

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

Postal Rate Commission  
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RATE AND SERVICE CHANGES TO IMPLEMENT  
FUNCTIONALLY EQUIVALENT NEGOTIATED  
SERVICE AGREEMENT WITH BANK ONE  
CORPORATION

Docket No. MC2004-3

REVISED RESPONSE OF THE UNITED STATES POSTAL SERVICE WITNESS  
PLUNKETT TO INTERROGATORY OF THE OFFICE OF THE CONSUMER  
ADVOCATE (OCA/USPS-T1-45) (ERRATA)  
(September 1, 2004)

The United States Postal Service hereby revises its response to the following interrogatory of the Office of Consumer Advocate: OCA/USPS-T1-45, filed on August 5, 2004. The initial Postal Service response was filed on August 16, 2004. Interrogatory 45 requested witness Plunkett to reproduce Appendix B of his testimony to reflect the impact of J.P. Morgan Chase. Today, the Postal Service has filed a hypothetical model that reflects the merger and the revision to Interrogatory 45 explains the model.

The interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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**OCA/USPS-T1-45.** Please reproduce Appendix B of USPS-T-1 for J.P. Morgan Chase.

**REVISED RESPONSE:**

By agreement with OCA, the Postal Service is answering this question by providing a supplemental analysis of a hypothetical scenario in which integration of all JPM Chase mail volumes occurs on January 1, 2005, the beginning of Year 2 of the NSA. The Postal Service's answer consists of the following narrative discussion, along with the Excel worksheets attached to the Postal Service's revised response to OCA/USPS-T1-44 (and incorporated by reference here). Attachment OCA/USPS-T1-44 presents a combined model that calculates the financial implications of the NSA for a merged Bank One/J.P. Morgan Chase (JPM Chase) entity, assuming integration of all JPM Chase mail volumes at the beginning of Year 2. Thus, the model assumes that, in Year 1 only Bank One First-Class Mail volumes will be counted towards the threshold and be eligible to receive discounts.

**Explanation of Financial Model**

The Bank One/JPM Chase Model (the "combined model") incorporates all of the per-piece cost and revenue information into one comprehensive workbook. It serves as a presentation mechanism for the customer-specific revenue and cost calculations. The model was essentially built upon the same revenue and cost assumptions (discount and exposure (leakage) calculations) as the Capital One NSA. The historical and forecasted volumes are provided by Bank One witness Rappaport (BOC-T-1 at 5-6; response of Bank One witness Rappaport to OCA/USPT-T-1-44, partially redirected to Bank One; and witness Rappaport's responses to OCA/BOC-T1-13 and 19). All of these inputs provide the basis for calculating the value of the NSA.

## **Assumptions**

The assumptions worksheet contains the rate of UAA returns for Bank One as provided by witness Rappaport (BOC-T-1 at 9), for JPM Chase as also provided by witness Rappaport (response to BOC/USPS-T1-17), and for the combined entity for Years 2 and 3 of the NSA. The Year 2 return rate for the combined entity was calculated by weighting the individual Bank One and JPM Chase return rates by Bank One and JPM Chase Year 2 Before Rates (BR) volumes. Similarly, the Year 3 return rate for the combined entity was calculated by weighting the individual return rates by Year 3 BR volumes.

The inflation cost adjustment factor, a weighted average of inflationary factors, represents the inflationary cost growth projected by the Postal Service. Currently, that factor is 4 percent. The Capital One manual and electronic return unit costs for letters, adjusted for inflation, serve as proxies in the model (USPS-LR-1/MC2002-2). The manual and electronic return unit costs for flats are the adjusted subclass averages (USPS-LR-1/MC2002-2). Costs for Years 1, 2 and 3 of the agreement are adjusted by the inflationary cost growth of 4 percent. The Address Change Service (ACS) success rate was explained by USPS witness Wilson (Docket No. MC2002-2, USPS-T-4 at 7) and is assumed to be constant throughout the life of the agreement.

The combined model assumes that 100 percent of the incremental mail volume growth comes from Standard Mail marketing letters migrating to First-Class Mail. The contingency<sup>1</sup> applied in the combined model is a multiplicative factor applied to all

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<sup>1</sup> The contingency is applied to all forecasted postal costs to protect against unforeseen circumstances. It is applied as the very last step in development of the roll-forward costs. It needs to be incorporated in NSA calculations for two reasons. First, the existing rates from which the NSA rates or discounts are being derived include a contingency allowance. Without an NSA, the rates that Bank One would be paying would have been set so as to recover the

forecasted postal costs. The application of the contingency is uniform across all unit costs.

### **Volume Calculations**

The Volume Calculations contain Bank One and JPM Chase's First-Class Mail volumes divided into operational mail, marketing mail letters, and marketing mail flats. This worksheet provides a historical view of Bank One's First-Class Mail profile for 2001-2003 and JPM Chase's First-Class Mail profile for 2002-2003. To illustrate the volume response to incentives, Bank One witness Rappaport has provided the volume forecasts for Bank One alone, both with the NSA ("After Rates" volumes) and without the NSA ("Before Rates" volumes). BOC-T-1 at 5-6. He has also provided these estimates for JPM Chase (see response to OCA/USPS-T-44, partially redirected to Bank One witness Rappaport).

### **First-Class Mail Revenue Calculations**

Page 3 of the model shows the First-Class Mail revenue profile for Bank One and JPM Chase. It is similar to the profile in the record of the Capital One NSA case (MC2002-2, USPS-T-3). The revenue profile breaks out the estimated revenue per piece individually for Bank One's marketing letters, Bank One's operational letters, JPM Chase's marketing letters, and JPM Chase's operational letters.

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contingency. Furthermore, the NSA financial analyses are projections into the future, and the further into the future the projections are made, the more appropriate the application of the contingency.

### **Operational Unit Cost and Marketing Unit Cost**

These spreadsheets develop unit costs separately for Bank One and JPM Chase. The unit cost estimates for operational mail are based on the same assumptions as the First-Class Mail Presort Letters/Flats Unit Cost Estimate sponsored by witness Crum in the Capital One NSA case (Docket No. MC2002-2, USPS-T-3, "Atta2.xls"). Estimates for the Bank One NSA differ from those of the Capital One NSA in the Test Year (TY) calculations, the Bank One/JPM Chase volumes, and the total unit cost (sources 17 and 18). The TYBR 2003 unit cost is based on Docket No. R2001-1, with the weighted distributions calculated from Base Year (BY) 2000 FCM volumes from the FCM letter model from Docket No. R2001-1, PRC, LR-4. The TY 2004 cost estimates are derived by multiplying the TYBR 2003 total unit cost by the inflationary growth rate of 4.0 percent.<sup>2</sup> FY 2003 Mail Volumes for Bank One and JPM Chase are used because FY 2003 is the most recent full year for which historical mail volume data are available. The Before Rates and After Rates estimates of Total Unit Cost, including Contingency (Model, Page 4, sources 17 and 18), are equal because the NSA does not affect return procedures for operational mail.

The Marketing Unit Costs rely on the same assumptions as the Operational Unit Costs. The major difference is electronic diversion from ACS and the cost differential between manual and electronic returns for UAA mail. Operational mail does not receive

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<sup>2</sup> Columns are labeled as "TYBR 2003" in these sheets because those figures are drawn from Docket No. R2001-1, in which FY 2003 was the test year. Columns are labeled as "TY 2004" because 2004 is the first of the three years in which the instant NSA is assumed to be in effect. Estimates for the last two years of the NSA, Years 2 and 3, are presented in the subsequent sheets. 2004 is not the exclusive "test year" in this proceeding in the sense that FY 2003 was the test year in the Capital One proceeding. 2004 is, rather, one of three relevant years for which estimates are presented and evaluated.

the Change Service Requested (“CSR”) endorsement, because the mail needs to be physically returned to Bank One and JPM Chase. Marketing mail receives the endorsement, and information is returned from UAA mail electronically 85 percent of the time. This explains why the Total Unit Cost, including Contingency, differs in sources 17 and 18 (Model, Page 5).

### **Discount and Exposure**

In Year 1, the declining block rate structure for the proposed NSA begins at 535,000,000 pieces, with a discount of 2.5 cents per piece. Exposure (to the Postal Service) measures the potential revenue foregone by the Postal Service when Bank One receives declining block rate discounts on mail volume that Bank One would have mailed even without the proposed NSA. In Year 1, Bank One's BR forecast falls within the second tier of the discount structure. Total exposure is therefore calculated by adding the first tier to the second tier. Because the first tier exposure must be maximized before discount calculations apply, the ending threshold is reduced by the beginning threshold (560,000,000 – 535,000,000), and that difference is multiplied by the corresponding discount (2.5 cents). The first tier exposure equals \$625,000. The second tier exposure is the remaining volume less the beginning threshold (571,080,000 – 560,000,001), multiplied by the discount (3.0 cents), equaling (\$332,400). Thus, the total exposure in each year in this case is \$957,400 (\$625,000+\$332,400).

Based on the Y1AR Forecast, Bank One could qualify for discounts in the first, second and third tiers of the agreement, equaling \$1,554,725, using the same formula as exposure. Discounts are given on pieces mailed above the threshold

Double counting of the 36,080,000 (Y1BR – Beginning Threshold: 571,080,000 – 535,000,000) mail pieces occurs in the discount and exposure calculations, because the 36,080,000 pieces are in the exposure calculation. The Y1AR volume of 590,135,000 is made up of the Y1BR volume plus the 19,055,000 additional marketing pieces. To account for this double counting, the Postal Service subtracts the discount from the exposure, to get the “real” discount calculation of \$597,325 (Model, page 11).

At the beginning of Year 2, the discount threshold is adjusted upward by 470.5 million, to 1,005.5 million to reflect the hypothetical integration of all J.P. Morgan Chase volumes at the beginning of the year. The adjustment is made pursuant to the term of the NSA, which bases the amount of the adjustment on the 12 month volumes prior to the date of integration. The threshold remains at this level in Year 3.

### **UAA Calculations**

In lieu of receiving physical returns, Bank One and JPM Chase will accept electronic information on address changes or corrections, as Capital One does. Providing this electronic information costs the Postal Service less than physically returning undeliverable mail. The estimated Capital One physical and electronic return unit costs described in USPS-LR-1/MC2002-2 are used to model the cost savings. The total return costs savings vary from the Capital One model because of the different marketing mail volumes and return rate forecasts (9 percent for Bank One’s marketing mail letters, 4 percent for J.P. Morgan Chase).

To calculate the cost savings, we multiply the expected volume of Bank One and JPM Chase’s UAA mail times the unit costs savings for each piece processed through the ACS times the percentage of UAA mail that will be processed. The calculation relies

on the evidence in Docket No. MC2002-2 for (1) the estimated percentage of UAA mail that will be processed through the ACS system (85 percent) and (2) the unit savings for each UAA piece processed through the ACS system. Page 11 of the model (USPS Value) applies the contingency factor to the UAA cost savings calculated in this worksheet.

### **Standard Mail Revenue Calculations and Standard Mail Cost Calculations**

The Standard Mail Regular and Enhanced Carrier Route (ECR) Revenues are based on the combined FY 2003 Standard Mail Regular and ECR billing determinants of Bank One and JPM Chase. The revenue per piece for both Regular and ECR is a weighted average of the revenue per piece and the percent of combined Bank One/JPM Chase volume. The Standard Regular and ECR unit costs are based on Docket No. R2001-1 for TY 2003 unit costs (Docket No. R2001-1, USPS LR-J-58 as corrected). The cost calculations are based on the USPS version of the cost models, because costs using the Commission's methodology are unavailable for some of the data. Specifically, the total unit costs of Standard Mail Regular and ECR letters are needed for this analysis. These data are found in the USPS Weight Study (Docket No. R2001-1 USPS LR-J-58 (revised)), and there is no PRC version of this document. Note that using the USPS version of costs for Standard Mail and the PRC version of costs for First-Class Mail understates the contribution of switched mail and hence the value of the agreement to the USPS. See Response to BOC/USPS-T-1-46, partially redirected to Bank One witness Buc.

### **Contribution Inputs**

The Contribution Inputs worksheet calculates the contribution per piece of Bank One's operational mail and marketing mail letters in Year 1 and of combined Bank One/JPM Chase operational mail and marketing mail letters in Years 2 and 3. This per-piece calculation provides the Postal Service with before rates and after rates revenue, cost, and contribution for First-Class Mail and Standard Mail on a customer-specific basis. This approach also allows for forecasting future contribution per piece in the out-years of the agreement by allowing the inflationary growth to be multiplied by the cost of each subclass.

In addition to applying inflationary factors to Year 1 unit costs to calculate First-Class Mail per-piece costs and revenues for Years 2 and 3 of the Agreement, this worksheet develops volume-weighted averages of the Bank One and J.P. Morgan Chase unit cost and revenue figures from Model, Pages 3, 4, and 5. The following table shows which volumes are used as weights for which First-Class Mail calculations:

<b>Weighting Factor</b>	<b>Cell</b>
Year 2 BR Operational Mail Volume	Column "Year 2" – Rows (1) a, (2), (3)
Year 2 BR Marketing Letter Volume	Column "Year 2" – Rows (1) b, (6), (7)
Year 3 BR Operational Mail Volume	Column "Year 3" – Rows (1) a, (2), (3)
Year 3 BR Marketing Letter Volume	Column "Year 3" – Rows (1) b, (6), (7)

**USPS Value**

The total USPS value looks at the value determinants, less the discount and exposure associated with the declining block rate structure. "Contribution from New Volume" is any volume above the before rates forecast multiplied by the difference between the First-Class Mail and the Standard Mail estimated contributions. This is so because Bank One as well as the merged entity indicates that all of its new First-Class

Mail volume will be switched from Standard Mail (100 percent conversion). BOC-T-1 at 8; Response to OCA/USPS-T1-44 (Rappaport). As noted above, I applied contingency to the UAA cost savings in this worksheet.

**Tab -3 (Table 5.2), Physical Returns, Electronic Returns**

Estimating the savings associated with conversion to ACS requires several steps. First, the physical return cost needs to be calculated. As shown on page 13 of the model, the estimated Postal Service cost of physically returning Bank One's flat-size First-Class Mail is \$1.0034 per piece. This value is derived as follows:

The base UAA cost in Docket No. R2001-1 (USPS-LR-J-69) is adjusted by removing the costs associated with collection of postage due. This follows the methodology employed by witness Crum in Docket No. MC2002-2 for Capital One's letter-size First-Class Mail.

Second, the cost of electronic "returns" must be calculated. Model, page 14, shows that the estimated cost of electronically handling UAA mail from point of return is 43.01 cents per piece. This cost is calculated by adjusting the electronic Address Correction Service costs provided in Docket No. R2001-1 by Postal Service witness Abdirahman (USPS-LR-J-69) to include costs that these mail pieces incur prior to actual electronic Address Correction Service processing. The difference between the cost of physically returning the mail piece and electronically handling the UAA mail piece via ACS is the estimated unit cost savings of 58.89 cents. This follows the methodology employed by witness Crum in Docket No. MC2002-2 for Capital One's letter-size First-Class Mail.

## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

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