

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

**Modification of Costing Methods
2008 – Postal Service Proposal Twelve**

Docket No. RM2009-1

REPLY COMMENTS OF PITNEY BOWES INC.

James Pierce Myers
Attorney at Law
1617 Courtland Road
Alexandria, Virginia 22306
Telephone: (571) 257-7622
Facsimile: (571) 257-7623
E-Mail: jpm@piercemyers.com

Michael F. Scanlon
K&L GATES LLP
1601 K Street, NW
Washington, DC 20006
Telephone: (202) 778-9000
Facsimile: (202) 778-9100
E-Mail: michael.scanlon@klgates.com

Counsel to PITNEY BOWES INC.

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I. INTRODUCTION

Pitney Bowes Inc. (Pitney Bowes) respectfully submits these reply comments in response to Order No. 130, Notice of Proposed Rulemaking on Costing Methods Used in Periodic Reporting (Proposal Twelve), issued by the Postal Regulatory Commission (Commission) on November 7, 2008. The Commission's Order was issued in response to the Postal Service's November 4, 2008 Petition requesting approval of a series of proposed improvements to the cost models for flats generally, and for Periodical flats in particular.

These comments reply to issues raised in the Public Representative's (PR) Initial Comments regarding the linkages between modeled costs and Cost and Revenue Analysis (CRA) cost totals and the proposal to adopt a single, system level CRA adjustment.¹

II. DISCUSSION

In its initial comments the PR observed that the cost methodology changes of proposed Modification 9 raise broader issues of how the interrelationship between modeled costs and CRA cost totals should be developed to accurately reflect unit costs at the rate category level. *See* PR Initial Comments, at 2-3. The initial comments of the PR state that because “[r]ate categories use activity level resources in different proportions. . . . [the] use of one system level adjustment factor would distort unit costs and, more importantly, unit cost differences for purposes of setting worksharing discounts.” *Id.*, at 5. The initial comments of the PR also provided an example of how using multiple adjustment factors – one for piece-sorting costs and one for allied costs – to adjust modeled costs for consistency with CRA costs would eliminate this distortion. *See id.*, at 5-8.

¹ *See* Public Representative Initial Comments Related to Postal Service Flat Cost Models, (PR Initial Comments) December 1, 2008, at 2-3.

Pitney Bowes agrees with the PR that more detailed adjustments of modeled costs are preferable and should be made where data are available.² For example, if a comparison of modeled and CRA costs shows that the modeled costs understate piece-sorting costs by 15 percent and overstate allied costs by 25 percent, the use of two adjustment factors (one that adjusts piece-sorting costs upward and another that adjusts allied costs downward) would be preferable to making a single, system level averaged adjustment to both categories of cost because two adjustment factors would allow more refined adjustments to reflect actual costs.

Pitney Bowes has performed detailed comparisons of modeled and CRA letter-sorting costs in the Docket Nos. ACR2007 and R2006-1 First-Class Mail and Standard Regular letter cost models and found that the use of a single, system level adjustment factor significantly distorts letter cost avoidance estimates. These comparisons show the use of separate CRA adjustment factors for modeled incoming secondary (IS) sorting costs, i.e., costs for sorting pieces from 5-Digit ZIP to carrier route and delivery point sequence (DPS), and modeled non-incoming secondary (non-IS) sorting costs, i.e., costs for sorting pieces by facility and 5-Digit, significantly improves the accuracy of the cost avoidance estimates.

As shown in Table 1 below, in the First-Class Mail and Standard Regular letter cost models the ratio of CRA-to-modeled costs is consistently higher for non-IS sorting than for IS sorting, indicating that a much larger adjustment should be made to non-IS costs than to IS costs to ensure consistency with the CRA. Thus, for purposes of the letter cost models a single,

² While two separate CRA adjustment factors (one for piece-sorting costs and one for all other costs) were used in the Periodicals cost model in Docket No. ACR2007, the two adjustment factors were not developed by comparing CRA and modeled costs separately for these two cost categories. Rather, the separate CRA adjustments stemmed from an assumption that piece-sorting costs were accurately modeled and, thus, an adjustment factor of exactly 1 was appropriate for piece-sorting costs. *See* PR Initial Comments, at 3-4. Pitney Bowes does not oppose the adoption of a single system level adjustment factor to the Periodicals Cost Model as proposed in Modification 9.

system level adjustment is inferior because it leaves the non-IS costs too low and IS costs too high.

Table 1. Ratio of CRA-to-Modeled Letter Sorting Costs³

Mail Class		Docket No. ACR2007		Docket No. R2006-1	
		IS	Non-IS	IS	Non-IS
		[1]	[2]	[3]	[4]
First-Class Mail	[a]	.986	1.449	.804	1.205
Standard Mail	[b]	.815	1.308	.639	1.098

[1a] PB-2, 2007FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell M31.

[1b] PB-3, 2007SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell J28.

[2a] PB-2, 2007FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell L31.

[2b] PB-3, 2007SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell I28.

[3a] PB-4, R2006FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell M31.

[3b] PB-5, R2006SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell J28.

[4a] PB-4, R2006FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell L31.

[4b] PB-5, R2006SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell I28.

In its initial comments the PR also observed that the purpose of the cost models is to estimate unit cost differences, not unit costs, by rate category. *See* PR Initial Comments, at 5. Pitney Bowes agrees. With respect to the letter cost models, using a single, system level CRA adjustment simultaneously understates non-IS costs and overstates IS costs and, thus, distorts unit cost differences for First-Class Mail and Standard Regular automation letters by biasing them downward. The distortion reflects the fact that non-IS sorting costs for First-Class Mail and Standard Regular automation letters are much more sensitive to presort level than are IS sorting costs.⁴ Specifically, non-IS letter sorts can be avoided by presorting. For example, 5-

³ The lower ratios of CRA-to-modeled costs in Docket No. R2006-1 are caused, in part, by the use of older and lower read / accept rates. These older read / accept rate data resulted in the model overstating the percentage of letters that are sorted manually and thus letter-sorting costs. More recent read / accept rate data were used in the ACR2007 models. Also, note that the ratios in Table 1 cannot be compared directly with the CRA adjustment factors used in Docket Nos. R2006-1 and ACR2007 because the CRA costs used to develop these ratios are only letter sorting costs while the CRA costs used in the R2006-1 and ACR2007 CRA costs also include other costs that vary with letter sorting costs.

⁴ However, IS sorting costs are not completely unaffected by presorting. Presort level does affect IS sorting costs indirectly by affecting the likelihood that a piece is sorted manually.

Digit letters avoid all non-IS sorting costs. In contrast, even 5-Digit letters (the most highly presorted letters in First-Class Mail and Standard Regular) require IS sorting.⁵

To remedy this distortion, Pitney Bowes has modified the First-Class Mail and Standard Regular letter cost models to more accurately reflect costs by performing separate CRA adjustments for IS and non-IS costs.⁶ As Table 2 shows, using separate CRA adjustments for IS and non-IS costs in FY 2007 corrects the distortion described above and improves the accuracy of the presort cost avoidances for First-Class Mail and Standard Regular automation letters.⁷

Table 2. Comparison of FY 2007 Presort Cost Avoidances for First-Class Mail and Standard Regular Automation Letters

Cost Avoidance	First-Class Mail		Standard Mail	
	ACR2007	2-Pt CRA Adj.	ACR2007	2-Pt CRA Adj.
	[1]	[2]	[3]	[4]
MADC-ADC	1.8	2.1	1.4	1.6
ADC-3D	0.5	0.6	0.3	0.4
3D-5D	2.2	2.5	1.6	2.0

[1] FY 2007 Annual Compliance Determination at 64.

[2] PB-2, 2007FCM.xls, worksheet "2Pt CRA - SUMMARY."

[3] PB-3, 2007SM.xls, worksheet "SUMMARY."⁸

[4] PB-3, 2007SM.xls, worksheet "2Pt CRA - SUMMARY."

Attached are five appendices, PB-1 through PB-5. Appendix 1 (PB-1) describes the methodology used to implement the two-part CRA adjustment for First-Class Mail and Standard Regular letters. The remaining appendices (PB-2-through PB-5) contain the SAS files used to disaggregate CRA letter sorting costs into IS and non-IS costs, and modified versions of Docket Nos. R2006-1 and ACR2007 letter cost models that implement the two-part CRA adjustment.

⁵ The same cannot be said for other shapes of mail. For example, presorting Periodicals flats to Carrier Route does avoid IS sorting costs.

⁶ To be conservative, Pitney Bowes retained the use of a single, system level adjustment for non-letter sorting cost pools.

⁷ The results using Docket No. R2006-1 models, which can be found in appendices PB-3 and PB-4, are similar.

⁸ The ACR2007 cost avoidance figures differ slightly from those shown in the FY 2007 Annual Compliance Determination because PB-3 corrects an error in the Docket No. ACR2007 Standard Mail Regular letter cost model.

Pitney Bowes respectfully submits that the improved cost avoidance estimates derived from the use of a “two-part CRA adjustment” should be taken into account by the Postal Service and the Commission when designing and evaluating discounts for First-Class Mail and Standard Regular automation letters.

III. CONCLUSION

Pitney Bowes appreciates the Commission’s consideration of these comments.

Respectfully submitted:

/s/

James Pierce Myers
Attorney at Law
1617 Courtland Road
Alexandria, Virginia 22306
Telephone: (571) 257-7622
Facsimile: (571) 257-7623
E-Mail: jpm@piercemyers.com

Michael F. Scanlon
K&L GATES LLP
1601 K Street, NW
Washington, DC 20006
Telephone: (202) 778-9000
Facsimile: (202) 778-9100
E-Mail: michael.scanlon@klgates.com

Counsel to PITNEY BOWES INC.

APPENDIX 1

Appendix 1 (PB-1)

Explanation of 2-Part CRA Adjustment for First-Class Mail and Standard Regular Letters

The proportional Cost and Revenue Analysis (CRA) adjustment is performed by comparing the CRA piece-sorting costs (and other costs that vary with piece-sorting costs) to the weighted-average modeled piece-sorting costs and then applying the resulting proportional adjustment to the modeled piece-sorting costs by presort level. The 2-part CRA adjustment for First-Class Mail and Standard Regular letters is based on the same comparison, except that for letter-sorting costs the comparison is generally performed separately for Non-Incoming Secondary (Non-IS) and Incoming Secondary (IS) sorting costs. The methodology used to perform the 2-part CRA adjustment for First-Class Mail and Standard Regular letters is summarized below. The workpapers used to implement the 2-part CRA adjustment can be found in the supporting appendices PB-2 through PB-5.

- PB-2 contains a modified version of the Docket No. ACR2007 First-Class Mail letter cost model.
- PB-3 contains a modified version of the Docket No. ACR2007 Standard Mail Regular letter cost model.
- PB-4 contains a modified version of the Docket No. R2006-1 First-Class Mail letter cost model.
- PB-5 contains a modified version of the Docket No. R2006-1 Standard Mail Regular letter cost model.⁹

To divide the CRA letter-sorting costs for mail processing into IS and non-IS costs, In-Office Cost System (IOCS) data were used to obtain the distribution of MODS codes for the nine letter-sorting cost pools: MODS D/BCS, MODS OCR, MODS MANL, MODS LD41, MODS LD42, MODS LD43, MODS LD44, NMOD AUTO/MEC, and NMOD MANL.¹⁰ The analyses used the IOCS data from ACR 2007 and R2006-1 and started from the corresponding SAS programs.¹¹ For each year, the USPS SAS programs were used through MOD1DIR for MODS and NONMOD1 for Non-MODS, which generate files of direct tallies for MODS and Non-MODS, respectively.¹² Separate SAS programs (which can be found in PB-2 through 5) were written for each of the cost pools to analyze the tallies.

⁹ The appendices also include the SAS programs used to analyze IOCS data and the corresponding output files.

¹⁰ In cases where there were no tallies for LD42, only eight letter-sorting cost pools could be analyzed.

¹¹ The ACR2007 IOCS data were filed in USPS-FY07-27 and the SAS programs were filed in USPS-FY07-7. The R2006-1 data were filed in USPS-LR-L-9 and the SAS programs were filed in USPS-LR-L-55.

¹² For R2006-1, it was necessary to make a minor modification as well to MOD1DIR, deleting the line of the program that sends tallies for LD41-44 to a separate file, so that they are preserved in the direct tally file that contains the direct tallies for the other MODS cost pools.

The MODS codes in the IOCS data were grouped into Non-IS, IS and Other categories.¹³ For MODS codes in the Other category, IOCS information on the scheme being run was used to categorize the tally as Non-IS or IS.¹⁴ For some MODS codes in the Other category, the IOCS scheme-related questions did not provide any additional information so the tallies were left in the Other category.

Within each of the letter-sorting cost pools, the CRA costs were distributed to the Non-IS and IS categories according to the proportion of the weighted IOCS tallies in those categories. The proportional costs for the tallies in the Other category – where neither the MODS codes nor the IOCS scheme questions allowed the tally to be classified as either IS or non-IS – were kept as a separate category of costs. The costs in the Other category for the letter-sorting cost pools were added to the proportional CRA costs for the non-letter-sorting cost pools. The result was a breakdown of the CRA piece-sorting costs into the three categories of Non-IS, IS and Other.¹⁵

To perform the two-part CRA adjustment, the modeled piece-sorting costs also had to be partitioned into IS and non-IS costs. This is straightforward because non-IS and IS costs are explicitly identified in the models. The resulting costs were then aggregated by computing a volume-weighted average across presort levels to obtain the volume-weighted average modeled piece-sorting cost for the two categories.¹⁶

The two-part CRA adjustment was performed by computing a separate CRA proportional adjustment for the Non-IS and IS categories, where the CRA and modeled piece-sorting costs were compared for each category and the necessary proportional adjustment calculated. In addition, a common CRA proportional adjustment was performed for those CRA piece-sorting costs that fall into the Other category as well as for all non-piece-sorting costs. The CRA adjustment was performed using the volume-weighted modeled costs computed over all sort schemes.

Once the CRA proportional adjustments were calculated (as described above), these adjustments were then applied to calculate the adjusted modeled unit costs by presort level and added to the fixed costs to obtain the total mail processing unit cost by presort level. The results of the two-part CRA adjustment were then incorporated into new summary sheets for the letter cost models, labeled “2Pt CRA – SUMMARY” in each of the four separate workbooks in appendices PB-2 through PB-5.

¹³ The groupings appear in the SAS output files in PB-2 through PB-5.

¹⁴ IOCS collects relevant scheme information in questions Q18C5 and Q18D2.

¹⁵ See the calculation performed on worksheet “2Pt CRA – PRESORT LETTERS” in each of the four separate workbooks in PB-2 through PB-5.

¹⁶ The calculation is performed on worksheet “2Pt CRA - PRESORT LETTERS SUM” in each of the four separate workbooks in PB-2 through PB-5.