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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

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Docket No. R2000-1

DIRECT TESTIMONY

OF

ROBERT E. BURNS

ON BEHALF OF

THE OFFICE OF THE CONSUMER ADVOCATE

MAY 22, 2000

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

Postal Rate and Fee Changes, 2000)

Docket No. R2000-1

DIRECT TESTIMONY
OF
ROBERT E. BURNS

I. STATEMENT OF QUALIFICATIONS

My name is Robert E. Burns. I am a Senior Research Specialist and one of two attorneys at the National Regulatory Research Institute (NRRI), which is the research and public service organization for the National Association of Regulatory Utility Commissioners (NARUC). The Postal Rate Commission is a federal member of NARUC and has been since 1971. The NRRI was established by NARUC at the Ohio State University with the purpose of providing NARUC members, both state and federal, with neutral and objective public policy research on matters such as ratemaking. In that capacity, members of NRRI are occasionally retained by NARUC-member regulatory agencies to present evidence in proceedings before those agencies. I am a Phi Beta Kappa graduate of Marietta College, as well as a graduate of The Ohio State University College of Law. I have over twenty-one years of public utility and public policy research experience, with the last twenty being at the NRRI. I have written fifty major NRRI reports, including studies dealing with average and marginal cost of service issues. I am also the principal author of the NRRI report on *The Prudent Investment Test*, a

1 report, which, among other things, deals with incentives for honest, efficient, and
2 economical management.

3 I have previously testified before the Federal Energy Regulatory Commission,
4 the Mississippi Public Service Commission, and, most recently before the Arizona
5 Corporation Commission as a staff witness, on July 16, 1998, In the Matter of the
6 Proposed Agreement Between the Arizona Public Service Company and the Salt River
7 Project. ACC Docket No. E-01345A-98-0245.

8 II. PURPOSE AND SCOPE OF TESTIMONY

9 My testimony will explore the purposes of "a reasonable provision for
10 contingencies" being included as a statutory item in the revenue requirement under the
11 Postal Reorganization Act, 39 U.S.C. §3621, so that the Postal Rate Commission might
12 judge for itself whether the contingency reserve proposed by the Postal Service
13 exceeds the amount that would be reasonable. In order to examine whether the
14 contingency is reasonable, I will explore the purpose of the Postal Service's
15 contingency reserve and will relate that to the purpose that a contingency rate reserve
16 serves in another industry where it is used, the insurance industry. I show that a
17 contingency reserve cannot be adjudged to be reasonable without some justification
18 stemming from an assessment and systematic analysis of the risks that the contingency
19 reserve is expected to protect the Postal Service against. Relying solely on
20 management discretion to pick the contingency reserve will not guarantee its
21 reasonableness. I also review the standards applied by the Postal Rate Commission in
22 reviewing contingency requests, and examine the adequacy of the reasons given for

1 the 2.5 percent contingency, which amounts to \$1.68 billion in the test year, by the
2 Postal Service's witness on this subject, William P. Tayman. My colleague, Dr. Edwin
3 Rosenberg, will suggest an assessment and systematic analysis by which the
4 Commission can judge the reasonableness of the contingency reserve in this case.

5 III. THE CONTINGENCY MUST BE REASONABLY RELATED TO FUTURE
6 UNCONTROLLABLE EVENTS

7 The purpose of the contingency is to cover "expenses which could be neither
8 foreseen nor prevented through the exercise of honest, efficient, and economical
9 management. . ." PRC Op. R76-1 at 52. Stated another way, the purpose of a
10 contingency is to cover expense which are unexpected in their magnitude and are
11 uncontrollable, that is, beyond the control of management; or to cover expenses that
12 are unforeseen and unforeseeable and beyond the control of management. After all,
13 honest, efficient, and economical management will make every reasonable effort to
14 control those costs that are foreseen and foreseeable. Expected and foreseeable costs
15 are captured in the Postal Service's forecast of future costs. In particular, "[t]he
16 contingency allowance is . . . designed to offset the effects of misestimates in the test
17 year relating to revenue and costs." PRC Op. R77-1 at 29.

18 Contingency reserves are used by the insurance industry for the same purpose,
19 that is, to offset the effects of misestimates relating to revenue and costs. Here the
20 contingency reserve is generally referred to as a catastrophe reserve. The National
21 Association of Insurance Commissioners ("NAIC") recommends that a separate
22 component of insurance premiums cover catastrophic hazards, including unusual
23 floods, wind, or storm damage, and large fires, where the loss may exceed \$1 million.

1 The position of the Financial Accounting Standards Board is that a contingency
2 reserve or catastrophic reserve for insurance is improper unless related to a current
3 obligation or liability of the reporting company, that is, insurance in force. If there is no
4 connection made between the future sacrifice (represented by the reserve) and some
5 past transaction or event (the risks actually insured for), the reserve is tantamount to
6 improperly attempting to smooth out irregularities or volatility in earnings. In other
7 words, for a contingency reserve to be proper and reasonable, it must be tied to a duty
8 to pay for events that have not occurred, but for which there is a projected probability of
9 occurrence. Indeed, California Insurance Regulations, Title 10, Section 2644.5, require
10 that any loading for catastrophic losses must be based on a multi-year, long-term
11 average of catastrophic claims with the number of relevant years set by the regulator.

12 In other words, in the insurance industry a contingency will permit the insurance
13 industry to collect monies for those years that a greater number of losses occur than
14 are forecasted. For example, for a year when a greater number than expected
15 hurricanes make landfall or for a year with a Hurricane Andrew. Otherwise, a
16 contingency reserve, if any is allowed, will be included in the profit allowance.

17 The Postal Rate Commission in endorsing variance analysis as a sound
18 analytical tool, does not rely solely on that tool to the exclusion of other factors. The
19 Commission will apply other pertinent factors to the variance analysis, "such as the
20 financial condition of the Postal Service, the state of the economy, the causes of the
21 variances, and such other relevant factors which may arise [that] must be considered in
22 arriving at a contingency provision." PRC Op. R 80-1, ¶0112 (citations omitted).

1 There has been for some time movement away from contingency reserves that
2 are not based on the likelihood of a future event. In the 1984 NAIC Study of Investment
3 Income, the NAIC Task Force stated, "Estimates of losses, expenses, and investment
4 income are used by insurers in combination with overall profit objectives to determine
5 the price at which its policy will be written. . . . The addition of a contingency provision
6 to a target return based upon . . . the relative risk is not necessary. . . ."¹

7 The implication that this has for the Postal Service and the Postal Rate
8 Commission is the contingency provision should, to the maximum extent possible, be
9 tied to the possibility that its expense and revenue forecasts contain misestimates.
10 These "variances, between estimated and actual results 'will occur as a result of errors
11 in assumptions underlying projections contained in the rate filing estimates arising from
12 unforeseen events and/or errors in forecasting techniques. . . .'" PRC Op. R80-1,
13 ¶0110. Indeed, the Postal Rate Commission has concluded that "historical variance
14 analysis supplemented by other pertinent factors is a proper and feasible procedure to
15 employ in establishing a reasonable contingency provision." PRC Op. R77-1 at 31.
16 And, the Commission has found "appropriate the utilization of variance analysis as a
17 starting point in evaluating the Postal Service's contingency request." *Id.* at 33.

18 The approach to a contingency reserve taken by the insurance industry also
19 indicates that, unless the Postal Service's proposed contingency reserve is related in
20 some fashion to future, uncontrollable events, it is merely a device to even out
21 controllable expenses. Under Financial Accounting Standards, such a device would be

¹ NAIC Study of Investment Income, Supplement to the NAIC Proceedings, vol. II, at 9 and 25 (1984).

1 considered part of the profit allowance in the insurance industry. Of course, the Postal
2 Service is required to operate on a break-even basis, so such a profit would not be
3 allowed. This underscores the importance of the Postal Service relating its contingency
4 request to future, uncontrollable events.

5 Other experiences in regulated industries underscore the importance of tying a
6 contingency reserve to possible future, uncontrollable events. We can learn from the
7 utility regulatory experiences with fuel adjustment, purchased power adjustment, and
8 purchased gas adjustment clauses. Where managers are sheltered from the effects of
9 future events, they make less effort to take actions to control costs. In the case of
10 purchased fuel, purchased power, and purchased gas subject to automatic adjustment
11 clauses, public utilities tend to be mediocre negotiators of price, because any price that
12 they pay is passed through to the ratepayers. The automatic adjustment clauses thus
13 cushion the managers from the consequences of failing to control controllable costs.
14 Indeed, public utility managers of utilities with such automatic adjustment clauses have
15 tended not to hedge risks of purchased fuel, purchased power, and purchased gas,
16 even where futures and other hedging mechanisms exist, because there is no
17 advantage to be gained.

18 A larger than necessary contingency reserve creates a similar perverse
19 managerial incentive. Managers cushioned from the consequences of controlling costs
20 will tend not to act as aggressively to cut costs and waste. They become lax. This
21 could, and likely would, happen for Postal Service managers if the contingency reserve
22 were raised to a level that exceeds reasonable provision for future, uncontrollable

1 events and thus acts to cushion managers from the consequences of failing to curb
2 controllable risks.

3 These general precepts are consistent with the Commission's approach to
4 reviewing the Postal Service's contingency request. From the outset, the Commission
5 has evaluated the contingency in light of prevailing national economic conditions and
6 the degree of economic stability present.² The Commission has long considered the
7 contingency to serve the dual role of providing a "cushion against unforeseeable
8 events,"³ including unfavorable financial events, and compensating for forecasting
9 errors.⁴ The Postal Service's contingency request must be supported by substantial
10 evidence, and Postal Service management's subjective perception of risks must be
11 reasonably articulated.⁵ In all cases, review of variance analysis serves as a tool to
12 guide the final decision.⁶ The Commission's prior decisions suggest that evaluation of
13 the Postal Service's contingency request rests upon (1) careful evaluation of the Postal
14 Service's explanation of subjective management judgment; (2) an objective review of
15 potential forecasting errors; and (3) consideration of external factors such as key
16 national economic indicators and economic stability. I will discuss the first of these
17 three areas, the Postal Service's subjective management judgment. My colleague, Dr.
18 Edwin Rosenberg, will address the review of potential forecasting errors through

² PRC Op. R76-1 at 56.

³ PRC Op. R80-1, ¶0109.

⁴ *Id.*, ¶ 0110.

⁵ PRC Op. R87-1, ¶¶ 2072-73.

⁶ PRC Op. R80-1, ¶¶ 0112, 0115.

1 variance analysis and the consideration of external economic factors. Dr. Rosenberg
2 will also present a specific recommendation for the appropriate contingency to be
3 recommended in this case.

4 IV. THE POSTAL SERVICE HAS NOT ARTICULATED A REASONABLE BASIS
5 FOR ITS SUBJECTIVE JUDGMENT

6 *It is clear from the history of Commission proceedings that the Postal Service*
7 *cannot justify a contingency reserve as being reasonable simply because management*
8 *deems it so. Yet that is what the Postal Service has done in this case. The testimony*
9 *of Postal Service witness Tayman makes various general observations on risks facing*
10 *the Postal Service, all of which witness Tayman frankly characterizes as subjective and*
11 *not based on specific evaluation of individual factors.⁷ Witness Tayman presents a*
12 *variance analysis "[i]n deference to the Commission's desire to evaluate forecast*
13 *errors,"⁸ but expressly disavows any reliance on such an analysis.⁹ Therefore, witness*
14 *Tayman's evidence must be judged as primarily being a subjective articulation of*
15 *management's perception of unforeseeable and uncontrollable risk. While such*
16 *evidence is permitted, "management's perception of those risks must be articulated to*
17 *a reasonable degree in order to satisfy the substantial evidence requirement." PRC*
18 *Op. R87-1, ¶2073.*

⁷ Tr. 2/385-86 (witness Tayman's response to interrogatory OCA/USPS-T9-43), *id.* at 280 (response to interrogatory DMA/USPS-T9-15), and *id.* at 304 (response to interrogatory DMA/USPS-T9-47).

⁸ USPS-T-9 at 44.

⁹ "[M]anagement must be allowed to assume its responsibility to determine the amount of contingency most appropriate for achieving its goals." *Id.* at 45.

1 Review of witness Tayman's discussion shows that management's request has
2 not been sufficiently well-articulated to permit the Commission to place dispositive
3 reliance upon management's subjective judgment. Mr. Tayman devoted less than two
4 pages—and no supporting information, data, or studies—to justify the \$1.68 billion
5 annual revenue that the contingency represents.¹⁰ A review of Mr. Tayman's points
6 shows that the necessary substantial evidence is lacking.

7 *Recent financial performance.* Mr. Tayman states that recent financial
8 performance "has not been as favorable as in the mid 1990's," that FY 99 fell short of
9 plan, and that the Postal Service spent more than expected on Y2K remediation.¹¹ But
10 the Postal Service finished FY 99 in the black, with net revenue of \$363 million dollars.¹²
11 This was achieved despite spending \$88.6 million on Y2K resolution in FY 1998,
12 \$267.0 million in FY 1999, and an estimated \$42.6 million in FY 2000.¹³ This latter point
13 is a very good example of the sort of expense that a contingency can cope with. It was
14 known many years ago that the transition of computer systems to year 2000 would
15 present remediation problems, but due to the unique nature of the problem, the Postal
16 Service did not have a track record of reliable forecasting. Yet the Postal Service

¹⁰ See USPS-T-9 at 43-44.

¹¹ *Id.* at 43.

¹² 1999 Cost and Revenue Analysis, LR-I-275, filed April 4, 2000.

¹³ Tr. 2/278 (response of witness Tayman to interrogatory DMA/USPS-T9-13).