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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 |

**UNITED STATES POSTAL SERVICE**
**MEMORANDUM ON RECONSIDERATION**
**(May 13, 2005)**

## Summary

The Postal Service's Governors have asked the Postal Rate Commission (PRC) to reconsider and revise its recommendations in this docket in three respects: (1) the Commission should reconsider and change its conclusion that discounts established by the Negotiated Service Agreement (NSA) with Bank One should be capped at a level of revenue approximating the cost savings created by the NSA; alternatively, the Commission should clarify and explain further its decision to impose the cap; (2) the Commission should elaborate on the type and level of proof it would find persuasive to establish reliable estimates of Bank One's before-rates volumes; and (3) the Commission should explain further its view of the role of settlements in reviewing and recommending proposals based on NSAs.

The Governors' Decision was founded on their belief that the Commission should evaluate the need for caps on volume-related discounts (declining block rates) in light of a progressive standard that realistically takes into account the full economic potential of rate and service agreements with individual mailers. In this memorandum, the Postal Service expands and supplements the Governors' views. The Postal Service proposes and supports the following practical standard to guide the Commission's determination on proposed NSAs:

> When evaluating a declining block rate proposal, the standard to apply is whether
>
> (1) The forecasts are reliable and reflect an appropriate tolerance for error in light of industry practice, sound regulatory principles, and the requirements of the Postal Reorganization Act; and
>
> (2) The Postal Service has demonstrated that risks in the NSA are reasonably constrained by (a) identifying factors that could impact mail volumes; (b) using contract terms to minimize risks, and (c) showing that any residual risk is offset by the potential benefits.

The merits of applying this standard in Commission proceedings are supported by sound economic principles; the Postal Service's own disciplined analysis in negotiating and evaluating NSAs with mailers; common business practices; the application of sound regulatory principles; and reasonable interpretations of the policies and procedures of the Postal Reorganization Act. In applying the standard, the Commission should determine the need for caps in light of the particular circumstances involved in each specific proposal. The Commission should not rely on any *a priori* determination that discounts must be capped for NSAs to be functionally equivalent or legally viable. Finally, the Commission should not discourage the practice of settlement in proceedings to consider NSAs. Rather, the Commission may rely on settlement agreements among affected parties to resolve contested issues and develop realistic solutions to problems arising out of NSA proposals.

I. INTRODUCTION

A. Background

On December 17, 2005, the Postal Rate Commission issued its Opinion and Recommended Decision approving, with the significant addition of a cap on discounts, the rate and fee changes necessary to implement the Bank One Negotiated Service Agreement (NSA).[1] The Commission imposed a cap on discounts tied to the cost savings, following a methodology that is substantially similar to the one used to impose a discount cap in the Capital One NSA case. [2] As in its Capital One recommended decision, the Commission found that such a stop-loss provision was necessary to protect against the potential loss of revenue from applying discounts to mail that would have been sent anyway, even in the absence of the agreement. In its Opinion and a Concurring Opinion signed by the four Commissioners who issued the main Opinion, the Commission emphasized its perceived deficiencies in the before-rates volume estimates submitted to support the declining block rates.[3] The Commission noted that the record provided no means of evaluating the sensitivity of the volume estimates to changes in exogenous factors.[4] The Commission found that the unreliability of these estimates created an unacceptable risk of financial loss which would be remedied by the imposition of a cap.[5]

The Commission stated that, without the cap, the NSA would not protect the interests of mailers who were not a party to the NSA, and who would have to make up

[1] Opinion and Recommended Decision etc.
[2] PRC Op. MC2002-2,
[3] PRC Op. MC2004-3, at 60-61; Concurring Opinion at 3.
[4] PRC Op. MC2004-3, 67.
[5] See *id.* at 4, 61; Concurring Opinion, at 3.

any losses the NSA might produce, and as a consequence, the NSA would not accord with the requirements of the Postal Reorganization Act (PRA). The Commission concluded that a cap would eliminate the risk of harm to the interests of mailers who are not parties to the NSA.[6] By doing so, it implied that it would not recommend any NSAs that were supported by volume forecasts unless the attendant risks could be eliminated.

The Commission imposed the cap even though a nearly-unanimous and unopposed settlement was reached with the Office of Consumer Advocate and mailers from a broad cross-section of mail subclasses who had intervened. The settlement represented a belief by those who actively participated in the review of the Bank One NSA that the conditions that led to the imposition of the cap in the Capital One case did not exist in the Bank One record and that financial benefits need not be similarly limited. The Commission's decision also suggested that settlement should have a limited role in functionally equivalent cases.

Despite the stated reservations, all the Commissioners who issued the Recommended Decision renewed their strong support for NSAs and held out the prospect that not all NSAs with declining block rates would need to be constrained with a cap.[7] Their Concurring Opinion stated that the addition of a stop-loss cap should not be construed as a precedent for all NSAs, or even for all NSAs that are functionally equivalent to the Capital One NSA. It noted that the reliability of before rates volume estimates is a factual issue that must be evaluated by the Commission.[8]

On February 18, 2005, the Governors of the United States Postal Service, acting pursuant to 39 U.S.C. § 3625(c)(2), allowed under protest the rate and classification

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[6] PRC Op. MC2004-3, at 40-41, 77.
[7] Concurring Opinion at 1, 3
[8] Concurring Opinion at 3.

changes recommended by the Commission and returned the matter to the Commission for reconsideration and a further recommended decision. In their decision, the Governors expressed substantial agreement and appreciation regarding the Commission's recommendations enabling the NSA. The Governors, however, disagreed with the Commission's decision to impose a cap. They expressed three concerns: (1) that the standards the Commission has erected in evaluating forecasts may not be realistic or attainable; (2) that the Commission has not clearly explained its expectations about how declining block rates could be decoupled from a stop-loss cap; and (3) that the Commission's decision to overlay unwanted conditions on the settlement agreement and its views on settlement in NSA cases may inhibit the role of settlement as a means for creative resolution of issues.

In particular, the Governors requested that the Commission give currency to the views expressed in their Decision and that it reconsider the recommendation to impose the cap on the Bank One NSA. The Governors also asked the Commission to elaborate and provide specific guidance on the type of evidence that the Commission might find persuasive to recommend uncapped volume based discounts in future NSAs. And, they asked the Commission to clarify the role of settlement in functionally equivalent NSA cases. The Governors anticipated that the Commission could address these issues and render their further recommended decision on the existing record.

On March 7, 2005, the Postal Service requested leave to file a memorandum addressing the issues raised by the Governors in their decision and proposed additional procedures for this stage of the proceedings. In the motion it filed on March 7, 2005, the Postal Service stated that its experiences in developing NSAs, as well as its financial and ratemaking objectives, substantially shaped the context for the Governors' views. To begin reconsideration and explanation of an evidentiary standard to support uncapped NSAs, the Postal Service requested leave to file a memorandum that would present its views on the questions raised by the Governors in their Decision and address the pertinent legal, economic, and practical issues. The memorandum would also propose an evidentiary approach that could serve as a standard for future NSA proposals.

The Postal Service also suggested procedures designed to facilitate the development of a realistic approach to establishing a record support for declining block rates that meets the requirements of the PRA without unduly restricting the potential of NSAs. In a second stage of the proceedings, intervenors, including past and prospective NSA partners, and the Office of the Consumer Advocate would be able to comment on the Postal Service's views, which would allow NSA stakeholders to address suitable evidentiary standards, in light of their own capabilities and concerns.

The Postal Service then suggested a third stage that would permit the Commission to take full advantage of the opportunity to comprehensively explore these issues in the context of the record in this case. The Postal Service recommended that the Commission, either through a Notice of Inquiry or other mechanism, elaborate on its views of the appropriate standard of evidence necessary to support uncapped declining block rates. At this stage, the Commission would address the Postal Service's and other parties' proposals, in light of the Commission's own expectations, and would propose an approach that would overcome its concerns. The Commission would then permit parties the opportunity to comment on the practical and legal implications of the Commission's preliminary guidance.

Finally, the Commission would deliberate, based on the existing record, supplemented by the comments submitted on reconsideration, and would issue a further recommended decision, including further explanations and guidance for future cases.

In Order 1433, issued on March 16, 2005, the Commission granted the Postal Service's request to file a memorandum but delayed any decision on subsequent procedures until after it has reviewed the memorandum. On April 14, 2005, the Postal Service, after consultation with the Office of the Governors, requested an extension of time in which to file its memorandum. On April 15, 2005, the Presiding Officer issued Presiding Officer's Ruling No. 8 granting the extension until May 13, 2005.[9] Pursuant to Order 1433 and POR 8, the United States Postal Service respectfully submits this memorandum on the pertinent, economic, legal, and practical issues raised by the Governors in their decision.

B. A Unique Opportunity

The reconsideration of the Commission's opinion and decision in the Bank One NSA case comes at an important juncture in the development of the Commission's practice in reviewing NSAs. The Commission's support for NSAs, not only in this docket but also in the Capital One NSA and Discover NSA cases, provides valuable flexibility within the current ratemaking statutory scheme. But its concerns about the reliability of volume forecasts, combined with the Commission's more traditional

[9] Presiding Officer's Ruling Granting Extension of Time, MC2004-3/POR- 8 (April 15, 2005).

expectation that discounts should be linked to cost savings, present an impediment to further progress that may not be warranted. As will be explained below, NSAs that grow contribution through inducing cost-savings behavior will be the exception not the rule. Rather, the Postal Service and the Governors believe that the opportunities for increasing contribution through volume incentives are far better than through cost-based discounts. The reconsideration presents a unique opportunity to explore the issues related to the evidence necessary to support these important volume incentives, and for the Commission, the Postal Service, and the postal community, to work together to develop a realistic approach that is consistent with the PRA.

The Postal Service has carefully reviewed the record and the Commission's relevant Opinions and Recommended Decisions. The Bank One decision, more than the other NSA decisions, addressed the extent of the Commission's concerns about the reliability of the volume forecasts, given non-price factors that could lead to an underreporting of the before rates volumes. The Postal Service has consulted with outside experts and its NSA partners to craft a proposed conceptual and practical approach to these concerns, one that we believe tolerates a level of risk commensurate with the requirements of the PRA. The proposed standard of evidence requires an extensive factual review.

In the course of its review, the Postal Service has concluded that additional information could illuminate and guide the Commission's reconsideration. For example, the Postal Service applied an all-encompassing vetting process in its assessment of the reliability of Bank One forecasts. The process incorporates analysis of a wide range of exogenous variables, which the Postal Service believes is rigorous and reliable. Yet, the details of the Postal Service's due diligence and its risk assessment of the NSA have not previously been explained. Moreover, the Postal Service crafted its evidentiary approach in Bank One, by reviewing, not only Commission precedent, but also common practices employed by business and other regulators when faced with need to make decisions on the basis of less than perfect information. This context has also not been described previously..

We propose to fill these gaps with three declarations. The first declaration from witness Plunkett explains how the Postal Service assessed the reliability of the Bank One forecasts and how it determined that risk that the agreement would yield a negative contribution was well within acceptable tolerances. The second is from Dr. Samuel Hadaway, a principal of Financial Analysis Consultants (FINANCO, Inc.) and an adjunct finance professor at the University of Texas at Austin, who has extensive experience in regulatory economics, both as a senior member of the Public Utility Commission of Texas staff and as an expert witness. The third is from Dr. John Matthews, Professor Emeritus, Graduate School of Business, University of Wisconsin, Madison. Dr. Matthews has consulted and provided expert witness testimony for thirty years in the areas of automotive network analysis, trucking, dealership/distribution issues, and other industries. He also owns and operates a small business involved with manufacture and assembly of internationally sourced components for sporting goods.

The Postal Service believes that this supplemental information creates a useful framework to explain its proposals for a progressive standard for evaluating proof of NSA volume estimates and NSA proposals generally. In submitting these declarations, we are mindful that the Governors in their Decision expressed the expectation that the evidentiary record would not need to be reopened for the Commission to reconsider its recommendations in Bank One, and for it to clarify the type and level of proof it would find convincing and reliable in future cases. While we do not believe that this additional information need have the status of evidence for the second purpose, the Commission could conclude that it should not rely on it in connection with its reconsideration of the Bank One recommendations, unless it is incorporated as evidence and subjected to adversarial testing. In that event, the Office of the Board of Governors has agreed that the Postal Service may represent that the Board would not object to reopening the record for that limited purpose.

## II. THE COMMISSION, POSTAL SERVICE, AND MAILERS SHARE A COMMON INTEREST IN ENSURING THAT NSAs ARE PROFITABLE

In each of the NSAs that the Commission has recommended, it has required that the discounts be capped at the amount of cost savings. It has done so because its paramount concern is that rates be sufficient to cover costs, and that mailers other than the NSA partner will not be made worse off.[10]

The Postal Service shares the same interest in ensuring that NSAs will yield a positive contribution. As the Governors stated in their Decision, the downward pressure on First-Class Mail volumes impels the Postal Service to innovate and to seek out new sources of revenue growth.[11] The Postal Service approaches NSAs as a prudent business would—it seeks to maximize the contribution while minimizing risk that the contribution will be negative. In Bank One, it pursued and evaluated these possibilities by developing as much information as possible to improve and support its negotiating

[10] MC2002-2, Op. at 4
[11] Governors' Decision at 15 & n. 28.

position, exercising due diligence in its assessment of Bank One's volume information, minimizing risks through contract terms, and by vetting the information through a rigorous internal review process.

Mailers also share a common interest in ensuring that NSAs are profitable, as evidenced by the intervention, in each of the NSA cases filed to date, of mailers representing almost every class of mail. These mailers have enriched the records in these cases on a wide range of costing and revenue issues. This is particularly evident in the settlement of the Bank One case, which added a mechanism to guarantee a positive marginal contribution. It was an innovative resolution crafted with the thoughtful input from the OCA, representing the public, and Valpak, a Standard Mailer, and had nearly unanimous support and no opponent.

## III. THE DOWN-SIDE OF CAPS

### A. Practical Issues

Coupling caps with the cost-savings as a requirement for NSA presents practical problems. The Postal Service anticipates very few NSA candidates will have enough cost-saving potential to justify the transaction costs associated with obtaining Commission review of each NSA. The Postal Service's rate schedule is replete with rates and classifications that induce cost-saving behavior and, in most cases, it is usually more appropriate to induce such behavior through classification changes rather than through NSAs. Based on experience so far, however, cost savings NSAs will likely be the exception, not the rule.

The Postal Service's experience in the credit card company is illustrative. Only a credit card company that sends a significant volume of solicitations through First-Class

Mail can generate a pool of cost-savings large enough to justify an NSA. Yet, most credit card companies rely almost exclusively on Standard Mail for their marketing purposes. Only a handful of companies generate the necessary First-Class Mail savings. The Commission has already reviewed NSAs these companies: Capital One, Bank One, and Discover, and its recommended decision on a fourth HSBC is pending. The Postal Service knows from its extensive research in the credit card industry, however, that the opportunities for this type of NSA has almost run dry.[12]

B. Economic Issues

Imposition of a cap based on cost savings may lessen the risk of revenue leakage, but it does not necessarily lessen total system risk. Unless a mailer's elasticity of demand with respect to price is non-existent, a stop-loss cap of this type reduces or eliminates the mailer's incentive to send additional contribution-generating volume. Thus, by seeking to minimize a perceived unfair transfer of value from the Postal Service to one customer, the cap may prevent the system as a whole from benefiting from a similar transfer from that customer. Just as the system as a whole must shoulder the burden if there is revenue leakage, so must it suffer when volume growth is artificially curtailed. See the Appendix to this memorandum for a fuller discussion of the economic issues surrounding the imposition of a stop-loss cap.

[12] Data Collection Report, September 1, 2003 to September 30, 2004, Docket No. MC2002-2, at 17, MC2002-2 at 17 (January 31, 2005).

## IV. COMMON PRACTICES IN BUSINESS AND IN OTHER REGULATORY CONTEXTS PROVIDE A MODEL FOR EVALUATING NSAs UNDER THE POLICIES OF THE POSTAL REORGANIZATION ACT

The type of risk that the Commission sought to address by imposing a cap is not unique to Postal Service NSAs. Similar risks are faced and managed by entities in the private sector in unregulated contexts and by regulators in other industries. The experiences of these other entities is instructive and supports the Postal Service's position that it has maximized reduction of the risk through various actions it took; that imposition of the cap induces additional, unwarranted risk; and that the Postal Reorganization Act does not require the Commission to eliminate all risk.

### A. An Examination of Common Business Practices and Results for Managing Risk Supports the NSA Without the Need for a Cap

The Postal Service and the Commission are not faced with a unique situation in having to address the "what ifs" and "anyhows" inherent in this situation. Indeed, in the attached Declaration, professor emeritus and business expert, Dr. John P. Matthews, provides several illustrations of risk reduction in non-regulated business contexts—both corporate and personal. He explains the measures that are generally taken in such situations to meet the often conflicting goals of generating new business and mitigating risk of loss. He then examines the Bank One NSA issue in light of his experience in this area and the examples he provided.

Dr. Matthews found that the Postal Service had undertaken the relevant risk-reduction measures. The Postal Service had "gathered additional useful information before and during the negotiation period," and "developed data and analyzed the factors that influence demand for mail in the credit card industry and Bank One's First-Class

Mail volume" before negotiating the block rates, so as to "independently assess Bank One's volume projections with and without the NSA." This was followed by public scrutiny by the Commission and other interested parties. Moreover, the NSA features a review cycle with formula-based adjustments, a provision to account for mergers and acquisitions, and a limitation of duration.

Dr. Matthews notes that the Commission's stop loss provision introduces "the risk that the full gains from a mutually beneficial contract will not be realized." Ironically, the mechanism that the Commission applies to deal with the issue of anyhow volume itself suffers from the same inability to distinguish such volume. As Dr. Matthews notes, the "'stop loss' provision apparently does not distinguish between discounts that represent lost contribution due to exploitation of private information by Bank One or other adverse outcomes, and discounts that reflect the success of the NSA terms in generating additional volume." In other words, due diligence having been done, the "stop loss" provision might be even more effective as a "stop gain" provision, which reduces the benefit of the NSA to Bank One, the Postal Service, and, ultimately, all ratepayers.

### B. Other Regulators Rely on Similar Mechanisms and Take a Relatively Permissive Approach

In the case of regulated industries, once courts cleared the way for non-cost based discounts and for customized pricing, regulators have relied on very similar safeguards to those at work in the market, as described above. The courts have held for more than a century that rate discounts based solely on competition, rather than cost savings, violate neither the just and reasonable rate standard of the Interstate

Commerce Act nor its prohibition of unjust discrimination or undue preference.[13] In the late 1970s, the Interstate Commerce Commission and the courts began to allow volume discounts to be established in private rate and service contracts—*i.e.*, NSAs—with individual ratepayers. Although the Interstate Commerce Act did not explicitly authorize the Commission to approve customized rate and service contracts, the ICC and reviewing courts held that the traditional ratemaking norms of the Act (which, like the Postal Reorganization Act, required that rates be just, reasonable and nondiscriminatory) were sufficiently flexible to enable the Commission to give effect to customized rate and service contracts.[14]

In 1992, an Administrative Law Judge of the Federal Energy Regulatory Commission found that a common carrier petroleum pipeline could reasonably establish a variety of annual volume discounts and geographically-limited discounts to meet the threat of intermodal competition. No cost savings caps were imposed on these discounts.[15]

The attached declaration of Dr. Samuel C. Hadaway surveys the range of guidelines used by regulators to minimize risk without unduly restricting the benefits of contract rates. These guidelines include those elements at work here: expert analysis, limited scope, public scrutiny of uncertainties, potential benefit to the system as a whole, and periodic regulatory review. The general regulatory approach to managing the inherent risks associated with contract rates is to provide an open process whereby all

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[13] *See Associated Gas Distributors v. Federal Energy Regulatory Commission*, 824 F.2d 981, 1011 (D.C. Circuit), *cert. denied*, 485 U.S. 1006 (1988); *accord*, *National Gypsum Co. v. United States*, 353 F. Supp. 941, 946-49 (W.D.N.Y.); *Williams Pipe Line Co.*, 58 FERC ¶ 63,004 (1992) at 65,024-27.
[14] *See Railroad Contract Rates: Policy Statement*, Ex Parte No. 358-F, 43 Fed. Reg. 58189 (1978) (Policy Statement I); *Burlington Northern R.R. Co. v. ICC*, 679 F.2d 934 (D.C. Cir. 1982); *Sea-Land Serv., Inc. v. ICC*, 738 F.2d 1311 (D.C. Cir. 1984).
[15] Williams Pipe Line Co., 58 FERC 63,004 (1992) at 65,024-65,027.

interested parties can scrutinize the supporting information. The realistic objective is to end up with reasonable forecasts, rather than to eliminate the uncertainty and risk inherent in all contract negotiations.[16]

Examining this experience in the context of postal NSAs, Dr. Hadaway states: "While the PRC cannot be given absolute assurance that additional discounts will be the sole cause of incremental volumes, it can only test this approach by allowing it and evaluating the results. This is the approach that utility regulators by necessity have had to apply. The results have been favorable because they have led to pricing policies that are more consistent with market forces. The PRC and the Postal Service and its customers should benefit from a similar approach."

### C. The Postal Reorganization Act Does Not Require that Ratemaking Be Free from Risk and the Commission Has Appropriately Acted Accordingly in Other Contexts

Among the principal purposes of the Postal Reorganization Act was to allow the Postal Service to operate in a businesslike manner. But Congress understood that imprecision inheres even in the most "scientific" of business activities—in the ratemaking and financial management areas. Notwithstanding the concerted efforts of the Postal Service, and its ratemaking partner, the Commission, Congress explicitly recognized that even in the context of one of the most basic tenets of the PRA—that rates cover costs—the process could not be so finely calibrated as to guarantee that result and, instead, it qualified that goal with the standard "as nearly as practicable." 39 U.S.C. § 3621.

[16] California Public Utilities Commission, Decision 88-03-008, March 9, 1988, Rulemaking Proceeding on the Commission's Own Motion to Revise Electric Utility Ratemaking Mechanisms in Response to Changing Conditions in the Electric Industry, at 38.

Just as Congress anticipated the risk that break even could not so easily be ordained in ratemaking, it gave the Commission sufficient authority, through the fullness of its proceedings, to accept a reasonable degree of risk in the outcomes of its recommendations. Most recently, in the Priority Mail Flat Rate Box case, the Commission reviewed the Postal Service's balancing of the risks and rewards from the experiment and found the risk to be minimal, since the risk of revenue leakage was likely to be more than offset by the potential financial benefits. The Commission found that "a reasonably bounded risk of potential revenue leakage estimated by the Service does not significantly detract from the merits of its proposed innovation." PRC Op., Docket No. MC2004-2, at 14.

Accordingly, in areas as large as the revenue requirement and as small as a few rate cells, the Commission has always been able to tolerate appropriate risk. Where, as here, the attempt at protection from a possible risk—the discount cap—is itself a potential cause of greater loss of benefits from possible net revenues that exceed the unrelated cost savings, such "protection" ought not to be imposed.

## V. DECOUPLING DISCOUNTS FROM A COST-SAVINGS CAP

In the Bank One decision, the Commission imposed the stop-loss cap on the available discounts because it found that volume forecasts were unreliable and that the NSA had an unacceptable level of risk. By limiting the discounts by the amount of cost-savings, the Commission determined that it had eliminated the risk. Yet, that action was in no way required to comport with the policies of the Postal Reorganization, Commission precedent, or accepted business and regulatory practices, all of which show tolerance for a reasonable degree of risk. Moreover, the cap introduced the risk of limiting revenues that might otherwise benefit the postal system as a whole and all ratepayers.

In its March 7, 2005 motion, the Postal Service indicated that it would propose a standard of evidence for the Commission to consider when evaluating an NSA proposal that seeks rate and fee changes for volume incentives in the absence of cost savings. After careful consideration of the Commission's concerns in its Bank One Opinion and the Commissioners' Concurring Opinion, the issues the Governors, relevant Commission precedent as well the input from the experts whose declarations are attached and from our NSA partners, the Postal Service has developed a standard that. It believes, is realistic and comports with the requirements of the PRA.

A. A Proposed Standard:

When evaluating a declining block rate proposal, the standard to apply is whether

(1) The forecasts are reliable and reflect an appropriate tolerance for error in light of industry practice, sound regulatory principles, and the requirements of the Postal Reorganization Act; and

(2) The Postal Service has demonstrated that risks in the NSA are reasonably constrained by (a) identifying factors that could impact mail volumes; (b) using contract terms to minimize risks, and (c) showing that any residual risk is offset by the potential benefits.

B. Application of the Standard to the Bank One NSA

The facts presented during the initial evidentiary phase of this proceeding, as supplemented by the attached declaration of witness Plunkett, fully support a Commission finding that the proposed standard has been met. The Postal Service has demonstrated that the Bank One forecasts are reliable, that the risks are reasonably constrained and well within acceptable tolerances, and that any risk not mitigated by terms in the contract are more than offset by the potential benefits. In his declaration, Mr. Plunkett explains the details of how the Postal Service negotiated the NSA with Bank One, evaluated the tradeoffs among different types of risks and rewards, and determined that the NSA would yield a positive contribution.

The Postal Service has developed a formalized framework for the development of NSAs built upon comprehensive research and analysis.[17] Before negotiating with Bank One, the Postal Service conducted extensive research on the company and its use of the mail.[18] The Postal Service also relied upon its extensive expertise on the credit card industry and the factors that influence the demand for mail.[19] It used this data to identify key exogenous factors that could impact Bank One's mail volume. It then performed several separate analyses to develop a reliable range for projections of Bank One's mail volume. The Postal Service analyzed Bank One's volume trends, the economic variables that affect mail volume, and the correlation between the growth in accounts and the growth in mail volume.[20] In addition, the Postal Service incorporated into its projections input from financial analysts and from Bank One's responses to

[17] Declaration of Michael K Plunkett (Plunkett Declaration), ¶15-19
[18] *Id.*, ¶¶ 20-39.
[19] *Id.*, ¶¶ 12-14.
[20] *Id.*, ¶¶ 20-64

negotiating strategies.[21] These analytical tools enabled the Postal Service to develop a projection of Bank One's mail volumes. The Bank One forecasts submitted in support of the Postal Service's Request fell within this range and were determined to be reliable.

The Postal Service also mitigated most of the risks that before rates volumes might be underreported through the use of four contract terms: he contract terms that mitigate this risk are the limited duration of the agreement (three years); the annual adjustment mechanism, which modifies the volume threshold for discounts based on changes in the number of accounts; the limitation on the number of flats; and the merger provisions.[22] In its Opinion, the Commission found that the annual threshold adjustment limited the risks associated with operational mail volume,[23] but it imposed a cap because of its concern about the forecast with marketing mail volume.

As Mr. Plunkett explains in his declaration, the annual threshold adjustment also mitigates the risk inherent in the solicitation mail forecast.[24] This adjustment is based upon changes in the number of accounts. The growth in the number of accounts is highly correlated with growth in marketing mail volume. The exogenous factors that drive the growth in accounts, such as a reduction in the cost of credit (e.g., decline in interest rates) or increase in demand (e.g., rise in household income) also drive up mail volume. Therefore, by adjusting the threshold upward based on the growth in the number of accounts, the NSA also controls for the impact of exogenous factors that would result in an increase in the Before Rates volumes. As a result, even if an

[21] *Id.*, ¶¶ 42 and 45.
[22] *Id.*, ¶ 78. See also Docket No. MC2004-3, PRC Op. at 70-71.
[23] Docket No. MC2004-3, PRC Op. at 70-71
[24] Plunkett Declaration ¶ 80

exogenous factor would cause an increase in mail volume that cannot be anticipated, the agreement self-corrects.

The Postal Service has also shown that the residual risks, i.e. the risks that could not be mitigated through contract terms are more than offset by the potential benefit of the volume incentives.[25]

By meeting the standard, the Postal Service has addressed the concerns that the Commission expressed in its Opinion and Concurring Opinion about the reliability of volume forecasts and the appropriate level of risk. As a result, the Commission should recommend the rates and fees necessary to implement the NSA, without the imposition of the cap.

## VI. FUNCTIONALLY EQUIVALENT STATUS SHOULD NOT DICTATE IMPOSITION OF A CAP

In the Bank One Opinion, the Commission's discussion of functional equivalency dominates its Findings and Conclusions.[26] The Commission relied substantially on a finding that a cap needed to be imposed on the Bank One NSA, because, without it, Bank One would lose its claim to status as functionally equivalent to the baseline NSA with Capital One. *See* PRC Op. MC2004-3, at 37-41. In summarizing its conclusions in this regard, the Commission stated:

> The Commission finds that one of the differences [between the Capital One NSA and the Bank One NSA], the absence of a stop-loss cap, does not preserve the win-win situation that is present in the baseline agreement. This is inconsistent with the requirements of the Act because the interests of mailers not party to the agreement are not protected from harm. The Commission employed similar reasoning in its findings and conclusions in the Capital One decision. Following logic consistent with the Capital One decision, the Commission recommends the addition of a stop-loss cap to the Bank One Negotiated Service Agreement. This

[25] *id.* ¶¶ 86-91.
[26] PRC Op. MC2004-3, at 37-65.

> recommendation will bring the Bank One Negotiated Service Agreement into compliance with the requirements of the Act by assuring that mailers other than Bank One will not be made worse off as a result of the agreement.

*Id.* at 41.

In the Commission's discussion, functional equivalency has two dimensions. On one hand, the Commission acknowledges the procedural origins of the role of functional equivalency as a mechanism that justifies incorporating testimony from the baseline case to support the recommendation of a related NSA. This dimension and use of the concept, as a practical matter, is critical to realizing the value of the NSA approach to ratemaking flexibility. Only by streamlining procedures for NSAs, and expediting proceedings, will it be possible to hold transaction costs to a level that makes NSAs a viable pricing alternative for more than the largest customers. As noted by the Governors and elsewhere in this memorandum, furthermore, this has been a major concern of the Postal Service in seeking new, mutually beneficial NSAs, since the uncertainty surrounding functionally equivalent status that has emerged from the Commission's previous recommendations, culminating in its Bank One decision, has apparently had a chilling effect on the hunt for future NSAs.

On the other hand, in finding that a cap must be imposed, the Commission, in effect, has also used functionally equivalent status as short-hand for a finding of legal consistency between NSAs and the policies and requirements of the PRA. The heart of this legal finding lies in the Commission's reconciliation between NSAs as rate contracts with individual mailers, the policies of equity and nondiscrimination embodied in the PRA, and the balancing of cost allocation and revenue generation that the Commission must ensure in recommending rates for all mailers. This reconciliation is epitomized in the Commission's determination that NSAs in general, and any NSA in particular, must represent a "win-win" situation in which all mailers benefit and no mailer is disadvantaged, even in the abstract, as a result of the NSA.

In the context of the instant proceeding, the two different dimensions of functional equivalency intersect on the issue of proof of before-rates volumes. The Commission states:

> The Commission finds the uncertainties presented with the Bank One volume estimates produce a similar effect as the uncertainties presented by the Capital One volume estimates. The recent Bank One merger with J.P. Morgan Chase adds to these uncertainties. The risks associated with misestimation of before rates volume estimates identified in the testimony of witness Panzar, and discussed in the Capital One Decision continue to be present with the Bank One Negotiated Service Agreement. Without the addition of a stop-loss cap, the win-win situation important to Negotiated Service Agreements is not preserved. Mailers not party to the agreement would not be adequately protected from the risk of harm. On this basis, the Commission recommends the addition of a stop-loss cap.

*Id.* at 61 (footnote omitted).

By equating a cap with the Bank One NSA's legal status, the Commission has undermined functional equivalency status as a procedural mechanism. In practical effect, it has also elevated caps to a structural and legal requirement.[27] In the future, the Postal Service will apparently only be able to proceed under the more efficient rules for functional equivalency, if it can establish at the outset that the NSA will inevitably increase postal revenues without a cap. Demonstrating this, however, would normally require adversarial testing and review of the estimates on which the NSA proposals rely. Alternatively, the Postal Service must include a cap in order for the NSA to be deemed functionally equivalent for procedural purposes.

[27] As a practical matter, the Commission's conclusions may similarly restrict other types of NSAs, insofar as they involve cost savings associated with volume discounts.

At the least, this result appears inconsistent with other Commission pronouncements. As noted by the Governors, in the Commission rulemaking that created specialized procedures for functionally equivalent NSAs, the Commission only identified two elements as essential to functional equivalency with the Capital One NSA. PRC Order No. 1391, Docket No. RM2003-5, at 50. These did not include a cap. Furthermore, the Commissioners' concurring opinion in Bank One stated:

> The addition of a stop-loss cap in this case should not be construed as establishing a precedent that all NSAs functionally equivalent to the Capital One agreement must include a stop-loss cap. That is not the Commission's view. The reliability of before rates volume estimates is a factual issue that must be evaluated by the Commission, but this does not bar an NSA without a stop-loss cap.

PRC Op. MC2004-3, Concurring Opinion, at 3.

In Bank One, the Presiding Officer initially determined that the case could proceed under the functional equivalency rules, even though the NSA did not include a cap. The Commission's subsequent determination that a cap must be imposed on the otherwise acceptable settlement agreement could be characterized as an attempt to validate Bank One's procedural status, and reconcile it with the Commission's later conclusion that a cap was necessary for legal sufficiency. Whether that was the intent, the practical effect of the Commission's finding apparently was to require the Postal Service to prove the win-win situation through credible proof of before rates volumes, before the status of functional equivalency can be established procedurally.

This situation amplifies the Governors' request for clarification. Unless the Commission really intends to establish a cap as a structural requirement for future functionally equivalent NSAs, it should not confuse the procedural status of functionally equivalent with the legal status of the proposed NSA. Under the Commission's formulation in Bank One, the legal status should depend on a determination of the financial effects of the proposal, which can only be made after testing and review of the evidence presented to support the Postal Service's and Bank One's estimates of volumes and revenues. The Commission should therefore make clear that this issue need not be resolved prior to determination of a proposal's status as functionally equivalent. Otherwise, the prospect of being unable to prevail on the issue of "win-win" legal sufficiency, particularly without Commission guidance on the type of proof it would prefer, will effectively inhibit pursuit of potentially beneficial NSAs.

The only other practical option would be for the Commission to adopt a realistic standard of risk to determine whether win-win can be achieved, and to clearly describe the type of proof that the Postal Service must submit. If the Commission could identify a type and level of proof that would create a prima facie presumption of sufficiency under the Commission's legal standard for NSAs, procedural status of functional equivalency could be established at the outset. Under either alternative, furthermore, as we have discussed elsewhere in this memorandum, the Commission should describe a realistic way of demonstrating that a proposed NSA is functionally equivalent, and that it will meet the legal standard that the Commission has erected.

## VII. WHEN PARTICIPANTS IN FUNCTIONALLY EQUIVALENT CASES BELIEVE SETTLEMENT NEGOTIATIONS ARE FRUITFUL, THE COMMISSION SHOULD NOT UNNECESSARILY DISCOURAGE THEM

The Governors asked the Commission "to clarify whether, as a policy matter, it disfavors settlements in functionally equivalent NSAs," and, if so, "to reconsider such a policy." Governors' Decision at 9. A brief review of the negotiations in this matter reveals a tremendous amount of both work and resulting benefits, and the Commission should encourage such negotiations.

First, the Postal Service negotiated an agreement with Bank One, and reached the conclusion that the agreement would be beneficial, not only to the Postal Service but to mailers in general. Among the items it negotiated, not present in the Capital One agreement, were a threshold adjustment mechanism, an enhanced mergers and acquisitions clause, and an annual limit on the mailing of flat-shaped mail. All three of these items limited risks that the Postal Service considered serious enough to warrant such clauses. In contrast, the Postal Service concluded that an overall cap on discounts available to Bank One was not only unnecessary, but could be counterproductive, possibly resulting in a loss of new First-Class Mail volume contribution.

Second, after extensive negotiations, the Postal Service was able to reach an agreement with other participants in this docket. Specifically, the participants negotiated an additional risk avoidance mechanism designed to meet a concern expressed by some participants that there was too great a risk presented by the fact that Bank One anticipated that new First-Class Mail volume generated by the NSA would be converted from Standard Mail volume, as opposed to being entirely new mail volume. This negotiated mechanism protects the Postal Service (and other ratepayers) from loss by incorporating actual data (the ACS success rate, the forwarding rate, and the return rate) into an analysis of the cumulative impact of the deal, and then limits the discounts available only to those that will yield a positive result.

Thirteen participants, by signing the settlement, expressed their agreement that the risk avoidance mechanisms were now sufficient, and that a cap on discounts was unnecessary.  These participants represented a broad range of interests in postal matters  -- Alliance of Nonprofit Mailers, American Bankers Association, American Postal Workers Union, AFL-CIO, Association for Postal Commerce, Discover Financial Services, Inc., Magazine Publishers of America, Inc., National Association of Postmasters of the United States, National Newspaper Association, National Postal Policy Council, Inc.,  Office of the Consumer Advocate, Parcel Shippers Association, Valpak Dealers' Association, Inc., and Valpak Direct Marketing Systems, Inc.  The other two participants-- Newspaper Association of America and David B. Popkin, did not oppose the settlement.  Significantly, no competitor of Bank One saw fit even to intervene in the case to oppose the NSA.

Thus, the instant docket benefited substantially from the efforts of the litigation participants to formulate a settlement that would meet their own concerns, as well as their interpretations of the Commission's standards for recommending NSAs that are functionally equivalent to the Capital One NSA.  They mutually agreed that, in the particular circumstances of the Bank One proposal, the conditions that led the Commission to impose a cap on discounts in the Capital One case need not similarly constrain the potential for economic gain by Bank One and all other mailers.

To then have the Commission add an additional term based on its expressed concern for other mailers, in a case where such a wide variety of types of mailers were represented and did not share that concern, might negatively affect the NSA process. Parties to an NSA may be less willing to agree to undertake new burdens, such as risk avoidance mechanisms, if they deem it likely that the Commission not only will approve those mechanisms but impose additional ones as well.

While the Commission is not bound by settlement agreements, but must independently recommend changes based on the record and its own interpretation of statutory and other requirements, the Commission's decision in this case is potentially harmful. As the Governor's expressed, "the Commission’s views on the role of settlement might inhibit future progress and discourage innovative resolution of issues in potentially contentious cases involving NSAs." Governors' Decision at __.

Experience now dictates that functionally equivalent cases are likely to have issues arise that were not litigated in the baseline case. As demonstrated in both the Discover and the Bank One case, the Commission’s rules on functionally equivalent NSAs are flexible enough to handle such issues, as long as the core requirements of functional equivalency are met. As such, it benefits the proceedings if contested issues can be resolved through settlement.

**Conclusion**

The Postal Service respectfully requests that the Commission consider the proposed standard for evaluating the need for caps on declining block rates in the specific context of the Bank One NSA. The Postal Service believes that the information and views presented above will provide useful guidance for further consideration of the questions raised in the Governors’ Decision. The Postal Service also believes that the circumstances of this reconsideration create a unique opportunity for the mailing community to consider and comment on these issues. As noted above, and in its motion filed on March 7, 2005, the Postal Service respectfully suggests that the

Commission establish procedures for further consideration and comment. While the Commission might elect to reopen the record to incorporate the new material submitted by the Postal Service, subsequent proceedings should include an opportunity for other participants to comment on the Postal Service's memorandum, as well a separate stage in which the Commission would express its own views, and the participants would be allowed to submit subsequent comments. Finally, the Commission would issue a further recommended decision that specifically addresses the Governors' Decision.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Nan K. McKenzie

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May 13, 2005

## 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.

Nan K. McKenzie

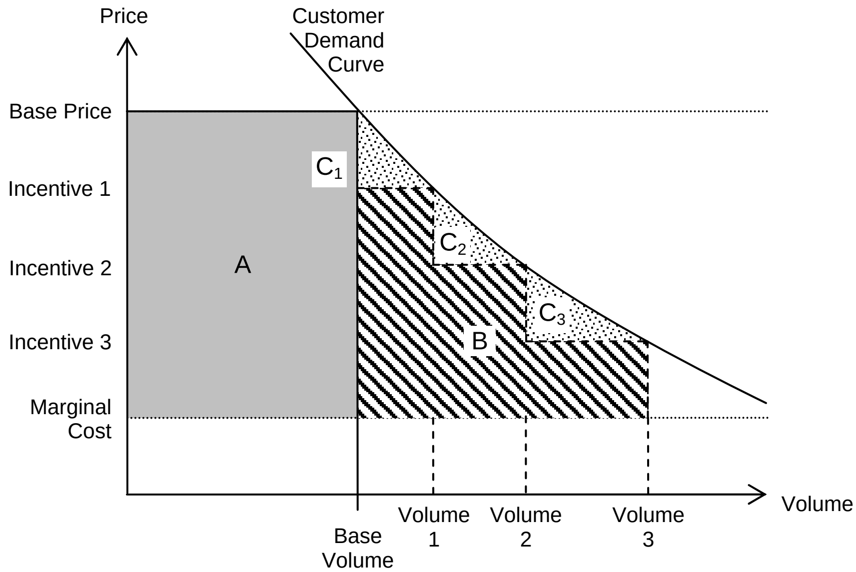
475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
May 13, 2005

# APPENDIX

The purpose of offering declining block rates is to increase customers' contributions to margin. The declining block rate achieves this by encouraging Postal Service customers to mail more than they otherwise would have. The additional volume adds to contribution so long as the discounted price exceeds the marginal cost of that volume.[28] As illustrated in figure 1, at the base price a customer would be willing to mail some number of pieces, but further mailings beyond the base volume would be uneconomical at that price. Thus, at the base price, the customer's mail earns the contribution represented by area A. The incentives induce the customer to mail more volume. By doing so, the customer gains additional consumer surplus, represented by areas $C_1$, $C_2$, and $C_3$. These new pieces provide the Postal Service with additional contribution, represented by area B. In short, *properly designed* declining block rates can approximate the customer's demand curve, resulting in a win-win outcome.

[28] If the additional volume is coming from another product line, then the currently received margin must be included in the marginal cost basis. For example, if the declining block rate induces migration of Standard Mail to First Class Mail, then the discounted First-Class Mail price needs to exceed the sum of marginal cost and the Standard Mail per-unit margin.

**FIGURE 1: BLOCK-RATE PRICING**



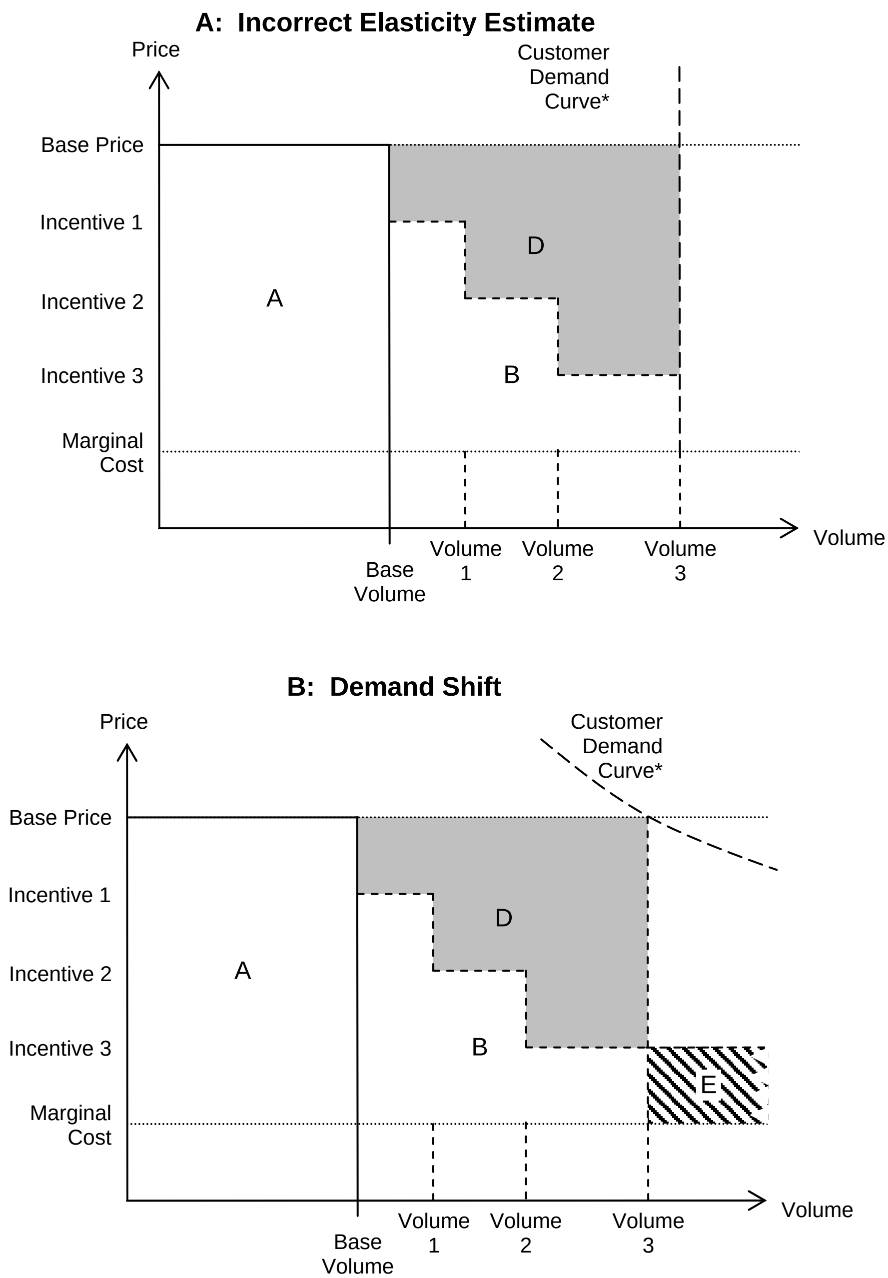

The challenge in designing the incentive structure lies in establishing the baseline threshold. A threshold that is too low gives away contribution, but a threshold set too high either negates the deal or fails to induce volume growth.

In its recommended decisions, the Commission expresses concern that there is a risk of the Postal Service giving an incentive on volume that would have been sent even in the absence of the incentive (so-called "anyhow volume"), because of a mis-estimation of the customer's demand curve, two illustrations of which are represented in figure 2. If the baseline volume were underestimated, then the declining block rates would reduce contribution and thereby harm other customers by making them shoulder more of the institutional cost burden.

Figure 2A shows the effect of incorrectly estimating the mailers elasticity of demand. In this diagram, the mailer has no demand elasticity, and would mail the same number of pieces, no matter what the price. In this diagram, the Postal Service loses contribution equal to area D as a result of giving incentives to the mailer.

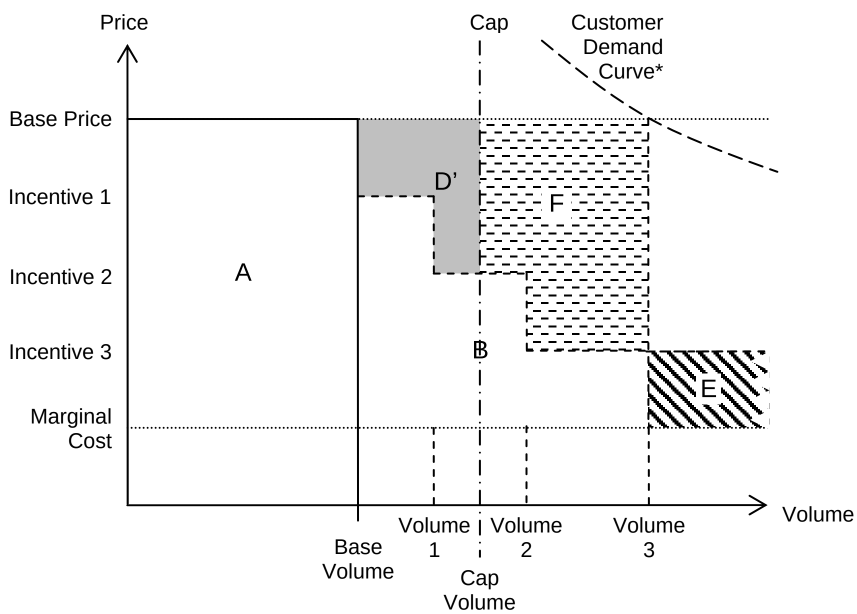
Figure 2B shows an outward shift in the customer's demand curve. In this case, some external change causes the mailer to send more pieces at all rates. Here again, the Postal Service loses contribution by discounting pieces that would otherwise have been sent at the full tariff. This lost contribution is represented by area D in figure 2B. However, one would also expect to see even more volume mailed at the discounted rate, so additional contribution from these pieces (represented by area E) would offset contribution loss in area D. That is, area D overstates the loss from incentives in this case.

**FIGURE 2: RISK FROM "ANYHOW VOLUME"**



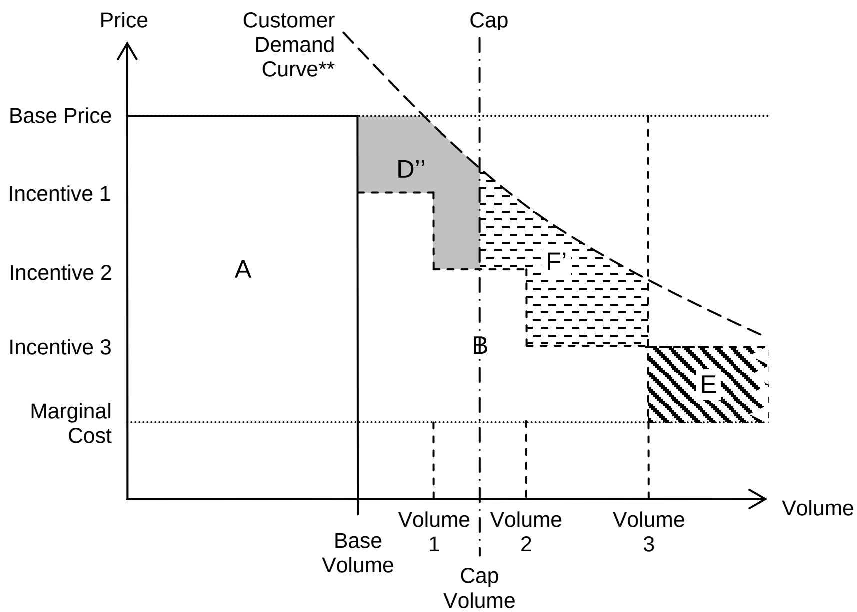

In order to limit this risk, the Commission has recommended a cap to prevent the loss of significant revenue and contribution on what might be "anyhow volume" (shown in figure 3). By limiting the total value of the incentive the customer can receive, here represented by area D', the Commission seeks to protect against loss by preserving contribution on pieces that would otherwise have been eligible for the incentive (area F). The imposition of a cap would also eliminate any offset to the contribution loss from new volume (area E).

**FIGURE 3: OPERATION OF STOP-LOSS CAP, CASE 1**



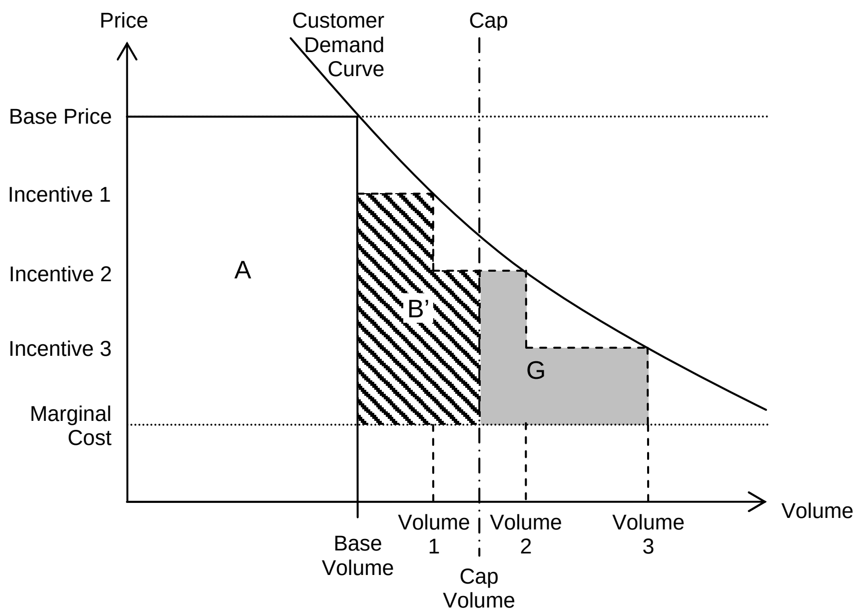

As noted above, however, only in some cases will the amount of the incentive given to the mailer equal the value of that incentive to the mailer. Figure 2A represents the only case where the value transfer from the Postal Service to the mailer equals the Postal Service's contribution loss. Even if the customer's demand curve were underestimated, the amount of potential contribution lost through incentives is probably less than the total value of the incentives, as shown in figure 4. As can be seen, even though the customer's demand is greater than the estimate used to set the incentives, the customer would still not send all of the additional mail at the base price. Thus, the actual contribution lost in this case is represented by area D'', and the contribution "saved" by the cap is area F' (compare to area D' and F in figure 3). Here again, potential offsetting contribution from additional volume (area E) is lost when the cap is imposed, as is the contribution represented by the part of area B that lies beyond the cap.

**FIGURE 4: OPERATION OF STOP-LOSS CAP, CASE 2**




Additionally, any action taken to mitigate the risk that “anyhow volume” will receive an incentive limits the gains in consumer surplus and thereby increases the likelihood that, from the customer’s perspective, the benefit (gains in consumer surplus) does not exceed the cost (shifting mailing procedures). If so, then no change in mailing will occur and the stop-loss cap either effectively eliminates an otherwise win-win outcome, or drastically reduces the gain. This case is presented in figure 5. Here, the cap serves to limit the amount of additional contribution from new volume that the mailer sends to area B’. The cap removes the mailer’s incentive to mail beyond this point, resulting in the loss of potential contribution in area G.

**FIGURE 5: OPERATION OF STOP-LOSS CAP, CASE 3**




There is no getting around the risk associated with demand uncertainty. If the base volume is underestimated, some contribution may be lost; but if the base volume is overestimated, or customer benefits are otherwise limited, an otherwise value-creating arrangement is put at risk. Both sides of this risk are borne by Postal Service customers. In the case of "anyhow volume," the Postal Service loses contribution that it would otherwise have earned on those pieces, forcing the rest of the users to contribute more to cover institutional costs, and in both cases, pieces that would have provided additional contribution to overhead are not sent, again forcing other Postal Service customers to shoulder more of the burden.

**DECLARATION OF MICHAEL K. PLUNKETT**

I, Michael K. Plunkett, declare under penalty of perjury:

1. I am the manager of Pricing Strategy (previously Pricing Innovation) for the Postal Service. In this position, I have management responsibility for overseeing the development and implementation of the Postal Service's strategy for Negotiated Service Agreements ("NSAs"). I participate in, and oversee the research, analysis, negotiation, and implementation of NSAs. This declaration supplements my earlier testimony in support of Docket No. MC2002-2, the Capital One NSA case, and Docket No. MC2004-3, the Bank One NSA case. I offer this declaration in support of the Postal Service's Reconsideration Memorandum in the Bank One case.

2. In my previous testimony and answers to discovery requests and Presiding Officer's Information Requests, I provided details of how the Postal Service negotiates and reviews NSAs generally. This declaration provides further detail of how the Postal Service negotiated the NSA with Bank One, evaluated the tradeoffs among different types of risks and rewards, and determined that the NSA would yield a positive contribution. Specifically, I discuss how the Postal Service negotiated declining block rate discounts and thresholds, evaluated Bank One's Before and After Rates volume forecasts, included contract terms to minimize the risks of declining block rates, and evaluated the risks and rewards associated with the NSA.

## I. The Postal Service's Process for Evaluating Before Rates Forecasts

3. Over the past three years, the Postal Service has learned a considerable amount about the factors that influence demand for mail in the credit card industry. It has developed expertise in this area through its own independent research, its experience with the Capital

One case, and a multitude of discussions with other banks and financial firms. Even before we began to negotiate the Bank One NSA, we had compiled, developed, and analyzed a tremendous amount of information on the factors that are likely to affect Bank One's First-Class Mail volumes and had developed, extensive knowledge of how credit card companies work and how they communicate with, acquire and retain customers through use of the mail and other channels. After the commencement of negotiations with Bank One, we did extensive additional research on the company, using data from Postal Service systems and from publicly available sources.

4. Before we negotiated the specific declining block rate discounts and thresholds, we worked with Bank One for several months to confirm and refine the information we had developed independently. We first spent considerable effort understanding Bank One's relationship with the Postal Service; then we obtained Bank One's projection of its Before Rates and After Rates volume forecasts for the term of the agreement. Bank One indicated that these forecasts were based on its company plan, which was used in making general business decisions in the ordinary course of business. Rappaport Direct (BOC-T-1) at 6-7. Through our own independent analyses, we verified that the forecasts were within a reasonable range and were thus reliable.

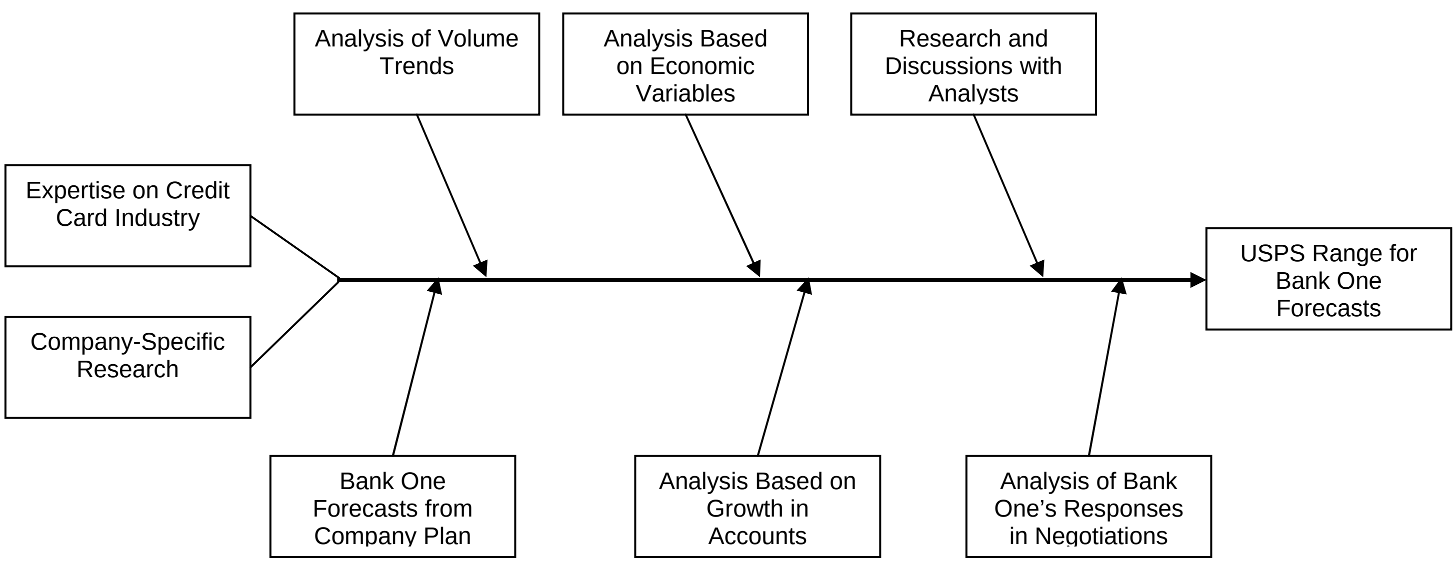
5. The Postal Service uses a combination of qualitative and quantitative tools to evaluate the forecasts provided by potential NSA partners. As the Postal Service negotiated more and more NSAs, we are able to further refine and supplement our methodologies for evaluating forecasts. The processes identified below form the framework for our analysis; however, we are continually incorporating new data and data sources to improve the specific tools.

6. For the Bank One NSA, we used the following analyses to evaluate the reliability of the company's Before Rates volume forecasts:

- Analysis of volume trends
- Analysis based on economic variables
- Analysis based on growth in accounts
- Research and discussions with analysts
- Analysis of Bank One's responses in negotiations.

7. The chart below illustrates how the different processes and models were combined to develop the USPS Bank One volume forecast range for evaluating the NSA.

ANALYSES USED BY USPS TO VERIFY VOLUME FORECASTS



8. Forecasting mail volumes for an NSA is difficult for many credit card companies. Many companies forecast budgets which include postage but do not forecast the actual number of mail pieces for more than three-fiscal quarters. For example, a company may have forecasts for expected marketing expenses but may not have allocated that budget across media channels.

9. Before engaging in any formal discussions, we require potential NSA partners to provide forecasts for the entire period of the proposed NSA. Many of the initial forecasts provided by customers to satisfy this requirement are based on volume trends. It is usually infeasible for a customer to undertake the effort, expense, and process changes required to provide a more detailed forecast before NSA negotiations have even begun. Once a customer has entered negotiations and has built an internal business case for pursuing an NSA, however, the customer will develop a more detailed forecast that incorporates data from its various individual business lines.

10. As in all negotiations, Bank One and the Postal Service had asymmetrical information. To improve the Postal Service's bargaining position, we apply our analytical tools for generating additional information about our potential NSAs partners and testing and assessing their negotiating positions. We also use these tools during our discussions with potential NSA partners to assess the risks and benefits of various negotiating positions. Throughout this process, we identify potential risks to the profitability of the deal and implement strategies to mitigate those risks.

11. Once the parties have negotiated an agreement, the NSA undergoes a rigorous internal review process, at the Postal Service, including review by a cross functional group of managers and executives. It must then be approved by the Board of Governors.

### A. USPS' Experience and Expertise In Credit Card Mail

12. The Postal Service has developed a detailed understanding of the credit card industry through extensive research of its own, and through discussions with over ten credit card companies that collectively account for (90 percent) of the credit card market. We analyze major newsletters and data services covering the industry and routinely engage in discussions with key members of the industry and with the industry analysts of brokerage firms. For example, we collect data on the number of accounts and cards issued, by issuer, as well as outstanding balances. We also research the various markets for credit (prime, near prime, and subprime), the market shares and product niches of individual financial institutions in each of these markets, and the methods these firms use to compete in each market. The expertise we have developed and maintained allows us to develop a company profile and assess the reliability of company's forecasts.

13. We have also studied in detail the mailing practices in the industry and the factors that affect its mail volumes. For example, we have studied the historical mail volumes of many credit card issuers and have collected information on their growth and marketing strategies, which influence mail volumes.

14. Credit card companies use First-Class Mail for two main purposes. The first is to maintain account relationships with current customers. This mail, typically called "operational mail," includes statements and correspondence with existing customers. The second purpose is to market products to existing customers and to solicit new ones. This mail is typically called "marketing mail." The forecasting tools and process developed by the Postal Service reflect the different economic drivers for these different categories of mail demand.

### B. USPS' Pre-Negotiation Due Diligence

15. The Postal Service has developed a formalized framework and specific guidelines for initiating NSA discussions. The Postal Service uses this approach in developing, negotiating, seeking regulatory approval for, and implementing NSAs.

16. Before formal NSA discussions begin, the Postal Service collects and analyzes data about the potential NSA partner. The specific due diligence tools we use are:

| Tool Name | Purpose |
|---|---|
| Negotiation Pack | To provide a common fact base for negotiating by capturing key data on the specific company's business and mail usage, and on trends in the industry. |
| Model Checklist | To ensure that the Postal Service negotiating position reflects sound economics by listing the requisite financial analyses for each type of agreement. |
| Business Case for NSA Candidate (presentation template) | To present relevant NSA characteristics to internal USPS committees. |
| NSA Dashboard | To track the progress of the NSA through the various stages from initial negotiations to approval to implementation. |

17. The negotiation pack, which provides the foundation for evaluating the business and mailing profile of the potential NSA partner, is the first step in the Postal Service's due diligence. The negotiation pack consists of the following templates:

- Executive summary
- Industry trends
- Company information
- Mail usage
- Candidate's mail usage relative to competition
- Underlying economic drivers
- Risk/reward evaluation
- Negotiating position
- Financial analysis.

18. The negotiation pack enables the Postal Service to understand the business environment of the customer before beginning to negotiate. The information from the negotiation pack allows us to exploit our initial discussions to gain insight into specific business and strategic factors that influence the customer's mailing decision process.

19. By starting our due diligence early, we can often evaluate the customer's mail demand functions at an early stage. For example, our ability to anticipate business line rollouts or regulatory changes allows us to determine whether the initial forecasts provided by a customer appropriately reflect these circumstances. This early due diligence has also enabled us to avoid pursuing NSAs with companies whose business climate and/or profile are too volatile to develop accurate volume forecasts.

### C. Analyzing Volume Trends To Verify Forecasts

20. The first step in evaluating the volume forecast of a company such as Bank One is to analyze its volume trends. We use this relatively simple approach to gain an initial sense of the company's mailing patterns and to predict future movements in mail demand.

21. Our trend analysis forecasts mail demand solely as a function of time, rather than a function of multiple economic, demographic, legislative, policy, technological, or market variables. Based on historical volumes, we extrapolate the bank's mailing history in a linear fashion into the future. We generate separate trend analyses for three subsets of the bank's mail volume: First-Class Mail operation volume, First-Class Mail marketing volume, and Standard Mail marketing volume.

22. For Bank One, we ran a simple regression to identify any correlation between the three categories of mail. This analysis was based on limited data sets because of the lack of long-term customer specific historical data.

23. We realize that a simplified trend analysis ignores exogenous factors such as pricing changes, interest rates, bankruptcy rates, competitors' strategies, unemployment rates and a host of other variables. But the trend analysis is intended to provide only a starting framework for understanding the mailing profile of our partner and a useful cross-check of the company's short-term forecasts. We also used our trend analysis to identify topics to explore during our initial discussions with Bank One.

24. Our trend analysis for Bank One mail volume indicated that (1) First-Class marketing volume was declining, (2) First-Class Mail operational volume was fairly stable, and (3) total Standard Mail marketing volume was growing slowly. Bank One's independent estimate of future mail volume was consistent with our trend analysis.

25. Based on these observations, the Postal Service focused its early discussions with Bank One on the forces driving the short-term trends in mail volumes and the likelihood that the factors underlying those trends would continue. During these initial discussions, Bank One provided information and data to aid the Postal Service in understanding the economic and policy decisions that were driving the mail volume trends we had identified.

26. These initial analyses showed that Bank One's future volume trajectory was likely to be fairly typical of that of the credit card industry as a whole: electronic bill presentment would have a depressing effect on operational mail, which would be partially offset by slow growth of the account base. These findings enabled us to develop a lower and upper range for Bank One's mail volumes and produce our first iteration of possible financial values under various forecasts. The analysis provided us with a decision point: whether to continue to pursue an NSA or to re-evaluate with the customer whether an NSA would really satisfy its requirements.

### D. Testing Volume Forecasts With Multiple Economic Variables

#### 1. Analyzing Marketing Mail Volume

27. With this general understanding of mail volumes, we could then focus on marketing mail. Mail solicitation volume is influenced by a wide range of economic factors. To determine the specific effect of these variables on Bank One volume, my group researched SEC filings and the reports of financial analysts. We also conducted discussions about these factors with financial analysts. In addition, we studied commercially available data from firms that track commercial trends in the credit card industry, such as Synovate and Forrester. These reports provided the Postal Service with key industry benchmarks and metrics to isolate significant economic factors that influence mail volumes.

28. Our research focused first on variables that affect overall mail expenditure for marketing mail, and then on the factors that influence the allocation of marketing mail volume between First-Class Mail and Standard Mail. Our research, not surprisingly, revealed that overall expenditures for marketing mail are affected by a host of variables. Our research was based on the total number of credit card solicitations mailed by the top 15 credit card issuers, which collectively account for almost 95 percent of credit card solicitation volume.

29. We were able to identify a small number of specific economic variables that affected not only Bank One's mail volumes, but also the volumes of many of other credit card issuers. The economic variables we identified were:

- Household Income
- Prime-interest rates
- Response rates
- Consumer Price Index

- Charge-off rates
- Bankruptcy rates
- Unemployment rates
- Company's marketing budget.
- General postal rate increase.

30. Most of these variables were highly correlated with total marketing mail volumes. For example, we found that when the cost of credit (interest rate) increased, marketing mail volume declined. When the cost of mail increased, the marketing mail volume declined. When the demand for credit cards increased (e.g., because of a rise in household income), marketing mail volume increased.

31. We derived a demand function specific to marketing mail for Bank One:

- MD = f (Y, Pi, Pj, I, S, C)

Where,

- MD = marketing mail demand
- Y = Household Income
- Pi = Own marketing expenditure
- Pj = Own net income
- I = Prime-interest rates
- S = CPI
- C = Charge-off rates.

32. This combination of variables produced the highest coefficient of determination ($R^2$ of 82%) in our stepwise regression analysis. We thus used this equation as an exploratory tool to identify the potentially important predictors of marketing mail demand. Then we compared results from the model with the volume estimates provided by Bank One. Again, Bank One's forecasts were consistent with the results of our model.

33. Other variables, such as average account balances, credit card fees, average FICO scores[1], directly impact the decision making process of credit card issuers and are highly correlated to mail volumes. However, we were unable to identify a statistically significant combination of those variables. Although they do not enter into the regression, we can use them outside of the regression to verify volume predictions.

34. The equation identified above helped us to better understand the impact that changes in exogenous factors have on mail volumes. For example, based on our understanding of the U.S. economic environment, we concluded that interest rates over the period of time covered by the NSA would most likely not decrease, and thus reductions in interest rates over the course of the NSA would be unlikely to spur additional marketing mail volume. We applied the same approach to the other variables, and concluded from our analysis that, based on current market conditions, no exogenous economic factor would likely result in significantly higher mail volumes.

35. In addition, we discovered that the equation identified above also predicted the total number of accounts for credit card issuers. In fact, if marketing expenditure were removed from the equation, the result would be a higher $R^2$ than the original demand function. I will describe the implications of this later in this declaration. See ¶ 41, below.

**2. Analyzing Operational Mail Volume**

36. Credit card operational mail volume includes statements, plastics, credit increase letters, renewals, and other customer specific correspondence. For Bank One, we tried to develop a demand function for operational mail based on exogenous economic factors. We

[1] Credit issuers use "FICO scores" (named after Fair, Isaac and Co., which pioneered the use of scoring models of this kind) or analogs to FICO scores to evaluate the

were unsuccessful. The reason for this outcome, we believe, is that by far the most important variable affecting First-Class Mail operational volume is the number of accounts.

37. A less significant factor in First-Class operational mail volume is the market penetration of electronic bill presentment ("EBP"), which often substitutes for operational mail. Because of the gradual adoption of EBP by consumers and the varying degree to which individual financial institutions have invested in and promoted EBP to their customer base, we were unable to model this factor adequately. Sources such as Forrester, however, allowed us to evaluate more effectively the online diversion threat for each financial institution. We used these data and statements by a number of financial institutions regarding their partnerships with online EBP providers to gauge the level of EBP activity and its potential effect on mail volumes. According to Forrester, on-line adoption rates for both a billing and marketing vary widely across the credit card industry.

38. Finally, a statistically significant relationship exists between marketing mail volumes and operational mail volumes. An increase in marketing mail volume generally leads to a higher number of accounts, which, in turn, generates higher operational volume.

39. Our analysis failed to identify a meaningful correlation between operational mail volumes and econometric factors. As with marketing volume, however, we observed a significant correlation between operational mail volume and the total number of accounts.

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creditworthiness of potential borrowers. The higher the FICO score the greater the indicated creditworthiness.

### E. Using The Number Of Accounts to Verify Forecasts

#### 1. The Relationship Between Number Of Accounts And Overall Mail Volume

40. As previously described, the economic factors that influence marketing mail demand correlate closely with the total number of accounts. Furthermore, because operational mail is used to communicate with existing accounts and marketing mail is used to acquire new accounts, the volumes for both types of mail are directly related to the number of accounts.

41. An important determinant of both operational and marketing mail is thus the number of active customer accounts. Forecasting mail volumes based on the number of accounts diminishes the need to use a greater variety of macro and micro economic variables, and provides insulation against factors that cannot be modeled, such as regulatory requirements. Therefore, as a second independent checkpoint, we developed an analysis based on number of accounts to verify the NSA partner's volume forecasts.

42. We utilized reports and research provided by analysts to help us identify the growth in the number of accounts. Analysts employed by investment firms track the performance of major companies to provide investment advice to their clients. These analysts have extensive knowledge of both the industry and the individual companies in the industry. They develop intricate models to provide detailed forecasts of account growth at individual companies. They also receive information from the companies themselves and analyze the economic and regulatory factors affecting the competitive marketplace. Because postage is a substantial line item expense for a credit card issuer, analysts track and estimate this specific information. The analysts' reports can provide an independent check on mail volume estimates based on a neutral source of data. We also conduct discussions with analysts before entering negotiations with a firm.

43. The credit card company's strategies and goals for total number of accounts may be affected by exogenous factors that influence profitability. For example, an increase in charge-off rates (i.e., the rate at which receivables are written off) tends to lower a credit issuer's profitability, in turn causing the company to become more selective in its marketing programs. Higher selectivity then lowers the target pool of potential credit card holders and results in lower mail volumes.

44. Moreover, many issuers have clearly defined goals for growth. Credit card companies that have chosen to follow a managed growth strategy may be less likely to invest in mass-marketing mail campaigns, while new entrants into a market may have much more aggressive marketing strategies, resulting in higher mail volumes.

45. Instead of developing forecasts of the number of Bank One accounts from scratch, we relied on independent financial analysts' projections of Bank One's account growth. These projections could incorporate not only the analysts' findings about Bank One's growth strategy, but also their analysis of changes in economic variables. For example, analysts could adjust the account growth projected by Bank One because the analysts believed that the anticipated rise in interest rates and unemployment rates would increase the cost of credit and decrease the demand for credit cards.

46. The public nature of the NSA process helps ensure that customers do not provide misleading forecasts. If customers were to provide significantly lower mail forecasts to the Postal Service while forecasting higher account growth to investment analysts, the contradiction would be obvious. Postage remains one of the largest line items for issuers, and any changes relating to this expense would not go unnoticed. In addition, it is highly unlikely

that a company would provide unrealistically low forecasts in a public NSA proceeding, which might artificially depress the company's stock price.

47. The effect of total accounts on operational and marketing mail volumes is discussed below.

### 2. Using The Number of Accounts to Verify Operational Mail Volume Forecasts

48. To validate forecasts of operational mail volume, we developed the following model based on the end-use method:

- M = N x B x C

Where

- M = mail consumption for operational purposes
- N = number of accounts
- B = number of billing cycles per year
- C = fixed factor for other mailings such as privacy notices, welcome kits, cards

49. The number of accounts, factor N, is disclosed in the company's annual report as well as SEC filings. By far the greatest percentage of operational mail is statement mail, for which credit card companies are required to provide volume data each month (factor B).

50. For factor C, we used a combination of internal and external data sources to generate ranges for the average number of First-Class Mail pieces, excluding monthly statements, sent by the ten largest issuers, to existing accounts. Our research indicated that companies mail 0.86 to 1.5 pieces per year in addition to statements.

51. As discussed above, because a credit card company's use of operational mail correlates closely with the number of accounts, it is relatively easy to estimate a company's current operational mail volume.

### 3. Using The Number of Accounts to Verify Forecasts of Marketing Mail Volume

52. We also developed a demand function for total marketing mail based on the total number of accounts:

- MD = f (N, C, R)

Where

- MD = Marketing mail demand
- N = Net New Number of Accounts
- C = Charge-off rate (the average rate at which accounts receivable balances are charged off as uncollectible.
- R = Response rate

53. This function allowed us to estimate total marketing mail volumes prior to our NSA negotiations. We used response rates for the model that we learned from discussions with potential NSA partners or that we found in publicly available data sources such as Mail Monitor, which tracks and reports on the volume of credit card solicitations sent through the mail. We obtained data on charge-off rates from the SEC 10-Q Reports filed by publicly traded financial institutions (including the corporate parent of Bank One). Data on net new accounts—i.e., the average number of new accounts of the particular NSA partner in a given period—were obtained from the estimates of independent financial analysts.

54. Table 1 illustrates how we use the relationship between the number of accounts and mail volume to verify forecasts. In Table 1, we have assumed a response rate of 0.4% and that 75% of those responding will be approved. For each additional 1 million pieces of marketing mail a customer will gain an additional 30,000 accounts.

| Additional Volume | New Accounts |
|---|---|
| 1,000,000 | 30,000 |
| 10,000,000 | 300,000 |
| 25,000,000 | 375,000 |
| 50,000,000 | 750,000 |
| 75,000,000 | 1,125,000 |

Assuming that the NSA partner will acquire all of its new accounts through the mail, we can estimate how much marketing mail will be required to obtain the new number of accounts expected by the analysts.

55. For example, Bank One currently has 43 million cards outstanding. Thirty thousand new accounts would represent an increase of 0.07 percent, an insignificant amount. However, 375,000 new accounts would represent an increase of almost 0.9 percent. The average account growth rate for most credit card companies is in the range of 0.5% to 2.0% annually.

56. To estimate the volume of marketing mail implied by a given target growth in the net account base, we convert the net growth target into a gross growth rate by adding the expected annual attrition of existing accounts, and then multiply the result by the reciprocal of the expected yield rate of mail solicitations for new accounts. The mail volume target thus derived provides a good indication of the likelihood that a bank will increase its marketing mail volumes even without any incentive from the proposed NSA discounts.

### 4. Analysis of Factors that Influence the Company's Division Of Marketing Mail Volume Between First-Class Mail And Standard Mail

57. Another estimate that we seek to validate is the company's allocation of its marketing mail between First-Class Mail and Standard Mail. The factors that influence this decision are not readily modeled by the tools described so far. We have thus developed a more qualitative analysis based on our research and specific discussions with credit card companies.

58. First, we identify whether the credit card company is targeting the type of customer that issuers generally solicit with First-Class Mail. We study the demographics of customers that are likely to have higher response rates in First-Class Mail and whether the credit card

company has adopted a strategy that would result in an increase in First-Class Mail volumes without a price incentive.

59. We also ask potential NSA partners to give us an overview of the products that they currently offer. We supplement this information with data from external sources, and then analyze the product offerings by matching particular products to the customer segments that they target. For example, a 0% interest-card with a high credit limit is more likely to be offered to individuals with very good credit profiles. Banks tend to use Standard Mail rather than First-Class Mail to market to these individuals, because they tend to move less often. Hence, the forwarding service included with First-Class Mail is less valuable for those customers. Similarly, we also track the average FICO scores of each company's card holders. A decrease in the average FICO score of a company's customer base indicates that the Company's use of First-Class Mail for marketing may increase. Thus, we use FICO score information as another factor in determining whether a company would move into First-Class Mail from Standard Mail without the need of NSA discount incentives.

60. We also study the individual portfolios of card customers comprised within the each card issued by the bank. A brand of card like the Bank One card is, in reality, an umbrella for a variety of portfolios of cardholders. Each portfolio uses different marketing strategies, and each is focused on different customer segments. We ask each potential NSA partner to explain how it intends to use First-Class Mail as a marketing medium for each of its business lines.

61. The main factors that affect the division of marketing mail between First-Class Mail and Standard Mail are the relative cost and potential benefits of the two classes of mail. Credit card companies choose First-Class Mail for marketing if the value of the additional customer response rate (also known in industry parlance as "lift ") from First-Class Mail

exceeds the significantly higher costs of acquiring customers through this class. Witness Buc's testimony in MC2004-3 provides a top-level view, without proprietary customer-specific data and variables, showing how a bank chooses between First-Class Mail and Standard Mail.

62. Budgetary constraints force customers to develop cost-benefit analysis to choose between the classes of mail. Assuming no other advantages, First-Class Mail is economically superior to Standard Mail as a marketing medium only when the higher response rate (lift) or revenue per customer (or both) outweigh the lower cost of marketing via Standard Mail. Table 2 provides a simple illustration of this optimization analysis.

**Table 2**

| **Table 2** | Standard Mail | First-Class | Difference |
|---|---|---|---|
| Cost | $0.177 | $0.292 | 64.97% |
| Acquisition Pieces | 56,497,175 | 34,246,575 | -39.38% |
| Response Rate | 0.30% | 0.40% | 33.33% |
| New Customers | 169,492 | 136,986 | -19.18% |
| Revenue | 100 | 124 | 24.00% |
| Total Revenue | $16,949,153 | $16,986,301 | 0.22% |

In the example, Bank One's portfolio X has a budget of $10 million for postage. Under this scenario, First-Class Mail would need to increase the response rate by at least 33%, and revenue per customer by at least 24%, for First-Class Mail to be preferable to Standard Mail as a marketing medium.

63. Shifts between mail classes can also be caused by strategic shifts in markets. Information about the latter appears in many sources. It is highly unlikely that a company could migrate wholesale from Standard Mail to First-Class Mail without a significant shift in underlying marketing strategy. Such a strategy shift is almost certain to become public knowledge, and we are confident that our evaluation tools allow us to identify major marketing shifts while they are in progress.

64. We used the approach described above to review Bank One's forecasts of its First-Class Mail and Standard Mail marketing volumes. The forecasts provided by Bank One forecasts fell well within the forecasts we generated using the methods described above.

### F. Using Bank One's Responses to Negotiating Strategies to Verify Forecasts

65. As in any negotiations, the Postal Service adopts different opening positions when exchanging proposals and counterproposals with potential NSA partners. It is my responsibility to evaluate the mailer's response to our positions, and to ensure that the Postal Service reaches an agreement that has a high probability of producing an acceptable return. The responses of a potential NSA partner to our proposals provide an additional way to test the credibility of the Before Rates and After Rates volume estimates that we have received from that mailer.

**Table 3**

| **Scenario** | **A** | **B** |
|---|---|---|
| Threshold volume | 90 | 105 |
| Company's Initial Forecast | 100 | 100 |
| More Accurate Forecast | 130 | 130 |
| Pieces eligible for discount | 40 | 25 |
| Effective Discount/piece | 2.5¢ | 5¢ |
| Total Discounts | 100 | 125 |

66. For example, we often make an opening offer that would allow the mailer to earn much higher discounts in exchange for volume thresholds that are significantly higher than volume in any previous year. Table 3 illustrates such an offer. If, for example, during the negotiation process a customer provided a forecast of 100 million pieces but actually intended to mail 130 million pieces, it would be in the self-interest of a mailer who has understated its expected test-year Before Rates volume to opt for the deal in column B.

67. Using various opening positions of this kind allows us to gauge the credibility of the mailer's volume forecasts and refine our negotiating strategy. By presenting offers with

different combinations of discounts, thresholds, and block increments, we can roughly approximate the company's demand curve.

68. We have also found that the imposition of a stop-loss cap has hardened the negotiating positions of some potential NSA partners. Because the maximum potential benefit of an NSA now appear much more limited than previously thought, mailers have increasingly reluctant to explore potentially beneficial avenues, or to make what one might consider relatively innocuous concessions. The effect of this phenomenon has been the cessation or suspension of many negotiations.

### G. Summary of The USPS' Analyses To Verify Before Rates Forecasts

69. In our experience, potential NSA partners do not submit point estimates of Before Rates volume that are knowingly false. As with Bank One, the volume forecasts we receive from our NSA partners are often based on data generated in the ordinary course of business and used for internal management purposes that are far more important to the company than the dollar savings in postage potentially available from an NSA. These estimates are very unlikely to be manipulated.

70. In no case, however, does the Postal Service take these customer-provided forecasts on faith. As described above, we have developed tools and processes, based on third party or publicly verifiable data sources that allow us to set reliable upper and lower bounds on the likely Before Rates volume of each potential NSA partner. We use these volume forecast ranges as a check on the credibility of the customer's point estimate. Based on these evaluations, we have rejected Before Rates estimates and even suspended negotiations with some mailers. For example, one customer initially provided a flat volume forecast which, under our analyses, we did not find plausible, and we suspended NSA discussions. In the months that followed, the customer's volumes grew as we had predicted.

71. Although the volume ranges we develop are not as precise as a point estimate, they are relatively tight: we can develop a target range for volume forecasts within 25 million pieces. A forecasting range of error of 25 million pieces corresponds to a potential risk exposure of approximately $750,000. Balanced against the much large potential benefits of an NSA, this level of risk in forecast variance is quite reasonable.

72. The relatively short term of an NSA also provides the Postal Service with further protection from risk. The realization that agreements will expire, requiring their renewal and perhaps re-negotiation, along with the knowledge that the Postal Service will analyze and report the results of the NSAs, provides a strong deterrent to gaming the process by offering unrealistically low Before Rates volume projections. The value of an NSA to a company is maximized if it can continue the NSA over a long period of time. The options and benefits of the NSA can affect a customer’s long-term strategic position. A company whose volume forecasts are at odds with the company’s actual volume over the initial term of the NSA is less likely to receive favorable consideration of any proposal to renew or re-negotiate the NSA. Most companies are unwilling to jeopardize their long-term business relationship with the Postal Service for short-term postage discounts that may amount to less than two percent of total postage spending over the three-year life of the NSA.

## II. Evaluating After Rates Forecasts

73. We have also developed tools to evaluate After Rates forecasts. These tools emulate a credit card issuer’s decision process for selecting media mix. All credit card issuers have models that allow the allocation of spending among the various marketing channels based on cost effectiveness. Our internal models replicate these models at a high level. We also look at available budgets and the company’s current allocation of marketing across

channels. For example, a credit card issuer that already acquires 95 percent of its customers through the mail obviously cannot switch a large additional share of existing media spending the mail, regardless of the NSA discount. Conversely, a company that currently spends much of its marketing budget on non-postal marketing channels has more resources to switch to the mail.

74. The Commission's decisions have focused on the risk of offering discounts for "anyhow" volume, which is purely a function of the Before Rates forecast. It is important to emphasize, however, that After Rates forecasts tend to be less certain than Before Rates forecasts, and are far more likely to be understated. In fact, the After Rates forecasts presented in all of the NSA cases thus far have been remarkably conservative, and there is a strong possibility that existing NSAs will induce more First-Class Mail volume than indicated in After Rates forecasts.

75. A number of factors cause the Postal Service and its NSA partners to tend toward conservatism in projecting the After Rates volume effects of NSAs. The most basic reason is that organizations in general are risk averse. This produces projections of future results that do not differ too greatly from known trends. For NSA partners, the natural inclination toward risk aversion that organizations exhibit is compounded by regulatory considerations as well. The individuals who have testified on behalf of NSA partners represent their organizations in a public setting, where their statements may be reviewed by competitors, stock analysts, and SEC officials. It is therefore not surprising that projections of the after rates volumes are conserve.

## III. Mitigation of Risk

76. We do not contend that the due diligence procedures described above will reduce to zero the risk of error in Before Rates volume estimates. The risk of underestimating the Before Rates volume, by one, two or five million pieces of mail annually, cannot be eliminated in its entirety. Risks are inherent in any volume forecast, even after extensive research and detailed knowledge of a company's marketing plans. For this reason, the Postal Service has insisted on including terms in the NSA contracts, including the Bank One NSA, that mitigate or limit these risks.

77. The sophistication of these contract provisions has increased from one NSA to the next. Each NSA has enabled us to improve our knowledge about the factors that drive mail volume in the credit card industry, and we use this information to improve the risk mitigation factors in subsequent agreements. For example, the Bank One NSA contains risk-limiting terms that were absent from the Capital One NSA.

78. The Commission has stated that its main concern is the risk that the Before Rates forecast has been understated to such an extent that the NSA may result in a negative contribution. Docket No. MC2004-3, PRC Op. at 4. The contract terms that mitigate this risk are the limited duration of the agreement (three years); the annual adjustment mechanism, which modifies the volume threshold for discounts based on changes in the number of accounts; and the expanded merger provisions.

79. The term limit greatly reduces the potential harm from under-reported mail volumes. As with experimental changes in rates and fees that the Postal Service might propose, any potential adverse effects, as well as potential benefits, are limited. The NSA cannot be renewed without review of current data and a reassessment of the appropriate thresholds and discounts. Because the impact of the Bank One NSA is relatively small as a

percentage of aggregate presorted First-Class Mail, the opportunity for the Postal Service to lose a material amount of money in this short period of time is almost negligible.

80. The annual adjustment mechanism is perhaps the most important risk mitigation device. This mechanism adjusts the volume discount thresholds up or down depending on the increase or decrease in the number of accounts. As I stated in my previous testimony, this is an important mechanism because it ensures that the Postal Service does not give unwarranted discounts on increases in operational mail. This mechanism mitigates the risk of understated operational mail volume.

81. What I did not explain in my testimony, however, is how the annual adjustment mechanism mitigates the risk of the impact of exogenous factors on Bank One's *marketing* mail volume. As stated above, growth in marketing mail volume correlates highly with growth in the number of accounts. The exogenous factors that drive the growth in accounts, such as a reduction in the cost of credit (e.g., decline in interest rates) or increase in demand (e.g., rise in household income) also drive up mail volume. Therefore, by adjusting the threshold upward based on the growth in the number of accounts, we are also controlling the impact of exogenous factors that would result in an increase in the Before Rates volumes. Hence, even if an exogenous factor would cause an increase in mail volume that we did not anticipate, the agreement self-corrects.

82. This self-correction occurs in the second and third year of the agreement. The inapplicability of the adjustment to the first year is acceptable because we generally have a higher degree of confidence in forecasts for the first year of the agreement.

83. Finally, the merger and acquisition provisions mitigate the risk that subsequent events may lead to unanticipated growth in mail volumes. Mergers and acquisitions are

regularly experienced in the credit card industry. The merger adjustment clause adds the volume of the new entity to Bank One's threshold so that the NSA discounts continue to provide an incentive to grow new First-Class Mail volume. With the inclusion of these terms in the Bank One NSA, we have a high degree of confidence that almost all of the risks inherent in the Before Rates forecast would be mitigated.

84. In that regard, the merger of Bank One and JP Morgan Chase did not increase the risk that estimates of Bank One's Before Rate volume submitted in support of the Postal Service's request would prove to be unrealistically low. First, as noted above, the merger provision and the provisions in the NSA contract require an "absolute" increase in thresholds based on merger volumes minimize the ability of the merged entity to use First-Class Mail volume from inherited the Chase side of the merger to satisfy the discount volume thresholds.

85. Second, we have no reason to believe that the marketing officials responsible for administering the credit card portfolios inherited from Chase will have a greater relative preference for First-Class Mail vis-à-vis Standard Mail than did their marketing department counterparts in the pre-merger Bank One. The reason is straightforward: the Bank One marketing people are basically in control of this aspect of the combined marketing operation. The Commission found that this claim was unsupported in the record. The Commission appears to have overlooked the portion of the record that deals with this issue, the response of Bank One witness Rappaport included in the Supplementary answer of Bank One to OCA/USSP-T1-44 (filed Sept. 1):

> [P]ost-merger marketing decisions for the merged corporate entity will be the responsibility of a company-wide marketing composed primarily of former Bank One marketing employees, and headquartered in Wilmington, Delaware, the home of the former Bank One marketing department.

If the Bank One people will be running this part of the show, there is no reason to believe that the merger has increased Bank One's relative preference for First-Class Mail, or the aggregate Before Rates First-Class Mail marketing volume of the merged entities combined.

86. Third, we believe that the result would not be much different even if former Chase marketing managers were still calling the shots. Before the Bank One NSA filing, the Postal Service had also engaged in discussions for a separate NSA with the pre-merger JP Morgan Chase. As part of these discussions, we verified the volume estimates of JP Morgan Chase using the same data, models and other tools described above. After the merger was announced, we performed an analysis of the likely Before Rate volume of the combined entity. In performing, this analysis, we made no attempt to reduce the combined volume figures to account for the cost savings that might result from the elimination of duplicate solicitations to consumers having separate accounts with both of the two pre-merger entities. Despite this conservatism, our analysis showed that the combined post-merger Before Rates volume of the merger entity appeared unlikely to enable the merged entity to claim After Rates discounts for the Before Rates volume inherited from either of the pre-merger entities. For these following reasons, we are confident that the merger is not going to allow the combined entity to obtain discounts under the NSA for Before Rates volume generated by either side of the merged entity.

## IV. Balancing of Residual Risk and Potential Benefits

87. Although the contract mitigates much of the risk inherent in volume forecasts, some residual risk necessarily remains. We must then evaluate this residual risk, and balance it against the potential benefit of the NSA.

88. To estimate the residual risk, we calculate the value of the NSA at a variety of mail volumes assuming that all of the mail would have been mailed without the incentives provided by the NSA. A similar calculation appears in Table 4, page 47, of the Bank One brief. We then explore the value of the NSA under a range of distributions of probabilities for the volumes.

89. We next perform a similar calculation for the upside benefits of the NSA. We calculate its value at a variety of After Rates estimates, assuming that Before Rates volumes were accurately estimated. We explore the full range of benefits of the NSA, and believe many of our NSA underestimate their After Rates volume. We also explore this upside this upside under a range of distributions for the probabilities of the volumes. Finally, we compare the residual risk to the expected benefit. In the Bank One NSA, the benefit more than compensates the Postal Service the residual risk.

90. We also incorporate an allowance for the condition that on a per-unit basis the Postal Service under all circumstances receives ample revenue per unit to account for all unit variable costs.

91. Previous comments have assumed that the only risk from NSAs is that customer's Before-Rate forecase is higher than those forecast. However the Postal Service must also consider the possibility that overall mail volumes may decrease and that failure to increase or retain mail volumes represents as significant a risk as underestimating Before Rates volumes.

## V. Internal Processes

92. In addition to the due diligence performed within Pricing Strategy, the Postal Service also processed the Bank One NSA proposal through a series of internal reviews before filing it with the Commission. After we reached an agreement in principle with Bank One on the core elements, including the conversion of marketing mail to ACS and the declining block rate structure, we analyzed the contribution that the NSA would generate. To do so, we modeled the effects of the NSA on the costs, revenues, and volumes of the Postal Service, in compliance with Commission's rules, Rule 193(e). As a result, the internal review process used the financial data that would support the Postal Service's filing with the Commission.

93. Final approval to proceed with the filing of the proposed Bank One NSA at the Commission required four separate levels of internal review. The proposal was reviewed first by a group of Postal Service executive managers from Finance, Marketing, Operations, and the Law Department. The next level of reviewers consisted of a group of officers from Finance, Operations, Strategic Planning, Marketing, and the Law Department. The third level of review was by the Executive Committee (EC), the senior level of management decision making in the Postal Service. Finally, the EC authorized the presentation of the Bank One NSA to the Board of Governors for approval of the filing the Request.

94. In addition to this internal review process, we had to secure the certification of the cost statements and supporting data necessary for any filing with the Commission. This involved a detailed review of the Bank One financial model by the Finance and Law Departments. Multiple reviews involved careful examination of the basis for our financial projections.

95. The above description of these internal reviews suggests that they occurred sequentially. In fact, the process had multiple iterations. The Bank One NSA was reviewed

several times at the manager and officer level before it was finally approved to proceed to the Board of Governors.

96. As a result of our tests, analyses, and reviews, the Postal Service concluded that Bank One's volume forecasts are reliable.

I declare, under penalty of perjury, that the foregoing is true and correct to the best of my knowledge.

Date: ____________________ ____________________________
Michael K. Plunkett

**DECLARATION OF JOHN P. MATTHEWS**

I, John P. Matthews, declare:

1. I am Professor Emeritus, Graduate School of Business, University of Wisconsin, Madison. My graduate work and Ph.D are in the area of Quantitative Analysis in Business and I have taught and worked in that field for over thirty-five years. I have taught at the graduate level at Northwestern University, Boston University as well as the University of Wisconsin. I have consulted and provided expert witness testimony for thirty years in the areas of automotive network analysis, trucking, dealership/distribution issues, and other industries. I also own and operate a small business involved with manufacture and assembly of internationally sourced components for sporting goods. Our markets are the U.S. and Europe. My CV is attached to this declaration.

2. I was asked by the Postal Service to evaluate the imposition of a cap on its Negotiated Service Agreement with Bank One as a means of mitigating risk in light of actions typically taken in other business contexts. As I explain below, in my view, the features of the Bank One NSA and the actions taken in its formulation are adequate to mitigate risk, whereas the cap introduces the needless risk of limiting the fullest possible gains from the agreement.

3. I first address below the risks that parties face in negotiating agreements, particularly where the two sides do not have equal access to all relevant information and the steps that prudent negotiators take to mitigate risk.

**Asymmetric Information.**

4. Asymmetric information is an element of many important buy-sell transactions, if not most. Indeed it is rare that buyers and sellers have access to identically complete data bases such that both buyers and sellers are equally informed of the advantages, drawbacks, risks and rewards of acquiring or divesting marketable assets. And even if all parties have access to the same data, it is unlikely that the data would be processed or analyzed by all parties in exactly the same way. Training, education and experience

would allow some to evaluate the data in a more effective manner than others. As a result, even symmetric access to data may not result in symmetric benefits.

5. In personal settings, asymmetric information can be the basis for entire industries as diverse as is found in real estate or the marketing of used vehicles. For example, the seller of a dwelling may be very intimately familiar with the quirks of the property offered for sale, from the heating system, occasional leaks in the roof, the noise level of neighbors' parties and the like. This information may temper the home-owners asking price aspirations, but if the information is withheld from all prospective buyers, the sellers may profit from the asymmetry of that information. Similarly, sellers of late-model used vehicles may be well aware of the quirks of the vehicle that they wish to sell. Prospective buyers may take the car for a test drive, but this test may be insufficient to allow discovery of all the prospective problems that may arise from ownership of the vehicle. And within this arena there is considerable room for negotiation, but there are safeguards that may come into play.

6. As a safeguard to consumers, there are legal safeguards requiring disclosure of relevant, material information to the prospective buyer of certain assets. These safeguards reduce the effect of undisclosed problems with the property in question, and reduce to some degree the effect of asymmetric information on the asset value perceived by the (uninformed) buyer and seller.

7. In a business setting, asymmetric information may be an integral part of the power that a party may have in a setting requiring negotiation. And whereas the individual consumer may rely on a large, viable marketplace to ensure a reasonable price for an asset, in the business setting the market may be "thin" with relatively few buyers and sellers. In this context, one cannot rely on the invisible hand of the market to assure a reasonable price for the transfer of an asset. On the contrary, the asymmetry of information is part of the value of being an agent in the industry. Through time and practice, one becomes more familiar with the market, the manner in which it values assets and the true worth that the asset may represent to others.

**Negotiating in an environment involving asymmetric information.**

8. Clearly, if all parties to a transaction had access to the same data, the same methodologies of evaluation and complete knowledge of recently bought/sold assets of a similar nature to the one in question, there would be only relatively minor differences of opinion regarding the price that the market would bear for the asset in question. In this case, both the prospective buyer and seller could rely on market forces to bring the seller's price in line with other sellers and the buyers bid in line with other bidders.

9. In contact negotiations between private parties for services that are unique to or customized for the parties involved, one cannot rely so heavily on the marketplace to determine reasonable prices. The contract struck will rely importantly on the knowledge that each party has about the market, each other and the value/cost of the product.

10. After a bargain has been struck, it is not unusual for one or both parties to suffer some regret. The buyer may regret not having held out for a better deal or higher price and the seller for having sold to quickly or at too low a price. Whereas these feelings are common to almost all transactions, the feelings of having sold/bought too quickly do not indicate in and of itself that the transaction was ill-structured or ill-conceived or ill-suited to the parties involved. Hardly any contract is immune from being second-guessed in the calm afforded the retrospective analyst. Unfortunately, bargains are not stuck retrospectively when much is known, but only prospectively when much is unknown.

**Methods for addressing the risks associated with asymmetric information.**

11. Depending on the situation, a number of approaches can be identified that seek to deal with the some of the most troubling aspects of information asymmetry.

12. Information gathering before and during the negotiation process. In many situations, decision-makers attempt to reduce the perceived risk by seeking more information. This information may be about the agents involved in the transaction, the environment in which they operate, the industry, the competition, the substitutes for the product, the price sensitivity of demand, the non-price attributes of the product to which the prospective buyer is sensitive and other types of information relating to the product,

its market or its producers. A protracted negotiation process provides the time and opportunity to seek this type of information.

13. In other situations, it may be prudent to establish limits on the degree to which the firm may be disadvantaged by the degree of information asymmetry. As some of the examples that follow will show, absent the ability to assess important aspects of the needs/demands of the client, there sometimes are simple limits that will bound the degree to which the information asymmetry can be used against the firm. Loss limits may take the form of a time limit, a series of renewal/renegotiations, or a pricing strategy that always ensures a constant positive marginal contribution to the seller. Limiting the duration of the contract reduces the overall exposure of each party to the contract to adverse outcomes, and provides an incentive for each side to bargain fairly with the other, since at the end of the contract period there will need to be a renegotiation if the contractual relationship is to continue.

14. Compliance monitoring during the contract period of performance. In still other situations, it is possible to determine if the buyer to whom concessions have been made in exchange for actions desired by the selling firm actually are executed. For example, if representations have been made by a foreign importer that if certain price concessions are made, marketing promotion actions will be initiated in the foreign market. When the selling firm is an exporter and the buying firm is in another county, verification is not a simple matter. However, negotiations may be undertaken which can ensure that sufficient evidence is provided to convince the manufacturer/ exporter that the concessions were merited and justified by action taken by the foreign distributor. Compliance can be scrutinized by closely monitoring the actual performance under the contract. Frequent sales reviews provide the firm with information to see if actual performance meets expectation as disclosed during the negotiation process. In addition, the parties can impose collateral requirements to prove compliance with representations. Defining milestones or targets within the contract based on negotiations assures that when deviations from these milestones occur, they can be explained, contract terms can be adjusted, or if necessary the contract can be terminated.

**Application 1.**

**Insurance industry. Request for a quote from a firm that is not a client.**

15. Background. From time to time firms do change their selection of insurance service providers. In these situations, quotes are requested from firms that provide coverage/service products in the areas of interest. However, from time to time firms do request outside quotes to use as a device to extract concessions from their current insurance provider. In these situations the prospective client has no real interest in switching insurance providers, but simply use the quote as a negotiating device with its current provider.

**Estimation of the true demand for the service product.**

16. In this context, the estimation of the demand curve for the insurance company's products is complicated by the actions of customers who mask their intentions in order to extract information from the insurance company and use this information to further their negotiating position with a third party. As a result, the interest shown for the insurance company's services in this instance is misleading and not reflective of the true market for the company's products.

**Quote process.**

17. In all but the most simple of businesses, the insurance company from whom the quote was solicited would spend considerable time and effort in the analysis of the firm, its operations, assessment of risk, possibilities of risk reduction via improvements in operations, future work force plans, limits of insurance coverage, consortia of other firms that may have interest in participation and other related matters. The process would likely involve marketing, underwriting, actuarial and other skills. A serious effort in the development of a quote may require several weeks/months of evaluation and planning.

**Risk of misestimating the true nature of the query.**

18. If the company requesting the quote does not appear to be truly interested in the possibility of switching insurance providers, the insurance company would likely dismiss

the feigned interest and quickly submit a high quote rather than expend the resources of time and money on assessing the firms business, its operations, the risk inherent in its business and the competitive environment in which the bid would be evaluated. Alternatively, misinterpreting the client firm's interest would risk offending a serious inquiry from a firm truly interested in the possibility of switching.

**Objectives.**

19. It is in the insurance company's best interest to be able to identify the truly interested quote requester from a firm seeking only to use the quote as a negotiating device to seek concessions from its current insurance provider.

**Information relating to genuine interest in switching insurance providers**.

20. Planning horizon. How long in advance of the termination of the current contract was the quote requested? The longer the lead time, the more likely the decision-makers have been considering the possibility of switching carriers.

21. How high up in the organization are the contacts? The higher in the organization that those involved in the process are, the more likely that they attach importance to the outcome of the search process.

22. How large is the prospective contract? The larger the contract, the greater need for planning and the longer the time necessary to fashion an appropriate instrument for coverage.

23. What are the stated reasons for changing, if any? Vague reasons do not suggest a careful assessment of either the current situation nor the advantages sought in switching.

Is the incumbent carrier engaged in multiple lines of business, or only one? It is more difficult and complex to deal with multiple lines of coverage, although it is also potentially more lucrative.

24. Has the firm a history of switching from one insurance firm to another? While a history of switching lends credence to the claim of interest in a quote for coverage, it will also temper the long-term assessment of future renewals and continuing business.

25. Analysis of the above information helps the firm assess the risks and will lend support (or not) for a decision to move forward.

**Methods taken by insurance companies to limit risk.**

26. A stop limit on quotes. A limit on quotes is often used as a device to avoid excessive loses associated with those customers who misrepresent their real interests for personal advantage in negotiations with a third party. Since the process of creating a competitive quote is a very time-consuming any practice that limits the number of times that a quote is made does two things: it limits the involvement of the insurance firm in non-productive activity and as well sends the quote-soliciting firm a message that it had better be serious in its request. It is not unusual for an insurance firm to limit its unproductive quotes to three. Requests beyond that level are politely turned down.

27. Request for post-selection feedback. If a serious quote is turned down, an inquiry of the prospective client's evaluation of the proposal is frequently requested. This provides two types of information: what was superior about the accepted bid and what was the process by which bids were evaluated by the prospective client firm. It will also be possible to determine if the prospective client did if fact remain with the incumbent or if the bid was turned down in favor of a different firm that was not the incumbent.

**Application 2.**

**Request for exclusive distributorship authorization over a territory.**

28. Background. While many firms do *not* grant an exclusive distribution right (EDR) over geographic territories, there are instances in which exclusive rights are offered. An example of an industry in which exclusive rights are *not* granted is the automotive industry. Automobile dealers are free to sell to any consumer in the U.S. without regard to the location of either the buyer or the selling dealer. And while residency restrictions do apply to some prospective buyers, any U.S. dealer can sell into any territory within the U.S. Alternatively, in international trade, exporters frequently do agree to give selected distributors exclusive distribution rights for their products on a regional or county-specific basis. For example, Graber Corporation, a subdivision of Springs Mills,

has on occasion given exclusive distribution rights to distributors of its window treatment products in the middle east. These agreements were renewed annually. When EDRs are given the provide the distributor the right to sell to all consumers in the designated territory and it also prohibits other distributors from selling into that protected territory.

**Estimation of the buyer's post-EDR demand curve.**

29. Clearly, the position of a distributor armed with an EDR is strengthened since at least two areas of uncertainty are more under the distributor's control: the level of demand that the distributor will likely experience from the territory and the degree to which price changes are likely to affect profitability. Since the distributor will have exclusive distribution rights, confounding effects derived from a competitors actions are eliminated from the marketplace.

30. Given the above, then, it is one thing for the exporter/manufacturer to reward the distributor for his/her marketing and promotional activities, but it is quite another to expect that the distributor enjoying exclusive distribution rights would continue to behave in exactly the same way that the distributor did when it did not have exclusive distribution rights.

**Rational for the granting on an EDR.**

31. In many instances in order to effectively market the product, the distributor will advertise the product, promote the product, stock it in quantity and service the product in the field. As a result, the distributor can make a significant investment in the product and does not want to see other distributors profit from his/her investment of time, effort and money.

32. On the exporters side, the granting of the EDR is associated with some specific benefits and risks. The benefits are that the exporter has someone in the territory promoting the product more aggressively than the exporter might be able to do. In addition, the distributor's inventory makes it possible to respond to local orders in a timely manner and far more quickly than the exporter would be able to.

**Risks of granting an EDR.**

33. Normally, the exporter does not set prices in the foreign market but allows the distributor or set prices, promotion levels and establish retail accounts in manners that serve the distributor's interest. And if the distributor prices the product in such a manner as to skim the market, or if the product is not advertised or promoted well, the volume of sales might be much lower than the exporter would like. Ordinarily, the exporter would rely on distributors' competition in the same territory to set a reasonable market price. But in exclusive markets, the single distributor is free to charge whatever price seems reasonable to the distributor. As a result, there is considerable risk in granting of EDRs in foreign markets.

**Information relating to the distributor and the market.**

34. In not all, but in many situations there are data regarding the makeup of the consumer market that may be helpful in estimating what a reasonable sales level might be for a given territory. For example, household income levels, age levels, educational levels, sales of other products (automobiles and telephones, for example) may be helpful in assessing what a reasonable sales level might be. On the other hand, sales of fashion goods or goods that have not been tested before in the territory may be very difficult to forecast. Absent historical sales data, reliable projections may be very difficult to make…and it is in this context that an aggressive distributor may be most valuable.

**Methods taken to reduce risk.**

35. Frequent sales reviews and contract renewals. A long-run agreement with no contingencies places the exporter at great risk of losing control of the distribution of the product. The exporter will often require frequently reviewed (at least annual) sales objectives. Frequent reviews and possible disengagement when targets are not met assures that deviations from expected levels are explained and plans and when appropriate, expectations can be adjusted.

36. Minimum sales requirements. Part of the negotiating process normally requires the distributor to commit to a level of minimum sales. This minimum sales level will

have to be exceeded in order to allow the distributor to remain exclusive.  But there is danger in setting the minimum sales level as well.  If the sales level is set too low, the exporter will lose sales as a result.  If it is set too high, in an effort to satisfy the exporter the distributor may stock too much product and failing to sell it in a timely manner, may have to market it down and spoil the pricing for the product in that market.

37. Minimum promotion requirements.  The exporter may also require proof of promotional activities, advertising, attendance at local trade shows and other promotional activity for the product.  Thus, absent reliance only on high sales targets, these types of requirements can signal to the exporter that the distributor is reinvesting in the product and that the sales level is likely to be about as high as can reasonably be expected.

38. Distributors will need assurances as well.  Along with minimum sales requirements a schedule of prices must be established, complete with exchange rate assumptions and terms of payment.  This will help the distributor assess the degree of difficulty he/she may have in meeting sales targets as well as helping assess profitability of the annual commitment.

**Application 3.  International supplier agreements.**

39. Sometimes businesses can rely on the market to supply it with all the components and raw materials it requires, particularly if the required material is commodity-like or if there are many potential suppliers for the required components. There are, however, instances in which the sources of supply may prove unreliable or capable of extracting painful price concessions in times of scarcity.  As a result, some corporations will establish subsidiaries in areas in which the raw materials are plentiful and/or components can be manufactured at a reasonable cost.  The capturing of a source of supply serves as a device to ensure both more control over prices and continued availability of materials.

40. Medium-sized firms, however, may not have the resources to establish subsidiaries in all locations from which they may have interest in obtaining materials. As a result, some other device must be employed to achieve what they need.

41. Supplier agreements. While agreements with suppliers can be relied upon to provide a wide variety of needs, if a component must be made to the unique needs of the manufacturer, a more complex agreement may be required. For example, if a component is sufficiently different or unique or its design makes it useful only to a particular manufacturer, the supplier is as dependent on the manufacturer for both recovery of its investment in the component and commitment of productive resources as the manufacturer is on the supplier for creation of the component. And if the process requires significant dedication regarding tooling or staffing, the dependency is great.

**Estimation of demand.**

42. Clearly, the demand for the component is derived from the demand for the product that consumes it. And both the manufacturer and the supplier are dependent on the manufacturer's correct assessment of the demand for the end item, and therefore the component. But in this context, the manufacturer has for more information than the supplier. Since the manufacturer takes actions that affect demand, such a pricing and promotion, the manufacturer can moderate to some degree, the level of demand to which it will respond. Furthermore, the manufacturer may review the product's profitability and decide to sharply reduce output even though the level of sales is within a reasonable range of expectations. For example, plans for a redesign of the product may be advanced in order to increase sales of the product. If the redesigned product makes less intensive use of the component, the supplier of the component will suffer the consequences.

**Supplier risks.**

43. Response time commitment. The supplier will be required to respond to the manufacturer's orders within an agreed-upon time frame. Inability to respond in a timely manner will normally involve extra costs of expedited shipping, the cost of overtime and/or penalties.

44. Volume commitments. The supplier will be required to devote adequate resources to the support of the manufacture of the needed component(s). This involves dedication of not only equipment but also staffing and inventory stocking levels.

**Manufacturer risks.**

45. Late delivery of components. A lack of components will require at a minimum a series of last minute schedule changes, idle labor and/or missed sales opportunities.

46. Long lead times. Long lead times generate a high degree on inertia in the productive system. It becomes difficult to change plans once made. The system cannot easily respond to unanticipated increases in demand and the manufacturer may have to rely on price changes to reduce demand those levels for which productive capacity is available. Alternatively, backordering of orders could be a possibility when the ultimate consumer has few other choices for substitute product.

**Risk reduction activities.**

47. Information sharing behavior. The manufacturer will frequently add the supplier to its list of users for access to the manufacturer's sales database so that changes in actual sales from anticipated levels will be made known to the supplier as soon as they are known to the manufacturer. In this manner, the supplier can anticipate the volume of orders that will eventually be executed by the manufacturer. This will allow the supplier to respond to a far greater array of needs than would be the case if information were lagged.

48. Take-or-pay contracts. In order to commit resources and hold or acquire productive capacity in anticipation of orders from the manufacturer, the supplier may insist on a take-or-pay agreement that will require the manufacturer to pay for the cost of idle capacity when orders fall below the agreed-up level. This agreement would allow the supplier to acquire and maintain productive capacity at minimal risk and would also allow the supplier to quote prices that are less affected by a risk premium that would otherwise be appropriate to use.

49. Take-or-pay contracts are also found in agreements in which mining or processing plants are developed with foreign financing. It is not unusual for a foreign firm to seek financial assistance in the development of a processing plant and offer to pay for the plant with the output from the plant. In order to make the financial package viable, one of the parties to the transaction must agree to a take-or-pay agreement with

regard to the output so that revenues from the sale of the product is assured. Once revenues are assured, the project may be viewed as having far less risk than would otherwise be the case if the financial security of the plant rested solely on the ability of the plant to sell its output on international markets.

**Application 4. International distributor requests for price concessions.**

50. Distributors located in markets distant from the manufacturer may request price concessions on material that are requested for special promotions. For example, it is not unusual for a relatively new product to profit from a set of activities meant to introduce the product and speed its adoption. In addition, in an effort to respond to competitor's actions, a special promotion may be considered.

51. These requests are usually based on the distributor's assessment of the market and what the distributor feels will be an appropriate way to react to his/her market. The distributor's perceptions are frequently based on relative prices in the market, the sales level of the manufacturer's product relative to expected levels, information of upcoming competitor's actions and comments from retailers.

**Estimating the effect on product demand of the distributor's stated promotion intentions.**

52. Clearly, the exporter/manufacturer is highly dependent on both the distributor's assessment of the impact of the suggested promotional effort, but also the degree to which the distributor is candid about how the price concession will be used. Since the distributor will normally refuse to identify his/her retail accounts identities, it will be very difficult for the manufacturer to check very closely the exact use and disposition of the products on which the price concession was made. In the worst case, the price concession may be given and the products simply sold at the same price as the non-discounted sales. In other words, the manufacturer may have been misled into giving an important price concession without any benefit.

**Manufacturer's risk.**

53. Similar to other situations in which information is filtered and may be biased by the source, the manufacturer would like to minimize classic type I and type II errors. In

other words, the manufacturer would like to give appropriate consideration to those requests based on an correct assessment by the distributor of the market and be in a position to deny requests for pricing or promotion concessions that are unjustified or likely to be subverted for a use that may further the distributor's interests but not the manufacturer's.

**Considerations that could justify the price concession.**

54. Short of spending time in the distributors territory to personally view the promotional activities, the manufacturer could review information that could shed light on the situation and aid in the decision.

55. Will the product be used for participation in trade shows? Most international distributors attend trade shows in their industry that are offered within their market. It is reasonable for the distributor to request concessions from the manufacturer to help promote the product for their mutual benefit. The question of the number of units to which the price concession will apply will immediately arise as well as the disposition of the unused or unsold units. In certain instances, the products could be market as not for resale and then any overage could be returned to the manufacturer.

**Risk reduction activities.**

56. Review of historical patterns of sales. Declining sales may support the distributor's representation of need of additional promotional efforts. Declining market share would suggest the same. Increases in industry sales levels would suggest additional sales opportunities that could be captured by a higher level of promotional effort.

57. Maintenance of historical sales levels. As a condition for the price concession on products used in the promotional activity, a side agreement concerning maintenance of historical sales levels may be made. This would help ensure that the promotional materials were really targeted at new account rather than existing accounts.

58. Transparency of plans. Simply requesting of the distributor how the manufacturer could check to ensure that the discounted product was being used for the agreed purpose could elicit a procedure that the distributor might find agreeable and

satisfactory. In addition, solicitation of copies of all materials that the distributor would create in conjunction with the promotion such as copies of ads, promotional literature, emailings and the like could help ensure that the use of the materials is as presented.

59. Prospect of future promotions should the proposed promotion bear fruit. The action of imbedding the current proposal into a process of invite proposals-review proposals-approve proposals-evaluate results removes the current proposal from a one-time affair to a continuing effort to improve sales levels in the territory. Generally, if the distributor sees benefit in a continued, mutual effort there is less inclination to press for immediate one-sided gains versus more continuous complementary activities leading to benefits for both the distributor and the manufacturer.

**The Bank One situation compared to the applications cited above.**

60. In the Bank One negotiated service agreement (NSA) a declining block pricing structure contained discounts for volumes of First-Class Mail above a specified threshold. The Postal Service used information on Bank One's volumes and business plans, as well as analysis of the credit card market, in determining the parameters of the block structure. The NSA is subject to external regulatory review, and entails potentially significant litigation expenses on top of transaction costs incurred in the negotiation stage. The discounts were intended as inducements for Bank One to switch large amounts of its mailings from Standard Mail to First-Class Mail. Discounts were selected to allow the Postal Service to achieve a contribution margin on the discounted rates that were still significantly greater than the contribution margins on Standard Mail. The Bank One NSA also allows for automatic post-contract adjustments of terms based on Bank One customer count data and other events, notably the merger between Bank One and JP Morgan Chase.

**Benefits of the declining block pricing structure.**

61. There are clear benefits that accrue to the Postal Service in a number of scenarios brought about by the discounted rates on First-Class Mail. Among these are:

a. An increase in volume of First-Class Mail and an offsetting reduction in standard mail will still provide an increased total contribution relative to the same level of volume at rates for Standard Mail.
b. An increase in volume of First-Class Mail and no reduction in Standard Mail will provide and increased total contribution.
c. There is no reason to expect a decrease in total volume from what volumes would have been had the discount not been offered.

**Perceived drawbacks of the declining block pricing structure.**

62. One can in retrospect question if the volume of First-Class Mail would have been similar without the discount than it was with the discount. In such a case, one may feel that the user was provided a discount on volumes that would have been purchased anyway, and that an incremental contribution was needlessly lost.

**Similarity of the Bank One situation to other applications cited above.**

63. Recall that in the situation of the insurance company a potential loss of time and effort associated with an unsuccessful quote would likely initiate activities to better assess the likelihood of a successful quote, increase the likelihood of identifying a poorly motivated buyer, or limit the misallocation of resources spent on “false positives” and “false negatives.” This process involved increased information about the prospective buyer, the history of the buyer, the success of previous quotes and the duration of the buyer with the incumbent insurance provider.

64. Similarly, the Bank One situation has elements in common with the distributor wishing to have exclusive distribution rights for a designated territory. In that case the distributor was willing to invest in the development of the market if and only if the manufacturer/ exporter granted the exclusive distribution rights. While the manufacturer would value the investment in the manufacturer’s product and resulting impact on sales levels, the manufacturer may regret having done so if the distributor increases prices, skims the market and reduces total sales volume from levels that might otherwise have obtained had there been one or more additional distributors serving the market.

**Actions taken to reduce risk.**

65. In all of the situations cited above, actions could be initiated by either or both parties to attempt to reduce risk. In all situations additional information would have been useful. In some instances a review cycle or renewal period would temper the inclinations of some to make a "one-time" gain at the expense of a long-term relationship. In this latter setting, the prospect of continuous comparisons of representations to following actions would serve to increase the likelihood of more transparency and honesty.

66. In negotiating and drafting the Bank One NSA, the Postal Service employed a number of these actions to reduce the risk. First, the Postal Service gathered additional useful information before and during the negotiation period. Specifically, the Postal Service developed data and analyzed the factors that influence demand for mail in the credit card industry and Bank One's First-Class Mail volume before even negotiating the block rates. In doing so, the Postal Service could independently assess Bank One's volume projections with and without the NSA.

67. Scrutiny of the NSA by the Commission and other interested parties also helps ensure that the projections underlying the NSA's terms are realistic. Bank One also bears substantial costs in the negotiation and review stages.

68. Second, the Postal Service implemented a review cycle in the NSA with formula-based adjustments to the block discount thresholds.. Each year the annual adjustment mechanism adjusted the threshold based upon changes in the number of credit card accounts. Since the NSA was intended to induce Bank One to switch mailings from Standard Mail to First-Class Mail, this protects the Postal Service from losing contribution that it would have had anyway from an increase in account mailings ("operational" mail) at First-Class Mail rates.

69. Third, the merger clause protects the Postal Service from a change in Bank One circumstances (mergers with or acquisition of or by other companies) that would lead to unanticipated increases in baseline mail volumes. It is my understanding that this clause has led to significantly higher discount thresholds reflecting the recent merger of Bank One with JP Morgan Chase.

70. Finally, the Postal Service limited the term of the agreement to three years, thereby limiting the desirability of each party to leverage its asymmetrical information for its own gain. Since the terms of the agreement would have to be renewed relatively soon in order for Bank One and the Postal Service to continue deriving the economic benefits of the relationship, each party has an incentive to bargain fairly.

71. In circumstances in which there remains the perception of significant residual risk, the benefits of proceeding with the arrangement may still outweigh the risks even when risk cannot be reduced to modest levels. In such a setting the question is, have we been prudent and taken all reasonable action to reduce risk as much as appears possible. Having reached that point, a business decision can then be made.

72. Requiring additional strategies to mitigate risk, such as the stop loss provision recommended by the Postal Rate Commission, is not without risk of its own. The "stop loss" provision apparently does not distinguish between discounts that represent lost contribution due to exploitation of private information by Bank One or other adverse outcomes, and discounts that reflect the success of the NSA terms in generating additional volume. As such, the stop loss provision reduces one form of risk while creating the risk that the full gains from a mutually beneficial contract will not be realized. In reducing the expected benefits of the NSA, it will tend to reduce the incentive for the Postal Service and its customers to enter into otherwise desirable agreements. A business would impose such a constraint [as the stop-loss cap] only if the expected gain from capping the discounts in the case of adverse outcomes (*i.e.*, avoiding revenue leakage from the discounts) exceeds the expected loss of profit (or contribution) from the cap when the contract is working as intended. This is also a reasonable test for a regulator or other party reviewing the contract to apply in determining whether a feature like the stop-loss cap is in the general interest.

I declare, under penalty of perjury, pursuant to 28 USC § 1746, that the foregoing is true to the best of my knowledge.

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Professional Associations

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Teaching Experience

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Strategic Decisions in Operations Management
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Dealer Sales Performance Analysis in Multiple Dealer Markets. Automotive Accountants Executive Committee, Winter, 1998.

Factors of Importance for Dealers in Multiple-Dealer Markets. Chicago Area Trade Association. Spring, 2001.

Network Planning: Analysis and Modeling. Graduate School of Business. Location Analysis Class. Spring Semester, 2000.

Doctoral Dissertations and Masters Theses

Kerry D. Schmidt, MBA Thesis, 1976
Robert Mark Brown, Ph.D., 1980
Vincent Akinyosoye, Ph.D., 1981
Jaya P. Moily, Ph.D., 1982, Chairman
Asoo J. Vakharia, Ph.D., 1987
Neji Haji, MS Thesis, 1987
Woo Soek Chai, Ph.D., 1988, Chairman
Laurel Travis, Ph.D., 1988
Suan Tong Foo, Ph.D,1990 Chairman
Seung Y. Hyun, Ph.D. 1994

Continuing Education

Equipment Leasing - The Lessor's Point of View. Main speaker and program chairman from 1976 through 1985. The three-day seminar focused on the economic analysis of single-investor leases. Seminars were offered twice annually.

Equipment Leasing - Variable Rate Leases. Main speaker and program chairman from 1978 through 1981. The two-day seminar was focused on the economic analysis of variable-rate leases and their use in times of varying interest rates.

Equipment Leasing - The Leverage Lease. Main speaker and program chairman from 1981 through 1985. The two-day seminar was focused on the economic analysis of the use of leverage leasing for acquisition.

Manufacturing Strategy - Northwestern University. Lecturer during a portion of a five-day seminar on Manufacturing Strategy with emphasis on the marketing/operations interface. This seminar is offered once or twice annually at Northwestern University. My involvement started in 1985 and continues to date.

Equipment Leasing in Portugal - Lisbon, Portugal. Main speaker and program developer for a five-day seminar on leasing. Two seminars were held in Lisbon in 1984 and 1985 and were sponsored by CIFAG, a Portuguese educational agency.

International Education and Related Activities

Management Training in POLAND/HUNGARY. One of two faculty selected for development and deployment of management training seminars in production/operations management in Eastern Europe. These seminars were coordinated by universities and management training organizations in the host countries and were delivered in five-day sessions on location. (1992)

Directed Study Abroad. Co-director and co-founder of a program jointly administered by the Chambre de Commerce of Marseille, the Department of French and the School of Business at the University of Wisconsin. Students are assigned to one of sixteen agencies/companies in the south of France to study business, import/export and management practices. The program was developed in 1984 and continues to date. Under an extension of this program we now place ten French student interns with as many engineering companies in southern Wisconsin. To date approximately 100 students have participated in this highly successful program.

International Trade. Organized the participation of a fourteen European countries in a conference promoting international trade. All EEC countries plus Switzerland and Denmark agreed to send trade mission and consulate staff to this unique three-day conference. Unfortunately, interest among regional business was found to be less than our expectations. (1986)

Lisbon University. Provided a presentation on "Equipment Leasing and Its Economic Implications. This presentation was one of three addressing the role of leasing as a form of investment activity in Portugal's expanding industrial base. (1983)

University/School of Business Committees/Appointments

Undergraduate Studies Committee
Graduate Studies Committee
Continuing Education Committee
Faculty Senator of the University Senate (1986 to 1993)
Manufacturing Systems Engineering Program Advisory Committee
Department Chair of Quantitative Analysis (1987 to 1992)

# DECLARATION OF SAMUEL C. HADAWAY, Ph.D.

I, Samuel C. Hadaway, declare:

1. My name is Samuel C. Hadaway. My business address is 3520 Executive Center Drive, Austin, Texas 78731. I am a principal of Financial Analysis Consultants (FINANCO, Inc.) and an adjunct finance professor at the University of Texas at Austin. I have extensive experience in regulatory economics, both as a senior member of the Public Utility Commission of Texas staff and as an expert witness. My qualifications are described in my resume, which is attached as Appendix A.

**Overview**

2. In this filing, the Postal Service asks the Postal Rate Commission (PRC) to re-evaluate its standard for Negotiated Service Agreements (NSA). To date, the PRC has required that to be acceptable NSAs must, in effect, eliminate the risk of potentially incorrect volume estimates. The PRC has enforced this policy by capping NSA discounts at amounts no greater than savings derived from mailing practices that directly reduce the Postal Service's costs. In this regard, the Postal Service maintains that PRC policy represents an overly strict standard that goes beyond the business requirements of prudent ratemaking.

3. The Postal Service urges the PRC to adopt a standard for uncapping NSA discounts that

- Would accommodate more risk than is presently represented by the PRC's restricted discount policy;
- Would counterbalance the PRC's inclination to recommend discounts only if there is no possibility that the PRC could be wrong about the economic consequences; and
- Could be based on a type and level of proof or evidence that is practically available in the context of the mailing industry.

4. In this context, the purpose of this report is to offer anecdotal evidence in support of the Postal Service position. My discussion is based on my knowledge and experience with common practices and results in both unregulated businesses and regulated industries. These practices and outcomes are particularly useful for evaluating NSAs because many of the Postal Service issues and PRC concerns are analogous to the difficult questions faced by unregulated businesses and for other regulated companies and their regulators. For regulated electric and gas utilities, these issues have resulted in nontraditional pricing methods under titles like contract rates, customer-specific tariffs, economic development riders, load retention rates, cogeneration deferral rates, and interruptible rate contracts—all initially intended to deal with changing economic and technological realities and all now typical offerings of both electric and gas utilities.

5. Although the Postal Service and PRC are beginning to face many of the same issues that energy utilities have faced over the past 30 years, it is not the thesis of this report that off-the-shelf remedies from the utilities' experience are available. Rather, from my review of the economic circumstances faced by the mailing industry, I believe there are analogous circumstances that can and should be used to assist in the development of PRC policy. Although the Postal Service has not yet experienced the complete industry evolution and the negotiated rate experience that has occurred in the utility industries, the mailing industry has changed significantly and will change even more rapidly in the future. In this context, the evolution of utility regulation provides an extant sounding board with methods and results that can serve as an initial guide for more relaxed discount policies from the PRC.

6. The Postal Service's need to promote revenue and contribution growth and its efforts to meet this need through declining block rates is similar to efforts of other capital intensive companies and particularly to the circumstances of regulated utilities. The risk to any seller from a declining block rate is that product delivered in the tail block might have been sold without the additional discount. For successful unregulated companies, the assessment of this risk is a

matter of informed marketing judgment developed from experience. For entities with high fixed costs and relatively low variable costs, the risks are especially high and difficult to deal with. For such companies, such as the airlines, marketing mistakes may effectively give away potential profits in the form of unnecessary discounts, or at the other extreme they may lead to business failure due to lost market share. For regulated companies and their regulators, under traditional regulation, the risk of non-linear pricing was one of efficiency and equity. Under the assumption that utility customers had few meaningful options and that consumption levels were relatively price inelastic, a lower price for higher usage was only a tacit acknowledgment that small customers were likely subsidized by larger customers in the cost allocation process.

7. In recent years, due to changing technology (and changing regulatory philosophy), electric and gas utilities have had to deal with excess capacity and the potential loss of some of their largest customers. In this environment regulators have had to balance the potential harm from losing large contributors to system fixed costs against the potential for harsh or unfair treatment of smaller captive customers. I will discuss how utility regulators generally have evaluated these issues, how they have developed a standard of evidence for their evaluations, and what the results have been. I believe these experiences and results support the Postal Service’s position that it has applied prudent business practices in evaluating the NSA and the demand forecasts for purposes of negotiating the agreements, and that the Bank One NSA contains an acceptable level of risk and should be approved without a stop-loss cap.

**A Changing Regulatory Environment**

8. Over the past three decades, traditionally regulated electric and gas utilities have undergone tremendous change. Rising commodity prices and capital costs in the 1970s and early-1980s created unprecedented challenges and opportunities. Rising utility prices caused large customers to seek alternatives, and rising prices created political pressures to change the status

quo. Higher prices also lead to technological opportunities and economic realities that previously had not existed, or had been ignored. Faced with the potential loss of their largest customers and largest contributors to system fixed costs, both utilities and their regulators were forced to reconsider many long-held beliefs and standards.

9. Earliest efforts focused on improved efficiency and "load management" options. These efforts recognized that conservation during peak hours and seasons could lead to better utilization of existing facilities and could help utilities defer future high cost capital investments. Higher fuel costs and concerns about dependence on imported oil also led to similar efforts for improved operating efficiency. So-called "combined cycle" technology, already in place in many industrial applications, was touted as an important contributor.[1] The economic and political realities that flowed from these changes ultimately transformed utility companies and the nature of electric and gas utility regulation.

**Regulatory Questions**

10. In the face of changing technology and evolving regulatory philosophy, regulators of traditional electric and gas utilities faced difficult questions. One of the most difficult is the assessment and containment of risks associated with non-traditional pricing. Risk assessments have ranged from simple statements that large users might "bluff" their way to lower rates to formal and extremely complex analyses to demonstrate customer economic options. In many cases the answers have not been clear and utility regulators have had to make Solomon-like decisions, hopefully to the ultimate net benefit of all customers. In most cases regulators have been willing to take some risk in order to gain knowledge and to avoid a too late decision.

11. The evidence required for approval of negotiated utility rates has been similarly wide-ranging. For large natural gas customers, the proximity of an

[1] In a combined cycle generating process, electricity is generated with waste heat from another industrial process. Specifically designed cogeneration plants often use 25% less fuel than traditional single cycle generation.

alternative pipeline and a customer's stated plan to leave the incumbent provider may be all that is required. The proof may be a simple map, evidence of rudimentary connection costs, and a cost comparison against standard tariff provisions. In such cases a demonstrated economic alternative and a consensus that some contribution to system fixed costs is better than none is the extent of the issue. In other circumstances, decisions about cogeneration or self-generation deferral rates have been much more complex. The large capital requirements and long-term nature of generation commitments make regulators' evaluation these cases more difficult and subjective. In the following section, I will describe the so-called California benefits tests, which have become a working standard for many state regulators. In any case, a standard of proof based on expert analysis and experience has been developed and is now routinely applied in most regulatory jurisdictions.

12. To contain the risks of negotiated rates, access to such rate plans in their initial stages typically has been limited. Either from unique customer circumstances or by limited area offerings, the amount of total system discount and the duration of programs has been used to limit system risk. Through on going review and formal reassessment in each rate case, special rates must be periodically reconfirmed, modified, or eliminated. Tariff and contracting provisions that specifically limit the scope and acknowledge periodic review requirements have provided comfort to most parties in the process. Additionally, the regulated company has typically borne a disproportionate share of the risk through customer class cost segregation and agreements not to shift unrecovered costs from a special rate class to other customers. Utilities have been willing to bear this threshold risk to maintain options with their largest customers and to develop information about results from negotiated approaches. Obviously, utilities would not expose themselves to the potential for deadweight losses unless they viewed the risk-reward tradeoff favorably.

13. Some of these provisions do not have exact analogs in the Postal arena. For instance, the NSAs so far submitted by the Postal Service are based on a negotiated discount to the relevant rate, rather than a negotiated price per se. As

a result, prices for the NSAs would adjust automatically in the wake of a general rate case. However, many of the concepts from the management of special rates in the utilities industry should be, and are being, applied to Postal NSAs. The current NSA structure mandates periodic public reporting of NSA volumes and revenues, enabling ongoing scrutiny and analysis. The Postal Service also makes use of contract provisions, including threshold adjustment mechanisms based on customer business growth and merger activity, to mitigate system risk. And as is the case with utility companies, it is worth some risk to the Postal Service to gain information about its customers and the value they place in postal services.

14. These issues are analogous to the situation faced by the PRC in the sense that the PRC is charged with upholding and protecting the Postal System and its customers. If non-linear pricing is not encouraged and if potential incremental volume is missed, the loss of growth and additional system contribution will result in higher prices for all customers. The evaluation of this tradeoff appears to be particularly difficult for the PRC because its discount policy standard requires a demonstration of cost savings that are not part of the risk-return tradeoff. The PRC cost-justification standard is similar to the traditional cost allocation standards and requirements that utility regulators applied when it was believed that utility customers had very limited options. As large utility customers obtained options (through technological and legislative changes), utility companies and their regulators were forced to accept risks and to apply business practices more like those of unregulated entities.

15. The PRC and the Postal Service are experiencing the same kinds of issues. In the face of internet and other competing options, declining postal volumes represent a significant threat, much as the potential loss of large customers did for utilities. While the PRC cannot be given absolute assurance that additional discounts will be the sole cause of incremental volumes, it can only test this approach by allowing it and evaluating the results. This is the approach that utility regulators by necessity have had to apply. The results have been favorable because they have led to pricing policies that are more consistent

with market forces. The PRC and the Postal Service and its customers should benefit from a similar approach.

**Negotiated Service Agreements for Regulated Utilities**

16. Recent special rate contracts filed with the Arkansas Public Service Commission (APSC) provide a useful illustration of current regulatory philosophy for electric and gas utilities. The subject contract was initially filed with the APSC on March 31, 2005 under the Commission's Rules and Regulations Governing Promotional Practices of Electric and Gas Public Utilities (Promotional Practices Rules) and after staff review and recommendation was approved by the Commission on April 20, 2005. In its Order approving the contract, the Commission offered the following staff discussion and assessment:

> After review of the information provided in this docket and the results of the cost-effectiveness tests, it is my conclusion that the proposed Agreement is in the best interest of CEAG ratepayers at this time. Therefore, I recommend that the Agreement between CenterPoint Energy Arkansas Gas and Tyson Poultry, Inc. – Nashville, Filed on April 8, 2005, be approved. Finally, in accordance with the Promotional Practices Rules, Section 8, Biennial Report, CEA should include the status of this contract in its report that is to be filed with the Commission in the promotional practices reporting docket, Docket No. 90-205-R. (Docket No. 05-034-P, Order No. 3, April 20, 2005, p. 2.)

17. To support the Tyson contract, Arkansas Gas provided testimony that described Tyson's circumstances as a large gas customer, but also explained that Tyson had by-pass options and economic circumstances that would cause it to leave the incumbent system and switch its gas service to an alternative provider. Based on "the California Test results," the company witness opined that "…by retaining the customer at the proposed (reduced) rate, the Company's remaining customers clearly benefit…." (Redacted Direct Testimony of Alan D. Henry, page 4, lines 20-21.) The company testimony also appears to imply that the economics of the subject facility were such that without a special rate other factors might produce results detrimental to the remaining customers. Based on

these arguments and cost-benefit tests, the APSC staff offered its favorable recommendation and the Commission approved the contract.[2]

18. Although the type of cost-benefit analysis used in this case may be difficult to apply in the Postal arena, the conceptual framework that underlies it is very relevant to the evaluation of Postal Service NSAs. The focus of the California Tests is the evaluation of expected costs and benefits to a system's stakeholders, and the establishment of a set of standards within which to make such an evaluation. The Postal Service's proposed standards perform the same role for NSAs in a manner that takes into account the unique circumstances of the Postal System.

**California Cost-Benefit Tests**

19. California regulators have taken the lead in developing programs and methods of evaluation, which have become known as the "California Tests." The introduction to the most recent edition of the *California Standard Practice Manual: Economic Analysis of Demand-Side Programs and Projects,*[3] offers the following description of philosophy and cost-benefit test methodologies:

> Since the 1970s, conservation and load management programs have been promoted by the California Public Utilities Commission (CPUC) and the California Energy Commission (CEC) as alternatives to power plant construction and gas supply options. Conservation and load management (C&LM) programs have been implemented in California by the major utilities through the use of ratepayer money and by the CEC pursuant to the CEC legislative mandate to establish energy efficiency standards for new buildings and appliances.

20. The initial focus of the California standards was primarily on load management programs to defer capital investment and energy conservation. Over time, however, the standards of evaluation ("Tests") have been generalized and

[2] The Arkansas Gas redacted testimony and the APSC Order are attached as Appendix B.
[3] California Standard Practice Manual: Economic Analysis of Demand-Side Programs and Projects, California Public Utilities Commission and the California Energy Commission, October 2001.

refined so that they are now the basis for evaluating most types of alternative rate programs. The Tests generally revolve around the proposal's net present value effect on the various parties.

21. The California Manual specifically notes that its tests are applicable to load retention and load building programs:

> In addition to Fuel Substitution and Load Building Programs, recent utility program proposals have included reference to "load retention," "sales retention," "market retention," or "customer retention" programs. In most cases, the effect of such programs is identical to either a Fuel Substitution or a Load Building program — sales of one fuel are increased relative to sales without the program.

Whereas initial measurements were intended to determine the cost effectiveness for load management and energy efficiency programs, and thus the amount of money that could be invested in these programs, over time it has become obvious that the basic premise of such evaluations fits most other types of rate proposals as well. A positive net present value impact on all parties indicates that a program is worthwhile.

22. The Tests specifically measure a proposal's effects for Participants, Other Ratepayers, Total Resources, Program Administrators, and Societal Effects

> This manual identifies the cost and benefit components and cost-effectiveness calculation procedures from four major perspectives: Participant, Ratepayer Impact Measure (RIM), Program Administrator Cost (PAC), and Total Resource Cost (TRC). A fifth perspective, the Societal, is treated as a variation on the Total Resource Cost test. The results of each perspective can be expressed in a variety of ways, but in all cases it is necessary to calculate the net present value of program impacts over the lifecycle of those impacts.

Thus the California net present value tests consider the specific circumstances of all parties as well as the overall impacts of a proposed program or proposal. From what were initially narrow tests focused on load management and energy efficiency issues, over time the California Tests have become broad industry standard.

23. The Postal Service's proposed standards for evaluating NSAs make use of the same concepts as the California Tests. The particular circumstances of the systems are different, but the challenges--allowing the regulated companies to provide flexibility that benefits the system without putting that system unduly at risk--are the same.

24. The following table concisely summarizes of the California Test procedures:

**Table I**
**Cost-Effectiveness Tests**

| **Participant** | |
|---|---|
| Primary | Secondary |
| Net present value (all participants) | Discounted payback (years)<br>Benefit-cost ratio<br>Net present value (average participant) |
| **Ratepayer Impact Measure** | |
| Lifecycle revenue impact per Unit of energy (kWh or therm) or demand customer (kW)<br><br>Net present value | Lifecycle revenue impact per unit<br>Annual revenue impact (by year, per kWh, kW, therm, or customer)<br>First-year revenue impact (per kWh, kW, therm, or customer)<br>Benefit-cost ratio |
| **Total Resource Cost** | |
| Net present value (NPV) | Benefit-cost ratio (BCR)<br>Levelized cost (cents or dollars per unit of energy or demand)<br>Societal (NPV, BCR) |
| **Program Administrator Cost** | |
| Net present value | Benefit-cost ratio<br>Levelized cost (cents or dollars per unit of energy or demand) |

## Conclusion

25. As demonstrated by the California Tests and utility regulators' general efforts with nontraditional rate plans, procedures have been developed to deal with difficult and extremely complex rate issues. The development of such procedures initially exposed the process and all participants to uncertainties and monetary risks that could not be entirely avoided. Given the changing circumstances of the electric and gas utility industries, however, action was necessary to avoid even greater risks or at least perceptions of virtually certain harm if nothing was done. This environment led to standards of practice and evidence that are now integral parts of the energy regulatory process. The PRC is encouraged to reconsider its limited risk taking standard for NSAs in favor of procedures and cost-benefit tests that have been used successfully by other similarly situated regulators.

I declare, under penalty of perjury, pursuant to 28 USC § 1746, that the foregoing is true to the best of my knowledge.

Samuel C. Hadaway

Samuel C. Hadaway

**Appendix A**

**SAMUEL C. HADAWAY**

**FINANCO, Inc.**
**Financial Analysis Consultants**

**3520 Executive Center Drive, Suite 124**
**Austin, Texas 78731**
**(512) 346-9317**

## SUMMARY OF QUALIFICATIONS

- Principal, Financial Analysis Consultants (FINANCO, Inc.).
- Ph.D. in Finance and Econometrics.
- Extensive expert witness testimony in court and before regulatory agencies.
- Management of professional research staff in academic and regulatory organizations.
- Professional presentations before executive development groups, the National Rate of Return Analysts' Forum, and the New York Society of Security Analysts.
- Financial Management Association, Vice President for Practitioner Services.

## EDUCATION

| | |
|---|---|
| **The University of Texas at Austin**<br>**Ph.D., Finance and Econometrics**<br>**January 1975** | Dissertation: *An Evaluation of the Original and Recent Variants of the Capital Asset Pricing Model*. |
| **The University of Texas at Austin**<br>**MBA, Finance**<br>**June 1973** | Thesis: *The Pricing of Risk on the New York Stock Exchange.* |
| **Southern Methodist University**<br>**BA, Economics**<br>**June 1969** | Honors program. Departmental distinction. |

## OTHER EXPERIENCE

| | |
|---|---|
| **University of Texas at Austin**<br>**Adjunct Finance Professor** | Corporate Financial Management, Investments and Integrative Cases. |
| **Texas State University San Marcos**<br>**Associate Professor of Finance** | Graduate and undergraduate courses in Financial Management, Managerial Economics, and Investment Analysis. |
| **Public Utility Commission of Texas**<br>**Chief Economist and Director of Economic Research Division**<br>**August 1980-August 1983** | Lead financial witness. Supervised Commission staff in research and testimony on rate of return, financial condition, and economic analysis. |
| **Assistant Professor of Finance**<br>**Texas Tech University**<br>**July 1978-July 1980**<br>**University of Alabama**<br>**January 1975-June 1978** | Member of graduate faculty. Conducted Ph.D. seminars and directed doctoral dissertations in capital market theory. Served as consultant to industry, church and governmental organizations. |

## ECONOMIC ANALYSIS AND TESTIMONY

**Antitrust Litigation: (client)**

- Marginal Cost Analysis of Concrete Production/Predatory Pricing (Stiles)
- Analysis of Lost Business Opportunity in Waste Disposal Site Permit dispute (Browning-Ferris Industries, Inc.).
- ERCOT Electric Power Transmission Costs in Purchased Power Dispute (City of College Station, Texas).

**Contract Litigation:**

- Water Rights/Billing Dispute (Texarkana, Texas)
- Analysis of Cogeneration Contract/Economic Viability Issues(Texas-New Mexico Power Company)
- Definition of Electric Sales/Franchise Fee Contract Dispute (Reliant Energy HL&P)
- Analysis of Purchased Power Agreement/Breach of Contract (Texas-New Mexico Power Company)
- Regulatory Commission Provisions in Franchise Fee Ordinance Dispute (Central Power & Light Company)
- Analysis of Economic Damages resulting from attempted Acquisition of Highway Construction Company (Dillingham Construction Corporation).
- Analysis of Economic Damages due to Contract Interference in Acquisition of Electric Utility Cooperative (PacifiCorp).
- Analysis of Economic Damages due to Patent Infringement of Boiler Cleaning Process (Dowell-Schlumberger/The Dow Chemical Company).

**Lender Liability/Securities Litigation:**

- ERISA Valuation of Retail Drug Store Chain (Sommers Drug Stores Company).
- Analysis of Lost Business Opportunities in Failed Businesses where Lenders Refused to Extend or Foreclosed Loans (FirstCity Bank Texas, McAllen State Bank, General Electric Credit Corporation).
- Usury and Punitive Damages Analysis based on Property Valuation in Failed Real Estate Venture (Tomen America, Inc.).

**Personal Injury/Wrongful Death/Lost Earnings Capacity Litigation:**

- Analysis of Lost Earnings Capacity and Punitive Damages due to Industrial Accident (Worsham, Forsythe and Wooldridge).
- Analysis of Lost Earnings Capacity due to Improper Termination (Lloyd Gosselink, Ryan & Fowler).
- Present Value Analysis of Lost Earnings and Future Medical Costs due to Medical Malpractice (Sierra Medical Center).

**Product Warranty/Liability Litigation:**

- Analysis of Lost Profits due to Equipment Failure in Cogeneration Facility (WF Energy/Travelers Insurance Company).
- Analysis of Economic Damages due to Grain Elevator Explosion (Degesch Chemical Company).
- Analysis of Economic Damages due to failure of Plastic Pipe Water Lines (Western Plastics, Inc.)
- Analysis of Rail Car Repair and Maintenance Costs in Product Warranty Dispute (Youngstown Steel Door Company).

**Property Tax Litigation:**

- Evaluation of Electric Utility Distribution System (Jasper-Newton Electric Cooperative).
- Evaluations of Electric Utility Generating Plants (West Texas Utilities Company).

**Valuations of Closely Held Business in Domestic Affairs Proceedings and for Federal Estate Tax Planning.**

**FINANCIAL AND ECONOMIC TESTIMONY IN REGULATORY PROCEEDINGS (Client in parenthesis)**

**Cost of Money Testimony:**

- Louisiana Public Service Commission, Docket No. U-23327, January 18, 2005 (Southwestern Electric Power Company, American Electric Power Company)
- Idaho Public Utilities Commission, Case No. PAC-E-05-1, January 14, 2005 (PacifiCorp)
- Arkansas Public Service Commission, Docket No. 04-121-U, December 3, 2004 (CenterPoint Arkla)
- Oregon Public Utility Commission, Case No. UE- , November 12, 2004 (PacifiCorp).
- Texas Public Utility Commission, Docket No. 29206, November 8, 2004 (Texas-New Mexico Power Company).
- Texas Railroad Commission, Gas Utilities Division Nos. 9533 and 9534, October 13, 2004 (CenterPoint Energy Entex).
- Texas Public Utility Commission, Docket No. 29526, August 18 and September 2, 2004 (CenterPoint Energy Houston Electric).
- Utah Public Service Commission, Docket No. 04-2035- , August 4, 2004 (PacifiCorp).
- Oklahoma Corporation Commission, Cause No. PUD-200400187, July 2, 2004, (CenterPoint Energy Arkla).
- Minnesota Public Utilities Commission, Docket No. G-008/GR-04-901, July 2004, (CenterPoint Energy Minnegasco).
- Washington Utilities and Transportation Commission, Docket ,UE-032065/General Rate Case, December 2003 (PacifiCorp).
- Washington Utilities and Transportation Commission, Docket UE-, December 2003 (PacifiCorp).
- Washington Utilities and Transportation Commission, Docket UG-031885, November 19, 2003 (Northwest Natural)
- Wyoming Public Service Commission, Docket No. 20000-ER-03-198, May 2003 (PacifiCorp).
- Public Service Commission of Utah, Docket No. 03-2035-02, May 2003 (PacifiCorp)
- Public Utility Commission of Oregon, Case. UE-147, March 2003, (PacifiCorp)
- Wyoming Public Service Commission, Docket No. 20000-ER-00-162, May 6 and December 18, 2002, (PacifiCorp).
- Public Utility Commission of Oregon, UG-152, November 2002 (Northwest Natural)
- Massachusetts Department of Telecommunications and Energy, D.T.E. 02-24/24, May 17, 2002, (Fitchburg Gas and Electric Light Company).
- New Hampshire Public Utilities Commission, Docket No. DE 01-247, January 25, 2002, (Unitil Corporation).
- Washington Utilities and Transportation Commission, Docket UE-011569,70,UG-011571, November 26, 2001 (Puget Sound Energy, Inc.).
- California Public Utilities Commission, Docket No. 01-03-026, September 13, 2001, (PacifiCorp).
- New Mexico Public Regulation Commission, Docket No. 3643, July 3, 2001, (Texas-New Mexico Power Company).
- Texas Natural Resources Conservation Commission, Docket No. 2001-1074/5-URC, May 25, 2001, (AquaSource Utility, Inc.).

- Massachusetts Department of Telecommunications and Energy, Docket No. 99-118, May 2, 2001, (Fitchburg Gas and Electric Light Company).
- Public Service Commission of Utah, Docket No. 01-035-01, January 12, 2001, (PacifiCorp)
- Public Service Commission of Utah, Docket No. 01-035-01, January 12, 2001, (PacifiCorp)
- Federal Energy Regulatory Commission Docket No. ER-01-651, January 2001, (Southwestern Electric Power Company).
- Wyoming Public Service Commission Docket No. ___, December 2000, (PacifiCorp).
- Public Utility Commission of Oregon, Case. UE-116, November 2000, (PacifiCorp)
- Public Utility Commission of Texas, Docket No. 22344, September 2000, (AEP Texas Companies, Entergy Gulf States, Inc., Reliant Energy HL&P, Texas-New Mexico Power Company, TXU Electric Company)
- Public Utility Commission of Oregon, Case UE-111, August 2000, (PacifiCorp)
- Texas Public Utility Commission, Docket Nos. 22352,3,4, March 31, 2000 (Central Power and Light Co., Southwestern Electric Power Co., West Texas Utilities Co.).
- Texas Public Utility Commission, Docket No. 22355, March 31, 2000 (Reliant Energy, Inc.).
- Texas Public Utility Commission, Docket No. 22349, March 31, 2000 (Texas-New Mexico Power Co.).
- Texas Public Utility Commission, Docket No. 22350, March 31, 2000 (TXU Electric).
- Washington Utilities and Transportation Commission, Docket UE-991831 November 1999 (PacifiCorp).
- Public Service Commission of Utah, Docket No. 99-035-10, September 20, 1999 (PacifiCorp)
- Louisiana Public Service Commission Docket No. U-23029, August 1999 (Southwestern Electric Power Company)
- Wyoming Public Service Commission, Docket No. 2000-ER-99-145, July 1999, January 2000 (PacifiCorp, dba Pacific Power and Light Company).
- Texas PUC Docket No. 20150, March 1999 (Entergy Gulf States, Inc.)
- Federal Energy Regulatory Commission Docket No. ER-98-3177-00, May and December 1998 (Southwestern Electric Power Company).
- Public Service Commission of Utah, Docket No. 97-035-01, June 1998 (PacifiCorp, dba Utah Power and Light Company).
- Massachusetts Department of Telecommunications and Energy, Docket No. DTE 98-51, May 1998, (Fitchburg Gas and Electric Light Company, a subsidiary of Unitil Corp.)
- Texas PUC, Docket No. 18490, March 1998, (Texas Utilities Electric Company)
- Texas PUC Docket No. 17751, March 1998 and July 1997 (Texas-New Mexico Power Company).
- Federal Energy Regulatory Commission Docket No. RP-97, February 1998 and May 1997 (Koch Gateway Pipeline Company).
- Federal Energy Regulatory Commission Docket No. ER-97-4468-000, December 1997 (Puget Sound Power & Light).
- Oklahoma Corporation Commission, Cause No. PUD 960000214, August 1997 (Public Service Company of Oklahoma).
- Oregon Public Utility Commission Docket No. UE-94, April 1996, (PacifiCorp).
- Texas PUC Docket No. 15643, May and September 1996, (Central Power and Light and West Texas Utilities Company).
- Federal Energy Regulatory Commission Docket No. ER-96, April 1996 (Puget Sound Power & Light).
- Federal Energy Regulatory Commission Docket No. ER96, February 1996, (Central and South West Corporation).
- Washington Utilities & Transportation Commission Docket No. UE-951270, November 1995 (Puget Sound Power & Light).
- Texas PUC Docket No. 14965, November 1995, (Central Power and Light).
- Texas PUC Docket No. 13369, February 1995 (West Texas Utilities).

- Texas PUC Docket No. 12065, July and December 1994, (Houston Lighting & Power).
- Texas PUC, Docket No. 12820, July and November 1994, (Central Power and Light).
- Texas PUC Docket No. 12900, March 1994, and New Mexico PUC Case No. 2531, August 1993, (TNP Enterprises).
- Texas PUC, Docket No. 12815, March 1994, (Pedernales Electric Cooperative).
- Florida Public Service Commission, Docket No. 930987-EI, December 1993, (TECO Energy).
- Iowa Department of Commerce, Docket No. RPU-93-9, December 1993, (US West Communications).
- Texas PUC, Docket 11735, May and September 1993, (Texas Utilities Electric Company)
- Oklahoma Corporation Commission, Cause No. PUD 001342, October 1992 (Public Service Company of Oklahoma).
- Texas PUC Dkt. No. 9983, November 1991, (Southwest Texas Telephone Company).
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- California PUC (Application No. 92-05-004), April 1993 and May 1993, (Pacific Telesis).
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- Texland Electric Cooperative, Dkt. No. 3896, February 1983
- El Paso Electric Company, Dkt. No. 4620, September 1982.
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## PROFESSIONAL PRESENTATIONS

"Fundamentals of Finance and Accounting," the $IC^2$ Institute, University of Texas at Austin, December 1996 and 1997.

"Fundamentals of Financial Analysis and Project Evaluation," Central and South West Companies, April, May, and June 1997.

"Fundamentals of Financial Management and Valuation," West Texas Utilities Company, November 1995.

"Financial Modeling: Testing the Reasonableness of Regulatory Results," University of Texas Center for Legal and Regulatory Studies Conference, June 1991.

"Estimating the Cost of Equity Capital," University of Texas at Austin Utilities Conference, June 1989, June 1990.

"Regulation: The Bottom Line," Texas Society of Certified Public Accountants, Annual Utilities Conference, Austin, Texas, April 1990.

"Alternative Treatments of Large Plant Additions -- Modeling the Alternatives," University of Texas at Dallas Public Utilities Conference, July 1989.

"Industrial Customer Electrical Requirements," Edison Electric Institute Financial Conference, Scottsdale, Arizona, October 1988.

"Acquisitions and Consolidations in the Electric Power Industry," Conference on Emerging Issues of Competition in the Electric Utility Industry, University of Texas at Austin, May 1988.

"The General Fund Transfer - Is It A Tax? Is It A Dividend Payout? Is It Fair?" The Texas Public Power Association Annual Meeting, Austin, May 1984.

"Avoiding 'Rate Shock' - Preoperational Phase-In Through CWIP in Rate Base," Edison Electric Institute, Finance Committee Annual Meeting, May 1983.

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"Inflation Protection from Multi-Asset Sector Investments: A Long-Run Examination of Correlation Relationships with Inflation Rates," (with B.L. Hadaway), *Review of Business and Economic Research*, Spring 1981.

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# APPENDIX B

ARK P... ...C.L.I. DI... ...I SEC... ...MM.

ARKANSAS PUBLIC SERVICE COMMISSION APR 20 1 00 PM '05

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| IN THE MATTER OF THE APPLICATION OF CENTERPOINT ENERGY RESOURCES CORP., D/B/A CENTERPOINT ENERGY ARKANSAS GAS, FOR APPROVAL OF A SPECIAL CONTRACT RATE FOR TYSON POULTRY, INC. - NASHVILLE | ) | FILED<br>DOCKET NO. 05-034-P<br>ORDER NO. 3 |

ORDER

On March 31, 2005, CenterPoint Energy Resources Corp., d/b/a CenterPoint Energy Arkansas Gas (CEAG or the Company) filed an application establishing this docket and requesting approval of a Large Volume Commercial Customer Agreement (Transportation Supply Option - Special Rate Contract), hereinafter referred to as the agreement, attached to CEAG's application as Exhibit A thereto, between CEAG and Tyson Poultry, Inc. - Nashville (TPN). TPN operates a poultry processing plant located in the City of Nashville in Howard County, Arkansas, and currently receives natural gas service from CEAG, but it is considering bypassing CEAG and purchasing gas service from another supplier. This agreement, effective as of the date of this order, is for a term of five (5) years, and is designed to retain TPN as a customer of CEAG.

Along with its application CEAG filed in support thereof the prepared testimony and exhibit of Alan D. Henry, Director of Pricing and Load Research for CEAG.[1]

On April 15, 2005, the General Staff of the Arkansas Public Service Commission (Staff) filed the prepared testimony of Robert D. Booth, Manager of the Gas and Water Section of the Staff. In his testimony Mr. Booth analyzes the agreement between CEAG and TPN in detail. He also

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1 The prepared testimony and exhibit filed by CEAG along with its application was redacted to protect confidential and proprietary information, and it was subsequently replaced with an unredacted version under seal pursuant to a protective order of nondisclosure issued by the undersigned Administrative Law Judge on April 7, 2005.

9

examines the agreement in the light of the Arkansas Public Service Commission's (Commission) *Rules and Regulations Governing Promotional Practices of Electric and Gas Utilities*. Mr. Booth concludes his testimony with the following recommendation:

> After review of the information provided in this docket and the results of the cost-effectiveness tests, it is my conclusion that the proposed Agreement is in the best interest of CEAG ratepayers at this time. Therefore, I recommend that the Agreement between CenterPoint Energy Arkansas Gas and Tyson Poultry, Inc. - Nashville, filed on April 8, 2005, be approved. Finally, in accordance with the *Promotional Practices Rules*, Section 8, Biennial Report, CEA should include the status of this contract in its report that is to be filed with the Commission in the promotional practices reporting docket, Docket No. 90-205-R.

From the application, exhibit thereto, the prepared testimony filed herein, and all other matters of record, I find and conclude that it would be in the public interest that the agreement between CEAG and TPN be approved.

Accordingly, it is ORDERED that the agreement between CEAG and TPN for which approval is sought in this docket be, and is hereby, approved; and CEAG is hereby directed to file a report periodically as recommended in the last sentence of Staff's testimony hereinabove quoted.

BY ORDER OF THE ADMINISTRATIVE LAW JUDGE PURSUANT TO DELEGATION.

This 20th day of April, 2005.

Burl C. Rotenberry
Administrative Law Judge

Patricia W. Morgan (acting)
Diana K. Wilson
Secretary of the Commission

I hereby certify that the following order issued by the Arkansas Public Service Commission has been served on all parties of record this date by U.S. mail with postage prepaid, using the address of each party as indicated in the official docket file.

Diana K. Wilson
Diana K. Wilson
Secrectary of the Commission
Date 4-20-2005

ARK P... COMM.
SECRETARY ... COMM.

MAR 31 1 30 PM '05

BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

FILED

| | | |
|---|---|---|
| IN THE MATTER OF THE APPLICATION OF CENTERPOINT ENERGY RESOURCES CORP., D/B/A CENTERPOINT ENERGY ARKANSAS GAS FOR APPROVAL OF A SPECIAL CONTRACT RATE FOR TYSON POULTRY, INC.–NASHVILLE | ) ) ) ) ) ) ) | DOCKET NO. 05-034-P |

REDACTED DIRECT TESTIMONY AND EXHIBITS

OF

ALAN D. HENRY

DIRECTOR OF PRICING
AND LOAD RESEARCH

ON BEHALF OF

CENTERPOINT ENERGY RESOURCES CORP.,
d/b/a CenterPoint Energy Arkansas Gas

Filed: March 31, 2005

3

Q. Please state your name, position and address.

A. My name is Alan D. Henry, and I am Director of Pricing and Load Research for CenterPoint Energy Southern Gas Operations. My business address is P.O. Box 751, Little Rock, Arkansas 72203. In this job, I work in the area of pricing and load research for all of the Southern Gas Operations properties in Arkansas, Louisiana, Oklahoma, Texas, and Mississippi. In this proceeding, I am testifying on behalf of CenterPoint Energy Resources Corp., d/b/a CenterPoint Energy Arkansas Gas (the "Company").

Q. Please tell us about your educational background and work experience.

A. I received a Bachelor of Science in Education degree in 1971 and a Master of Science degree in 1973 from the University of Central Arkansas with Mathematics as the primary course of study. I began my career with the Company in July 1973 and have previously held the positions of Programmer and Analyst, Information Systems Coordinator, Manager Distribution Gas Accounting, Operations Analyst, Manager Finance Division, Arkansas Division, Division Staff Manager, and Director of Industrial Relations. During the period from March 1984 through March 1986, I was employed by Arkansas Western Gas Company as Manager of Customer Accounting. I returned to the Company in 1986, and I was responsible for monitoring and controlling Lost And Unaccounted-For Gas (LUFG). I have managed the Measurement Department which is responsible for testing large meters at sales and purchase locations, building large meter stations and controlling the purchase of meters, regulators and measurement instrumentation. I have prepared gas sales, LUFG, and measurement budgets. I have also worked directly with the Rate and Regulatory Department during rate cases with primary responsibilities in the LUFG and Billing Determinants areas. My duties as Director of Industrial Relations included overseeing the Company's transportation program and its relationships with large volume customers. I then served as a consultant for the Company from January 1999, through September 30, 2000. From October 2000 through May 2004, I served as Director of Pricing and Regulatory Affairs for CenterPoint Energy. On June 1, 2004, I became Director of Pricing and Load Research, and my jurisdictional duties were expanded to cover the Entex properties.

Q. Have you ever testified before this Commission?

A. Yes, I have previously testified in Docket Nos. 92-032-U, 93-164-U, 93-081-U, 97-345-TF, 98-269-TF, 99-232-TF, 00-263-U, 02-244-TF, 03-029-P, 03-046-P, 03-119-TF, 04-012-P, 04-028-P, 04-041-P, 04-042-P, 04-043-P, 04-062-P, 04-066-P, 04-068-P, 04-101-P, 04-121-U, 04-124-P, 04-127-P, 05-008-TF, 05-022-P, and 05-023-P.

Q. What is the purpose of your testimony?

A. I am supporting the Company's application for approval of a special contract rate for Tyson Poultry, Inc.-Nashville ("TPN"), which is currently served under the Company's PC-1 rate. TPN is located in Nashville, Arkansas. The contract expires on March 31, 2004[1].

Q. Please tell us more about this plant?

[1] The Company regrets that this filing is late, and as noted by Mr. Robert Booth in Docket No. 05-023-P (see page 3, lines 15-17), the Company has assured Mr. Booth that after getting through this filing and two

A. The plant processes poultry, and uses approximately [redacted] MMBtu per year and [redacted] In the past, this customer has threatened to bypass the Company absent a better rate. They are receiving the discounted rates provided via the PC-1 rate schedule because of their proximity to another supplier.

Q. What special rate is the Company proposing?

A. The Company is proposing a [redacted] The contract term is for five years.

Q. Why is this rate appropriate?

A. First let me state that the Company believes that given the specific economics at this particular plant, if the Company [redacted] Such an outcome would obviously be detrimental to the interests of the Company's remaining customers, when compared to continuing the existing rates. [redacted]

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others (one of which will be filed today), the Company will be caught up and will provide future requests for special rates well before the expiration of the current contract.

Nevertheless, the Company believes that the economics provided in this testimony reflect that the proposed rate is indeed justified.

Q. Will you please provide the economics that justify the special rate?

A. At my request, the Company's Engineering Department has produced an estimate of [redacted] to provide a meter station and the necessary piping that would allow the plant to be served directly from [redacted] Under standard rates, the customer would pay the Company approximately [redacted] per year, and given the bypass alternative, they would see a simple payback of approximately [redacted] years. We believe that virtually any business would make an investment with that type of payback. The special contract rate will cause the customer to pay the Company approximately [redacted] per year. Even given the discounted rate that the Company is offering, and taking into consideration the additional O&M expense, the customer would still save [redacted] per year by bypassing, which would yield a simple payback of approximately [redacted] years, which is still an investment that would be appreciated by most companies.

On the other hand, if the customer were to bypass the Company at this location, the Company's avoided costs would be only approximately [redacted] per year. Therefore, by retaining the customer at the proposed rate, the Company's remaining customers clearly benefit a fact that will be further evidenced by the California Test results.

Q. [redacted]

A. I believe it is because, in addition to simply transporting the gas to the customers, there are certain less tangible benefits that come from receipt of service from the Company. For example, while the Company has toughened its transportation gas balancing provisions, customers will find that the Company's system remains more customer friendly than balancing directly on an upstream pipeline. Also, and perhaps as importantly, the Company will provide transportation customers with emergency sales gas on a "best efforts" basis should the customer's supply fail. In the past, there have been many times when the Company's transportation customers have taken advantage of this supply when their own supply had failed. While it is impossible to directly measure the benefits of easier balancing and additional security of supply, these are undoubtedly features in which the Company's customers place value.

Q. Is there other evidence concerning this special contract that you wish to discuss?

A. Yes. Exhibit B to the Company's Application in this docket, which is incorporated herein by reference, presents a schedule setting forth the information required in Section 5 of the Commission's Promotional Practices Rules. I have reviewed Exhibit B, and the statements made therein are true and accurate to the best of my knowledge.

Q. Has the Company performed the economic tests required by the Commission's Promotional Practices Rules for approval of this type of contract?

A. Yes. We have performed the California Standard Practice for Cost-Benefit Analysis which includes the tests commonly referenced as the Participant Test (PT), the Ratepayer Impact Measure Test (RIM), and the Total Resource Cost Test (TRC).

Q. How were the tests performed?

A. We took the approach of determining whether the special rate was good for the participant (TPN), the remaining ratepayers and from a total resource perspective. In performing these tests, we looked at the period of the contract term (five years), but also reviewed longer-term periods, specifically a ten-year period and a fifteen-year period. We calculated a net present value of benefits and costs as well as a benefit-cost ratio for each of the three tests.

Q. What were the results?

A. The results for the participant test at the five, ten and fifteen year periods reflects that the contract is [redacted] The spreadsheets that yielded these results will be available for Staff's review upon issuance of the Protective Order of Non-

Disclosure that the Company has requested in connection with this application. Summaries of the results of these tests at five years, ten years and fifteen years are attached hereto as Exhibit ADH-1.

Q. How do you interpret these results?

A. The results reflect that if you ignore the intangibles, [redacted]

[redacted]

Q. Do you believe this special contract is in the public interest?

A. Yes. This rate will allow the Company to recover revenues that are clearly in excess of the fixed costs required to serve TPN. Absent the special contract, I believe the customer is likely to bypass the Company's distribution system, and these contributions will be lost. Therefore, the special contract is in the best interest of both the Company and its remaining customers.

Q. Does this conclude your testimony?

A. Yes it does.

## CALIFORNIA BENEFIT COST ANALYSIS - RESULTS 5-YEAR

| Client: | Tyson's Nashville |
|---|---|

| | |
|---|---|
| Net Present Value of Participant Test = | Redacted |
| Net Present Value of Rate Impact Test = | Redacted |
| Net Present Value of Total Resource Cost Test = | Redacted |
| Participant Test Benefit/Cost Ratio = | Redacted |
| Rate Impact Test Benefit/Cost Ratio = | Redacted |
| Total Resource Cost Benefit/Cost Ratio = | Redacted |

| Period (t) | Year | Participant Cost | Participant Benefits | RIM Cost | RIM Benefits | TRC Cost | TRC Benefits |
|---|---|---|---|---|---|---|---|
| Totals: | | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 1 | 2005 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 2 | 2006 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 3 | 2007 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 4 | 2008 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 5 | 2009 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |

## CALIFORNIA BENEFIT COST ANALYSIS - RESULTS 10-YEAR

**Client:** **Tyson's Nashville**

| | |
|---|---|
| **Net Present Value of Participant Test =** | **Redacted** |
| **Net Present Value of Rate Impact Test =** | **Redacted** |
| **Net Present Value of Total Resource Cost Test =** | **Redacted** |
| **Participant Test Benefit/Cost Ratio =** | **Redacted** |
| **Rate Impact Test Benefit/Cost Ratio =** | **Redacted** |
| **Total Resource Cost Benefit/Cost Ratio =** | **Redacted** |

| Period (t) | Year | Participant Cost | Participant Benefits | RIM Cost | RIM Benefits | TRC Cost | TRC Benefits |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Totals: | | **Redacted** | **Redacted** | **Redacted** | **Redacted** | **Redacted** | **Redacted** |
| | | | | | | | |
| 1 | 2005 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 2 | 2006 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 3 | 2007 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 4 | 2008 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 5 | 2009 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 6 | 2010 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 7 | 2011 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 8 | 2012 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 8 | 2013 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 10 | 2014 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |

## CALIFORNIA BENEFIT COST ANALYSIS - RESULTS 15-YEAR

| Client: | Tyson's Nashville |
|---|---|

| | |
|---|---|
| **Net Present Value of Participant Test =** | **Redacted** |
| **Net Present Value of Rate Impact Test =** | **Redacted** |
| **Net Present Value of Total Resource Cost Test =** | **Redacted** |
| **Participant Test Benefit/Cost Ratio =** | **Redacted** |
| **Rate Impact Test Benefit/Cost Ratio =** | **Redacted** |
| **Total Resource Cost Benefit/Cost Ratio =** | **Redacted** |

| Period (t) | Year | Participant Cost | Participant Benefits | RIM Cost | RIM Benefits | TRC Cost | TRC Benefits |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| **Totals:** | | **Redacted** | **Redacted** | **Redacted** | **Redacted** | **Redacted** | **Redacted** |
| | | | | | | | |
| 1 | 2004 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 2 | 2005 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 3 | 2006 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 4 | 2007 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 5 | 2008 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 6 | 2009 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 7 | 2010 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 8 | 2011 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 8 | 2012 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 10 | 2013 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 11 | 2014 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 12 | 2015 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 13 | 2016 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 14 | 2017 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |
| 15 | 2018 | Redacted | Redacted | Redacted | Redacted | Redacted | Redacted |