

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

**RESPONSE OF UNITED STATES POSTAL SERVICE  
WITNESS AYUB TO INTERROGATORIES OF THE OFFICE OF CONSUMER  
ADVOCATE (OCA/USPS-T1—9-12)**

The United States Postal Service hereby provides the response of witness Ayub to the following interrogatories of the Office of Consumer Advocate: OCA/USPS-T1—9-12, filed on April 19, 2006. The interrogatories are stated verbatim and followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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May 3, 2006

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OCAOCA/USPS-T1-9. This interrogatory seeks information that could be used to reduce financial risk to the Postal Service from the Washington Mutual Bank (WMB) NSA. Please refer to your response to OCA/USPS-T1-1d. Your response reads,

If a variable causes a change in the before-rates forecast, holding all other factors constant, it should have a similar impact in the same direction on the after-rates forecast.

Please consider a situation where a variable other than postage costs (e.g., interest rates) differs in the future from expectations during negotiations.

- a. Could such a difference cause actual after-rates volumes to differ from forecasted after-rates volumes? If not, why?
- b. If thresholds were periodically adjusted (up or down) when variables other than postage costs (e.g., interest rates) differed from forecasted values, would financial risk to the Postal Service be reduced? If not, why?

**RESPONSE:**

- a) Such a difference could cause a variance in the after-rates volumes; however, the magnitude of the impact would depend on factors influencing the larger economic and market conditions in which mailing decisions are made.
- b) The thresholds are currently adjusted in the NSA by the change in the number of accounts. In our assessment, we believe that this is the optimal method for adjusting thresholds, as this variable is reflective of the economic environment within which the particular mailer operates. Furthermore, linking to a specific economic variable and not evaluating the market and political environment could result in adjustments that do not correspond well with the particular mailer's mailing patterns. The perceived benefit of any attempt to minimize perceived risk must be weighed against the cost of making such an attempt. Even if it were theoretically possible to identify, track, and write contractual provisions for some number of variables that would reduce risk, the cost of doing so could exceed the expected benefit and further erode customer confidence in the NSA

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process. For example, annual threshold adjustments and shorter contract durations to the NSA agreements might offer some ways to reduce perceived risk; however, some approaches might be incompatible with the current litigation process.

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OCA/USPS-TI-10. This interrogatory seeks information that could be used to reduce financial risk to the Postal Service from the Washington Mutual Bank (WMB) NSA. Please refer to your response to OCA/USPS-T1-1a. In this response you say that “the impact of these variables on mail volume cannot be evaluated independently of other market conditions such as: consolidation within the industry, lower response rates, legislative changes, market saturation, and increases in postage costs.” Please consider a situation where several variables other than postage costs differ in the future from expectations during negotiations.

- a. Could such differences cause actual after-rates volumes to differ from forecasted after-rates volumes? If not, why?
- b. Does the possibility of such differences create financial risk for the Postal Service from the WMB NSA? If not, why?
- c. Do you understand the expression “risk management”? If so, please describe your understanding and explain how the Postal Service generally manages the risk of interest rates’ or gas prices’ differing in the future from current expectations.
- d. Do you know whether firms in the credit card industry engage in risk management? If so, please describe how such firms might manage the risk of interest rates’ differing in the future from current expectations.
- e. Do you understand there to be a difference between “risk management” and “risk mitigation,” as the latter term is used at page 29, line 17, of your testimony? If so, is it possible to manage a risk that cannot be mitigated? If so, how?
- f. You have stated in your testimony at page 29, lines 15-17 that “part of the Postal Service analysis is to identify the sources of variability, whether technical or financial, and to manage and reduce the variability.” Please list all “sources of variability” that you have identified with respect to the WMB NSA.
- g. You have stated in your testimony at page 28, lines 4-5 that “the Postal Service has attempted to point to exogenous factors that might affect mail volumes . . . .” Please list all such factors of which you are aware.
- h. Under the terms of the proposed NSA, and assuming that WMB fulfills all other terms of the NSA, does WMB have the right, but not the obligation, to purchase unlimited quantities of First-Class solicitation mail? Please provide the basis for your response, including citations to DMCS and/or NSA provisions where appropriate.

**RESPONSE:**

- a) Generally speaking, when used in financial terms, the term “risk” is synonymous with variation. Thus, the financial risk inherent in NSAs is that the actual value will vary (in either direction) from the expected value. If expressed in terms of mail volume, the

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risk is that the actual volumes will vary from the projected volumes. The question appears to suggest that variance from the volume projections of any kind is to be avoided at all costs, and that positive and negative variances are undesirable. In this instance, it should be pointed out that the financial impacts of these two kinds of variance are asymmetrical. In general, if volumes exceed expectations, there is some probability that the Postal Service will have paid out more in NSA incentives than planned; however, the Postal Service could gain substantial contribution that will exceed any incentives that are paid. On the other hand, if volumes fall short of projections, then the Postal Service could pay less in incentives than planned, but could be worse off financially because of the loss of high contribution First-Class Mail.

It should be pointed out that forecasts – even those relating to fairly simple phenomena – often vary from actual experience. When projecting mail volumes over a three year horizon, where many variables interact, the probability of having a perfectly accurate forecast is, in our experience, small. Consequently, such differences could cause actual after-rates volumes to differ from forecasted after-rates volumes.

b) Under the terms of the WMB NSA, every piece of mail - even among those that receive the highest possible discount - is expected to yield positive contribution. This is because WMB volume in each discount tier exceeds the attributable cost of workshared First-Class Mail. If the after-rates volume is higher, there will be a positive financial impact on the Postal Service. However, if the after-rates forecast is less than projected, then the estimated financial value to the Postal Service is lower, but may still be contribution positive and therefore beneficial to the Postal Service.

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c) My understanding of the concept of risk management is the use of tools and processes by an organization to manage uncertain variables. Additionally, risk management involves identifying which assets to “risk” in order to create value. Effective management of risk is necessary because fear of risk can mask the opportunity to create more value or threaten the value already being created. Finally, risk management is not only used to address economic risk, but also operational, market, and other types of risk. The challenge is to manage processes and assets in such a way so as to continue create value in the face of changing customer needs in a changing environment. I am not involved in developing risk mitigation strategies for the Postal Service in connection with changes in interest rates or gas prices, and cannot speak to the process used to manage those variables. However, I note that page 36 of the USPS 2005 Annual Report states:

In the normal course of business, we are exposed to market risk from changes in commodity prices, certain foreign currency exchange rate fluctuations, and interest rates. With the limited exception explained on the following page, we do not use derivative financial instruments to manage market risks.

d) It is my understanding that many firms in the credit card industry engage in risk management. However, not every company manages risk in the same manner. Generally speaking, it is my understanding that firms in the industry manage risk through a variety of economic and management tools, such as interest swaps, futures, options, and adaptive customer management processes. One means by which credit card firms manage risk is by having a very large base of customers. Portfolio theory counsels that diversification reduces risk; thus, having a large number of assets for

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which returns are not positively correlated reduces the variance in outcomes of the whole. Interestingly, the NSA process that exists today – by limiting the financial viability of NSAs through protracted and costly litigation – serves to limit the Postal Service’s ability to manage risk in this way.

e) My understanding of the concept of risk management is that it consists of the process of managing unknown variables. Risk mitigation is the usually the ultimate objective of risk management, whereby the adverse effects of unknown variables are understood, reduced, and/or neutralized.

f) Some of the variables we have looked at include: prime rate, federal funds rate, treasury rates, outstanding credit, unemployment indexes, wage rates, consumer price index, total consumption, inflation indexes, bankruptcy rates, consumer credit outstanding, employment cost index, charge-off rates, response rates, housing starts, personal income, household financial assets, percent of disposable income, producer price index, net income, number of cards outstanding, GDP, marketing spends/budgets, total credit card solicitation volume, type of cards, annual fees, card interest rates, consumer expenditure, number of card customers, delinquency rates, charge-off rates, and allowance for loss.

g) Exogenous factors may include the variables identified above. Moreover, it also includes regulatory and market factors that cannot be quantified. Examples of these factors are: changes in bankruptcy laws, changes in interest rate laws, allowances for bad debt, market consolidation, and life-cycle position. Interestingly, one of the variables that the Postal Service cannot control is time. When negotiating an NSA, the Postal Service and its customer must make assumptions about when an NSA will be

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implemented. Because of lengthy and unpredictable litigation times, it is difficult to predict an implementation date, thereby reducing our ability to manage risk given the variables identified above.

h) WMB has the right to purchase unlimited quantities of mail under the terms of the agreement at contribution-generating rates for its credit card-related mailings. The agreement is not capped.

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OCA/USPS-T1-11. This interrogatory seeks to determine the value of enhanced economic efficiency resulting from the WMB NSA. You have stated in your testimony at page 26, lines 1-4, that “setting a threshold below forecast volume is economically efficient because it reduces the mailer’s marginal price of First-Class Mail relative to other forms of solicitation, and reduces the gap between marginal price and marginal cost of the mailer’s First-Class Mail.”

- a. Is there a “marginal price of First-Class Mail” that would not be economically efficient? If so, please provide an example of such a price?
- b. Does improving economic efficiency provide a financial benefit to the Postal Service? If so, how?
- c. Would it improve economic efficiency if the Postal Service were to “reduce[] the gap between marginal price and marginal cost of the mailer’s First-Class Mail” for all mailers? If not, why?

**RESPONSE:**

a) The concept of economic efficiency of thresholds was addressed in Witness Eakin’s testimony in Docket No. MC2002-2. I referenced his testimony at footnote 9 on page 26 of my testimony. The statement quoted in the question from my testimony addresses the economic efficiency of thresholds, and not prices.

It may be that economic efficiency can best be thought of in terms of relative efficiency (comparing one rate to another), rather than in absolute terms, such as suggested by the question. But I suppose an example of a marginal price that would not be efficient in absolute terms would be a price so much above marginal cost that there is absolutely no demand from consumers at that price.

b) It depends on what the question intends by financial benefit. It is true that, as long as the Postal Service operates under a global breakeven standard, the amount of total contribution to institutional costs necessary to achieve breakeven from a set of economically efficient rates (e.g., Ramsey prices) is the same as the amount of total contribution that must be obtained from a set of less efficient rates. By that measure,

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one could argue that the more efficient rates do not provide any “financial benefit” to the Postal Service. The aggregate benefits thus accrue to mailers, not the Postal Service.

c) It depends. Reducing the “gap between marginal price and marginal cost of the mailers for First-Class Mail” for all mailers is, under the rate structure by which typical (i.e., non-NSA) mailers are charged, simply another way to express an overall rate reduction for First-Class Mail. This is because, for typical mailers, there is no vehicle by which the marginal price can be anything other than the uniform rate established in the rate schedule. Given the Postal Service’s breakeven requirement, the effect of reduced First-Class Mail rates on overall efficiency would depend on the relative demand for the other postal services for which rates would have to be raised to offset the lost contribution. The overall effect could be an increase or a decrease in economic efficiency.

In allowing for differences between the marginal rate and the uniform rate established in the rate schedule, NSAs such as that proposed in this case create the opportunity for efficiency gains that do not apply to “all mailers,” when the vast majority of “all mailers” pay rates directly off of the rate schedule.

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OCA/USPS-T1-12. This interrogatory seeks to find a volume cap that would be satisfactory to the Postal Service. Please refer to your response to OCA/USPS-T1-3. Your response reads,

Volumes eligible for discounts are not capped at WMB's after-rates volume estimates because that could potentially discourage additional growth of WMB First-Class marketing volumes.

- a. If after-rates volume forecasts are accurate, given current expectations for variables other than postage costs, what would cause actual after-rates volumes to differ from forecasted after-rates volumes?
- b. Is it not the case that actual after-rates volumes in excess of forecasted after-rates volumes *must* be "anyhow volume"? Please explain your response.
- c. Do you expect WMB to mail in excess of 593 million First-Class solicitation pieces in Year 1?
- d. If WMB mails fewer than 593 million First-Class solicitation pieces in Year 1, would a 593-million-piece cap for Year 1 have an adverse effect on the Postal Service or WMB? If so, how?

**RESPONSE:**

a) The factors identified in OCA/USPS-T1-10(f) could cause this result.

b) No. It is not the case that actual after-rates volumes in excess of forecasted after-rates volumes "must be anyhow volumes." NSAs are a new tool that will impact the marketing decision processes of our customers. Currently, customers have very limited experience in utilizing these incentives. After implementing the NSA, customers may discover that they can expand the use of the new postage rates to target markets they previously had not considered in their forecast.

c) I believe WMB will mail in the range of 590 million pieces in Year 1.

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d) It would depend on the circumstances that resulted in WMB mailing less than 593 million pieces. If WMB volume in Year 1 was 580 million pieces, and WMB refrained from sending a 25 million piece marketing campaign in the absence of a pricing incentive, then the cap would produce adverse effects for the Postal Service because it would not benefit from the additional positive contribution of the 25 million additional First-Class Mail pieces. Moreover, WMB could be adversely affected by a cap because it would not be able to gain revenue through any new business it could acquire through the mailing.

## 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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