

DIRECT TESTIMONY

OF

JAMES F. CALLOW

ON BEHALF OF

THE OFFICE OF CONSUMER ADVOCATE

August 17, 2006

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DIRECT TESTIMONY
OF
JAMES F. CALLOW

1 I. STATEMENT OF QUALIFICATIONS

2 My name is James F. Callow. I am a Postal Rate and Classification Specialist. I
3 have been employed in the Office of Consumer Advocate (OCA) since February 1995.

4 I have testified before the Commission in Docket Nos. MC2002-2, R2000-1,
5 MC98-1, R97-1, MC96-3, and MC95-1. My testimony in Docket No. MC2002-2
6 proposed, as alternatives to the principal features of the Capital One Negotiated Service
7 Agreement, two new experimental mail classifications whereby First-Class mailers that
8 improved their address databases would receive free electronic address correction
9 notices, and access to declining block rates.

10 In Docket No. R2000-1, I examined three issues related to First-Class Mail. I
11 proposed that the rate for single-piece letters be maintained at 33 cents in order to
12 mitigate the growing institutional cost burden on First-Class Letter Mail. Second, I
13 proposed a new approach for setting the single-piece First-Class rate that would provide
14 a longer period of rate stability for household mailers, while permitting smaller, more
15 predictable rate adjustments desired by business mailers. Finally, I proposed
16 elimination of the nonstandard surcharge for First-Class "low aspect ratio" (e.g., square
17 or nearly square) letter mail. I also testified on rebuttal in Docket No. R2000-1. That
18 testimony addressed the proper methodology for forecasting the number of additional
19 ounces per piece for single-piece First-Class Letter Mail in the test year.

20 My testimony in Docket No. MC98-1 proposed a computer-implemented postage
21 pricing formula for Mailing Online as an alternative to the single average discount rate,

1 Automation Basic (within class and shape), proposed by the Postal Service for all
2 mailings using Mailing Online. In Docket No. R97-1, I proposed a restructuring of post
3 office box fee groups to better reflect costs of providing box service in high and low cost
4 post offices. My testimony in Docket No. MC96-3 opposed the Postal Service's non-
5 resident surcharge on post office boxholders, and proposed alternative box fees
6 designed to equalize inter-group cost coverage and reduce the disparity in cost
7 coverage by box size. In Docket No. MC95-1, I summarized the comments of persons
8 expressing views to the Commission and the Office of Consumer Advocate on postal
9 rates and services.

10 Prior to joining the OCA, I was a special assistant to H. Edward Quick,
11 Commissioner of the Postal Rate Commission. In that capacity, I advised the
12 Commissioner in Docket Nos. R94-1, MC93-2 and MC93-1. I was previously employed
13 by the State of Michigan in Washington, and served on the staff of a Senator and a
14 Member of Congress from Michigan.

15 I am an accountant by training. In 1985, I earned an MS degree in accounting
16 from Georgetown University. My course work included cost accounting and auditing. In
17 1977, I obtained my BA degree from the University of Michigan-Dearborn with a double
18 major in political science and history and a minor in economics.

1 II. PURPOSE AND SCOPE

2 The purpose of my testimony is twofold. First, I propose application of an
3 alternative financial model to the negotiated service agreement concluded between
4 Washington Mutual Bank and the Postal Service, based upon the “Panzar” analysis
5 presented by the Commission in Docket No. MC2005-3.¹ This alternative financial
6 model incorporates a “price-difference” elasticity to estimate Washington Mutual’s
7 before-rates volume and the expected increase in institutional contribution to the Postal
8 Service, rather than relying on the point volume estimates provided by Washington
9 Mutual. The price-difference elasticity is used because, for purposes of estimating the
10 financial value of the NSA, I accept Postal Service witness Ayub’s assumption that
11 Washington Mutual’s entire discount induced First-Class Mail solicitation letter volume is
12 converted from Standard Mail. OCA-T-1, Attachment 1, filed concurrently with this
13 testimony, presents the development of the Panzar analysis as applied to Washington
14 Mutual.²

15 Second, I propose two approaches to assure that the Postal Service obtains a
16 meaningful contribution to institutional costs. Both approaches estimate the forecast
17 volume that would provide expected contribution sufficient to recover the Postal
18 Service’s investment in the Washington Mutual NSA.

19 One approach uses net present value analysis to estimate a positive rate of
20 return on the Postal Service’s investment in the Washington Mutual NSA. I propose

¹ PRC Op. MC2005-3 (herein “Bookspan”), paras. 4089-4093 (“Application of Panzar Analysis”).

² OCA-T-1, Attachment 1, is developed in the Excel file “OCA-T-1_Att1-WMB.xls.”

1 that the Commission limit Postal Service participation in the Washington Mutual
2 NSA to that volume that produces a rate of return at least equal to the Postal Service's
3 "cost of money."

4 The other approach, using analysis from the alternative financial model, identifies
5 the point where the financial benefits of the agreement between Washington Mutual and
6 the Postal Service are nearly in balance. I propose that the Commission limit discounts
7 to that volume where the increase in contribution equals the discounts earned by
8 Washington Mutual. This approach assures additional contribution sufficient to recover
9 the Postal Service's investment in the Washington Mutual NSA, and provides a
10 meaningful contribution to institutional costs.

1 III. POSTAL SERVICE RELIANCE ON WASHINGTON MUTUAL'S VOLUME
2 ESTIMATES IS INSUFFICIENT TO ESTIMATE EXPECTED CONTRIBUTION
3 AND PROTECT MAILERS NOT PARTY TO THE NEGOTIATED SERVICE
4 AGREEMENT

5 In this proceeding, the Postal Service presents, along with Washington Mutual
6 Bank (herein "Washington Mutual"), a new "baseline" Negotiated Service Agreement
7 (herein "NSA").³ This baseline NSA, like nearly all previous NSAs presented to the
8 Postal Rate Commission, provides Washington Mutual with access to declining block
9 rates for volumes of eligible First-Class Mail that exceed specified volume thresholds.⁴
10 The testimony of witness Ali Ayub (USPS-T-1) presents the financial model estimating
11 the value of the Washington Mutual NSA to the Postal Service. Witness Michael
12 Rapaport (WMB-T-1) presents testimony describing Washington Mutual's approach to
13 marketing credit cards and estimating before-rates and after-rates mail volumes.

14 However, the Washington Mutual NSA differs in important respects from the first
15 NSA with Capital One Services, Inc., and the baseline NSA with Bookspan, as initially
16 proposed. Unlike the Capital One NSA, where the Postal Service's financial gain was
17 derived in part from cost savings associated with providing electronic address correction
18 notices in lieu of physical returns, the Washington Mutual NSA does not rely on
19 measurable cost savings as the source of additional contribution to institutional costs.

³ Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement a Baseline Negotiated Service Agreement With Washington Mutual Bank (herein "Request"), at 1.

⁴ Supplemental Testimony of Ali Ayub (USPS-T-1), June 8, 2006, at 3; see also PRC Op. MC2002-2 (herein "Capital One"); PRC Op. MC2004-3 (herein "Bank One"); PRC Op. MC2004-4 (herein "Discover"); PRC Op. MC2005-2 (herein "HSBC"), for other declining block rate schedules applicable to First-Class Mail. The Bookspan NSA declining block rate schedule is applicable only to Standard Mail solicitations. See PRC Op. MC2005-3 (Bookspan), Appendix Two (Classification Schedule for Bookspan Negotiated Service Agreement, §620.11).

1 Rather, under the Washington Mutual NSA, additional contribution is derived primarily
2 from increased volumes.⁵ In contrast to the Bookspan NSA, discounts “earned” by
3 Washington Mutual are not proposed to be limited by a cap on the total amount of
4 incentives under the agreement.⁶

5 These differences affect assessment of the estimated financial value (and risks)
6 of the Washington Mutual NSA to the Postal Service, and by extension, mailers not
7 party to the agreement. In the absence of a “cost savings” or volume cap, the Postal
8 Service’s reliance on volume estimates provided by Washington Mutual is insufficient
9 for estimating the financial value of the agreement. Those volume estimates are
10 inherently unreliable, given the existence of non-price factors that can influence actual
11 mail volumes. Moreover, the Postal Service, not Washington Mutual, bears all risk of
12 error for misestimating the agreement’s financial value if it fails to estimate correctly
13 volumes that would be mailed absent the NSA.

14 In recommending the approval of previous NSAs, the Commission has viewed
15 their purpose as a means to increase system-wide institutional contribution above what
16 would be realized absent such NSAs.⁷ NSAs that increase institutional contribution
17 create what the Commission has characterized as a “win-win” situation for both the
18 Postal Service and participating mailers, which in turn protects mailers not party to the
19 agreement—especially mailers dependent on the Postal Service’s monopoly services.

⁵ Request, at 2 and 3.

⁶ See USPS-T-1 (Ayub), at 5.

⁷ See PRC Op. MC2004-3, (herein “Bank One Opinion and Further Recommended Decision”), para. 3006.

1 The Commission will increase the likelihood that the Postal Service receives a
2 meaningful increase in institutional contribution by applying the analyses and proposals
3 in my testimony to the Washington Mutual NSA. In doing so, this proposal would
4 achieve the “win-win” outcome for the Postal Service and Washington Mutual desired by
5 the Commission, while protecting mailers not party to the agreement.

6 A. The Postal Service Should Assure the Expected Contribution from the
7 Agreement Produces a “Win-Win” Outcome for Washington Mutual and
8 the Postal Service and, by Extension, Other Mailers

9 An essential requirement of any negotiated service agreement is mutual financial
10 gain for both the Postal Service and the potential NSA partner. Mutual gain arises
11 where the agreement generates additional contribution for the Postal Service resulting
12 from the entry of additional mail in response to discounted rates offered to the
13 participating mailer. From the Commission’s perspective:⁸

14 Negotiated Service Agreements are tools to create win-win situations
15 between the Postal Service and the participating mailers. The Postal
16 Service wins by reducing its costs, increasing its revenues, or providing
17 improved service. The mailer wins by increasing its internal efficiencies,
18 reducing postal costs, sharing in the Postal Service’s cost savings, or
19 benefiting by the improved service.

20
21 A “win-win” outcome for the Postal Service and the participating mailer is also
22 essential to reduce the risk of harm to mailers not party to the agreement, especially

⁸ PRC Op. MC2004-3 (Bank One), para. 6043.

1 where such mailers are dependent on the monopoly services of the Postal Service.⁹

2 This follows from the Commission's belief that,¹⁰

3 the Postal Service has what is akin to a fiduciary responsibility to its
4 captive mailers to conserve and properly apply its financial resources.
5 Thus, the success or failure of a NSA should not be speculative. It is
6 permissible to favor one mailer when other mailers will not be
7 disadvantaged, but it is far more difficult to justify favoring one mailer at
8 the expense of others.

9
10 The possibility of other mailers being "disadvantaged" exists should the Postal Service
11 experience a loss in contribution under an NSA. In such circumstances, the "burden of
12 recovering this contribution would fall largely on captive monopoly mailers not party to
13 the agreement."¹¹

14 Accordingly, the Commission considers the existence of captive monopoly
15 mailers as requiring "adherence to a higher level of scrutiny for individualized rates"
16 than other federal agencies (e.g., the ICC, the FCC, and the FERC, in certain
17 circumstances) overseeing negotiated rates among private firms.¹² This in turn
18 "result[s] in a lower risk tolerance for the Postal Service than may be acceptable for a
19 business that exists completely in the private sector."¹³

⁹ PRC Op. MC2004-3 (Bank One), para. 1003. The Commission describes such mailers as being "captive" in that "they are without the ability to take their business elsewhere if they are not satisfied with the Postal Service's prices or service." PRC Op. MC2005-3 (Bookspan), para. 4015.

¹⁰ PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 4009.

¹¹ Id., para. 1004. The Commission also views this result as "inconsistent with the requirements of the Act." PRC Op. MC2004-3 (Bank One), para. 6014.

¹² PRC Op. MC2005-3 (Bookspan), para. 4015, citing *Williams Pipe Line Co.*, 80 FERC ¶ 61,402 (1997) (Williams), where FERC allows the "fill[ing of] an incentive rate that is less than the applicable ceiling, [with] no further regulatory action... ."

¹³ Id.

1 The Washington Mutual NSA could produce a “win-win” outcome for both
2 Washington Mutual and the Postal Service and, by extension, mailers not party to the
3 agreement. The likelihood of achieving this outcome will depend upon the reliability of
4 the volume estimates provided by Washington Mutual and, more specifically, whether
5 and to what extent those estimates consist of volumes induced by the discounted rates
6 or would have been sent absent the NSA. These considerations take on greater
7 importance since the Washington Mutual NSA, unlike previously proposed or
8 recommended NSAs, permits unlimited discounts.¹⁴

9 B. The Postal Service’s Estimate of Expected Contribution from the
10 Washington Mutual Agreement Relies on Volume Estimates that Do Not
11 Exclude Exogenous Factors

12 In nearly all previous NSAs, a continuing source of controversy has been the
13 “perceived unreliability of mailer provided volume estimates.”¹⁵ Such controversy, in
14 turn, raises questions about the accuracy of the Postal Service’s estimate of the
15 financial value of an agreement. In this NSA, the Postal Service’s expected contribution
16 is entirely dependent upon Washington Mutual’s volume estimates, as all contribution is
17 to be derived from additional volume.¹⁶

18 To increase contribution above what would be realized absent a NSA requires
19 that “additional mail volume is caused by the incentive to mail additional volume
20 (because of the mailer’s demand characteristics), and not because of exogenous

¹⁴ USPS-T-1 (Ayub), at 6.

¹⁵ PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 1008. See also PRC Op. MC2002-2 (Capital One); PRC Op. MC2004-3 (Bank One); and, PRC Op. MC2005-3 (Bookspan).

¹⁶ USPS-T-1 (Ayub), Appendix A (REV 6-7-06), Page 11.

1 factors.”¹⁷ Examples of exogenous factors include regulatory and market factors, such
2 as bankruptcy law changes, changes in interest rate laws, allowances for bad debt, and
3 market consolidation.¹⁸ Others include changes in corporate management, or changes
4 in corporate financial goals or marketing strategies.

5 The Postal Service’s development of an accurate estimate of expected
6 contribution also depends upon segregating increases in volume induced by discounted
7 rates from volume increases unrelated to the discounted rates. This requires controlling
8 for the effects of exogenous factors when estimating volumes; that is, assuming all
9 other factors that might influence demand are unchanged.¹⁹ The resulting estimate of
10 financial value is therefore based on volumes attributable to the discounted rates, rather
11 than exogenous factors.

12 The Postal Service estimate of the financial value of the Washington Mutual NSA
13 is flawed because it does not control for exogenous factors in the estimate of quantity
14 demanded before-rates and after-rates. In fact, the Postal Service is unable determine
15 whether and to what extent Washington Mutual injected exogenous factors into its
16 before-rates and after-rates volume estimates. Moreover, this problem cannot be
17 resolved by analyzing the point volume estimates provided by Washington Mutual.

18 As a mailer responding to economic incentives, Washington Mutual has a
19 natural, and not unanticipated, bias to provide volume estimates producing a favorable

¹⁷ PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 3006.

¹⁸ Tr. 2/39 (OCA/USPS-T1-10(g)); see also Tr. 2/27 (listing “other market conditions such as: consolidation within the industry, lower response rates, legislative changes, market saturation, and increases in postage costs.” (OCA/USPS-T1-1(a))).

¹⁹ This assumption is often referred to as *ceteris paribus*, or the “all other things being equal” assumption. McConnell, Campbell R., *Economics* (10th Ed., 1987), 5 and 65.

1 financial result. The Postal Service of necessity must begin with the before-rates and
2 after-rates point volume estimates provided by Washington Mutual to estimate its
3 expected contribution. However, Washington Mutual possesses “asymmetrical
4 information” concerning possible mail marketing plans vis-à-vis the Postal Service.²⁰ In
5 order to claim discounts on a larger quantity of eligible mail, “it is well recognized that
6 potential Negotiated Service Agreement partners will face a strong temptation to provide
7 estimates that tend to support generous agreements.”²¹ Such estimates might involve a
8 pessimistic (or “low”) before-rates volume estimate and an optimistic (or “high”) after-
9 rates estimate, or both.

10 Moreover, Washington Mutual’s volume estimates are not subject to replication.
11 The Postal Service cannot replicate “mailer judgment” because decisions concerning
12 the development and execution of marketing plans for mail campaigns on which volume
13 estimates are based are not transparent. This prevents the Postal Service from
14 isolating discount induced volume from volume occurring because of exogenous factors
15 in Washington Mutual’s volume estimates.

16 Nor can the Postal Service ascertain the influence of exogenous factors on
17 Washington Mutual’s actual volumes after implementation to determine their effect on
18 contribution. “Once discounts intended to influence mailer behavior are established, it is
19 not possible to ‘observe’ what mailer behavior would have been without such
20 discounts.”²² This follows from the fact that it is not possible to separately identify

²⁰ See USPS-T-1 (Ayub), at 14.

²¹ PRC Order No. 1450 at 16 (citing Docket No. MC2002-2, Tr. 8/1651, PRC Op. MC 2002-2 (Capital One), para. 5094).

²² Docket No. MC2002-2, Tr. 4/767 (Response of Witness Plunkett to POIR No. 2, Question 5).

1 “existing” volume, or volume the mailer would have entered in the absence of discounts,
2 from “new” or discount induced volume.²³ Consequently, the Postal Service cannot
3 determine whether more contribution is generated than would have been generated in
4 the absence of the discounted rates.

5 Washington Mutual’s point volume estimates and the Postal Service’s inability to
6 verify such estimates is problematic. The risk of error is borne solely by the Postal
7 Service, whose expected contribution is dependent upon the entry of discount induced
8 eligible mail. From Washington Mutual’s perspective, the existence of exogenous
9 factors that cause actual volumes to vary from estimated volumes is largely academic.

10 Volume discount agreements (including declining block rate Negotiated
11 Service Agreements) with a maximum rate equal to the undiscounted
12 uniform rate will not be unprofitable for the mailer under any
13 circumstances. In this regard, all risk related to volume forecasts used as
14 the basis for unrestricted volume discounts is borne by the Postal Service
15 and other mailers not party to the agreement.²⁴

16
17 Washington Mutual receives discounts on all eligible First-Class Mail solicitation letters
18 exceeding the minimum discount threshold volume of 490 million mailpieces that are
19 prompted for any reason, ensuring Washington Mutual a positive financial outcome.²⁵
20 Moreover, there is no limit on the discounts offered to Washington Mutual.

²³ Id.

²⁴ PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 5007, fn 21.

²⁵ According to witness Ayub, “Article II, Paragraph J of the NSA commits WMB to mailing the lesser of 500 million First-Class Mail solicitation pieces or 90 percent of the total marketing mail volume. Failure to meet this commitment will result in a financial penalty of \$250,000.” USPS-T-1 (Ayub), at 8. Nothing in the NSA, however, precludes Washington Mutual from earning discounts on First-Class Mail solicitation letters if volume is less than 500 million but greater than the discount volume threshold of 490 million. See Request, Appendix F, Article II, as amended June 6, 2006.

1 IV. THE "PANZAR" ANALYSIS SHOULD BE APPLIED TO THE WASHINGTON
2 MUTUAL NEGOTIATED SERVICE AGREEMENT TO ESTIMATE EXPECTED
3 CONTRIBUTION TO THE POSTAL SERVICE

4 In its Opinion and Recommended Decision in Bookspan, the Commission applied
5 for the first time an alternative financial analysis to estimate whether forecasted volumes
6 would generate an increase in contribution to the Postal Service's institutional costs.²⁶
7 That alternative analysis, based in part on the testimony of Commission witness John
8 Panzar in Docket No. MC2002-2, identified the entire range of volumes over which the
9 Postal Service could reasonably be expected to generate an increase in institutional
10 contribution, and where higher volumes would generate a loss for the Postal Service.
11 The alternative analysis was also intended to address the inherent difficulties of
12 verifying mailer provided volume forecasts, where exogenous factors in addition to price
13 influence the actual amount of volume to be mailed.²⁷

14 I propose application of the Panzar analysis to the Washington Mutual NSA. The
15 analysis presented herein is largely similar to the analysis presented in the
16 Commission's Opinion and Recommended Decision in Bookspan. Unlike the Panzar
17 analysis in Bookspan, however, I utilize a "price-difference" elasticity in the Panzar
18 analysis applied to the Washington Mutual NSA.

²⁶ PRC Op. MC2005-3 (Bookspan), paras. 4089-4093.

²⁷ See id., paras. 4087-4088.

1 A. Commission Application of the Panzar Analysis in Bookspan Used an
2 Estimate of Bookspan's Own-Price Elasticity to Estimate Before-Rates
3 Volumes

4 In discussing application of the Panzar analysis in Bookspan, the Commission
5 described the "impact" of discounted rates on net revenue, or "new contribution," as
6 having two parts. The first is the increase in net revenue resulting from the increase in
7 volume induced by the discounted rates.²⁸ The second part of the impact is the
8 "decrease in net revenue . . . [from] discounts on volume that the potential NSA partner
9 would have demanded at the higher rate if there were no discounts."²⁹

10 To estimate this impact on net revenue, the Commission derived an own-price
11 elasticity of demand for Bookspan to reflect the fact that under the agreement, the
12 forecast volumes induced by the discounted rates consisted entirely of new, or
13 incremental, Standard Mail solicitation mailpieces. The Commission-derived own-price
14 elasticity represented the average of the elasticity for the Regular and ECR subclasses
15 weighted by Bookspan's base year letter volumes.³⁰ Bookspan's estimated price
16 elasticity was applied to the proposed discounts at various forecasted after-rates
17 volumes to produce estimates of before-rates volumes. The decrease in net revenue is
18 calculated on volume greater than the thresholds at each discount tier but less than the
19 various before-rates volumes, i.e., volume at discounted rates that the participating
20 mailer would have mailed even absent the NSA.³¹

²⁸ Id, para. 4089.

²⁹ Id.

³⁰ Id, para. 4090, fn 112.

³¹ PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 5014.

1 For each after-rates volume, then, if the increase in net revenue induced by the
2 discounted rates exceeds the decrease in net revenue, the Postal Service will realize an
3 overall increase in net revenue. Otherwise, the Postal Service will experience a loss in
4 net revenue at that after-rates volume.³² The Commission applied the above analysis to
5 various possible after-rates volumes to “determine the points that would result in an
6 increase in net revenue and those that would result in a decrease in net revenue.”³³

7 B. Application of the Panzar Analysis to the Washington Mutual Agreement
8 Requires Use of a “Price-Difference” Elasticity to Estimate Before-Rates
9 Volume and Expected Contribution to the Postal Service

10 In the case of the Washington Mutual NSA, witness Ayub assumes forecast
11 after-rates volumes are to be derived entirely from the conversion of solicitation letters
12 from Standard Mail to First-Class Mail for purposes of estimating the financial value of
13 the agreement.³⁴ To estimate expected contribution, I make the same assumption. I
14 therefore apply the Panzar analysis to Washington Mutual’s forecast volumes utilizing a
15 price-difference, rather than an own-price, elasticity of demand. Like Bookspan’s own-
16 price elasticity, this elasticity is used to estimate Washington Mutual’s before-rates
17 volume of Standard Mail solicitation letters converted *as a result of discounted rates* for
18 First-Class Mail.

19 The form of the equation used to estimate Washington Mutual’s before-rates
20 volume is

³² PRC Op. MC2005-3 (Bookspan), para. 4089.

³³ Id.

³⁴ USPS-T-1 (Ayub), at 25; *see also* Tr. 2/58 (“I assumed 100 percent of the growth in First-Class Mail resulted from conversion of Standard Mail for the purposes of estimating the financial value of the NSA,” OCA/USPS-T1-29(a)).

1
$$Q_0 = Q_1 \left(\frac{d_0}{d_1} \right)^{E_d} \quad \text{Equation 1}$$

2 where Q_0 is the before-rates Standard Mail volume, Q_1 is the forecast after-rates First-
 3 Class Mail volume, d_0 is the before-rates average marginal price difference between
 4 First-Class Mail and Standard Mail, d_1 is the after-rates average marginal difference,
 5 and E_d is the price-difference elasticity.³⁵

6 Neither the Postal Service nor Washington Mutual, however, supplied a price-
 7 difference (or own-price) elasticity specific to Washington Mutual in this proceeding.³⁶
 8 In the absence of such a company-specific elasticity, I use the “Average Standard
 9 Regular Letters Discount (relative to First-Class)” developed by witness Thress (USPS-
 10 T-7) in Docket No. R2006-1.³⁷ That elasticity, estimated at -0.1115, serves by default
 11 as a proxy for Washington Mutual’s elasticity of demand for Standard Mail with respect
 12 to the change in the price difference between First-Class Mail and Standard Mail.

13 The use of the price-difference elasticity in the Panzar analysis applied to the
 14 Washington Mutual NSA results in another difference as compared to the Bookspan
 15 NSA. The impact of the discounted rates on net revenues, or “new contribution,” has
 16 three parts, rather than two. Like the Bookspan NSA, there is the increase in net
 17 revenue resulting from the increase in First-Class Mail volume induced by the
 18 discounted rates, less the decrease in net revenue from discounts earned on mail
 19 volume that would have been sent absent the NSA. However, as assumed above,

³⁵ Tr. 2/58 (OCA/USPS-T1-29(c)).

³⁶ Tr. 2/64 (OCA-USPS-T1-33(a)-(c)).

³⁷ Docket No. R2006-1, USPS-T-7 (Thress), Table 16; see also USPS LR-K-64.

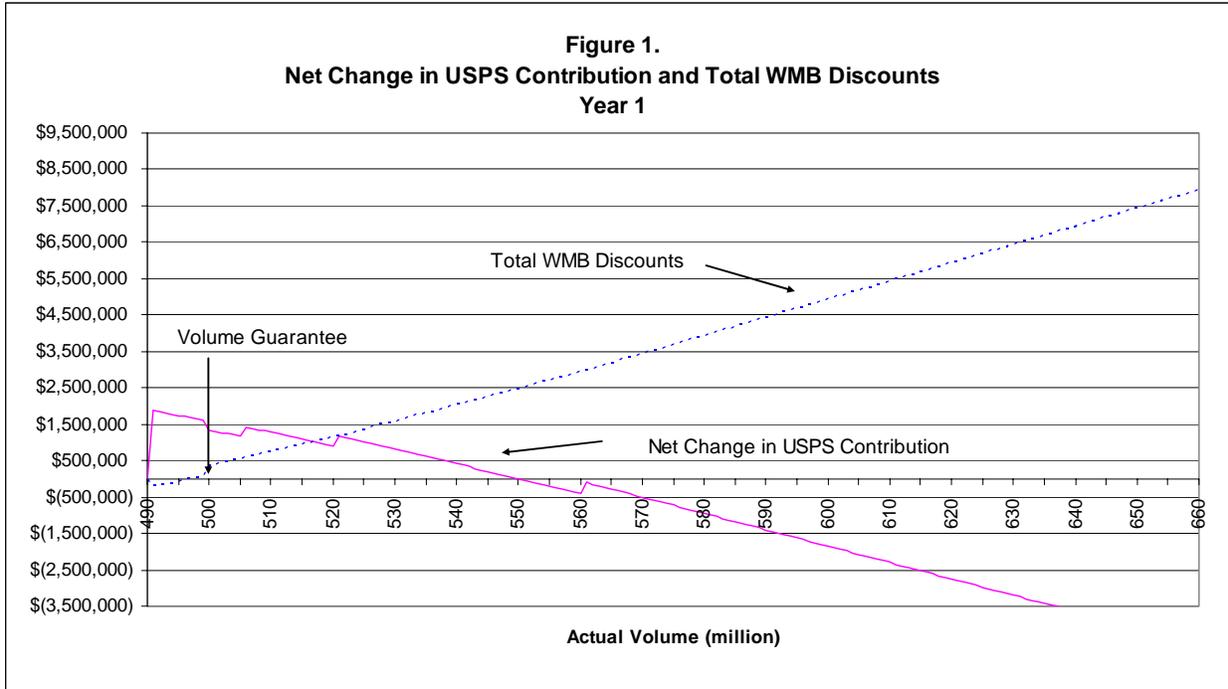
1 Washington Mutual's discounted First-Class Mail under the agreement consists entirely
2 of solicitation letters converted from Standard Mail. As a result, the third part of the
3 impact on Postal Service net revenue is the decrease in net revenue consisting of the
4 contribution of Standard Mail solicitation letters that convert to First-Class Mail.

5 Based upon the Panzar analysis, I estimate the financial value of the Washington
6 Mutual NSA using the price-difference elasticity discussed above. I also utilize
7 estimates of unit revenue and unit cost for Washington Mutual's First-Class Mail and
8 Standard Mail solicitation letters developed by witness Ayub.³⁸ My estimate of the
9 financial value of the Washington Mutual NSA for each year of the agreement is
10 presented in the figures below.³⁹

11 Figures 1, 2, and 3 present the estimated net change in contribution to the Postal
12 Service and the discounts earned by Washington Mutual during each year of the
13 agreement. These figures reveal the range of volume that is expected to provide an
14 increase in contribution to the Postal Service, and where volumes are expected to
15 generate a loss in contribution to the Postal Service.

³⁸ USPS-T-1 (Ayub), Appendix A (REV 6-7-06), Page 10.

³⁹ Development of the Panzar analysis, on which Figures 1, 2, and 3 are based, is presented in Excel file "OCA-T-1_Att1-WMB.xls."



1

2 Figure 1 shows that in Year 1, the Postal Service will not lose contribution on

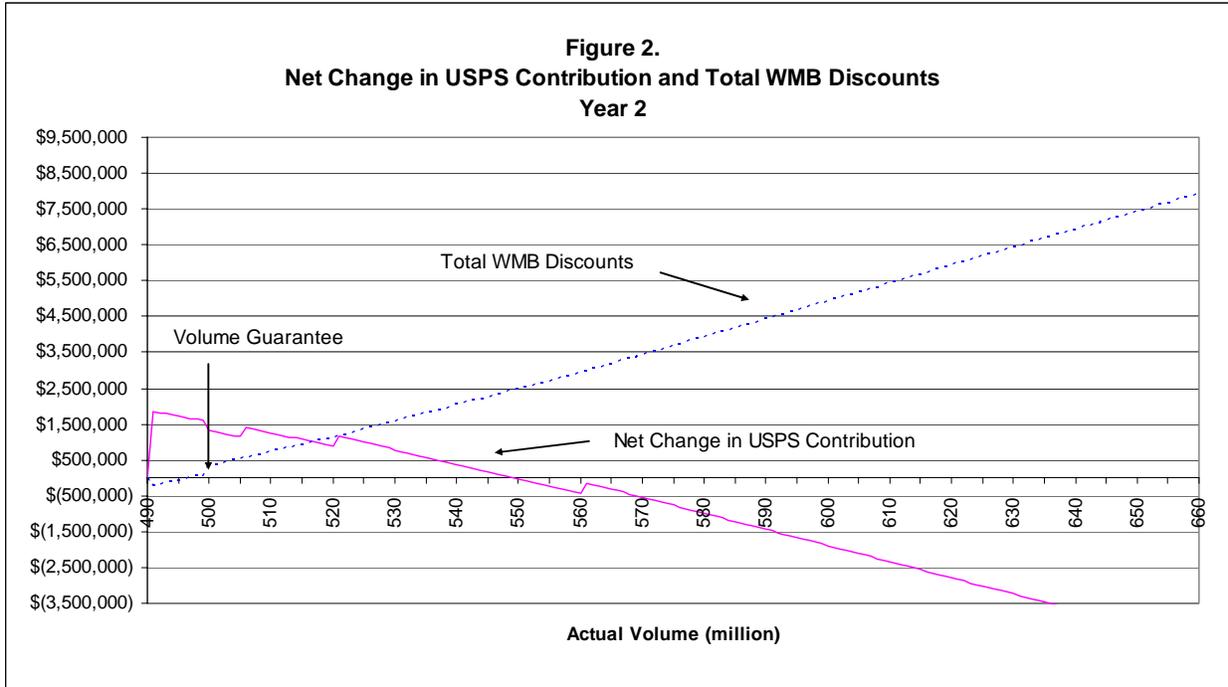
3 First-Class Mail solicitation letters converted from Standard Mail if the volume of

4 solicitation letters mailed by Washington Mutual ranges between 490 million and 550

5 million. However, if the volume of Washington Mutual's total First-Class Mail solicitation

6 letters exceeds 550 million, the Postal Service will lose First-Class Mail contribution in

7 Year 1 of the agreement.



1

2 In Year 2 of the agreement, Figure 2 shows the Postal Service will not lose

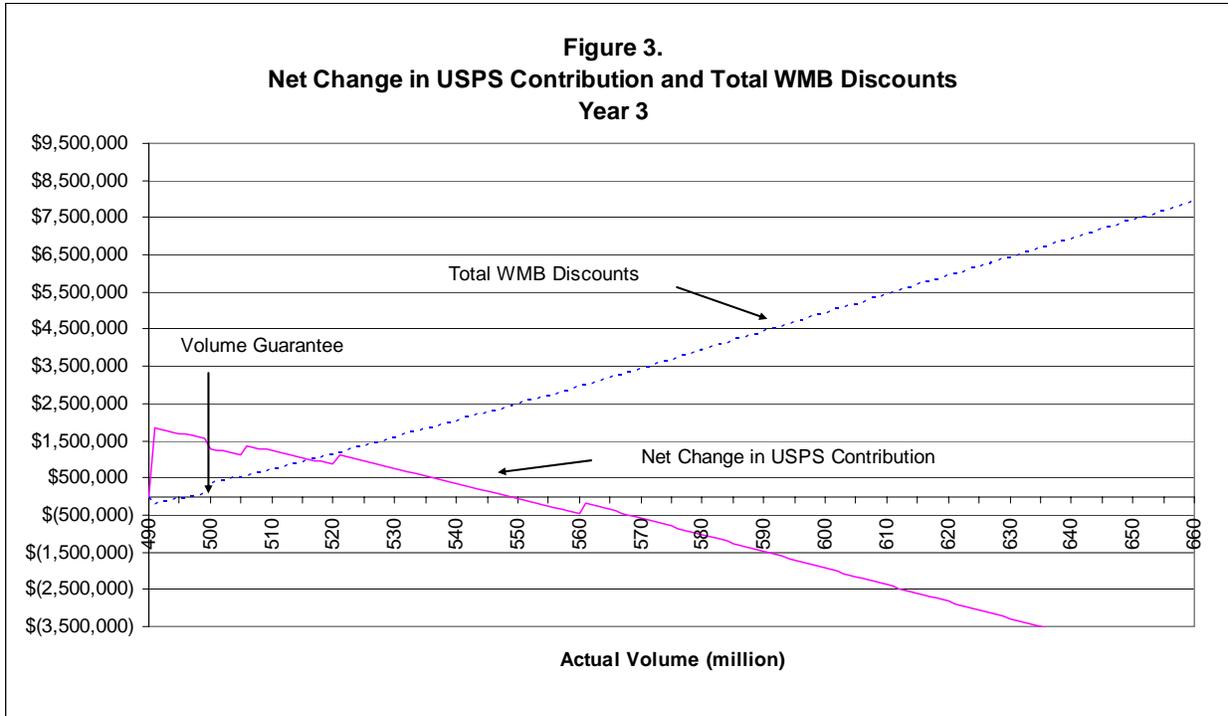
3 contribution on First-Class Mail solicitation letters converted from Standard Mail if the

4 volume of solicitation letters mailed by Washington Mutual ranges between 490 million

5 and 549 million. By contrast, if the volume Washington Mutual's total First-Class Mail

6 solicitation letters exceeds 549 million, the Postal Service will lose First-Class Mail

7 contribution in Year 2.



1

2 Figure 3 shows that in Year 3 of the agreement, the Postal Service will not lose

3 contribution on First-Class Mail solicitation letters converted from Standard Mail if the

4 volume of solicitation letters mailed by Washington Mutual ranges between 490 million

5 and 548 million. Should Washington Mutual's total First-Class Mail solicitation letter

6 volume exceed 548 million, however, the Postal Service will lose First-Class Mail

7 contribution in Year 3.

1 V. THE WASHINGTON MUTUAL NEGOTIATED SERVICE AGREEMENT WILL
2 BENEFIT THE POSTAL SERVICE IF THE EXPECTED CONTRIBUTION
3 COMPENSATES THE POSTAL SERVICE FOR ITS INVESTMENT IN THE
4 AGREEMENT

5 The Postal Service has undertaken a significant commitment of resources to
6 conclude negotiations with Washington Mutual, and present the agreement to the
7 Commission in this proceeding. The Postal Service must earn a positive rate of return
8 on this investment in the form of additional contribution to institutional costs.

9 I propose the use of net present value analysis to estimate the forecast volume
10 that produces a positive rate of return on the Postal Service's investment in the
11 Washington Mutual NSA. Based upon this analysis, if Washington Mutual's total First-
12 Class Mail solicitation letter volume exceeds 544 million in any year, the expected
13 contribution does not provide a positive rate of return equal to the Postal Service's "cost
14 of money." Consequently, the Commission should limit the agreement to 544 million.

15 In the alternative, I propose that the Commission limit discounts under the
16 agreement to a volume of 521 million. At this volume, the financial benefits—discounts
17 earned and additional contribution—as between Washington Mutual and the Postal
18 Service are approximately equal. Balancing the financial benefits in this manner would
19 recover the Postal Service's investment in the Washington Mutual NSA and provide a
20 meaningful contribution to institutional costs.

21 A. Net Present Value Analysis Can Estimate the Postal Service's Return on
22 Investment in the Washington Mutual Agreement

23 Discounted rates offered to Washington Mutual pursuant to the agreement are
24 designed to induce conversion of Standard Mail solicitation letters to First-Class Mail,

1 and generate additional contribution to the Postal Service. According to the
2 Commission.⁴⁰

3 These tariff rates are analogous to the returns on investment that the
4 shareholders would receive if the Postal Service were a for profit entity
5 since instead of any upsides or downsides resulting in dividends, it would
6 directly translate into higher or lower tariffs.

7 In the most unfavorable circumstances, “captive customers would have to absorb higher
8 rates and fees if individualized agreements fail to produce a positive return on
9 investment.”⁴¹ This suggests the importance of net present value analysis to estimate
10 the forecast volume that would provide a positive return on investment to the Postal
11 Service. Moreover, net present value analysis is a form of “pricing” in the unique
12 context of individualized rates for the Washington Mutual NSA.

13 1. Net present value analysis permits evaluation of the Postal
14 Service’s investment in the Washington Mutual agreement

15 A firm typically invests capital in a wide variety of projects. Such projects may
16 involve acquisition of property, plant, and equipment, as well as expenditures for
17 management contracts, advertising campaigns, and research and development. In
18 making such investments, the firm must decide between competing alternatives and
19 determine those projects that are most worthwhile.

20 Net present value analysis is often used to determine whether investment in a
21 project is desirable in terms of improving profits (or, in this case, increasing contribution
22 to institutional costs), given possible alternative investment options. Net present value
23 analysis permits judgment about the relative value of a project by calculating whether

⁴⁰ PRC Op. MC2005-3 (Bookspan), para. 4014, fn 50.

⁴¹ Id., para. 4015, fn 51.

1 present values of cash inflows exceed present values of cash outflows when discounted
 2 at a standard, or minimum, rate of return. Such a rate of return may represent the firm's
 3 interest rate on borrowed funds, often referred to as the "cost of money," or a
 4 management-established internal "hurdle rate."

5 If net present value exceeds zero, then the discounted cash inflows are greater
 6 than the minimum rate of return. Where the net present value equals zero, the
 7 investment will provide the required minimum rate of return. If, however, the net present
 8 value is negative, the net cash inflow is inadequate to repay the outstanding investment
 9 while providing the required minimum rate of return.

10 The formula I propose to use to estimate the net present value of the Washington
 11 Mutual NSA is:

$$12 \quad NPV = \sum \frac{P_n}{(1+r)^n} + \sum \frac{A_n}{(1+r)^n} \quad \text{Equation 2}$$

13 where NPV equals the sum of P , the amount invested or cash outflows, plus the sum of
 14 A , the cash inflows, which are discounted at r , the standard, or minimum, rate of
 15 return.⁴²

16 Net present value analysis applied to NSAs is analogous to the pricing of mail
 17 classes traditionally practiced by the Commission. For mail subclasses and mail
 18 classifications generally, the Commission considers the pricing criteria of the Postal
 19 Reorganization Act to arrive at an appropriate mark-up over attributable costs. In the
 20 context of NSAs, however, negotiated rates must simply generate an increase in
 21 institutional contribution greater than \$0 for the agreement as a whole. Neither the

⁴² Vichas, Robert P., *Handbook of Financial Mathematics, Formulas, and Tables* (1979), 129.

1 Postal Service nor the Commission has proposed the application of cost coverages to
2 NSAs generally, given the negotiated individualized rates established for each
3 agreement. Nevertheless, a determination should be made as to whether the Postal
4 Service's expected contribution from any NSA is appropriate to cover the institutional
5 costs of the Postal Service. For NSAs, then, net present value analysis serves as a
6 means to "price" NSAs to determine the appropriate expected contribution to the Postal
7 Service.

8 2. Net present value analysis reveals the Washington Mutual
9 agreement provides a positive return on the Postal Service's
10 investment for volumes of 544 million or less

11 As noted previously, the Panzar analysis reveals the range of volumes over
12 which the Postal Service can reasonably be expected to generate an increase in
13 contribution, and where volumes are expected to generate a loss in contribution to the
14 Postal Service. That range of volumes is defined by the curve entitled "Net Change in
15 USPS Contribution" in Figures 1, 2, and 3, and shows contribution to the Postal Service
16 at each possible volume. Based upon the Panzar analysis and the NSA discount
17 schedule, if Washington Mutual mails First-Class Mail solicitation letters exceeding 550
18 million, 549 million and 548 million in Years 1, 2, and 3, respectively, the agreement is
19 not worthwhile as a financial proposition since the Postal Service will lose First-Class
20 Mail contribution.

21 However, the Panzar analysis alone is not suited to estimate the financial value
22 of the Washington Mutual NSA to the Postal Service. The Panzar analysis does not
23 consider the Postal Service's investment in negotiating the agreement or the costs of
24 litigation to obtain regulatory approval. Consequently, when those investment expenses

1 are accounted for, actual volumes less than 550 million, 549 million and 548 million in
 2 Years 1, 2, and 3, respectively, will not necessarily generate contribution sufficient to
 3 produce a positive return on the Postal Service's investment.

4 I use net present value analysis to estimate the volume that would produce a
 5 return on investment equal to the Postal Service's "cost of money." Table 1 shows the
 6 net present value of the Washington Mutual NSA at the Postal Service's "cost-of-
 7 money" rate of return volume of 544 million First-Class Mail solicitation letters.

Table 1
 Net Present Value of Washington Mutual NSA
 At Selected Forecast Volume of 544 Million

	Year -1	Year 0	Year 1	Year 2	Year 3	Total
WMB Forecast Volume			544,000,000	544,000,000	544,000,000	
USPS Contribution			\$249,435	\$218,765	\$186,867	\$655,067
Annual Administrative Costs			(\$11,006)	(\$11,006)	(\$11,006)	(\$33,017)
Negotiation Costs	(\$250,000)					
Litigation Costs		(\$250,000)				
Net USPS Value	(\$250,000)	(\$250,000)	\$238,429	\$207,759	\$175,862	\$122,050
Interest Rate	5.25%	5.50%	5.50%	5.50%	5.50%	
TOTAL NPV	(\$263,125)	(\$250,000)	\$225,999	\$186,662	\$149,766	\$49,302
WMB Discounts Earned			\$2,205,000	\$2,205,000	\$2,205,000	\$6,615,000

8 Note: NPV estimated at "time 0:" i.e., the beginning of year 1.

9 At a volume of 544 million, the Panzar analysis reveals cash inflows in the form
 10 of additional contribution equal \$0.249 million, \$0.219 million and \$0.187 million in
 11 Years 1, 2, and 3, respectively, or \$0.655 million in total (Table 1, Line [2]). However, a
 12 true estimate of total financial value must also consider the Postal Service's investment
 13 in, and annual administrative costs of, the agreement. I estimate \$11,006 per annum to
 14 be incurred for the cost of administering the Washington Mutual NSA (Table 1, Line
 15 [3]).⁴³ In addition, I estimate the Postal Service's investment in negotiating and litigating
 16 the Washington Mutual NSA at \$250,000 each (Table 1, Lines [4] and [5]), or

⁴³ OCA-T-1, Attachment 1, Table 1a, presents the development of annual administrative costs.

1 \$500,000.⁴⁴ Deducting investment expenses and the annual costs of administration
2 from the estimated additional contribution results in a total “Net USPS Value” of \$0.122
3 million (Table 1, Line [6]).

4 Each of the cash inflows (e.g., additional contribution of \$0.238 million, \$0.208
5 million, and \$0.176 million in Years 1, 2, and 3, respectively) and cash outflows (e.g.,
6 investment expenses of \$500,000; and, annual costs of administration of \$11,006)
7 comprising total “Net USPS Value” are separately discounted at the Postal Service’s
8 interest rate, or “cost of money,” for the appropriate time period. I use two different
9 interest rates—5.25 percent and 5.50 percent—reflecting the “cost of money” in different
10 time periods.⁴⁵ The discount rate of 5.25 percent is used for negotiation expenses, and
11 the rate of 5.50 percent is used for litigation expense and the annual cash inflows (Table
12 1, Line [7]). Summing the discounted cash inflows and cash outflows results in a total
13 net present value of \$49 thousand (Table 1, Line [8]). At a volume of 544 million, the
14 Postal Service’s investment in the NSA provides the minimum rate of return, which
15 equals its cost of money. Washington Mutual, by contrast, earns discounts of \$2.205
16 million annually, or \$6.615 million during the same three-year period of the agreement
17 (Table 1, Line [9]).

⁴⁴ The “transaction penalty cost” of \$250,000 represents the Postal Service’s cost of litigation. Tr. 2/183-84. I assume the costs of negotiation are \$250,000, an amount equal to “transaction penalty cost.”

⁴⁵ Docket No. R2006-1, USPS-LR-L-50, Excel file “IntIncExp_06.xls,” worksheet tab “Assumptions.”

1 B. Alternatively, a Balancing of Financial Benefits Can Be Used to Assure a
2 Meaningful Contribution that Recovers the Postal Service's Investment in
3 the Washington Mutual Agreement

4 As an alternative to using net present value analysis to identify the volume that
5 provides a minimum rate of return, the Panzar analysis can be used to identify other
6 volumes that provide a meaningful contribution to the Postal Service. The Panzar
7 analysis reveals that expected contribution to the Postal Service is greatest where
8 forecast volume is 491 million in each year of the agreement. At this volume, the Postal
9 Service's expected contribution from First-Class Mail solicitation letters equals \$1.868
10 million, \$1.847 million, and \$1.826 million for Years 1, 2, and 3, respectively, a total of
11 \$5.541 million.⁴⁶ However, at this volume, Washington Mutual pays a net penalty of
12 \$215,000 per year because of the contract provision requiring a "volume guarantee."⁴⁷

13 Nevertheless, within the volume range derived using the Panzar analysis, there
14 is a forecast volume that is fair to both the Postal Service and Washington Mutual in that
15 the financial benefits received by both are roughly in balance. At a volume of 521
16 million, the estimated financial benefit to Washington Mutual, in the form of discounts,
17 approximately equals the expected contribution received by the Postal Service during
18 the three-year period of the agreement.

19 The Panzar analysis indicates expected contribution to the Postal Service of
20 \$1.181 million, \$1.151 million and \$1.121 million in Years 1, 2, and 3, respectively, or

⁴⁶ OCA-T-1, Attachment 1, Column [3] "Net USPS Benefit" at 491 million mailpieces, for year indicated. This estimate of expected contribution excludes investment expenses and the annual costs of administration.

⁴⁷ OCA-T-1, Attachment 1, Column [3] "Total Mailer Discounts" at 491 million mailpieces, for year indicated. The net penalty of \$215,000 represents the difference between discounts earned (\$35,000, Column [43]) and the volume guarantee penalty (\$250,000, Column [6]). See also USPS-T-1 (Ayub), at 5, *supra* note 25, at 12.

- 1 \$3.453 million, at a forecast volume of 521 million First-Class Mail solicitation letters.
- 2 This expected contribution is sufficient to recover the Postal Service's investment in the
- 3 Washington Mutual NSA, and provide a meaningful contribution to institutional costs.
- 4 During the same three-year period, Washington Mutual "earns" discounts of \$1.170
- 5 million annually, or a total of \$3.510 million. Washington Mutual's discounts exceed the
- 6 Postal Service's expected contribution by \$57 thousand.

1 VI. POSTAL SERVICE COMPLIANCE WITH THE DATA COLLECTION PLAN FOR
2 THE WASHINGTON MUTUAL NEGOTIATED SERVICE AGREEMENT IS
3 FACILITATED BY UTILIZING THE FINANCIAL MODEL APPROVED BY THE
4 COMMISSION.

5 Like all previous NSAs, the Postal Service proposes a data collection plan for the
6 Washington Mutual NSA.⁴⁸ As part of each annual data collection plan report for the
7 agreement, the Postal Service proposes “to provide an evaluation of the impact on
8 contribution.”⁴⁹

9 In addressing this requirement in each annual report, Postal Service compliance
10 must involve use of the financial model on which the Commission bases its estimate of
11 the financial value of the agreement, if approved. This would entail substituting average
12 unit revenues, average unit costs, and actual mail volumes entered for each year into
13 the Commission-approved financial model. Doing so would facilitate Commission
14 review and analysis of the financial value of the Washington Mutual NSA after
15 implementation.

16 For example, if the Commission approves the Washington Mutual NSA based
17 upon the financial model presented in the testimony of witness Ayub (USPS-T-1,
18 Appendix A), each annual report would be required to include the approved financial
19 model. The model would update estimated figures with Washington Mutual’s actual
20 operational and marketing letter mail volumes, the before-rates and after-rates average
21 revenue per piece, and the before-rates and after-rates average operational and
22 marketing unit cost per piece for the appropriate year. Updating the estimated figures

⁴⁸ USPS-T-1 (Ayub), Appendix C.

⁴⁹ Id.

1 for actual average unit revenue, average unit cost, and operational and marketing mail
2 volumes would be put into the alternative financial model proposed in this testimony, if
3 approved by the Commission.

4 Relying on the same financial model as approved by the Commission and simply
5 updating estimated figures in this manner would reduce work effort for both the Postal
6 Service and the Commission related to the annual data collection plan report.

7 Moreover, it would minimize the possibility of errors associated with creating a new and
8 separate financial model to display the annual results of the Washington Mutual NSA.

1 VII. CONCLUSION

2 This testimony presents analyses and proposals to increase the likelihood that
3 the Postal Service receives a meaningful increase in institutional contribution from the
4 Washington Mutual NSA. The Panzar analysis provides a method to explicitly control
5 for the effects of exogenous factors in the estimate of volumes provided by Washington
6 Mutual, and thereby presents an improved estimate of the financial value of the
7 agreement. It is for these reasons that I propose application of the Panzar analysis to
8 the Washington Mutual NSA.

9 Net present value analysis provides a basis for evaluating the financial value of
10 the Washington Mutual NSA against an objective standard—a minimum rate of return.
11 By limiting participation to that volume that at least recovers the Postal Service’s
12 investment in the Washington Mutual NSA, the Postal Service is assured a meaningful
13 contribution to institutional costs at least equal to the required minimum rate of return, or
14 “cost of money.”

15 As an alternative to using net present value analysis to determine a meaningful
16 contribution, I propose that discounts be limited to that volume where the increase in
17 contribution equals the discounts earned by Washington Mutual. This approach is
18 equitable to the Postal Service and Washington Mutual, and assures that contribution is
19 sufficient to recover the Postal Service’s investment while providing a meaningful
20 increase in institutional contribution.

21 Postal Service compliance with the data collection plan’s requirement to evaluate
22 the impact on contribution must involve use of the financial model relied upon by the
23 Commission to estimate the financial value of the agreement, if approved. Use of the

- 1 Commission-approved model would facilitate the annual review and analysis of the
- 2 performance of the Washington Mutual NSA, by simplifying preparation and review, and
- 3 minimizing the possibility errors.