

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

**Consideration of Workshare Discount
Methodologies**

Docket No. RM2009-3

INITIAL COMMENTS OF PITNEY BOWES INC.

James Pierce Myers
Attorney at Law
1617 Courtland Road
Alexandria, VA 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.

DATE: May 26, 2009

I. INTRODUCTION

By Order No. 192, dated March 16, 2009, the Postal Regulatory Commission (Commission) initiated the above-captioned proceeding to afford interested parties the opportunity to address the costing methodologies used by the Postal Service to develop its proposed First-Class Mail and Standard Mail rates in connection with the most recent Market Dominant pricing adjustment (PRC Docket No. R2009-2). *See* Order No. 192 at 3. Order No. 192 further invited interested parties to submit alternative cost avoidance and rate design proposals. *See id.* Pitney Bowes Inc. (Pitney Bowes) respectfully submits these comments in response to Order No. 192.

These comments discuss: (1) Pitney Bowes' support for the Postal Service's treatment of First-Class Mail Presort letters as a unique and distinct product from First-Class Mail Single-Piece letters for purposes of setting First-Class Mail letter prices, and (2) Pitney Bowes' proposed costing methodology change to the existing First-Class Mail and Standard Regular mail processing cost models to more accurately reflect costs by performing a separate or "two-part" CRA adjustment for incoming secondary and non-incoming secondary operations.

II. DISCUSSION

A. **The Commission Should Treat First-Class Mail Presort Letters as a Distinct Product from First-Class Mail Single-Piece Letters for Purposes of Setting First-Class Mail Prices**

The Commission initiated this rulemaking based on its finding in Docket No. R2009-2 that the Postal Service did not follow the Commission's pre-PAEA methodology for calculating First-Class Mail workshare cost avoidances. *See id.*, at 1-2. Under this methodology, Presort and Single-Piece letter rates were linked because the

rates for the least-workshared Presort Letters – Nonautomation Presort and Automation Mixed AADC letter rates – were established by subtracting workshare discounts from Single-Piece letter rates. For example, the cost avoided by Automation mixed AADC First-Class Mail letters was measured relative to the bulk metered mail (BMM) benchmark; that cost avoidance was multiplied by a pass-through and then subtracted from the Single-Piece First-Class Mail letter rate to calculate the rate for Automation mixed AADC First-Class Mail Presort letters. The Commission concluded that the Postal Service did not use the existing methodology when it “de-linked” the costs of Single-Piece First-Class Mail letters from First-Class Mail Presort letters. *See id.*, at 1.

While USPS did not use this approach, it disputes whether it has changed the relevant costing methodology. The Postal Service contends that under the Postal Accountability and Enhancement Act (PAEA)¹ First-Class Presort letters are not a workshare variant of Single-Piece First-Class Mail letters, but rather are a unique and distinct product. *See* USPS Response to CIR No. 1 (PRC Dkt. No. R2009-2), at 1-2.

The Postal Service’s position is correct. Under the PAEA, First-Class Mail Presort letters are a distinct product from First-Class Mail Single-Piece letters, not a workshare variant of Single-Piece letters. First-Class Mail Presort and Single-Piece letters have distinct costs and are perceived by mailers as distinct products. Because of these differences, First-Class Mail Presort and Single-Piece letters are listed as separate products under the Mail Classification Schedule. As discussed below, a rate design that treats Presort and Single-Piece letters as separate products should benefit all First-Class

¹ *See* 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.

Mail letter mailers because the Postal Service could implement prices that simultaneously protect “Aunt Minnie” and other consumer mailers, while facilitating the pricing flexibility needed to enhance the value of mail for small business and large commercial mailers. Adopting this approach would, thus, protect the Postal Service’s financial viability and promote the efficiency and pricing flexibility goals of the PAEA for all First-Class Mail letters.

1. The Postal Service’s Methodology Gives Effect to the Statutory Goals of Efficiency and Pricing Flexibility for the Benefit of Presort and Single-Piece Mailers

An overarching goal of the PAEA was to afford the Postal Service greater pricing and management flexibility to promote increased efficiency in the postal system. This goal is manifest in a number of the statutory objectives for the modern rate system. *See* 39 U.S.C. §§ 3622(b)(1), (4), (5) and (6). The Postal Service’s methodology is consistent with these statutory objectives because it provides a reasonable amount of pricing flexibility. Requiring the Postal Service to “link” two distinct products for rate design purposes frustrates these goals because the Postal Service has virtually no flexibility to set prices where all of the prices are established by reference to a benchmark in a separate, distinct product. As discussed below, a “linked” rate design, particularly when combined with the BMM benchmark, also frustrates efficiency because the Postal Service cannot use its pricing flexibility to encourage growth in more profitable Presort letter mail volumes.

As a practical example, one effect of a “linked” rate design is that the Postal Service no longer would have the pricing flexibility to balance the relative burden of above-average increases among separate products within the same class. In First-Class

Mail the restriction on the Postal Service's pricing flexibility is compounded by the integer constraint. As a consequence, the price cap mechanics will generally require Presort letters to bear the above-average increase in pricing adjustments.

A rate design that treats Presort and Single-Piece letters as separate products, should benefit all First-Class Mail letter mailers. Treating Presort and Single-Piece letters as distinct products will allow the Postal Service to further deaverage Single-Piece pricing to reflect innovative new service offerings without concern regarding the affect on the benchmark and, by extension, Presort letter prices. For example, the Postal Service might explore offering a "lifeline" rate for less affluent Single-Piece mail users that is lower than the prevailing Single-Piece rate. The Postal Service could effectively deaverage Single-Piece rates to protect those consumer mailers who need additional security most, while facilitating the pricing flexibility needed to enhance the value of mail for small business and large commercial mailers.

Pitney Bowes has consistently advocated for the deaveraging of Single-Piece rates in ways that would extend the benefits of worksharing to small businesses and consumers, reduce costs and encourage efficiency, and help the Postal Service achieve the objectives of the PAEA. The Postal Service could offer discounted pricing to encourage Single-Piece mailers to present "clean" mail using enhanced address hygiene practices, enhanced security via sender-identified mail, or to encourage the adoption of Intelligent Mail barcodes (IMb) and information-based indicia for small mailers. The Postal Service could also use its pricing flexibility to promote a "green rate" for qualifying Single-Piece letters or to promote the use of alternative retail access channels.

For example, Pitney Bowes has consistently promoted the idea of an expanded retail access discount, *see* PRC Dkt. No. R2006-1, Revised Direct Testimony of Lawrence G. Buc (PB-T-3) on Behalf of Pitney Bowes Inc. (Nov. 6, 2006), for Single-Piece mail that avoids the high transaction costs of purchasing stamps at Postal Service retail windows. Because Single-Piece mailers could avoid the window in multiple ways (e.g., by purchasing postage at kiosks, online, or via a postage meter), this discount would be a “universal” workshare discount that could be easily accessed by small business and consumer mailers. An expanded retail access discount would also benefit the Postal Service by moving simple transactions from higher-cost Postal Service retail windows to lower-cost sales channels.

It also bears noting that treating Presort and Single-Piece letters as distinct products does nothing to dilute the statutory requirement for “just and reasonable” rates. *See* 39 U.S.C. § 3622(b)(8). Rather, the “just and reasonable” statutory objective must be read in concert with the efficiency and pricing flexibility objectives of the PAEA; thus, the Postal Service should not be given unfettered flexibility. The statutory objective of a “just and reasonable” rate design serves as an important check on the Postal Service’s pricing flexibility and allows the Commission to intervene if Single-Piece letter mailers are unreasonably disadvantaged in relation to Presort letters.

2. The Postal Service’s Methodology Gives the Postal Service the Flexibility It Needs to Protect Low-Cost, High-Profit Presort Volume

The Postal Service is operating under significant financial stress as it continues to experience unprecedented, sustained mail volume declines across all major classes. In 2008, the Postal Service experienced a 4.5% decrease in volume, the largest single-year decline ever recorded. That trend has accelerated in the first half of 2009, with a double-

digit percent decline in overall mail volumes. Against this backdrop, protecting highly-profitable First-Class Mail Presort letters is critical to the Postal Service’s future.

Notwithstanding that price differences between Single-Piece letter and Automation Mixed AADC letters exceed the corresponding cost avoidance (calculated relative to the BMM benchmark), the unit contribution data for First-Class Mail published in the Commission’s FY 2008 Annual Compliance Determination (ACD) conclusively establish that the average price difference between Single-Piece and Presort First-Class Mail letters is only a fraction of the actual cost difference between these products. *See* FY2008 ACD, at 48, Table VI-1. The unit contribution of the average Presort First-Class Mail letter (23 cents) is approximately five cents more than the unit contribution of the average Single-Piece First-Class Mail letter (18 cents). *See id.* Moreover, the cost coverage of Presort letters (302 percent) is nearly double the cost coverage of Single-Piece letters (171 percent). *See* FY2008 ACD, at 48, Table VI-1.

Table 1. FY2008 Profitability of First-Class Mail Letters

Product	Cost Coverage	Unit Contribution	Total Contribution (Billions)
First-Class Single-Piece Letters	170.9%	\$0.179	\$5.99
First-Class Presort Letters	301.5%	\$0.227	\$10.97

FY2008 ACD, at 48, Table VI-1

A “linked” rate design would worsen the existing discrepancy in profitability and contribution between Single-Piece and Presort letters. For example, reducing the current Single-Piece letter first-ounce rate by one cent to 43 cents, would necessitate an increase in the Presort letter first-ounce rate of as much as 0.7 cents to offset the revenue loss;

thus, increasing the current unit contribution disparity by approximately 2 cents.² Further pricing increases on Presort letters threaten to accelerate the decline in mail volumes and thus, increase the revenue shortfalls experienced by the Postal Service by driving away low-cost, high-profit mail. In FY 2008, the contribution of Presort Letters represented nearly forty percent of total institutional cost contribution. The FY2008 cost coverage for Presort letters was the highest of any product and despite the low cost of Presort letters (11 cents per piece), their unit contribution (23 cents per piece) was the highest of any high-volume product. *See* ACD, at 11, 12, 48. Accordingly, increasing the price of Presort letters to conform to a “linked” rate design between distinct products, would harm the Postal Service and all mailers by driving away low-cost, highly profitable mail volume. In the current economic climate, the Postal Service should be afforded every opportunity to grow this product.

B. Alternatively, If the Commission Determines that Presort and Single-Piece Letters Should Be Linked, the Commission Should Modify the Benchmark to Improve the Cost Avoidance Estimates

To the extent the Commission insists that the Postal Service “link” Presort and Single-Piece letters for purposes of the First-Class Mail rate design, it should at the same time adopt a modified benchmark to reflect the heterogeneity of Single-Piece Letter costs and the Postal Service’s increased pricing flexibility under the PAEA. As explained by Dr. John Panzar’s R2006-1 testimony, most theoretical analyses of worksharing assume that all mail in a particular category (e.g., Single-Piece letters) avoids the same amount of

² A 0.7 cent increase for First-Class Mail Automation letter first-ounce rates would effectively offset the revenue shortfall caused by reducing the First-Class Mail Single-Piece first-ounce rate because there are approximately 70 percent as many Single-Piece letters as Automation letters. *See* Dkt. No. R2009-2, PRC-LR-1, FCM cap calculations 2009.xls “Cap Test Calculations.”

cost by worksharing. See PRC Dkt. No. R2006-1, Direct Testimony of John C. Panzar (PB-T-1) on Behalf of Pitney Bowes Inc. (Nov. 6, 2006), at 35-39. The reality is much more complex.

For example, within Single-Piece letters, some letters are prepared very efficiently, perhaps in a manner that is similar to the theoretical bulk metered mail (BMM) letter benchmark; other Single-Piece letters are trayed, but not faced and not metered; and still others are entered as individual pieces in blue collection boxes. Thus, the cost avoided when a piece migrates from Single-Piece to Presort Letters can vary significantly, depending on the specific characteristics of the mailpiece.

As Dr. Panzar explained in his testimony, “in the presence of Postal Service mail processing heterogeneity, any discount policy will lead to some mail being processed inefficiently.” See *id.*, at 37. The BMM proxy used as the benchmark under the Commission’s methodology is a low-cost, highly-efficient type of Single-Piece mail. Because BMM is highly-efficient mail, the cost avoided by a BMM letter fall toward the bottom of a theoretical cost avoidance range. Thus, setting workshare discounts equal to the cost avoided (relative to BMM) locks the Postal Service into setting the price difference between Single-Piece and Presort letters at no more than the costs avoided by a mailer who presorts and presents low-cost, highly-efficient Single-Piece mail.³ This approach is virtually certain to create inefficiencies that specifically contradict multiple

³ For example, assume that the Postal Service’s unit cost for a presort letter is 4 cents, the unit cost of a BMM letter is 8 cents, and the unit cost of an average single-piece letter is 12 cents. Setting the discount equal to 4 cents (the cost avoided by a BMM letter) would provide an inefficient price signal for the average single-piece letter. Specifically, mailers that can presort the average single-piece letter for more than four cents, but less than eight cents would not do so even though doing so would reduce the total system costs and improve efficiency.

objectives and factors of the PAEA. *See* 39 U.S.C. §§ 3622(b)(1), (4) and 3622(c)(5), (7) and (12).

To address this statutory conflict, give effect to the Postal Service’s enhanced pricing flexibility, and to take into account the heterogeneity of Single-Piece letter costs, the Commission should permit the Postal Service to measure workshare-related costs avoided between Presort and Single-Piece letters in relation to an established range of workshare-related costs avoidance estimates. The upper bound of this range could be set at the cost avoided relative to an average Single-Piece letter; the lower bound could be set at the cost avoided relative to BMM. Because the upper bound of this range is the cost difference relative to the average Single-Piece letter, not a high-cost letter (e.g., one with a handwritten address), this approach affords significant protection for Single-Piece letters.

C. Even If the Commission determines that Presort and Single-Piece Letters Should Be “Linked,” the Existing First-Class Mail Rate Design is Consistent with the Workshare Limitations of the PAEA

Even if the Commission decides to “relink” Presort and Single-Piece letters, the First-Class Mail rate design developed under the Postal Service’s methodology is consistent with the workshare provisions of the PAEA and, therefore, need not be modified. Section 3622(e)(2)(D) provides an exception to the general workshare limitation where the “reduction or elimination of the discount would impede the efficient operation of the Postal Service.” 39 U.S.C. § 3622(e)(2)(D). Under a “linked” rate design with a 100 percent passthrough of the BMM-Automation mixed AADC letter cost avoidance, the price of an Automation Mixed AADC letter would increase. Because the percentage markups on the two products are already unequal, further pricing increases for

the Presort letters product would be economically inefficient. A reduction in the price differential between the two products, by means of a price increase on more profitable Presort First-Class Mail letters, would likely also lead to reduced volume of Presort letters and, therefore, a reduced aggregate contribution to the institutional costs of the Postal Service from First-Class Mail as a whole. Accordingly, the Postal Service could also claim an exemption from the general workshare limitation under section 3622(e)(3)(A). *See* 39 U.S.C. § 3622(e)(3)(A).

Furthermore, regardless of the Commission’s determination on the “linking” issue, any proposed changes to the First-Class Mail rate design should be implemented in the ordinary course of the next regularly scheduled notice of pricing adjustment. Pricing changes impose significant resource demands on mailers and service providers. An “out-of-cycle” pricing change would be disruptive under the best of circumstances. In view of the current economic challenges facing the mailing community and the Postal Service, and the focus on IMb implementation issues, now is a particularly inopportune time to impose that burden.

D. The Commission Should Adopt a Two-Part CRA Adjustment for First-Class Mail Presort and Standard Mail Regular Letters to Improve the Accuracy of the Reported Mail Processing Costs

The Postal Service’s current letter cost models understate the cost avoided by improving the presort of automation letters by using a single adjustment factor to tie modeled costs back to actual costs reported in the Cost and Revenue Analysis (CRA).⁴

⁴ This problem does not understate the average cost avoidance between the Single-Piece and Presort letter products. Thus, the adoption of a two-part CRA adjustment should have no effect on the average rate difference between Single-Piece and Presort letters.

The letter cost models could be substantially improved by the use of two CRA adjustment factors, which would allow more refined calibration to reflect actual costs.

Pitney Bowes has performed detailed comparisons of modeled and CRA letter-sorting costs in the Docket Nos. ACR2008, 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 2 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, system level adjustment is inferior because it leaves the non-IS costs too low and IS costs too high.

Table 2. Ratio of CRA-to-Modeled Letter Sorting Costs⁵

Mail Class		ACR 2008		ACR2007		R2006-1	
		IS	Non-IS	IS	Non-IS	IS	Non-IS
		[1]	[2]	[3]	[4]	[5]	[6]
First-Class Mail	[a]	0.979	1.557	0.986	1.449	0.804	1.205
Standard Mail	[b]	0.773	1.411	0.815	1.308	0.639	1.098

- [1a] PB-2, PB-2.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell M31.
 [1b] PB-3, PB-3.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell K28.
 [2a] PB-2, PB-2.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell L31.
 [2b] PB-3, PB-3.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell J28.
 [3a] RM2009-1, PB-2, 2007FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell M31.
 [3b] RM2009-1, PB-3, 2007SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell J28.
 [4a] RM2009-1, PB-2, 2007FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell L31.
 [4b] RM2009-1, PB-3, 2007SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell I28.
 [5a] RM2009-1, PB-4, R2006FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell M31.
 [5b] RM2009-1, PB-5, R2006SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell J28.
 [6a] RM2009-1, PB-4, R2006FCM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell L31.
 [6b] RM2009-1, PB-5, R2006SM.xls, worksheet "2Pt CRA - PRESORT LETTERS SUM," cell I28.

This biases downward the estimates of costs avoided by improving presort on First-Class Mail and Standard Regular automation letters. This is because 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.⁶ Specifically, non-IS letter sorts can be avoided by presorting. For example, 5-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.⁷

⁵ 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. Holding all else constant, these older read / accept rate data overstated the percentage of letters that are sorted manually and thus letter-sorting costs. More recent read / accept rate data were used in the ACR2007 and ACR2008 models. Also, note that the ratios in Table 1 cannot be compared directly with the CRA adjustment factors used in Docket Nos. R2006-1, ACR2007, and ACR2008 because the CRA costs used to develop these ratios are only letter sorting costs while the CRA costs used in the R2006-1, ACR2007, and ACR2008 CRA costs also include other costs that vary with letter sorting costs.

⁶ 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.

⁷ The same cannot be said for other shapes of mail. For example, presorting Periodicals flats to Carrier Route does avoid IS sorting costs.

To remedy this, 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.⁸

Attached are three appendices, PB-1 through PB-3. 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 and PB-3) contain the SAS files used to disaggregate FY 2008 CRA letter sorting costs into IS and non-IS costs, and modified versions of the PRC's Docket No. ACR2008 letter cost models that implement the two-part CRA adjustment.⁹

Pitney Bowes respectfully submits that the Commission adopt the improved cost avoidance estimates derived from the use of a "two-part CRA adjustment" as a costing methodology change for designing and evaluating discounts for First-Class Mail and Standard Regular automation letters.

⁸ To be conservative, Pitney Bowes retained the use of a single, system level adjustment for non-letter sorting cost pools.

⁹ PB filed modified versions of the PRC's Docket Nos. R2006-1 and ACR2007 letter cost models (and the associated SAS files) as appendices to its reply comments in Docket No. RM2009-1 and modified versions of the USPS Docket No. ACR2008 letter cost models (and the associated SAS files) as appendices to its Docket No. ACR2008 comments.

III. CONCLUSION

The Commission in this proceeding could, with the best of intentions, thwart progress that is essential to realize the promise and potential of the PAEA. It could do this by failing to recognize that breaking the traditional pricing relationship between First-Class Mail Presort letters and First-Class Mail Single-Piece letters is in the best interest of users of *both* products, the Postal Service, and all of its customers.

The discussion above demonstrates there is ample authority under the PAEA to treat Presort letters and Single-Piece letters as separate, distinct products and to allow the Postal Service to price them accordingly as it has done in the first two market dominant rate adjustments under the PAEA. Even assuming the Commission has the authority to require otherwise, the Commission should refrain from doing so.

Reimposing a straitjacket on the Postal Service's flexibility in pricing these two separate and distinct products would be unjustified and counter-productive. The traditional benchmark, BMM, is no longer relevant to the relationship of these products. Users of Presort who find price incentives insufficient to justify worksharing likely would not revert to Single Piece. There are other, nonpostal, alternatives such as the internet readily available. As the recent economic downturn has shown, Presort Mail volume is vulnerable to diversion.

On average, each Presort letter today earns a nickel more "profit" for the Postal Service than a Single-Piece letter. To survive, the Postal Service must have the flexibility to price this profitable mail in a manner that encourages users to stay in the mail. It must be able to price without the artificial constraints that, as explained above, result from "linking" it to Single-Piece which itself is constrained by the integer constraint and price

cap mechanics.

Finally, concern that severing the relationship between Presort letters and Single-Piece letters will systematically disadvantage Single-Piece mailers is speculative and unrealistic. First, as discussed above affording more pricing flexibility opens new opportunities to make mail attractive to and affordable to household and small business mailers. Second, there is no indication that the Postal Service has any interest in treating Single-Piece mailers unfairly. Finally, should the price differential between Presort and Single-Piece rates some day exceed the zone of reasonableness, the Commission would have ample authority under the PAEA to require corrective action to ensure that prices are “just and reasonable.”

Respectfully submitted,

/s/

James Pierce Myers
Attorney at Law
1617 Courtland Road
Alexandria, VA 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.

DATE: May 26, 2009

Appendix 1 (PB-1)

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

This explanation closely follows Appendix 1 (PB-1) of PB's RM2009-1 Reply Comments (filed on December 10, 2008) and Appendix 1 (PB-1) of PB's ACR2008 Comments (filed on January 30, 2009).

The proportional Cost and Revenue Analysis (CRA) adjustment is performed by comparing the CRA letter-sorting costs (and other costs that vary with 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 Presort 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 Presort 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 and PB-3.

- PB-2 contains a modified version of the Docket No. ACR2008 PRC First-Class Mail letter cost model.
- PB-3 contains a modified version of the Docket No. ACR2008 PRC Standard Mail Regular letter cost model.¹⁰

To divide the CRA letter-sorting costs 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.¹¹ The analyses used the IOCS data and programs from Docket No. ACR 2008.¹² 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.

¹⁰ Specifically, PB-2 is a modified version of PRC-LR-3, FCM letter costs 2008.xls and PB-3 is a modified version of PRC-LR-4, PRC-FY08_STD_Reg_Letter_Costs.xls. The appendices also include the SAS programs used to analyze IOCS data and the corresponding output files.

¹¹ For Standard Mail, there were no tallies for LD42, so only eight letter-sorting cost pools could be analyzed.

¹² The ACR2008 IOCS data were filed in USPS-FY08-37 and the SAS programs were filed in USPS-FY08-NP18. See USPS-FY08-7, Preface to USPS-FY-08-7.doc at 1.

Separate SAS programs (which can be found in PB-2 and PB-3) were written for each of the cost pools to analyze the tallies.¹³

The MODS codes in the IOCS data were grouped into Non-IS, IS and Other categories.¹⁴ 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.¹⁵ In the small number of instances where neither the MODS code nor the IOCS questions provided scheme information, the tallies were left in the Other category.¹⁶

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 costs into the three categories of Non-IS, IS and Other.¹⁷

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.¹⁸

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 letter-sorting costs that fall into the Other category as well as for all non-letter-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 the workbooks in appendices PB-2 and PB-3.

¹³ There were 7,106 First-Class Mail Presort Letter and 6,946 Standard Mail Regular letter direct tallies in the letter-sorting cost pools.

¹⁴ The groupings appear in the SAS output files in PB-2 and PB-3.

¹⁵ IOCS collects relevant scheme information in questions Q18C5 and Q18D2.

¹⁶ Only about two percent of CRA costs in the letter-sorting cost pools was classified as “Other.”

¹⁷ See the calculation performed on worksheet “2Pt CRA – PRESORT LETTERS” in the workbooks in PB-2 and PB-3.

¹⁸ The calculation is performed on worksheet “2Pt CRA - PRESORT LETTERS SUM” in the workbooks in PB-2 and PB-3.