary at all with respect to presort level because we showed three reasons why they should vary with presort level.”² Tr. 20/7349.

3. Witness Buc’s Review of the Classification of “Anomalous” Cost Pools.

Another part of Buc’s analysis is his review of 16 anomalous cost pools, i.e., pools which unexpectedly contained costs for First-Class Mail Automation Letters. The Postal Service failed to model these cost pools and, therefore, classified them as “fixed.” Buc’s analysis demonstrates that both the piece handling pools and the cost pools that piggyback on these piece handling cost pools actually vary with presort level. *See* PB-T-2 at 20-22. The Postal Service does not even try to substantively rebut this analysis.

4. Witness Buc’s The Operational Analysis.

Buc’s detailed operational analysis further demonstrated that costs in 14 non-modeled cost pools classified as “fixed” by the Postal Service actually vary with presort level. *See* PB-T-2 at 24-29. These pools, too, should be classified as “proportional,” and again, the Postal

² In fact, using the modeled cost as a distribution key for the non-modeled pools that vary with presort level is fully appropriate. In mail processing cost pools, direct tallies are used to distribute piece handling costs to classes and subclasses. Not handling costs and general support costs are then also distributed on these direct tallies because the nature of these pools precludes tallies in them. In similar fashion, modeled costs are used to distribute the piece handling costs to the presort levels, playing exactly the same role for distributing mail processing cost to presort level as the tallies do for the classes and subclasses. Just as the Postal Service uses the mail processing direct costs to distribute overhead costs to the classes and subclasses in mail processing, witness Buc uses the mail processing direct costs for distributing overhead costs to the presort levels. Buc’s approach is thus fully consistent with Postal Service mail processing cost distribution methods.

Service, on brief, offers only characterization rather than substantive explanation as to why Buc's operational analysis was "arbitrary" or "flawed."

On the basis of these four analyses, Buc concluded that that many of the non-modeled cost pools classified as "fixed" by the Postal Service do in fact contain costs that vary with presort level and, therefore, should be classified as "proportional" and should be included in the Postal Service's cost avoidance estimates.

5. The Postal Service, Not Buc, "Misses the Point."

The Postal Service's summary argument that Buc "misses the point" in his attempt to analyze and reclassify the non-modeled costs pools because "only the modeled cost pools are the ones where the more finely presorted a piece is, the less the cost of processing in a given pool," is without merit. Postal Service Brief at 251. As demonstrated above, the Postal Service has no way of knowing whether only the modeled cost pools contain costs that vary with respect to presort level because, by definition, the Postal Service has not modeled the non-modeled pools. Buc's analysis proves that the Postal Service has no basis upon which to make its categorical statement.

In sum, the Postal Service's criticisms on brief of witness Buc's testimony are unfounded. The Postal Service can only assert that the costs in the cost pools it classified as "fixed," do not vary with respect to presort level. In contrast, Buc's four independently based analyses demonstrate that the costs in many non-modeled cost pools do vary with respect to presort level. The Postal Service failed to substantively engage or rebut any specific element of Buc's analyses. Furthermore, the Postal Service's own witness has conceded that costs in some of the non-modeled cost pools may in fact vary with respect to presort level. Accordingly, the Commission should reject the Postal Service arguments and adopt the improved methodology for

estimating cost avoidances for First-Class Mail Automation Letters and the rates proposed by Pitney Bowes.

B. The Postal Service Has Failed to Present a Reasoned Basis for Excluding Workshare-Related Costs Avoided Associated with In-Office Delivery Costs.

In the past, the Postal Service has accepted what its cost models have shown. The more finely presorted an automation letter, the less likely it will have to be manually sorted and, thus, less costs will be incurred for manual sortation. In this docket, however, the Postal Service changed its methodology. The Postal Service now ignores the results of its own models which show that automation Delivery Point Sequence (“DPS”) percentages vary by presort level (i.e., a higher percentage of more finely presorted 5-digit automation letters will be successfully DPS processed than less finely presorted mail such as AADC automation letters). It has also improperly excluded the cost differences between presort levels for the manual sort required in the absence of automation DPS processing. Pitney Bowes and other participants have shown that this change in the Postal Service’s cost methodology results in a substantial underestimation of workshare-related costs avoided for First-Class Mail Automation Letters. *See* Pitney Bowes Brief at 11-14; MMA Brief at 43-47.

The Postal Service acknowledges that in the past its automation DPS percentage calculations assumed that mail processed through a larger number of steps (i.e., less finely presorted mail) would have a lower DPS percentage than mail processed through fewer steps (i.e., more finely presorted mail) because of the cumulative probability of a piece being rejected on each successive letter operation. Postal Service Brief at 254. In this case, however, the Postal Service reverses course and states that it has “no data,” “no studies,” and no way of verifying via

field test whether DPS percentages vary with respect to presort level below the aggregate level of machinability.³ *See id.* at 255.

Notwithstanding this change of position, the Postal Service concedes, as it must, that the First-Class Mail mail flow models it presented in this case demonstrate that DPS percentages vary with respect to presort level. *See id.* at 255. The Postal Service further concedes that the DPS percentages are produced by the Postal Service's own letter cost models and admits that these same models are "adequate for estimating mail processing unit costs by rate category." Postal Service Brief at 254. And, in fact, the Postal Service relies on them for that.

Yet in this docket, unlike past dockets, the Postal Service does not use the results of its mail flow models for purposes of developing delivery cost differences and wrongly criticizes others that do. *See id.* at 256 (criticizing Pitney Bowes and other participants for relying on these same models to estimate *delivery* cost differences and describing delivery cost differences derived from the model as "specious"). Thus, the Postal Service maintains that its mail flow model produces accurate unit mail processing cost estimates for First-Class Mail rate category levels, *see* Postal Service Brief at 254, but that the same cost model produces inaccurate estimates of automation DPS processing percentages used to calculate delivery cost differences. *See id.* at 255. The problem with the Postal Service's position is that if the second proposition is correct, the first cannot also be. This is because the mail processing unit costs are critically dependent on the mail flows which generate the DPS percentages. Accordingly, the Postal

³ The Postal Service simply asserts without any discussion or analysis that "it was determined that machinability is the one characteristic of the mail-piece that has a quantifiable impact on delivery unit costs." USPS-RT-7 at 6. The Postal Service never discusses who made the determination or on what basis it was made. As discussed in the Initial Brief of the Major Mailers Association, as recently as R2005-1 the Postal Service's operational witnesses took the position that delivery costs, particularly in-office delivery costs and DPS percentages varied with respect to presort level. *See* MMA Brief at 43. Nor has the Postal Service made any showing to justify its reversal on this point.

Service's attempt to disown one of the two outputs, the DPS percentages, of the main mail flow model is internally inconsistent, without support and should be rejected.

The Postal Service's argument that the DPS percentages produced by its mail flow models are the product of the model's "data limitations" is also without basis. *See id.* at 255. The Postal Service faces the same data limitations in attempting to study the unit mail processing costs by presort level and yet relies on the very same model for that purpose. The Postal Service's position simply does not add up.

Not only does the Postal Service's position conflict with prior practice and common sense, the Postal Service has also failed to offer any record evidence to support the contention that DPS percentages do not vary with respect to presort level. In fact, the record evidence in the form of the Postal Service's own mail flow models confirm that DPS percentages do vary with respect to presort level. Incorrectly excluding the cost avoidances associated with the in-office delivery costs leads to substantial underestimation of workshare-related costs avoided. Accordingly, the Commission should reject the Postal Service's departure from past practice and adopt the approach recommended by Pitney Bowes and others.

III. THERE IS SUFFICIENT RECORD SUPPORT FOR PITNEY BOWES' EXPANDED RETAIL ACCESS DISCOUNT. THE COMMISSION SHOULD RECOMMEND IT.

Pitney Bowes proposes to begin deaveraging the costs of postage evidencing for Single-Piece First-Class Mail. To do this, it proposes an incentive in the form of a 0.1 cent expanded retail access discount for Single-Piece First-Class Mail postage purchased through certain efficient sales channels – PC Postage, postage meter, or permit mail – rather than purchased through the costly retail window channel. If implemented the proposal would extend the benefits of worksharing to Single-Piece First-Class Mail users. The current rate structure for Single-

Piece First-Class Mail fails to recognize any of the unit cost differences caused by retail sales channel or postage evidencing method used by the mailer. Yet the sales channel or postage evidencing method used by the mailer is a cost causative characteristic of Single-Piece First-Class Mail. An expanded retail access discount would send price signals to encourage mailer behavior that will reduce costs to the Postal Service. Initially, the proposed discount would pass through far less than the estimated costs avoided and apply only to those retail sales channels where costs are known to be substantially less than Postal Service retail transaction costs. Pitney Bowes expanded retail access discount proposal is limited to postage evidencing purchased via a PC postage device, permit mail, or postage meter in this case because the Postal Service has not provided the cost data necessary to expand the discount to other retail sales channels that reduce Postal Service costs. The modest size of the discount, set well below the transaction costs avoided for the Postal Service, is also a function of the lack of cost data provided by the Postal Service. To correct this deficiency, and eventually expand and correctly price this discount, Pitney Bowes urges the Commission to direct the Postal Service to collect cost data for all sales channels.

No participant presented testimony in opposition to the proposal. Only the Postal Service, on brief, expresses opposition. *See* Postal Service Brief at 225-229. Despite its opposition, the Postal Service does not dispute the underlying economic rationale that a discount would provide improved pricing signals or that deaveraging would reduce Postal Service costs. Nor does the Postal Service dispute the policy objective of extending workshare discounts to Single-Piece First-Class Mail customers. In fact, the Postal Service very recently appeared to embrace the underlying economic and policy rationales for such a discount when it proposed a

substantially similar discount for customers who purchase postage online for international retail products. *See* 71 Fed. Reg. 76231 (2006).

Rather, the Postal Service asserts that the expanded retail access discount proposed by witness Buc “lacks sufficient support to justify imposing this new discount and the record evidence suggests that the details of this proposal have not been adequately considered or examined.” Postal Service Brief at 226. It then raises a litany of issues, such as the costs of educating and training Postal Service employees on the new discounts. *Id.* at 227. But these issues are the very same issues that the Postal Service must have considered and resolved before announcing last month its own postage evidencing discount for international mail postage purchased online. Therefore, these implementation issues should not serve as a bar to providing domestic Single-Piece retail customers similar discounts to those afforded for the Postal Service’s international mail customers

The Postal Service’s repeated concern about “short paid” mail is also unwarranted.⁴ *Id.* at 226-27. First, it does not explain how or why a discount for postage evidencing methods that reduced Postal Service costs would present a greater potential for short paid mail. Second, any short paid mail issues for a domestic discount must be the same, or at least very similar, to those for international mail online postage discounts. Third, the 0.1 cent discount proposed is substantially below the estimated cost avoided which will more than compensate for “any revenue leakage” due to short paid mail.⁵

The Postal Service’s suggestion that the proposal is analogous to a “poll tax” and would not really benefit small mailers is inappropriate, offensive, and unfounded. Postal Service Brief

⁴ While the Postal Service does not define “short paid” mail, presumably it is mail for which the full required amount of postage has not been paid.

⁵ The Postal Service’s criticism that the proposed discount as too small is curious and self-contradictory. *Id.* at 228. Would a larger discount assuage these concerns?

at 229, n.36. The discount is proposed only for Single-Piece First-Class Mail, it is not targeted for large business mailers. While it is true that permit mailings require minimum volumes, mailings with postage evidencing via PC Postage or postage meter are not subject to such requirements. Nor does it follow that qualified pieces of a permit mailing should not receive a discount for the reduction in cost to the Postal Service. The facts are the facts. Selling stamps across a Postal Service retail sales window is very expensive. Providing the right incentives – as the Postal Service has proposed to do for international retail products – will encourage mailers to use alternative means of postage evidencing that will result in savings for the Postal Service. Further, when sufficient data is available, the discount could be significantly expanded to extend to other alternative sales channels such as private sector retail stores and postal kiosks, thus ensuring that it will benefit small mailers. But it is incumbent upon the Postal Service to collect and make available the cost data for selling postage via alternative retail sales channels.

Finally, the Postal Service’s value proposition analysis is also confused. Contrary to the Postal Service’s suggestion, the proposed discount is not intended to cover the cost of a permit, postage meter, or PC Postage device. Because many mailers already use permits, PC Postage devices and postage meters, it is safe to assume that these mailers have satisfied themselves with the value of those devices for reasons that are, obviously, independent of the proposed discount at issue here. Nor is that a consideration that should deter the Commission from recommending a discount to send pricing incentives to encourage mailers to engage in efficient behavior that reduces the Postal Service’s costs.

In sum, the only participant to oppose the proposed expanded retail access discount, the Postal Service, presents arguments that are unpersuasive and ignore the fact that the Postal Service itself has proposed a substantially similar discount for international retail products.

There is sufficient record support for Pitney Bowes' postage evidencing discount. The Commission should recommend it. Also, to ensure that in the future the discount may be extended to additional sales channels, the Commission should direct the Postal Service to collect and report appropriate cost data for all sales channels.

IV. AS RECOMMENDED BY PITNEY BOWES, THE COMMISSION SHOULD APPLY THE PRINCIPLES UNDERLYING EFFICIENT COMPONENT PRICING TO WORKSHARING AND OTHER COST CAUSING CHARACTERISTICS WITHIN A SUBCLASS. THIS WILL RESULT IN RATES THAT BETTER REFLECT COSTS.

In this docket, the Commission precipitated a discussion of how rate differentials within a subclass could better reflect both "traditional" workshare-related and non-workshare related cost causing characteristics of a mail piece. It invited participants to provide their views on whether the principles of ECP require that "the difference between any two rates within a subclass equal the difference in avoidable cost between two rate categories," and how ECP applies to worksharing, shape, and other "cost causing characteristics." Third Notice of Inquiry (July 26, 2006) at 6-7. In its direct case, Pitney Bowes witness Panzar demonstrated why the same principles that support ECP for traditional worksharing also are applicable to setting rates that reflect all cost differences within a subclass. *See* PB-T-1 at 45-47. In its brief, Pitney Bowes set forth a set of "organizing principles" for establishing prices for workshare-related *and* non-workshare related cost differences within a subclass. Pitney Bowes Brief at 19. These principles are restated here for convenience:

- Institutional costs should be allocated to class and subclass based on the factors of the Act.
- Within a subclass, pricing in accordance with the principles supporting ECP is the default presumption.
- Mailers can and will respond to these pricing signals and will therefore make mailing decisions reflective of the costs that they impose on the Postal Service.

- Deviations from ECP may be necessary to prevent rate shock, to prevent crossovers between classes or other anomalies, or in the instance where different products within the same subclass display very different price elasticities of demand.
- Accurate cost estimates of workshare and non-workshare-related cost differences within a subclass must be developed to support ECP.

See Pitney Bowes Brief at 19-20.

Pitney Bowes does not seek to disturb the Commission’s existing practice of assigning institutional costs among classes and subclasses based on the Commission’s full consideration of the rate-setting factors of the Act. *See* 39 U.S.C. § 3622(b)(1)-(9). Pitney Bowes further understands that rate making is an evolutionary process and that the Commission is not presented with a clean slate. Pre-existing rate relationships may necessitate deviations from a strict application of the principles underlying ECP.

The key point, however, is that the principles underlying ECP should apply regardless of whether cost differences result from “worksharing” or “other cost causing characteristics.” It should not matter whether the mailer activity constitutes what traditionally may have been considered “worksharing” activity. *Any and all* mailer activities that reduce Postal Service costs should, where practical, be reflected in rates. It is that simple. On brief, other participants express different views. For the reasons below, the Commission should embrace the Pitney Bowes approach.

A. Witness Panzar’s Extended Definition of Worksharing

1. The Postal Service and GCA Misread Panzar.

Two Pitney Bowes witnesses, Panzar and Buc, urge the Commission to broaden its notion of “worksharing” to enable the Postal Service to use pricing to incent any private sector activity, including activities of individual mailers, that reduces the costs of the Postal Service.

See PB-T-1 at 7; PB-T-3 at 2. Panzar offers a specific definition of worksharing: “*worksharing* refers to any private sector *activity which reduces the costs* of the Postal Service.” PB-T-1 at 7 (emphasis in original). The Postal Service and the Greeting Card Association (“GCA”) take issue with witness Panzar’s expanded definition of worksharing.

The Postal Service labels Panzar’s definition “unreasonable.” Postal Service Brief at 174. GCA objects to the definition as “theoretically unacceptable.” GCA Brief at 18. These concerns are based on the mistaken impression that Panzar’s definition would result in workshare rate incentives for mailer activities whether or not those activities result in reduced Postal Service costs. See Postal Service Brief at 174; GCA Brief at 17. This is not so. Under Panzar’s definition the *private sector* activity must *reduce the costs* of the Postal Service. In each of the examples provided in his testimony the discount is based upon – and set equal to – the Postal Service costs that are reduced or avoided.

In sum, if a private sector activity reduces Postal Service costs, postal rates, where practical, should reflect those reduced costs.

2. Contrary to Postal Service Assertions, the Pitney Bowes Approach Is Not “Mechanistic.”

The Postal Service also argues that Pitney Bowes’ proposed expanded application of the principles underlying ECP is “mechanistic.” See Postal Service Brief at 174, 174 n.5. This is also a misreading of Pitney Bowes’ position. Pitney Bowes is not advocating a mechanistic or rigid application of these extended principles. As noted above and discussed at length in Pitney Bowes’ direct case and Brief, Pitney Bowes advocates that the expanded application of ECP principles serve as a presumptive organizing principle for pricing within a subclass. Pitney

Bowes believes the Commission can and should retain its discretion to deviate from a pure ECP approach where necessary.⁶

3. GCA's Inexplicable Discussion of Address Quality.

GCA's assertion that a worksharing discount for mailer activity which improves address quality would somehow "violate ECP" is simply wrong. *See* GCA Brief at 17. Mailer activity which produces mail with accurate, readable, and deliverable addresses, enables the Postal Service to more efficiently process that mail, avoiding address correction, forwarding, and other work, and consequently reduces the costs incurred by the Postal Service. A readable, deliverable address is analogous to a barcode and "worksharing" discounts are available today for mailer applied barcodes. The mailer can choose whether to perform the work necessary to achieve a particular level of address quality just as a mailer can choose whether or not to apply a barcode. This is a classic "make or buy" analogy and, thus, under ECP a discount equal to the Postal Service's costs avoided would be appropriate for mail with accurate, readable, deliverable addresses.

B. The Postal Accountability and Enhancement Act.

On December 20, 2006, one day before initial briefs were due in this docket, the President signed into law H.R. 6407, the Postal Accountability and Enhancement Act ("PAEA"). Pub. L. No. 109-435, ___ Stat. ___ (December 20, 2006). The Postal Service and American Bankers Association ("ABA") suggest that the PAEA may be relevant to this docket, particularly

⁶ The Postal Service at least notes that witness Panzar expressly recognizes the practical limitations of extending his theoretical approach to an existing system of rate relationships. *See* Postal Service Brief at 174, n.5 (citing Tr. 26/9159).

its statutorily definition of “worksharing discount.”⁷ See Postal Service Brief at 174; ABA Brief at 9-12.

More than a decade in the making, the PAEA will dramatically change postal rate setting. Primary objectives of the law include to “maximize incentives to reduce costs and increase efficiency’ and to “allow the Postal Service pricing flexibility.” PAEA, §201(a) (adding 39 U.S.C. §3622(b)(1), (4)). “The importance of pricing flexibility to encourage increased mail volume and operational efficiency” is a “factor” to be taken into account. PAEA, §201(a) (adding 39 U.S.C. §3622(c)(7)).

The Postal Service asserts that witness Panzar’s definition of “worksharing,” discussed more fully above, “does not appear to be consistent with the definition of worksharing included in the reform legislation.” As an initial matter, this case and perhaps one more will be governed by the “old” law, not the new one. Thus, the PAEA may be instructive but it is not controlling.⁸ Moreover, the section referred to by the Postal Service and ABA limits (subject to several exceptions), *the amount* of a discount that may be afforded for defined “worksharing” activities, and only for those defined activities. The PAEA does not limit the type of discounts that may be afforded, or the rates or discounts that may apply to mail subject to activities other than those described.

There will be ample opportunity to explore the requirements and ramifications of the PAEA during the implementation process. “Worksharing” will be, for the first time, explicitly

⁷ The PAEA offers the following definition, “[i]n this subsection, the term ‘workshare discount’ refers to rate discounts provided to mailers for the presorting, prebarcoding, handling, or transportation of mail, as further defined by the Postal Regulatory Commission” PAEA, § 201(a) (adding 39 U.S.C. § 3622(e)).

⁸ It bears noting that the proposed application of Panzar’s extended conception of worksharing advocated by Pitney Bowes in this case – an expanded retail access discount for more efficient postage evidencing – is an item that is expressly contemplated in the reform legislation. See PAEA, § 302(d) (specifically directing the Postal Service to “expand and market retail access to postal services” through non-traditional sales channels including on-line postage and postage meters, among others).

recognized in law. Cost differences, including those resulting from activities other than those which may be ascribed to “worksharing” will be taken into account under the new “modern system for regulating rates and classes.” *See, e.g.*, PAEA, § 201(a) (adding 39 U.S.C. §3622(a), (c)(2)). One of the stated objectives of the new rate system is “to allow the Postal Service pricing flexibility” suggesting many factors may be taken into account in setting rates. PAEA, § 201(a) (adding 39 U.S.C. §3622(b)(4)). For example, a specific factor to be taken into account under the new system is “the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service.” *Id.* (adding 39 U.S.C. §3622(c)(5)). This suggests that the Postal Service and the Commission may appropriately consider mailer activities which reduce Postal Service costs in developing rates, as discussed by witness Panzar.

V. CONCLUSION

For the reasons stated in its Brief and as set forth above, Pitney Bowes respectfully urges the Commission to (1) adopt an improved methodology for estimating cost avoidances for First-Class Mail Automation Letters and recommend Pitney Bowes’ proposed rate schedule that better reflects those cost avoidances than that requested by the Postal Service, (2) recommend an expanded retail access discount for efficient postage evidencing of Single-Piece First-Class Mail, and (3) extend the principles underlying Efficient Component Pricing to establish intra-subclass rate differences that reflect both workshare-related and non-workshare-related cost differences.

Respectfully submitted:

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