Postal Regulatory Commission
Submitted 1/24/2008 8:00:00 am
Filing ID: 58680
Accepted 1/24/2008

Initial Filing
January 16, 2008 (edited for style, 1/20/08)

FURTHER COMMENTS ON THE USPS FILING OF FY2007 ANNUAL COMPLIANCE REVIEW DATA

(Provided to USPS, 1/16/08)

The purpose of this paper is to:

(1) Acknowledge and correct some mistakes in my initial comments regarding the Postal Service's ACR filing, particularly regarding the Periodicals worksharing discount table in LR-3; and

(2) Provide additional comments regarding the Periodicals mail flow model.

1. THE PERIODICALS WORKSHARING DISCOUNT TABLE

The worksharing discount table for Outside County Periodicals in LR-3 indicates a 7.7 cents unit cost differential between (1) machinable non-automation flats with 5-digit bundle presort and (2) carrier route presorted flats. My earlier comments criticized this estimate as being inconsistent with PRC methodology.

It is now clear to me that in developing the 7.7 cents estimate the Postal Service did in fact accurately follow the methodology adopted by the Commission at the conclusion of the Docket R2006-1 rate case. I explain below the mistakes I made in applying that methodology to the current set of cost numbers. I will also explain why I continue to believe that the true cost differential between carrier route presorted flats and 5-digit machinable non-automation flats is considerably larger than 7.7 cents per piece, and in fact larger than the current discount of 10.7 cents.

Robert Mitchell, whose Periodicals rate design workpapers the Commission adopted with only minor changes at the end of docket No. R2006-1, is preparing a separate set of comments that explain mistakes in the application of delivery costs in those workpapers.

Through Docket No. R2001-1, the delivery cost component used in Periodicals rate design to determine costs avoided by carrier route presorted flats was the IOCS determined cost differential between: (1) Standard <u>non-carrier route</u> flats; and (2) ECR basic flats, as suggested in my initial comments.[1]

I assumed, without checking, that the same approach had been used in R2006-1. In reality, however, the delivery cost component used in both Mitchell's and the Commission's workpapers was the difference between delivery costs for <u>all</u> Periodicals flats and ECR basic flats. Based on the FY07 cost data, that gives a delivery cost differential of only 1.1 cents, versus 2.9 cents under the traditional approach.

[1] Strictly speaking, the cost differentials used in earlier dockets were for non-letters (including a small volume of parcels) rather than just flats.

Because the Postal Service only provides a single delivery cost figure for Periodicals flats, and the Periodicals class includes a roughly equal number of flats with and without carrier route presort, it should be obvious that a comparison based on such a cost figure is useless for determining the delivery cost differential between flats with and without carrier route presort. The traditional approach, which takes advantage of separate IOCS based cost estimates for Standard flats with and without carrier route presort is clearly superior and should in my opinion be continued. Mr. Mitchell's comments will address this issue further.

Regarding the mail processing cost component of the carrier route cost differential, both the current FY07 (ACR) cost model and the R2006-1 model that the Commission adopted distinguish between: (1) piece costs related directly to piece sorting; and (2) piece costs related to transporting already sorted pieces between sorting operations and to the carriers after the final piece sort. The latter are referred to as "allied labor piece costs" in the Postal Service's FY07 model and were simply called "weight related piece costs" in my R2006-1 testimony and flats model.

In asserting in my earlier comments that the total mail processing cost differential indicated by the FY07 model was 8.2 cents, I was referring to the sum of both types of piece related costs. However, as the Postal Service pointed out at the first technical conference, only the first type of piece related costs were used to develop the R2006-1 rate design. Referring to "direct" piece costs only, the mail processing cost component of the carrier route differential that is consistent with the R2006-1 methodology is 6.6 cents, rather than 8.2 cents.

On the other hand, the FY07 model shows a 1.6 cents differential between "allied labor piece costs" for 5-digit machinable non-auto flats and carrier route presorted flats. Even though this differential was not used to set the Periodicals rates in R2006-1, it is nevertheless part of the total cost differential between the two categories of flats. If the purpose of the worksharing table in LR-3 is to compare total cost avoidance with the current value of each worksharing discount, then the 1.6 cents should be included.

The following are some further thoughts regarding the "allied labor piece costs" and how they might be considered in future rate designs. For simplicity, I will only compare two types of flats, namely (1) 5-digit flats that are finalized to carrier route on an AFSM 100 incoming secondary sort, then transported to the DDU; and (2) flats in carrier route bundles that are brought directly to the DDU before being opened.

The first type of flats will typically be placed in flats trays which are labeled and placed on a rolling container destined to the DDU. Its "allied" costs include bringing this container to the platform, loading it onto a truck to the DDU, then unloading the container at the DDU and bringing it to the mail processing area. In previous rate designs these costs were not considered in setting worksharing discounts.

The carrier route flats will typically be moved to the DDU either on a 5-digit pallet or in a container with bundles that have been sorted to the DDU. The costs of moving the 5-digit pallet to the DDU and breaking the pallet at the DDU are, in the R2006-1 rate

setting process, considered as costs of the pallet and included in the per-pallet charge. The costs of moving a container with sorted bundles to the DDU are considered parts of the costs of those bundles.

Since all flats must eventually be moved to the DDU, one could argue that those costs should be considered to the same extent, whether they are moved on a mailer prepared pallet, in a container with mailer prepared bundles or in trays with flats that already have been sorted.

As discussed in the section below, there is strong reason to believe that the current FY07 model significantly understates Periodicals piece sorting costs and thereby also the cost differential between carrier route flats and flats that receive piece sorting. This understatement is, at least partly, caused by significant operational changes between FY05 (the R2006-1 base year) and FY07, that have not been incorporated in the model.

2. THE CRA ADJUSTMENT AND THE LARGE GAP BETWEEN MODELED AND CRA PIECE SORTING COSTS.

My comments on the CRA adjustment in an earlier write-up referred to the large discrepancy between the modeled direct piece sorting costs ($396.947 million) and the costs indicated by the CRA ($584.73 million). I stated, incorrectly, that part of the large discrepancy occurred because $41.88 million in (MODS No.) 035 flats preparation costs had been modeled as “allied” piece costs. That is not the case. They were, (correctly and as in R2006-1) modeled as direct piece sorting costs.

But that only makes the discrepancy between modeled and CRA costs even larger. If one were to apply the CRA adjustment as I originally intended to do in my R2006-1 model, i.e., separately for direct piece sorting and for all other costs, an adjustment factor equal to 1.47 would be applied to all direct piece sorting costs. That would, for example, raise the mail processing cost component of the carrier route cost differential from 6.6 cents to 9.7 cents. Adding the 2.9 cents delivery cost differential that I believe is most consistent with past practices would give a total cost differential equal to 12.6 cents.

However, as I indicated at the first technical conference and in a separate paper provided at the conference, a major (if not the only) reason for the large discrepancy discussed above is that the model fails to reflect a very significant change in the mail processing environment that has occurred between BY2005 and FY2007. That is the deployment of AI (automated induction) attachments to many AFSM-100 machines, and the transfer of very significant mail processing workhours to the AI equipment, using MODS number 140. Workhours have been transferred to the 140 operation both from the manual flats preparation (MODS 035) operation and, apparently, from the traditional AFSM-100 feed stations.

The Postal Service indicated at the technical conference that several changes have been made to the R2006-1 model in order to be more consistent with current operational reality. But the creation and growth of the 140 AI operation is a major

change in the operational reality that has not been modeled. Given the size of this operation and its impact on flats costs , including it in the model is absolutely essential in order to be able to approximate current reality.

I do not know exactly how much of the 140 costs are attributed to Outside County flats. An exact determination would have to be based on analysis of IOCS tallies. But a rough estimate can be obtained as follows:

In R2006-1 the TY2008 costs at the AFSM-100 cost pool that was attributed to Outside County Periodicals, under PRC costing, was 1.2 cents per piece. The corresponding figure in the current model is 2.23 cents, even though the FY07 wage rate was lower than that used for TY2008. Taking the difference and multiplying with total Outside County volume indicates that approximately $80 million have been added to the Periodicals part of the AFSM 100 cost pool.

Since other parts of the AFSM 100 operation appear to involve fewer manhours than before, due to the transfer of employees from the traditional feeding stations to the AI, it seems fair to assume that significantly more than $80 million Periodicals mail processing costs are associated with the 140 part of the AFSM 100 cost pool. Yet this operation is not reflected at all in the current model.

My separate write-up on this issue suggested two ways to include the 140 mail prep operation in the model. Neither is ideal, but developing an ideal model solution might take more time than is available, and both approaches are preferable to simply ignoring the existence of this new operation. A third and even grosser approach would be to apply an overall CRA adjustment to the direct piece costs as suggested above.