CHAPTER 3

Organisation, costs and profits of Pitney Bowes

History

3.1. A company called Universal Postal Frankers Ltd (UPF) was incorporated in 1922. In the following year it began supplying a version of a New Zealand developed postal franking machine after it had been approved by the Post Office. In 1929 Pitney Bowes Inc acquired 94 per cent of the share capital of UPF which continued to operate autonomously, manufacturing its own range of postal franking machines but also acting as distributor of Pitney Bowes Inc's postal franking machines in the United Kingdom. UPF also developed an export trade in these products. Pitney Bowes Inc acquired the remaining shares in UPF in 1959. In the following year UPF's name was changed to Pitney-Bowes Ltd (subsequently changed to Pitney Bowes Ltd in 1975 and to Pitney Bowes PLC in 1982).

3.2. In the immediate post-war period Pitney Bowes Inc expanded its range of products to meet the growing mailing and paper handling needs of customers and in the 1960s began a major programme of planned expansion in the United States of America and other countries. In the United Kingdom Pitney Bowes PLC's manufacturing facilities were transferred from Edmonton to Harlow, a new range of meters and bases was introduced and a network of branch offices was established which enabled the company to double its sales and servicing operation. Pitney Bowes PLC also widened its product range by the introduction of addressing and copying machines. In the following decade a new small integrated postal franking machine was introduced and Pitney Bowes PLC diversified further into the supply of other types of business equipment such as collators, inserters, scales and mailing systems furniture, and also expanded its export business. In 1982 the company introduced to the United Kingdom market the remote meter resetting system (RMRS)[1] developed by Pitney Bowes Inc in the United States of America (see Appendix 2.2), and also introduced the first fully electronic postage meter in the United Kingdom.

Corporate structure

3.3. Pitney Bowes Holdings Ltd (PB Holdings), a non-trading company, is the parent company for Pitney Bowes Inc's interests in the United Kingdom. PB Holdings has three wholly-owned subsidiaries:

(*a*) *Pitney Bowes PLC* which carries on business in the manufacture, supply and maintenance of postal franking machines and in the supply and maintenance of other types of office equipment;

(*b*) *PB Leasing Ltd* which provides leasing facilities to customers of Pitney Bowes PLC and of other group companies and to customers outside the group; and

(*c*) *Dictaphone Company Ltd* which supplies dictation equipment.[2]

[1] RMRS is a registered trade mark of Pitney Bowes.
[2] Not within the terms of the references.

PB Holdings is a wholly-owned subsidiary of PB Leasing International Corporation which in turn is wholly owned by Pitney Bowes Inc. Pitney Bowes Inc and PB Leasing International Corporation are incorporated in Delaware in the United States of America.

3.4. Mailing systems (including, but not limited to, postal franking machines) are Pitney Bowes' major activity accounting for 54 per cent of its world-wide turnover in 1984. Other major product groups are facsimile transmission systems, copiers, dictation equipment, retail price marking equipment, data processing supplies and financial services (principally leasing). The group has manufacturing facilities in Australia, Belgium, Brazil, Canada, the Federal Republic of Germany, Mexico, Singapore, Switzerland, the United Kingdom and the United States of America although most are not concerned with postal franking machines. There are other subsidiaries in Austria, Finland, Japan, the Netherlands and Sweden. The Finnish subsidiary company, Pitney Bowes OY, is wholly-owned by Pitney Bowes PLC which also owns 49 per cent of the Swedish subsidiary Pitney Bowes Svenska AB. The structure of the group so far as relevant to the United Kingdom is set out in Appendix 3.1.

Management structure

3.5. The organisational control of Pitney Bowes in the United Kingdom does not follow the same pattern as the corporate structure set out in paragraph 3.3. The managing director of Pitney Bowes PLC reports to the group vice-president of Pitney Bowes Business Systems-International in the United States of America. The managing director of PB Leasing reports to the president of financial services, Pitney Bowes Inc.

3.6. Pitney Bowes PLC's managing director has guidelines which lay down the areas in which, except in relation to external subsidiaries, he is responsible and those in which he is required to inform or seek approval as appropriate of the group vice-president. In general under these guidelines day-to-day management is delegated but all major policy and financial matters including the annual budget, expenditure and personnel matters are subject to review and decision by the group vice-president. Price changes, which are put forward by the marketing division, are approved by Pitney Bowes PLC's managing director without prior reference to the company's board of directors or to the group vice-president.

3.7. Pitney Bowes PLC has operating divisions for finance, management services, manufacturing and marketing, and a personnel and training department. There is a separate sales and maintenance organisation for Ireland which has responsibility for both Northern Ireland and the Republic of Ireland.

Turnover

3.8. Pitney Bowes PLC's turnover for the period 1979 to 1984 is set out in Table 3.1.

TABLE 3.1 **Pitney Bowes PLC: turnover, 1979 to 1984**

1979	1980	1981	1982	1983	£'000 1984
26,259	30,454	32,263	37,046	42,937	46,727

Source: Pitney Bowes PLC.

A breakdown of Pitney Bowes PLC's turnover for the same period showing the percentages accounted for by the supply and maintenance of postal franking machines in the United Kingdom, exports and other activities is at Table 3.2. Further financial information is at paragraphs 3.46 to 3.59.

TABLE 3.2 **Pitney Bowes PLC: analysis of turnover, 1979 to 1984**

Activity	*1979*	*1980*	*1981*	*1982*	*1983*	*per cent 1984*
Supply of postal franking machines in the United Kingdom	44·4	45·6	47·4	41·2	41·7	40·1
Maintenance of postal franking machines in the United Kingdom	11·1	11·2	12·4	12·3	12·5	12·4
Exports	25·8	26·9	21·5	27·9	25·4	25·9
Other activities	18·7	16·3	18·7	18·6	20·4	21·6
Total	100	100	100	100	100	100

Source: MMC study.

Production

3.9. Pitney Bowes PLC's headquarters and manufacturing facilities are situated in Harlow, Essex. The manufacturing plant is the group's main producer of postal franking machines outside the United States of America. The factory was built in 1963–64 and extended in 1968 to 1970. Electrical, electronic and a number of other components are bought in but much of the production is from raw material to finished product. On the basis of added value 96·7 per cent of the factory's output in 1983 was of postal franking machines for home and export markets. The volume of Pitney Bowes PLC's production of postal franking machines at Harlow from 1979 to 1984 is set out in Table 3.3.

TABLE 3.3 **Pitney Bowes PLC: annual volume of production of postal franking machines in the United Kingdom, 1979 to 1984**

	1979	*1980*	*1981*	*1982*	*1983*	*1984*
Integrated machines	12,423	14,595	12,006	11,460	14,684	14,340
Meters	11,128	12,675	11,843	10,196	11,525	15,484
Bases	56,259	39,435*	18,255	18,556	16,799	16,079
Machines in 'kit' form	749	7,642	12,982	21,890	14,060	21,000

Source: Pitney Bowes PLC.

*In 1980 some production of bases was transferred to Germany.

3.10. The numbers employed in Pitney Bowes PLC's manufacturing division as at the end of 1984 were 469. The company considered that utilisation of its production capacity in 1984 was 74 per cent. Capacity utilisation is affected significantly by product mix.

Productivity

3.11. Pitney Bowes PLC told us that between 1976 and 1983 it had improved productivity in the factory significantly by, *inter alia,* work study, value analysis and investment in new plant. We were told that as a consequence of improved productivity, overtime and downtime has been reduced and the ratio of indirect to direct production workers improved.

Technical development

3.12. Major design and development work on new postal franking machines is generally undertaken by Pitney Bowes Inc in the United States of America. Pitney Bowes PLC undertakes work in adapting designs for the United Kingdom and export markets and in production engineering. Design work on new products is being carried out both in the United States of America and in the United Kingdom. Expenditure on research and development (R & D) (including work on reference products) by Pitney Bowes Inc in 1984 amounted to US $40·8 million. Pitney Bowes PLC treats its R & D work as an integral part of its manufacturing activities and it was unable to identify its expenditure on R & D.

Patent policy and licensing

3.13. The protection of patents in the United Kingdom is sought mainly in the name of Pitney Bowes Inc though some inventions attributed to Pitney Bowes PLC have been patented by it. This work is co-ordinated by the patent department of Pitney Bowes Inc which is kept informed of all relevant developments by Pitney Bowes PLC. Exchange of technology between Pitney Bowes Inc and Pitney Bowes PLC is governed formally by a non-exclusive cross-licensing agreement entered into in 1965. The agreement was expressed as relating to all existing and future patents and machines but in practice the parties identify from time to time specific models as subject to the agreement and therefore to the royalty of 4 per cent of net revenue payable to Pitney Bowes Inc.

3.14. Pitney Bowes told us that the acquisition or grant of licences for technology is considered on a case-by-case basis. It will seek to acquire a licence when it believes that to do so will be more cost-effective than in-house development as a means of obtaining the technology needed to maintain its competitive position, and it will consider the grant of such a licence in cases where the licensee can offer financial or technological benefits to the group commensurate with the benefits granted.

3.15. Under the terms of a consent decree filed in 1959, Pitney Bowes Inc was required, *inter alia,* to grant unrestricted non-exclusive licences to any United States or foreign company authorised by the United States Post Office to manufacture postal franking machines in the United States of America. The consent decree was filed in settlement of a complaint by the United States Department of Justice that Pitney Bowes Inc was in breach of the United States anti trust legislation and did not apply to patents issued after 1969. It is understood that the patents covered by the consent decree have now expired and were not relevant to the negotiations described in paragraph 3.16.

3.16. In 1984 Pitney Bowes Inc entered into a non-exclusive licensing agreement in the United States of America with f.m.e. Corporation (trading as and subsequently referred to in this report as 'Friden-Alcatel') which is a wholly-owned United States subsidiary of CIT Alcatel. The agreement covers the non-exclusive licensing by Pitney Bowes Inc to Friden-Alcatel and by Friden-Alcatel to Pitney Bowes Inc of a limited number of present and future United States and Canadian patents covering postal franking machines. The agreement was entered into in settlement of patent infringement litigation commenced by Pitney Bowes Inc. Pitney Bowes Inc has also licensed certain RMRS patents and technology non-exclusively to Friden-Alcatel in the United States of America and has offered a similar licence to Rockaway Corporation, the United States distributor of Hasler's postal franking machines.

3.17. Following the litigation settlement discussions were held between Pitney Bowes Inc and CIT Alcatel in relation to patents held in Europe and elsewhere covering electronic meters and a second agreement covering the rest of the world excluding the United States of America and Canada was made with effect from 1 January 1985 (the 1985 agreement). Major provisions of this agreement include:

(*a*) cross-licensing of certain patents defined and listed in the agreement in consideration of a substantial non-refundable payment by CIT Alcatel;

(*b*) subject to detailed provisions set out in the agreement, the grant by CIT Alcatel to Pitney Bowes Inc of an option to designate, from time to time, up to eight patents (together with all related and counterpart patents in the territory) owned or controlled by CIT Alcatel and to obtain non-exclusive licences for such patents ('the pick option'). Provision is made for the payment by Pitney Bowes Inc to CIT Alcatel (subject to index linking) of a fixed fee for each patent so designated and licensed. It is provided also that the pick option shall expire upon the earlier to happen of the designation of the eight patents and the expiration of the agreement. The agreement will expire when the last of the patents licensed under the cross-licensing provision referred to in (a) above expires and we understand that this will be in or about the year 2020;

(*c*) agreement by CIT Alcatel that, until Pitney Bowes Inc no longer has the right to exercise the pick option, CIT Alcatel will not, in such a way as would preclude Pitney Bowes Inc from also obtaining a licence, request or demand a licence from any third party for the use in the territory of any patent relating to the processes or apparatus defined in the agreement or to the method of their manufacture or operation.

3.18. In the course of the negotiations which preceded the making of the 1985 agreement Pitney Bowes Inc offered CIT Alcatel an option in relation to two Pitney Bowes Inc patents for a similar period as that given by CIT Alcatel to Pitney Bowes Inc. This offer would have entailed payment by CIT Alcatel of a larger sum than that for which it ultimately agreed to settle and was not acceptable to CIT Alcatel.

3.19. Pitney Bowes Inc has offered terms to two United Kingdom suppliers of electronic mailing scales capable of interfacing with electronic postal franking machines for agreements under which the scale suppliers would obtain non-exclusive patent licences and certain technical information held by Pitney Bowes Inc. These terms have not been accepted. Pitney Bowes Inc has already concluded licensing agreements for interfacing electronic mailing scales with its electronic postal franking machines with two companies in the United States of America.

3.20. Pitney Bowes PLC announced in 1984 a scheme under which it is prepared to enter into arrangements with small companies to distribute (and possibly to manufacture under licence) innovative products that such companies have developed but cannot adequately market on their own. It is possible, according to the company, that the scheme will lead to future licensing arrangements in respect of products relevant to the references.

Distribution arrangements

3.21. Pitney Bowes PLC's marketing division is responsible for marketing, sales and customer services (including maintenance in the United Kingdom and the Republic of Ireland). In the United Kingdom the company distributes its complete range of products by direct supply and makes no use of distributors or retailers.

3.22. The sales force operates out of ten branch offices in Great Britain with a further office in each of Northern Ireland and the Republic of Ireland. In 1984 there were 47 sales teams, of which 36 sold mailing systems equipment (mainly postal franking machines) and copiers to standard account customers; ten sold the total range of equipment to major account customers and only paper-handling equipment to standard account customers; and one sold the total range of equipment to special account customers. In addition one team sold facsimile transmission equipment and telephone logging systems.

3.23. As at the end of 1984 the marketing division had 874 staff of whom 394 were primarily concerned with sales. Sales staff are paid a basic salary with commission. Pitney Bowes PLC told us that for the median salesman commission represented between 40 per cent and 50 per cent of total remuneration.

Maintenance arrangements

3.24. Pitney Bowes PLC provides its maintenance service in the United Kingdom from a network of eleven branch offices. Prior to 1940 the company provided this service only in London and the Home Counties and servicing in other parts of the United Kingdom was carried out by agents, but the company currently makes no use of agency servicing. Pitney Bowes PLC's service organisation employed some 310 staff in 1984. Service staff are also engaged on the installation and withdrawal of equipment and, in addition to their salaries, are paid commission at the rate of 1 per cent in respect of sales leads that are converted into firm orders.

3.25. The Post Office's regulations require all meters and integrated machines to be maintained by or on behalf of the supplier. Pitney Bowes PLC makes it a condition of the supply of meters and integrated machines that they be maintained by the company under a maintenance contract irrespective of whether the form of supply is purchase or leasing. Maintenance of rented postal franking machines is included in the rental charge. The company will, however, allow users who have purchased or leased bases to maintain them themselves and will provide spare parts, manuals and training for this purpose. We understand some independent maintenance of bases takes place in the United States of America but there is no third party maintenance of Pitney Bowes PLC's bases or meters in the United Kingdom. Pitney Bowes PLC does not maintain postal franking machines which have been supplied by other companies.

Pitney Bowes PLC's terms of supply

3.26. Pitney Bowes PLC offers users the option of purchase, lease-rental or rental, though not all options are available on all its postal franking machines. All integrated machines and bases are available for purchase, rental or leasing.[1] All the company's range of meters can be rented from Pitney Bowes PLC or leased from its associated leasing company, PB Leasing. The 5300 series meter (excluding RMRS versions) and the R series meters can be purchased but this option is open only to certain highly secure customers for their own use. Prior to July 1984 meters and integrated machines were not generally available on lease through third party leasing companies but this option is now open to customers in respect of the 6300 series integrated machines, R series meters and 5300 series (excluding RMRS) in those cases where a purchase option is available. Although leasing through third party leasing companies of most of its range of equipment is now allowed by Pitney Bowes PLC, in practice, as Table 3.4 indicates, almost all leasing of its postal franking machines is done by its associated leasing company, PB Leasing. Pitney Bowes PLC receives commission from PB Leasing but told us that it did not currently receive commission from third party leasing companies.[2]

3.27. The terms of Pitney Bowes PLC's agreement with PB Leasing require it to promote PB Leasing's facilities to customers. Pitney Bowes PLC does not permit its sales force to promote the services of third party leasing companies competing with PB Leasing. Pitney Bowes PLC told us that in 1985 it had been approached by one such leasing company prepared to offer lower rates than PB Leasing but Pitney Bowes PLC saw no reason to promote that company's services alongside those of PB Leasing. Customers who wish to use third party leasing companies have to make their own arrangements and then make a request to Pitney Bowes PLC to supply via the third party leasing company.

3.28. A breakdown of Pitney Bowes PLC's supplies of reference goods by method of supply in 1983 and 1984 is set out in Table 3.4.

[1] Paragraph 2.27 explains the types of arrangements used in the leasing of postal franking machines.

[2] PB Leasing's business is described in more detail in paragraphs 3.35 to 3.37.

TABLE 3.4 **Supplies of reference goods by Pitney Bowes PLC in the United Kingdom by method of supply, 1983 and 1984**

	1983		*1984*	
	£'000	*%*	*£'000*	*%*
Sales to PB Leasing	7,804	52·6	7,835	50·4
Sales to other principal leasing companies*	120	0·8	87	0·6
Sales to end users	3,826	25·8	4,271	27·4
Rental placements (notional value)	3,099	20·9	3,363	21·6
Total	14,849		15,556	

Source: MMC study from Pitney Bowes PLC data.

*Sales to principal leasing companies only. Sales to other leasing companies are very small and are included in sales to end users.

Note: Percentages do not always add up to 100 due to rounding.

Second-hand equipment

3.29. The limited nature of the second-hand market in postal franking machines is explained in paragraph 2.24. Pitney Bowes PLC acquires or repossesses postal franking equipment from users either in part-exchange or when it is returned after the termination of rental agreements. A few machines are obtained from company liquidations and, with the increase in leasing, larger numbers are expected to be repurchased from PB Leasing under the terms of Pitney Bowes PLC's agreement with it (paragraph 3.40). To avoid VAT problems arising on part-exchanged machines an undertaking has been given by Pitney Bowes PLC to HM Customs and Excise and part-exchanged equipment is generally scrapped.

3.30. Second-hand bases may be and non-mint bases generally are marketable without refurbishment. Such bases are either sold (usually at a discount) or retained by Pitney Bowes PLC for temporary loan to customers whose own bases are returned for repair. If not considered marketable they are scrapped. By way of exception some 5510 bases (which are no longer in new production) and some 5470 bases returned by PB Leasing during the primary lease term are refurbished. Scrapped bases may be cannibalised but this is generally not worthwhile.

3.31. A small proportion of non-mint and second-hand meters are in sufficiently good condition to be supplied for rental (particularly as substitutes for rented meters returned for repair) without refurbishment. The only other unrefurbished non-mint machine which the company markets is the 6330 integrated machine, a very few of which are sold non-mint at a discount. Subject to the foregoing, whenever possible Pitney Bowes PLC refurbishes or cannibalises non-mint and second-hand meters. Pitney Bowes PLC says that refurbished machines are in all respects as good as their newly produced counterparts and that refurbishment is capable of extending the life of meters and integrated machines almost indefinitely. Some newly produced machines may incorporate parts recovered from second-hand machines.

Spare parts

3.32. Pitney Bowes PLC does not supply spare parts for meters or integrated machines. As indicated in paragraph 3.25, spare parts for bases are readily available to customers who service their own bases and the company says it is prepared to supply spare parts for bases to third parties.

Imports and exports

3.33. Pitney Bowes PLC markets some machines imported from Pitney Bowes Inc. It also has a large export trade in postal franking machines and associated equipment which in 1984 amounted to about 70 per cent of its production. The exported machines are sold to Pitney Bowes PLC's associated or subsidiary companies in Austria, Brazil, Canada, Finland, the Federal Republic of Germany, Japan, Sweden, Switzerland and to Pitney Bowes Inc in the United States of America. In other countries machines are sold to distributors. The company markets its products directly in the Republic of Ireland through its branch office and through authorised distributors in other countries.

Other products

3.34. In addition to postal franking machines Pitney Bowes PLC supplies a wide range of other products in the office equipment field in the United Kingdom as follows:

mechanical and electronic scales;
mail openers and sealers;
cheque signers;
folders and inserters;
mailing systems furniture;
counters and coders;
multi-station inserters;
collators and decollators;
copiers;
addresser printers; and
facsimile transmission systems.

With certain exceptions (namely most electronic scales, mailing systems furniture, copiers, telephone logging equipment and facsimile systems) all these products are acquired from Pitney Bowes Inc or from that company's German subsidiary. Products acquired from sources outside the Pitney Bowes group are sold under the Pitney Bowes name. In 1984 total revenue from the supply and maintenance of non-reference products in the United Kingdom amounted to £10,082,000 which is equivalent to approximately 29 per cent of the total United Kingdom turnover.

PB Leasing Ltd

3.35. PB Leasing was incorporated in 1977 to provide leasing facilities to the Pitney Bowes group in the United Kingdom. Pitney Bowes told us that one of the factors in the decision to set up an in-house leasing company was the difficulty encountered after the secondary banking crisis in obtaining leasing facilities from external sources. From the outset Pitney Bowes intended to develop PB Leasing to meet the demands of the market for leasing services for equipment other than group products.

3.36. Until 1982 administration of PB Leasing's agreements was carried out by Barclay Mercantile Industrial Finance Ltd using that company's computer facilities. Administrative services were taken back from Barclay Mercantile in 1982 and in the middle of 1983 PB Leasing took on leasing for suppliers from outside the group. The external business of PB Leasing has grown significantly and it is expected eventually to provide a bigger portfolio than that provided by group companies. In 1984 reference goods constituted about 50 per cent of the new business. PB Leasing's income taken to the profit and loss account and the capital value of assets leased in the year is set out in Table 3.5.

TABLE 3.5 **PB Leasing Ltd: lease income and capital value of assets leased in the years 1979 to 1984**

£'000

	1979	*1980*	*1981*	*1982*	*1983*	*1984*
Lease income	1,589	3,258	4,470	5,611	6,642	7,937
Capital value of assets leased in year	6,724	7,780	7,388	9,629	15,100	19,627

Source: PB Leasing.

3.37. PB Leasing now has some 50 staff and 37,000 accounts mostly of small value. The company operates as a self-contained integrated leasing business which Pitney Bowes told us was run at arm's length from Pitney Bowes PLC and other group companies. PB Leasing's budgets, objectives, pricing, marketing and overall strategic planning are reviewed directly by Pitney Bowes Inc's Financial Services Division in the United States of America. PB Leasing has operating agreements with suppliers for whom it provides leasing services. Under the terms of the agreement with Pitney Bowes PLC, a commission or 'finder's fee' is payable by PB Leasing on goods purchased from Pitney Bowes PLC. The rate of commission was originally set at 7·5 per cent but was reduced to 4 per cent for postal franking machines in 1979. In 1983 revised rates of between 1 per cent and 4·5 per cent were agreed for all products according to the value of the lease. PB Leasing does not normally offer a finder's fee to other companies; if asked for, it has to be incorporated in the overall rental. The percentage asked for depends upon the type of business offered and the company prefers to avoid paying finders' fees and seeks to negotiate the lowest possible rates.

Pricing policy

3.38. Pitney Bowes PLC maintains an internal price list which includes details of the prices and, where applicable, rental and lease terms[1] with maintenance charges of all machines and ancillary supplies. As explained in paragraph 2.32, the company does not provide price lists except to certain major and special account customers, although some information on prices is occasionally available from trade magazines or in answer to specific telephone enquiries.

3.39. Pricing proposals are put forward in the first instance by the marketing manager for agreement by the marketing director and decisions are then subject to the final approval of Pitney Bowes PLC's managing director. Pricing proposals are not put to the board for approval. The authorisation of Pitney Bowes Inc is not required for specific price changes, though it is kept fully informed of developments. Pitney Bowes PLC says that in determining

[1] The lease terms relate only to those offered by PB Leasing.

prices, including rentals, it takes account of its own costs and market conditions. Market conditions include the prices (in relation to performance) of competing machines. Other factors are the reputation of competing suppliers for reliability and service, and competition from other means of postal payment and alternative communication technologies. Consideration is given to the gross contribution to the business that a product is thought capable of generating, the effect of discounts on revenues, the relationship between sale, rental charges and leasing rates and the combination of product and maintenance charges. The company has arrangements for discounts which are set out in paragraphs 2.40 to 2.43.

3.40. PB Leasing purchases postal franking machines from Pitney Bowes PLC at the latter's standard selling prices or, if a discount has been agreed with the lessee by Pitney Bowes PLC's sales staff, at the discounted price. PB Leasing itself offers special discounts when faced with competition or with customers requesting a lower rental and it told us that only a small proportion of its business is written at its standard rates. PB Leasing itself bears the cost of special discounts off its leasing rates. Pitney Bowes PLC and PB Leasing have an agreement, initiated in 1977, under which Pitney Bowes PLC buys back leased equipment when leases are terminated. Equipment that has been leased for four years or more is transferred to Pitney Bowes PLC for no charge.

3.41. PB Leasing's leasing rates are determined once a year for all products handled by the company. The company says that setting rates is a complex matter but in broad terms they are set with four factors in mind, viz market acceptability, market strategy, costs and profits. Rates vary according to the type of product and end user, the average value of the product, the possibilities of loss and past business experience. Rates are fixed at a level which will absorb the costs but still yield a profit before taxation. Profitability is looked at in general terms and the company's objective is to achieve 15 per cent growth in net income each year as a result of increased volumes of business and an expanding portfolio. The average leasing rate charged by PB Leasing for postal franking machines in 1984 was approximately £76 to £77 per quarter per £1,000 of capital cost.

Prices and rentals

3.42. Pitney Bowes PLC's standard list prices for its postal franking meters, bases and integrated machines as at April 1985 are set out in Appendix 2.1 which also shows yearly meter rentals and annual contract maintenance charges for meters (if not rented) and bases.

3.43. Pitney Bowes PLC's price trends are set out in Table 2.9 and are discussed in paragraphs 2.36 to 2.39. Generally prices for bases have risen significantly in real terms during the ten-year period but meter rentals and prices of the older smaller models have fallen. Contract maintenance charges have fallen in real terms for small machines and one medium to large machine but have risen for the other medium to large machines.

3.44. Pitney Bowes PLC explained its price changes since July 1982 by reference to a background of continuing inflation in the United Kingdom, and the decline in the value of sterling against the US dollar by 50 per cent from 1981 to early 1984. The decline in the value of sterling had increased the cost of reference goods and components imported from Pitney Bowes Inc which were priced in US dollars. Imported components accounted for a high proportion of the standard cost of certain models, though only a small proportion of other models. Of models for which information was available, import costs accounted for from 1 to 17 per cent of the list price of models produced or assembled in the United Kingdom and from 22 to 27 per cent of the list price of imported models.

3.45. Pitney Bowes PLC has price lists for exports to its overseas distributors and for sales to other companies in the group. List prices for distributors are generally higher than those applicable to intra-group transfers because Pitney Bowes PLC gives marketing support to its distributors that it does not give to other Pitney Bowes group companies. The list prices serve as a basis from which discounts are negotiated in the light of local market conditions. Pitney Bowes PLC says that similar considerations apply to the negotiation of prices for goods supplied to it by Pitney Bowes Inc. Export prices are wholesale and are significantly below the retail prices of machines supplied to the United Kingdom market but the company says that the prices of all export sales (except for one product to one country) are sufficient to cover direct (avoidable) costs.

Accounting system

3.46. Pitney Bowes PLC's financial and management accounting system includes a computerised management information and accounting system which incorporates the following features:

(*a*) analysis of income and costs according to function;
(*b*) a standard manufacturing costing system;
(*c*) annual budgets; and
(*d*) monthly reports comparing actual performance against budgets.

3.47. The company says that, within the group, parameters of performance and market strategy are set for each business unit or geographical area by the chairman of Pitney Bowes Inc. The annual budgeting process then seeks to establish targets within those parameters taking account of market conditions and opportunities. The annual budget of the United Kingdom operations is subject to the approval of the chairman and board of Pitney Bowes Inc.

3.48. Each unit, including Pitney Bowes PLC, is divided into a number of cost centres and control of the budgeting system is monitored through these centres, the managers being responsible for meeting the target allocation of costs and, where appropriate, sales revenue.

3.49. The overall operating results of Pitney Bowes PLC since 1979 derived from the company's management accounts are shown in Table 3.6.

TABLE 3.6 **Pitney Bowes PLC: calculation of return on sales and capital employed**

All reference and non-reference products

£'000

	1979	*1980*	*1981*	*1982*	*1983*	*1984*
Historical cost basis						
Revenue	26,259	30,454	32,263	37,046	42,937	46,727
Total directly attributed costs*	(12,487)	(14,825)	(14,731)	(19,782)	(23,444)	(26,630)
Contribution to indirect costs and profit	13,772	15,629	17,532	17,264	19,493	20,097
As a % of revenue	52	51	54	47	45	43
Selling, marketing, financial, administration and other costs not directly attributed	(10,681)	(11,931)	(13,790)	(14,684)	(15,849)	(17,654)
Operating profit/(loss) before interest and taxation	3,091	3,698	3,742	2,580	3,644	2,443
Average capital employed	8,575	9,190	9,942	10,415	10,982	13,000
Current cost basis						
Operating profit/(loss) before interest and taxation, historical cost basis	3,091	3,698	3,742	2,580	3,644	2,443
Current cost adjustments	(929)	(1,389)	(1,448)	(1,213)	(1,512)	(712)
Operating profit/(loss) before interest and taxation	2,162	2,309	2,294	1,367	2,132	1,731
Average capital employed	11,590	12,368	13,064	13,573	14,416	16,100
Historical cost basis						
Operating profit as a percentage of revenue	12	12	12	7	8	5
Return on capital employed (%)	36	40	38	25	33	19
Current cost basis						
Operating profit as a percentage of revenue	8	8	7	4	5	4
Return on capital employed (%)	19	19	18	10	15	11

Source: MMC study from Pitney Bowes PLC's management accounts.

*This figure includes standard factory or import cost plus those selling, marketing and other costs directly attributed.

3.50. We asked Pitney Bowes PLC for details of its operating profit before interest and taxation and return on capital employed on the reference goods and services. The company told us, *inter alia,* that:

(*a*) the management accounting system did not provide such information;

(*b*) in its view, if such data were derived from an allocation exercise, it would be purely arithmetical and of no commercial or economic value; and

(*c*) the business was run as a single integrated operation and the only sensible measure of the company's performance for the purpose of the references was the performance of its business as a whole.

3.51. Pitney Bowes PLC told us that the system in current use for budget and financial control purposes allocated standard manufacturing costs to individual products and direct labour costs to the cost of servicing particular products. But the systems did not allocate to individual products any manufacturing or purchase variances or inventory valuation adjustments (which were allocated to product groups, eg mailing systems or business operations), nor did they allocate to individual products or to ranges of products any non-manufacturing costs other than direct service labour costs (allocated to individual products) and direct sales personnel costs (allocated only to product groups). In the company's systems therefore the contribution made by individual products is identified only before charging non-manufacturing costs other than imputed direct service labour costs. These non-manufacturing costs include selling and marketing costs, and financial administration and general expenses.

3.52. In seeking to assess the profitability of reference goods and services we have adopted two different approaches. First, we asked Pitney Bowes PLC to explain, with the systems in use in the company, how it identified the level of net contributions that individual products or ranges of products were expected to make to indirect costs and profits and how the actual results were monitored. Secondly, while noting Pitney Bowes PLC's reservations (paragraph 3.50), we asked it to carry out an allocation of the company's net profits before interest and taxation between reference and non-reference goods and services so that we could make some assessment of relative returns on turnover and capital employed.

3.53. Pitney Bowes PLC told us that it sought to make a return of about 20 per cent after tax on a new product. In general it sought a margin on products sufficient to cover total overheads and produce enough profit to give an acceptable rate of return on capital invested. With regard to new business lines, ie those additional to established product ranges, the margins are calculated on the basis of direct costs and after taking account only of those other costs which are associated with entering the business.

3.54. Pitney Bowes PLC went on to tell us that when considering any price change, estimates were made of the effect of the change on the contribution to overheads and profit. Contribution to overheads and profit was calculated after deducting from selling prices the standard costs of manufacture or purchase plus royalties, anglicisation costs, installation and call-back and sales commission. Pitney Bowes PLC provided us with copies of calculations dated 1 July 1984. Examples of these showed that contributions to overheads and profit were in the range of 70 to 50 per cent for reference products, 57 to 23 per cent for domestic non-reference products and 40 to 17 per cent for exported reference-type products.

3.55. Pitney Bowes PLC explained that its computerised accounting system included a form of contribution accounting which had been intended to provide, on a historical basis, some information on the contributions which had been made by product groups and individual products. The system was no longer used for management reporting purposes and consequently had been allowed to degenerate. Pitney Bowes PLC could not, therefore, vouch for its accuracy. In these circumstances it was unable to provide us with information to compare the actual contribution made by products with the estimates made when the prices were decided.

The allocation exercise

3.56. The exercise which was undertaken followed, as closely as was practical, Pitney Bowes PLC's existing costing systems and was derived from the company's management and audited accounts. The basis adopted to allocate revenue, costs and capital employed is set out at Appendix 3.2. The resulting allocations are shown in:

Table 3.7—all reference products—supply

Table 3.8—all reference products—maintenance

Table 3.9—all business activity outside the scope of the reference, ie domestic supply of non-reference products and all exports.

It will be seen that in relation to turnover the proportion of costs not directly attributed which was allocated to reference products in each year was about double that allocated to non-reference activities.

TABLE 3.7 **Pitney Bowes PLC: illustrative calculations of return on sales and capital employed**

All reference products supply (and consumables)

						£'000
	1979	*1980*	*1981*	*1982*	*1983*	*1984*
Historical cost basis						
Revenue	11,655	13,889	15,303	15,261	17,914	18,753
Total directly attributed costs*	(3,067)	(3,387)	(3,785)	(4,015)	(5,198)	(5,530)
Contribution to indirect costs and profit	8,588	10,502	11,518	11,246	12,716	13,223
As a % of revenue	74	76	75	74	71	71
Selling, marketing, financial, administration and other costs not directly attributed	(6,134)	(7,269)	(8,105)	(8,038)	(8,798)	(9,275)
Operating profit/(loss) before interest and taxation	2,454	3,233	3,413	3,208	3,918	3,948
Average capital employed	4,022	4,163	4,930	4,700	4,328	6,332
Current cost basis						
Operating profit/(loss) before interest and taxation, historical cost basis	2,454	3,233	3,413	3,208	3,918	3,948
Current cost adjustments	(312)	(468)	(516)	(373)	(662)	(457)
Operating profit/(loss) before interest and taxation	2,142	2,765	2,897	2,835	3,256	3,491
Average capital employed	5,153	5,414	6,173	5,715	5,459	7,555
Historical cost basis						
Operating profit as a percentage of revenue	21	23	22	21	22	21
Return on capital employed (%)	61	78	69	68	91	62
Current cost basis						
Operating profit as a percentage of revenue	18	20	19	19	18	19
Return on capital employed (%)	42	51	47	50	60	46

Source: MMC study from Pitney Bowes PLC's information.

*This figure includes standard factory or import cost plus those selling, marketing and other costs directly attributed.

TABLE 3.8 **Pitney Bowes PLC: illustrative calculations of return on sales and capital employed**

All reference products maintenance

						£'000
	1979	*1980*	*1981*	*1982*	*1983*	*1984*
Historical cost basis						
Revenue	2,909	3,401	4,003	4,571	5,364	5,803
Total directly attributed costs*	(1,305)	(1,761)	(2,087)	(2,149)	(2,454)	(2,504)
Contribution to indirect costs and profit	1,604	1,640	1,916	2,422	2,910	3,299
As a % of revenue	55	48	48	53	54	57
Selling, marketing, financial, administration and other costs not directly attributed	(1,397)	(1,643)	(1,961)	(2,320)	(2,495)	(2,949)
Operating profit/(loss) before interest and taxation	207	(3)	(45)	102	415	350
Average capital employed	(1,077)	(1,225)	(1,340)	(1,512)	(1,766)	(2,138)
Current cost basis						
Operating profit before interest and taxation, historical cost basis	207	(3)	(45)	102	415	350
Current cost adjustments	(67)	(71)	(98)	(80)	(46)	(70)
Operating profit/(loss) before interest and taxation	140	(74)	(143)	22	369	280
Average capital employed	(686)	(783)	(876)	(1,080)	(1,327)	(1,772)
Historical cost basis						
Operating profit as a percentage of revenue	7	(0)	(1)	2	8	6
Return on capital employed†	—	—	—	—	—	—
Current cost basis						
Operating profit as a percentage of revenue	5	(2)	(4)	(0)	7	5
Return on capital employed†	—	—	—	—	—	—

Source: MMC study from Pitney Bowes PLC's information.

*This figure includes standard factory or import cost plus those selling, marketing and other costs directly attributed.
†Contracted maintenance is paid for in advance by Pitney Bowes PLC's customers. As a result capital employed is negative and no meaningful return can be stated.

Adjustments to the audited accounts

3.57. Pitney Bowes PLC considered that, in order to reflect more accurately the underlying position, it would be appropriate to adjust the revenue, costs and capital employed figures in its audited accounts which had been used to produce the table of the company's overall results (Table 3.6) and the tables resulting from the allocation exercise (Tables 3.7 to 3.9). In particular it explained:

(*a*) Pitney Bowes Inc incurred costs relating to the United Kingdom market on behalf of Pitney Bowes PLC which were not charged to the latter's statutory accounts. Pitney Bowes PLC suggested its costs should be increased to take account of these additional items.

(*b*) Pitney Bowes PLC uses a number of assets acquired on lease which had been included in the statutory accounts in the conventional way by charging the leasing payments to the profit and loss account. The

TABLE 3.9 **Pitney Bowes PLC: illustrative calculations of return on sales and capital employed**

All non-reference products (including exports of reference-type products)

	1979	1980	1981	1982	1983	£'000 1984
Historical cost basis						
Revenue	11,695	13,164	12,957	17,214	19,659	22,171
Total directly attributed costs*	(8,115)	(9,677)	(8,859)	(13,618)	(15,792)	(18,596)
Contribution to indirect costs and profit	3,580	3,487	4,098	3,596	3,867	3,575
As a % of revenue	31	27	32	21	20	16
Selling, marketing, financial, administration and other costs not directly attributed	(3,150)	(3,019)	(3,724)	(4,326)	(4,556)	(5,430)
Operating profit/(loss) before interest and taxation	430	468	374	(730)	(689)	(1,855)
Average capital employed	5,630	6,252	6,352	7,227	8,420	8,806
Current cost basis						
Operating profit/(loss) before interest and taxation, historical cost basis	430	468	374	(730)	(689)	(1,855)
Current cost adjustments	(550)	(850)	(834)	(760)	(804)	(185)
Operating profit/(loss) before interest and taxation	(120)	(382)	(460)	(1,490)	(1,493)	(2,040)
Average capital employed	7,123	7,737	7,767	8,938	10,284	10,317
Historical cost basis						
Operating profit as a percentage of revenue	4	4	3	(4)	(4)	(8)
Return on capital employed (%)	8	7	6	(10)	(8)	(21)
Current cost basis						
Operating profit as a percentage of revenue	(1)	(3)	(4)	(9)	(8)	(9)
Return on capital employed	(2)	(5)	(6)	(17)	(15)	(20)

Source: MMC study from Pitney Bowes PLC's information.

*This figure includes standard factory or import cost plus those selling, marketing and other costs directly attributed.

accounting standard SSAP 21 issued in January 1985 required a different treatment in the future. The company suggested that the changes in treatment suggested in SSAP 21 should be applied to past years from 1979 onwards.

(*c*) The company suggested that current liabilities to associated companies for group taxation relief should be added to the capital employed by Pitney Bowes PLC on the grounds that such liabilities were optional.

(*d*) A feature of Pitney Bowes PLC's business was the receipt of substantial payments in advance in respect of rented equipment and maintenance charges. The advance payments from customers are shown in the statutory balance sheets as a current liability but the company asked us to regard this as a source of capital rather than as a current liability, on the grounds that this would put the exercise on to a comparable basis with service organisations charging for work as it was carried out.

3.58. It is the view of the Commission that it is usually advisable when considering the costs, profits and returns on capital of companies to adopt the conventions and information that are used in the appropriate audited accounts. The views of Pitney Bowes PLC have been noted and the costs/profits ratios which result from the adjustments suggested by it are compared with those in the accounts in Table 3.10. We consider, however, that adjustments to the conventions and information contained in audited accounts should be avoided unless there are particularly compelling reasons.

TABLE 3.10 **Pitney Bowes PLC: summary of returns on sales and capital employed**

All reference and non-reference products

						per cent
	1979	*1980*	*1981*	*1982*	*1983*	*1984*
Historical cost basis						
Operating profit as a percentage of revenue						
published accounts basis	12	12	12	7	8	5
Pitney Bowes PLC's preferred basis	13	14	14	9	10	6
Return on capital employed						
published accounts basis	36	40	37	25	33	19
Pitney Bowes PLC's preferred basis	26	28	25	17	21	14
Current cost basis						
Operating profit as a percentage of revenue						
published accounts basis	8	8	7	4	5	4
Pitney Bowes PLC's preferred basis	9	9	9	5	6	5
Return on capital employed						
published accounts basis	19	19	18	10	15	11
Pitney Bowes PLC's preferred basis	13	13	12	8	9	8

Source: MMC study from Pitney Bowes PLC's information.

3.59. A summary of the source and application of funds for the period from 1979 derived from Pitney Bowes PLC's audited accounts is set out in Appendix 3.3.

PB Leasing Ltd

3.60. The overall operating results and returns on capital employed of PB Leasing since 1979 taken from its audited accounts, which have been prepared on a historical cost basis, are set out in Table 3.11 (page 42).

3.61. PB Leasing told us that the records of the company were such that within these overall figures it was not practical to identify the profits arising from postal franking machines but that these were probably lower than those on other equipment leased by the company. Based on its own recorded sales to PB Leasing, Pitney Bowes PLC subsequently submitted estimated figures to us which sought to show the results of leasing postal franking machines. These are set out at Appendix 3.4.

TABLE 3.11 **PB Leasing Ltd: six-year summary**

	1979	1980	1981	1982	1983	£'000 1984
Historical cost basis						
Leasing income*	1,589	3,258	4,470	5,611	6,642	7,937
Operating expenses	915	1,219	1,371	1,937	2,414	3,233
Operating profit before interest and taxation	674	2,039	3,099	3,674	4,228	4,704
Interest expense	735	1,491	1,592	1,503	1,125	1,162
Pre-tax profit/(loss) after interest	(61)	548	1,507	2,171	3,103	3,542
Taxation credit/(charge)	1,357	1,641	1,916	1,490	2,281	(1,280)
Net income	1,296	2,189	3,423	3,661	5,384	2,262
Operating profit before interest and taxation	674	2,039	3,099	3,674	4,228	4,704
Average capital employed†	6,514	11,606	15,185	18,196	22,147	28,688
Return on capital employed (%)	10	18	20	20	19	16

Source: PB Leasing.

* Leasing income is stated after deducting provisions for amortisation of the leased equipment.
†Capital employed is computed by aggregating shareholders' funds, deferred taxation, bank overdrafts and other borrowings less non-trading debtors outstanding for more than one year. Included in current debtors is group taxation relief falling due within one year and receivable from Pitney Bowes PLC.