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WASHINGTON, D.C. 20268-0001

Annual Compliance Report, 2007 **Docket No. ACR2007-1**

INITIAL COMMENTS OF PITNEY BOWES INC. IN RESPONSE TO NOTICE OF FILING OF ANNUAL COMPLIANCE REPORT BY THE POSTAL SERVICE AND SOLICITATION OF PUBLIC COMMENT

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I. INTRODUCTION

Pursuant to Section 3652 of the Postal Accountability and Enhancement Act (PAEA), the Postal Service filed its 2007 Annual Compliance Report (ACR) with the Postal Regulatory Commission (Commission) on December 28, 2007.[1] Pitney Bowes Inc. (Pitney Bowes) is pleased to provide these comments in response to the Commission's Notice of Filing of Annual Compliance Report by the Postal Service and Solicitation of Public Comment (December 31, 2007) (Docket No. ACR2007-1).

Pitney Bowes recognizes that the Postal Service's ability to comply with the full data collection and reporting requirements contemplated under the PAEA was inhibited by the transitional nature of the filing. For this reason, these comments do not address product information or quality of service measures. The ACR does, however, report worksharing discounts, cost avoidance estimates, and passthroughs for market dominant products as required by the PAEA. *See* 39 U.S.C. § 3652(b). Accordingly, these comments address the information relating to workshare discounts and demonstrate why, without important modifications, the cost avoidance estimates and passthroughs as reported in this ACR should not be used when the Postal Service files its first notice of rate adjustment for market dominant products under the new system created by the PAEA.

This is the first experience with the compliance process under the new law and the Postal Service and the Commission are to be commended for their efforts to meet the significant new responsibilities imposed by the PAEA. Pitney Bowes shares the Commission's hope that public comments on the ACR may "inform or influence the

[1] Pub. L. No. 109-435, 120 Stat. 3198 (Dec. 20, 2006). The PAEA amends various sections of title 39 of the United States Code. Unless otherwise noted, section references in these comments are to sections of title 39.

Postal Service's pricing decisions" in advance of the next rate filing, expected in February 2008. PRC Notice at 2, n.3.

II. DISCUSSION

A. Because 2007 is a Transition Year, the Commission's Compliance Determination Should be Based on the PRA, Not the PAEA

The Postal Service argues that "[f]rom a legal perspective, during FY 2007 Postal Service rates and fees were governed by the provisions of the PRA rather than the PAEA. Thus, the 'applicable requirements of title 39' that are relevant to the FY 2007 rates and fees are those of the PRA, not the PAEA." ACR at 1. Pitney Bowes agrees. Because all of the reported workshare discounts were recommended by the Commission and approved by the Governors of the Postal Service they are, by definition, compliant with the PRA. Therefore the Commission need not determine whether those rates and fees meet the PAEA's objectives and factors, *see* 39 U.S.C. § 3622, comply with the "price cap," *see* 39 U.S.C. § 3622(d), satisfy the workshare discount limitation, *see* 39 U.S.C. § 3622(e), or deviate substantially from economically efficient rates, *see* 39 C.F.R. § 3010.14(b)(6).

B. The PAEA Will Control the Next Rate Adjustment

While the Commission's compliance determination ought to be based on the rate-setting requirements of the PRA, the PAEA will control the rate adjustment, expected to be announced in February 2008 and implemented in calendar year 2008. Therefore, it is essential that costs and avoided costs be measured and reported correctly.

The Postal Service states that "[t]he workshare data provided in this Annual Compliance Report will also be used when the Postal Service files a notice of rate adjustment that includes workshare discounts. 39 C.F.R. § 3010.14(b)(5) provides that

the notice must contain a schedule of the workshare discounts included in the proposed rates, along with a schedule listing the avoided costs that underlie each such discount. The avoided costs figures must be *developed from* the most recent Annual Compliance Report." ACR at 20, n.9 (emphasis added). Thus, the Postal Service plans to use the cost avoidance estimates presented in the ACR for its first notice of rate adjustment under the new system. This approach is neither required nor justified. The avoided cost figures must be "developed from" the ACR, not simply lifted from the ACR and repeated in the notice of rate adjustment. In addition, the approach suggested by the Postal Service is inappropriate for the reasons outlined below.

C. The Cost Avoidance Estimates Reported in the ACR Do Not Provide a Complete and Accurate View of the Relationship Between the Existing Workshare Discounts and the Actual Avoided Costs

1. The Measurement Periods for Workshare Discounts and Cost Avoidance Estimates Are Not Aligned

Under section 3622(e), avoided costs must be measured to determine whether any "worksharing discount" exceeds those avoided costs by the Postal Service as the result of mailer worksharing activity. *See* 39 U.S.C. § 3622(e). Dividing the amount of the discount by the corresponding cost avoided yields a "passthrough." If that passthrough does not exceed 100 percent, the discount does not exceed the cost avoided. To be meaningful, however, the passthrough calculations must be based on discounts and avoided costs for the same time period. This is not the case with this ACR. As a consequence, the reported passthroughs for many First-Class Mail workshare letters appear larger than they should because avoided costs and discounts are reported for different time periods.

In this ACR, the cost avoidance estimates reported by the Postal Service are for the entire twelve months of FY 2007 while the reported discounts are only for the last 4 ½ months of FY 2007. Cost avoidance estimates are measured and reported for the period of October 1, 2006 through Sept 30, 2007. Yet discounts reported under this ACR reflect rates and discounts in effect only from May 15, 2007 through September 30, 2007. Thus the rates and discounts in effect from October 1, 2006 through May 14, 2007 are ignored.

The failure to align the measurement periods distorts the passthroughs as reported in the ACR. This is particularly true where, as in the case for First-Class Mail Letters, the workshare discounts were lower in the period October 1, 2006 to May 14, 2007. For example, the 3-digit to 5-digit First-Class Mail Automation Letters discount was 1.5 cents during the period from October 1, 2006 to May 14, 2007. That same discount was 2.2 cents from May 15, 2007 through September 30, 2007. Thus, in reality, for the entire year that avoided costs are measured, this discount was less than the avoided costs. Yet, as reported in the ACR, the discount exceeds the costs avoided, with an apparent passthrough in excess of 100 percent. When measured and reported correctly, this workshare discount did not exceed avoided costs.[2]

The cost avoidance estimates that will inform the Commission's review of the workshare limitations under section 3622(e) would be much more meaningful if the Postal Service were required to measure the cost avoidance estimates for the same time period as the discounts. The measurement periods could be reconciled simply by taking a

[2] Although volumes are not available for the 4.5 month period (October 1, 2006 - May 14, 2007) and the 7.5 month period (May 15, 2007 – September 30, 2007), if the volumes are proportional to the time period, the weighted average discount for the year would be 1.8 cents. And since monthly volumes are traditionally smallest in the period covered by the 4.5 months, with actual data the average weighted discount for the year is almost certainly less.

weighted average (by volume) of the discounts in effect for the fiscal year. This would produce a fair and accurate passthrough measure.

2. The Cost Avoidance Estimates Fail to Account for Reasonably Foreseeable Changes in Costs

The ACR underestimates workshare related cost avoidance estimates by failing to account for reasonably foreseeable changes in costs. The Commission should require the Postal Service to update its avoided costs to take into account reasonably estimatable increases in its costs. For example, labor costs which comprise about three-fourths of all postal costs increase as a consequence of COLA clauses in negotiated labor agreements. Therefore, it is reasonably foreseeable that Postal Service costs will increase over time as labor costs increase. All else being equal, cost avoidance estimates should increase in step with anticipated increases in postal service costs. Workshare activities avoid costs, so as costs increase, so too should the cost avoidances.

As discussed above, the avoided costs reported in the ACR are for the period ending September 30, 2007. A notice of rate adjustment is not expected until next month (five months after the close of the period covered by the ACR), and the next actual rate adjustment is not expected until May 2008 (eight months after the ACR period). This time lag between the time period covered by the ACR and the date of the rate adjustment announced in the notice of rate adjustment should be taken into account to accurately report avoided costs. This is not difficult or unprecedented. In dockets for Negotiated Service Agreements, costs are routinely inflated to out years to account for inflation. Similarly, cost avoidances from the ACR could be adjusted to reflect the percentage change used for the annual limitation (rate cap) under section 3622(d).

3. Selective Updates to the Cost Avoidance Models Distort Existing Rate Relationships

In this ACR data inputs have been selectively updated. Some inputs have been updated, others have not. These data updates have had a significant effect on existing rate relationships. For example, First-Class Mail letter models have been updated to reflect read / accept rates developed in a recent Negotiated Service Agreement docket,[3] rather than those used in the most recent omnibus rate case.[4] As a result, the cost avoidance estimates for First-Class Mail automation letters were reduced by 0.3 cents (holding all other inputs the same).[5] Other updates to the In Office Cost System (IOCS), wage rates, productivities in cost pools, and piggyback factors increased the avoided costs by about 0.2 cents for certain rates. As a consequence of these selective updates, the cost avoidance estimate for 3-digit to 5-digit First-Class Mail letters reflects a net decrease in measured avoided costs from the 2.2 cents recognized in the last omnibus rate case, Docket No. R2006-1, to 2.1 cents in this ACR.

But these cost avoidance estimates do not provide a complete and accurate view of the relationship between the existing discounts and the actual avoided costs. Many other inputs have not been updated and are probably no longer accurate. For example, the cost avoidance letter models are highly dependent on the assumed entry point for the mail and the flow through the mail processing system. Yet these models were not updated or validated in this ACR and only some, not all, inputs to these models have been updated. Pitney Bowes' analysis suggests that correctly and fully updating the model for

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[3] *See* PRC Op. MC2007-1 (October 19, 2007).
[4] *See* PRC Op. R2006-1 (May 27, 2007).
[5] Calculated by changing read/accept rates in PRC-LR-12 in Docket No. R2006-1 to updated read/accept rates and holding all other inputs constant.

the 5-digit discount will show avoided costs are greater than the 2.2 cents per piece found in the last rate case.

The ACR itself suggests that selective updating has degraded the accuracy of the models used to measure avoided costs. Specifically, the "CRA Adjustment," reflecting the adjustment necessary to conform modeled costs to the costs actually reported in the Cost and Revenue Analysis, is larger in the ACR filing than it was in the last rate case.

III. CONCLUSION AND RECOMMENDATIONS

The Postal Service and the Postal Regulatory Commission are to be applauded for their work to implement postal reform as well as for their efforts in connection with this initial ACR.

However, the Postal Service's reporting must be substantially improved to ensure that the Commission's review of workshare discounts and avoided cost estimates is based on accurate and complete information. Improvements to the cost models are critically important for future annual compliance reports, and of immediate concern, in connection with the upcoming notice of rate adjustment. Accordingly, we recommend that the Commission:

- Require the Postal Service to align the measurement periods for workshare discounts and cost avoidance estimates.
- Require an inflationary adjustment to the Postal Service's cost avoidance estimates for reasonably foreseeable cost increases.
- Adopt rules regarding data updates to mitigate unintended distortions caused by selective data updates.

Many of these and other issues will likely be considered as part of the Commission's forthcoming rulemaking on the reporting requirements. For purposes of the next rate adjustment, we are hopeful that the Postal Service will consider and address some of the problem areas identified in advance of the rate filing.

Finally, while the Postal Service must improve its cost reporting, it should not feel constrained in the next rate adjustment by workshare passthroughs that appear, incorrectly, to exceed 100 percent. The statutory exceptions to the workshare limitation provision are designed to ensure that the Postal Service has the flexibility it needs to promote "efficiency of operations." *See* 39 U.S.C. §3622(e)(2)(D). Viewed in the context of the transition from the PRA to the PAEA, and the need for improvements to the cost models, the statutory limitation is appropriately understood as a reasonable guide, not a straight-jacket. The Commission should encourage the Postal Service to establish workshare discounts that more fully reflect actual avoided costs thereby promoting economic efficiency – a "guiding principle in establishing and maintaining workshare discounts." Order No. 26 (August 15, 2007) at 23.

Respectfully submitted:

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