

UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Rate and Service Changes To Implement)
Baseline Negotiated Service Agreement)
With Washington Mutual Bank)

Docket No. MC2006-3

RESPONSES OF OFFICE OF CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW TO INTERROGATORIES OF
WASHINGTON MUTUAL BANK (WMB/OCA-T1-1-4)
(September 7, 2006)

The Office of Consumer Advocate hereby submits the answers of James F. Callow to interrogatories WMB/OCA-T1-1-4, dated August 24, 2006. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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WMB/OCA-T1-1.

Please refer to lines 6 through 12 on page 16 of your testimony where you state:

Neither the Postal Service nor Washington Mutual, however, supplied a price-difference (or own-price) elasticity specific to Washington Mutual in this proceeding. In the absence of such a company-specific elasticity, I use the "Average Standard Regular Letter Discount (relative to First-Class)" developed by witness Thress (USPS-T-7) in Docket No. R2006-1. That elasticity, estimated at -0.1115, serves by default as a proxy for Washington Mutual's elasticity of demand for Standard Mail with respect to the change in the price difference between First-Class Mail and Standard Mail.

Please also refer to witness Ayub's response to OCA/USPS-T1-29(d) where he confirms that "if Washington Mutual's First-Class mail volume had an own-price elasticity of demand equaling zero, the given equation could be solved as stated, within rounding" in response to OCA's calculation of a -.8538 "discount elasticity" for WMB's First-Class Mail volume.

Further, please refer to page 18 of your testimony where you discuss the volume above which the Panzar analysis indicates that "the Postal Service will lose First-Class Mail contribution in Year 1 of the agreement."

Finally, please refer to the elasticities for workshared First-Class Mail presented on page 73 of witness Thress' testimony (USPS-T-7) in Docket No. R2006-1.

- (a) Please confirm that the Panzar analysis presented in your testimony assumes that the own-price elasticity of demand of WMB's First-Class Mail volume is zero. If not confirmed, please explain fully.
- (b) Please confirm that the Panzar analysis presented in your testimony does not take into account any cost savings from the NSA. If not confirmed, please explain fully.
- (c) Please confirm that the Panzar analysis in your testimony assumes that WMB's "price-difference elasticity" is equal to the average for workshared First-Class Mail, but that its own-price elasticity is significantly less - zero - than the average for workshared First-Class Mail. If not confirmed, please explain fully.
- (d) Please confirm that the volume above which the Panzar analysis estimates "the Postal Service will lose First-Class Mail contribution" would be higher than presented in your testimony if it used average elasticities (for workshared First-Class Mail) for both the price difference elasticity and the own-price elasticity. If not confirmed, please explain fully.

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- (e) Please confirm that the volume above which the Panzar analysis estimates "the Postal Service will lose First-Class Mail contribution" would be higher than presented in your testimony if it used the price-difference elasticity of $-.8538$ that OCA calculated in OCA/USPS-T1-29(d) and an own-price elasticity of zero. If not confirmed, please explain fully.
- (f) Please provide revisions to Figures 1, 2, and 3 of your testimony based upon a Panzar analysis that uses a price-difference elasticity of $-.8538$ and an own-price elasticity of zero. Please also provide all of your underlying calculations in an electronic spreadsheet format.
- (g) Please provide revisions to Figures 1, 2, and 3 of your testimony based upon a Panzar analysis that uses the average price-difference and own-price elasticities for workshared First-Class Mail. Please also provide all of your underlying calculations in an electronic spreadsheet format.

RESPONSE TO WMB/OCA-T1-1

(a) Confirmed.

(b) Confirmed. Consistent with the financial model of the Postal Service, I do not assume any cost savings from the provision of electronic address correction notices in lieu of physical returns in estimating the financial value of the Washington Mutual NSA using the Panzar analysis.

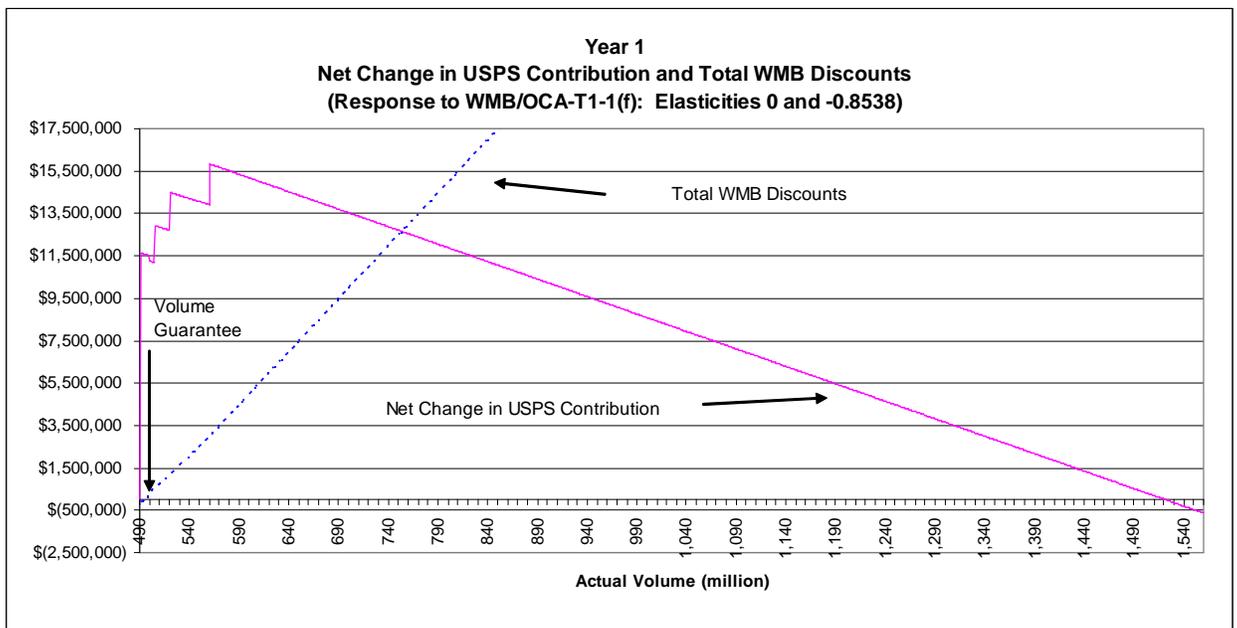
(c) Confirmed.

(d) Confirmed. Based upon the Panzar analysis using the average First-Class Mail workshared letters own-price elasticity and the average price-discount elasticity, if Washington Mutual mails First-Class Mail solicitation letters exceeding 585 million, 584 million, and 582 million in Years 1, 2, and 3, respectively, the Postal Service will lose First-Class Mail contribution. See response to part (g), below.

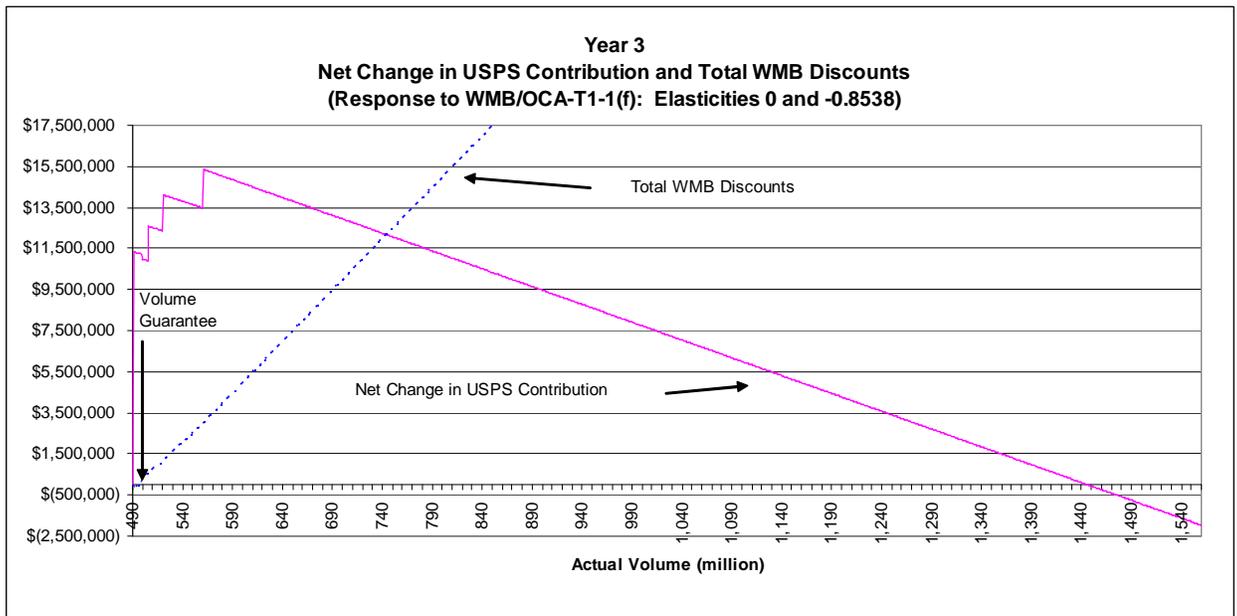
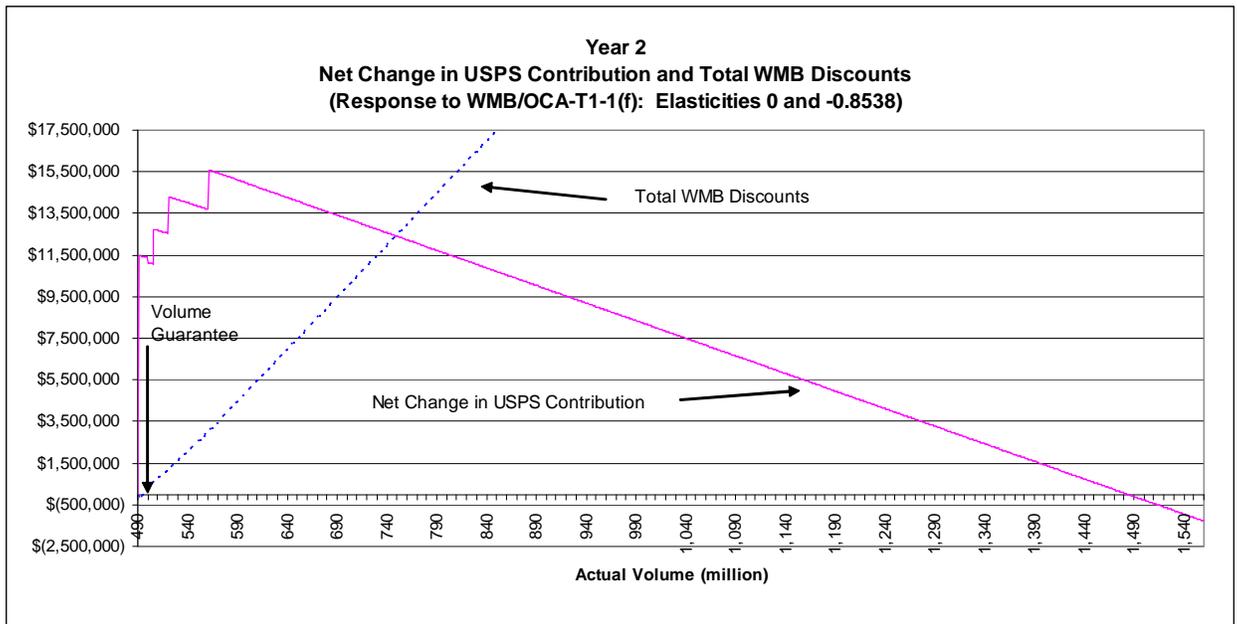
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(e) Confirmed. The price-difference elasticity of -0.8538 was “backed-out” of Washington Mutual’s stated before-rates and after-rates point volume estimates, using the average revenue for First-Class marketing letters of $\$0.324$, the Standard Mail revenue per piece of $\$0.204$, and the highest negotiated discount of $\$0.050$.

(f) See charts, below, for Years 1, 2, and 3, obtained by inserting -0.8538 in Cell D11 of Excel file “OCA-T-1_Att1-WMB.xls,” worksheet tab “Year 1.”



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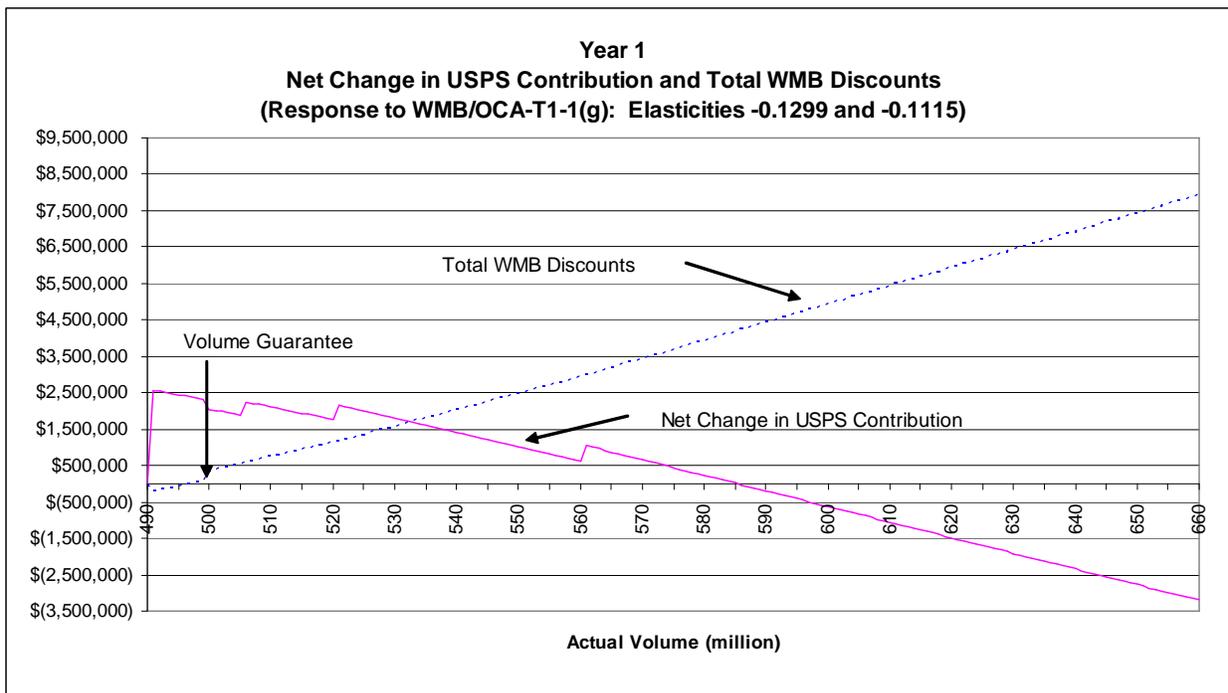


(g) See charts, below, for Years 1, 2, and 3, obtained by using the “Long-Run” own-price elasticity (-0.129934) for First-Class workshared letters estimated by witness Thress (USPS-T-7), Table 16, in Docket No. R2006-1, and the average price-difference elasticity (-0.111483) in the following equation

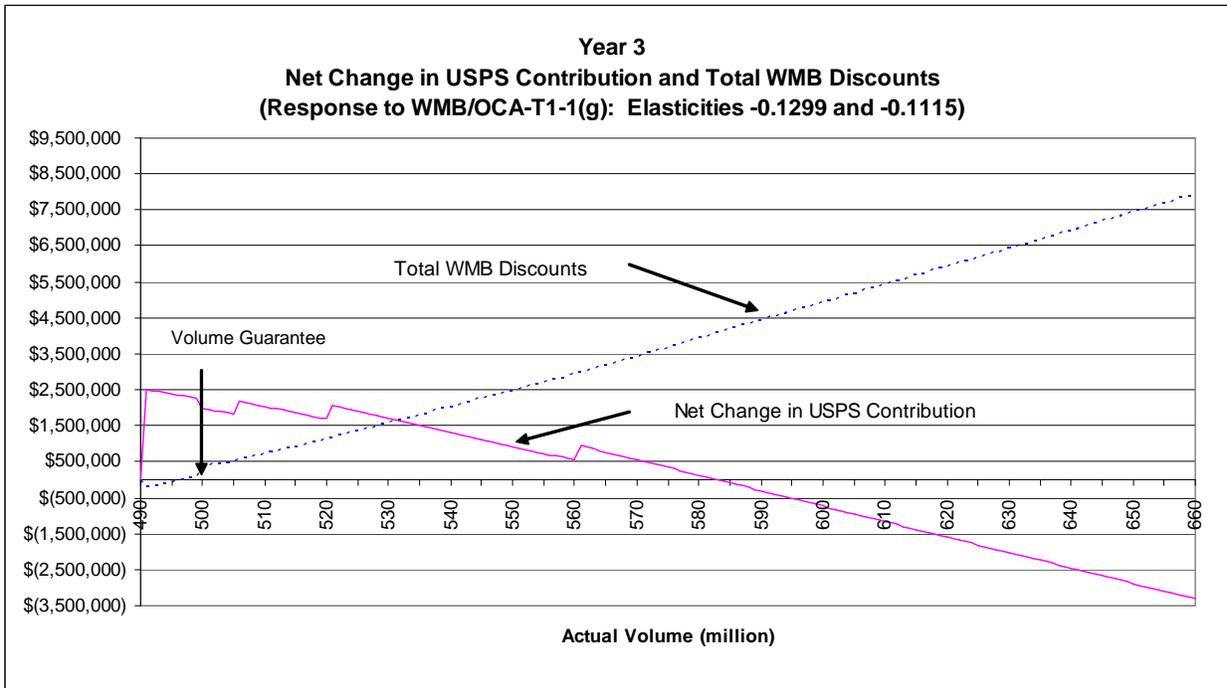
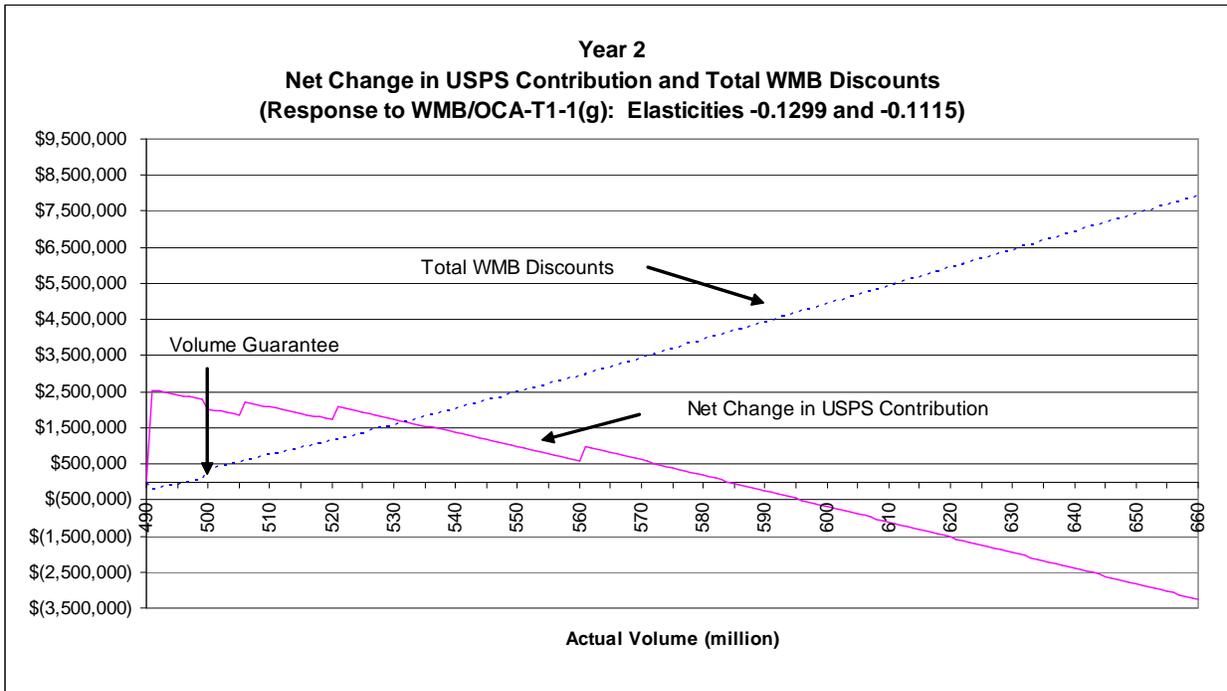
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$$Q_0 = Q_1 \frac{p_0}{p_d} \frac{E_p}{E_d} \frac{d_0}{d_d}$$

where Q_0 is the before-rates Standard Mail volume, Q_1 is the forecast after-rates First-Class Mail volume, p_0 is the before-rates average First-Class Mail marginal price, p_1 is the after-rates average marginal price, E_p is the average First-Class workshared letters own-price elasticity, d_0 is the before-rates average marginal price difference between First-Class Mail and Standard Mail, d_1 is the after-rates average marginal difference, and E_d is the price-difference elasticity.



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WMB/OCA-T1-2.

Please refer to page 80 of the Commission's Docket No. MC2005-3 Opinion and Recommended Decision where it states, "the Panzar test does not tell the whole story here since it does not take into account the potential benefits from the conversion of flats to letters or the positive benefits from Bookspan's unique multiplier effect." Please also refer to page 31 of witness Ayub's testimony.

- a) Please confirm that the Postal Service estimates that the WMB NSA will generate cost savings. If not confirmed, please explain fully.
- b) Please confirm that the Panzar test "does not tell the whole story" in the WMB NSA because it does not take into account these cost savings. If not confirmed, please explain fully.
- c) Please confirm that, in the Bookspan NSA, the Commission did, at least qualitatively, take into account potential benefits from the NSA that are not accounted for in the Panzar test. If not confirmed, please explain fully.
- d) Please explain fully how you believe the cost savings from the WMB NSA should be taken into account.

RESPONSE TO WMB/OCA-T1-2

(a) Confirmed that the Washington Mutual NSA will generate a cost saving associated with providing electronic address correction notices in lieu of physical returns, according to the Postal Service. However, those cost savings are not included in the Postal Service's estimate of the financial value of the Washington Mutual agreement.

(b) Confirmed that neither the Panzar analysis nor the Postal Service's financial model "tell[s] the whole story" since neither model takes into account cost savings from the provision of electronic address correction notices in lieu of physical returns.

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(c) Confirmed that the Commission qualitatively took into account the potential benefits of Bookspan's multiplier effect. In the absence of an estimate of the financial value of the multiplier effect, it is not possible to account for any potential benefits using the Panzar analysis. Assuming an estimate of the financial value of Bookspan's multiplier effect were available, that value could have been incorporated into the Panzar analysis as described in part (d), below.

(d) Consistent with the financial model of the Postal Service, I do not assume any cost savings from the provision of electronic address correction notices in lieu of physical returns in estimating the financial value of the Washington Mutual NSA using the Panzar analysis. However, those cost savings, estimated at \$2.2 million, \$2.4 million, and \$2.7 million in Years 1, 2 and 3, respectively, could be incorporated into the Panzar analysis as follows. For any assumed actual after-rates volume, the estimated cost savings for each year would be added to the "Net USPS Benefits" (Column [3] in OCA-T-5, Attachment 1) associated with the assumed actual volume for that year to estimate total value (i.e., net revenue plus cost savings) to the Postal Service. For example, the estimate of total value to the Postal Service in Year 1 assuming an actual volume of 521 million would be \$3,380,663, consisting of \$1,180,663 in "Net USPS Benefit" and \$2,200,000 in cost savings.

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WMB/OCA-T1-3

Please refer to Table 1 on Page 25 of your testimony, which presents your analysis of the Net Present Value of the Washington Mutual NSA.

- a) Has the Commission required the net contribution of previously approved NSAs to cover negotiation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.
- b) Has the Commission required the net contribution of previously approved NSAs to cover litigation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.
- c) Has the Commission required the net contribution of previously approved NSAs to cover administrative costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.
- d) Has the Commission required the net contribution of previously approved niche classifications to cover litigation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.
- e) Has the Commission required the net contribution of previously approved niche classifications to cover administrative costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.
- f) Are the administrative, litigation, and negotiation costs shown in Table 1 institutional costs or attributable costs according to USPS costing methods? Please explain your response fully.
- g) Are the administrative, litigation, and negotiation costs shown in Table 1 institutional costs or attributable costs according to PRC costing methods? Please explain your response fully.

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RESPONSE TO WMB/OCA-T1-3

(a) – (c) No. That said, one of the purposes of my testimony is to ask the Commission to determine whether the Washington Mutual agreement should produce a positive return on investment, using net present value analysis, considering the Postal Service's investment in negotiating and litigating the agreement, and the estimated annual administrative expenses.

(d) – (e) While the Commission has not specifically estimated the litigation or administrative costs associated with a niche classification, or required that those costs be covered by revenues generated from a previously approved niche classification, there is an essential difference between an NSA and a niche classification. For a niche (or any other) mail classification, the Commission sets rates sufficient to cover attributable costs *and* make a reasonable contribution to the Postal Service's institutional costs, which include litigation and administrative costs. The resulting cost coverage may cover all or part of these institutional costs associated with the niche classification. In any event, it is clear these costs are considered at least indirectly by the Commission in determining the appropriate cost coverage for the niche classification. In the case of NSAs, negotiation, litigation and administrative expenses are not considered at all because neither the Postal Service nor the Commission has established an appropriate "cost coverage," or specified a positive rate of return for NSAs.

(f) Under the Postal Service's costing methodology, negotiation, litigation, and administrative costs associated with an NSA would be considered incremental costs.

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Consequently, the Postal Service's markup would be expected to cover volume variable as well as incremental costs.

(g) Under the Commission's costing methodology, negotiation, litigation, and administrative costs associated with an NSA would also be considered incremental costs. In setting rates, the Commission would be expected to add incremental costs to volume variable costs, for which an appropriate markup would be made.

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WMB/OCA-T1-4

Please refer to footnote 44 on page 26. Please refer further to Tr. 2/184 where witness Ayub states, "I think [the penalty] is supposed to cover the transaction costs of pursuing the NSAs."

- a) Is the cited statement from Mr. Ayub the entire basis of your estimate of litigation costs? If not, please explain fully the basis of your estimate
- b) Please explain fully the basis of your assumption that the costs to negotiate an NSA are \$250,000.

RESPONSE TO USPS/OCA-T1-4

(a) Yes.

(b) During discovery, I attempted to develop directly the Postal Service's costs related to the negotiation of the Washington Mutual NSA. As a result of the Postal Service's objection to my discovery request (see Objection of United States Postal Service to Interrogatory of the Office of Consumer Advocate to Witness Ayub (OCA/USPS-T1-28), July 10, 2006), however, I assumed negotiation costs of \$250,000, based upon the work effort described in the testimony of witness Ayub, much of it occurring "[a]fter the commencement of negotiations with WMB." (Page 13). That work effort includes "extensive additional [Postal Service] research on the company using data from Postal Service systems and from publicly available sources." (Id.) The Postal Service work effort also involves considerable analysis "of a company's Before Rates forecasts," specifically analysis of volume trends, economic variables, account growth, and the company's response during negotiations, plus research and discussions with outside analysts. Moreover, the Postal Service's "process of

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evaluating WMB's forecast is an iterative process that continues through the course of our NSA negotiations." (Page 14) In addition, once negotiations have concluded, the agreement "undergoes a rigorous internal review process at the Postal Service, including review by a cross functional group of managers and executives." (Page 14-15) These elements—extensive additional research, considerable analysis, an iterative evaluation process, and rigorous management-executive review—formed the basis for my estimate.