

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

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

Postal Rate and Fee Changes, 2000

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Docket No. R2000-1

ANSWERS OF THE OFFICE OF THE CONSUMER ADVOCATE
TO INTERROGATORIES OF UNITED STATES POSTAL SERVICE
WITNESS: ROBERT E. BURNS (USPS/OCA-T2-1-9)
(June 20, 2000)

The Office of the Consumer Advocate hereby submits the answers of Robert E. Burns to interrogatories USPS/OCA-T2-1-9, dated June 6, 2000. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,



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ANSWER OF OCA WITNESS ROBERT E. BURNS
TO INTERROGATORIES USPS/OCA-T2-1-9

USPS/OCA-T2-1. Please refer to your discussion of the insurance industry at pages 3-4 of your testimony.

- a. Are insurance companies and utilities are [sic] allowed to earn profits?
- b. Do those insurance companies that earn profits have positive equity?
- c. Does positive equity provides [sic] a cushion against unforeseen events?

RESPONSE TO USPS/OCA-T2-1:

a. Yes. Insurance companies and investor-owned utilities are allowed to earn profits; however, the allowed rate of return of each company, which includes its return on equity, that is, its profit, is regulated. It should be noted, however, that the vast majority of utilities in number are municipal utilities, cooperatively-owned utilities, and federal power authorities that are not-for-profit.

b. Usually yes. Most typically, an insurance company or any other company that earns a profit has positive equity; however, it is possible for an insurance company or any other company or entity to earn a profit in any individual year and yet have negative equity. The latter can happen whenever an insurance company's or any other entity's income exceeds its expenditures for the individual year, while its balance sheet is negative. However, an insurance company is expected to maintain a positive equity to maintain capital adequacy. The latter is necessary for a Standard & Poor's Rating of BBB or better.

c. Yes, positive equity provides a cushion against unforeseen events. This cushion is in addition to the initial cushion of a contingency reserve.

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USPS/OCA-T2-2. Please refer to page 2, lines 19-20, of your testimony, where you state: "Relying solely on management discretion to pick the contingency reserve will not guarantee its reasonableness." Also refer to the Postal Service responses to OCA Questions 1-3 on the Contingency filed on May 17, 2000.

- a. What approach to contingency selection will "guarantee" reasonableness?
- b. Is it your testimony that the Postal Service did no analysis and relied solely on management discretion in determining the size of the contingency? If your answer is yes, please explain fully.
- c. Do you believe any management discretion is appropriate in determining the size of the contingency? If your answer is no, please explain.

RESPONSE TO USPS/OCA-T2-2:

- a. As the Postal Rate Commission has stated in the past, a reasonable result in establishing a contingency reserve is much more likely (that is, the reasonableness of the approach for picking the contingency reserve is better guaranteed) when the methodology begins with an objective analysis of the volatility of the forecasted cost variables contained in the proposed rates. Such an analysis was performed by Dr. Edwin Rosenberg in his testimony.
- b. Since the Postal Service refused to provide the documents underlying the Tayman testimony, I am, therefore, unable to answer whether the Postal Service conducted an objective analysis of the volatility of its forecasted cost variables. I am also unable to answer whether the Postal Service relied at all on any objective analysis that they may or may not have performed. Thus, due to problems related to asymmetry of information, I am unable to state whether the Postal Service did any objective analysis and whether or not they relied solely on management discretion in determining the size of the proposed contingency. However, given the recommended contingency

rate of 2.5 percent, the admitted lack of any set objective framework for reaching this contingency, and witness Tayman's statements that the determination of the contingency involves a subjective evaluation that is not based on specific evaluation of individual factors, it appears that the Postal Service relied very heavily, if not solely, on management discretion, that is, managerial gestalt, in determining the size of the proposed contingency.

c. Yes, management discretion can play a role in determining the size of a reasonable contingency reserve; but only after an objective analysis of the volatility of the forecasted cost variables has been completed. Again, Dr. Edwin Rosenberg has preformed such an objective analysis for the Postal Rate Commission, while Mr. Tayman's testimony contains no such analysis. Even so, to be useful, management's discretion must be clearly articulated and must either support a result consistent with the objective analysis or must clearly support (that is, support through clear and convincing evidence) why a reasoned contingency reserve should vary from the result indicated by the objective analysis. However, determinations that heavily or solely rely on management discretion, without having as a starting point an objective analysis of the variability of the future costs, can not be relied upon as being reasonable.

USPS/OCA-T2-3. Please refer to page 3, lines 18-19, of your testimony where you state: "Contingency reserves are used by the insurance industry for the same purpose, that is, to offset the effects of misestimates relating to revenue and costs."

a. What percentage of total costs, including the amount to cover catastrophic hazards such as floods and storm damage, are typically used for contingency reserves in the insurance industry? Please provide the source of your answer.

b. Please confirm the fact that hurricanes and other catastrophes will occur in the future is known. If you do not confirm, please explain why.

c. Please confirm that the number and severity of such catastrophes that will occur in the future is unknown. If you do not confirm, please explain fully.

RESPONSE TO USPS/OCA-T2-3:

a. The question as phrased does not lend itself to a ready answer because there is no standard definition of total costs for the insurance industry. Keeping that in mind, if one were to presume that a property and casualty insurance company had a combined ratio of approximately 100 percent of premiums, which is about typical, then the typical loss ratio or loss reserve would be between 60% to 80% of premiums. That might be considered equivalent to 60% to 80% of total costs. See *Standard & Poor's Insurance Property Casualty Industry Survey* (New York: McGraw-Hill, 1999), 22. The contingency reserve is rolled in as a part of this loss ratio or loss reserve.

In a recent article, "Enhanced Criteria To Evaluate European Insurers' Capital Adequacy,"

<http://www.standardandpoors.com/ratings/criteria/insurance/enhanced/enhancedcrit.htm>, what

I refer to as a contingency reserve is closely related to what is referred to in the article as a reserve risk. As defined in the article, reserve risk arises from the possibility that the actual cost of claims will vary from the expected cost reflected in the currently

reported loss reserve. The reserve risk does not address the adequacy of current reserves. Rather, it measures the expected variability in reserve levels and the capital required to finance the reserve. These variations result from deviations from the expected level of frequency and severity of losses, which can be exacerbated by changes in economic, legal, and social conditions. According to the article, the reserve charges for property loss would be 22 percent of the loss reserves, net of reinsurance recoverable.

Putting these two articles together, the contingency reserve portion of the premiums would be approximately 13 percent to 18 percent of the total premiums. One must keep in mind, however, that the business of a property and casualty insurance company is insuring against risk. As such, one would expect a reasonable contingency reserve for an insurance company to be much larger than what would be a reasonable contingency reserve for the Postal Service.

My discussion of the contingency reserves established by the insurance industry was not for the purpose of saying that the size of insurance reserves was in any way analogous to the size of appropriate Postal Service reserves. Rather, I cited the insurance industry as a model of the *method* that the Postal Service should use to determine accurately the size of its needed contingency reserve. The uncertainties associated with any particular industry and its ability to control costs and revenues are unique to each industry.

It would be naive to imagine that the obligations of the insurance industry, which determine the size of the reserves they require, would be directly applicable to the

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Postal Service. The Postal Service has a number of safety nets that witness Rosenberg discusses in his testimony, e.g., the provision for recovery of prior years' losses and management's ability to control expenses, that are not available to the insurance industry. The latter point is important—the insurance industry has no control over the catastrophes for which it promises compensation to its policyholders. The Postal Service, on the other hand, has considerable control over its revenues and costs.

The point that I make in my testimony is that the insurance industry's method of estimating its future liability is far superior to that employed by the Postal Service, *i.e.*, a “connection [is] made between the future sacrifice (represented by the reserve) and some past transaction or event (the risks actually insured for)” and, further, there must be a “projected probability of occurrence.” I also point out that “any loading for catastrophic losses must be based on a multi-year, long-term average of catastrophic claims with the number of relevant years set by the regulator.” OCA-T-2 at 4. In my opinion, the Postal Service has failed to perform the type of probability analysis and quantitative assessment that the insurance industry performs and which I cite at page 4 of my testimony. I also note in my testimony that to the extent the Postal Service performs a variance analysis, it does not base its contingency proposal upon the analysis but disavows it.

b. Yes, it is known that Atlantic hurricanes and other natural catastrophes have occurred in the past and will occur in the future.

c. While the number and severity of such catastrophes that will occur in the future is not exactly known, there are forecasting groups that forecast the number and severity of catastrophes such as Atlantic hurricanes, earthquakes, land/mudslides, and flood occurrences.

In the case of Atlantic hurricanes, the Colorado State University Hurricane Forecasting Team, led by Professor William Gray, has been issuing annual Atlantic hurricane predictions since 1994. Professor William Gray's most recent prediction for the 2000 Hurricane Season is for 12 named storms, 8 hurricanes, and 4 major hurricanes. The team is also predicting that the probability of one or more major hurricanes (Saffir-Simpson Category I, II, or III) coming ashore along the U.S. coastline is 71 percent. Thus, particularly within the last ten years, forecasting methods have been developed and put in place to better understand the variables that influence natural catastrophes, so that steps can be taken to mitigate the resultant damage and loss of life. My point here is this, during the last ten years, forecasting methods have also become available for the Postal Service to use to make an objective analysis of variables that could affect its future costs as well as to allow the Postal Service to bring those costs under control, through risk mitigation and/or prudent and efficient management. Before one can understand future costs, so that a reasonable contingency can be set at a level that mitigates uncontrollable risk while it provides management with an incentive to minimize costs, one must be able to conduct an objective analysis of the volatility of the forecasted cost variables. No such analysis is contained in the testimony of the Postal Service.

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USPS/OCA-T2-4. How much "profit allowance" is typically included in insurance rates? Please provide your sources.

RESPONSE TO USPS/OCA-T2-4:

Finding the "profit allowance" in insurance rates would require contacting each individual state insurance commission, an activity I did not undertake. Instead, I provide an estimate of the actual earned profit included in insurance rates. The actual earned profit included in insurance rates (insurance premiums) is typically very small, if not negative. My best property-casualty industry-wide estimate is between -3% and 4%. Here is how the calculation was done. *Best's Key Rating Guide, Property-Casualty* (Oldwick, NJ: A.M. Best, ed. 1999), inside cover, states that the pretax return on revenues (a measure of a company's operating profitability) is calculated as pretax operating income divided by net premiums earned. This figure is normally between 3% to 10%. However, to find an estimate of the actual profit that is included in insurance rates, it is necessary to net out the net investment yield. According to *Standard & Poor's Industry Survey, Casualty Insurance* (New York: McGraw-Hill, 1999), 19, the typical net investment yield for casualty insurance is 6%. After netting out the net investment yield, one is left with an estimated actual earned profits of -3% to 4% being included in insurance rates

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USPS/OCA-T2-5. Please refer to page 7, lines 10-11, of your testimony where you state: "Postal Service management's subjective perception of risks must be reasonably articulated." Please also refer to pages 43-46 of USPS-T-9.

a. Is it your testimony that Postal Service management's subjective perception of risks related to the contingency is not reasonably articulated in USPS T-9? If your answer is yes, please explain fully.

b. With reference to past contingency amounts proposed by the Postal Service and accepted by the Commission, please explain which ones were reasoned and which ones were not reasoned, and why.

c. For any previous contingency amounts considered by you to be reasoned, please explain how the support provided by the Postal Service for such contingency amounts differs from the support provided for the contingency in this docket which you say is not reasoned.

RESPONSE TO USPS/OCA-T2-5:

a. Yes. First, the Postal Service management's subjective perception of risks related to the contingency cannot be reasonably articulated unless it has some objective starting point. Without an objective analysis as a starting point, subjective perceptions of risk lack context. No such objective analysis of risk has been presented by the Postal Service witness. Second, where witness Tayman does present a variance analysis, he expressly disavows any reliance on the analysis, so that he relies totally on management's subjective judgment, which is not based on specific evaluation of individual factors. Third, the one formerly uncontrollable factor that witness Tayman cited, the Y2K remediation costs, did not prevent the Postal Service from finishing FY 99 in the black. As such, it is evidence that the current contingency is sufficient. Third, volume growth is not entirely out of the Postal Service's control. They can promote services. Fourth, management has input into salary levels, health care benefits, and

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labor contracts; and can project them fairly accurately into the future. Fifth, the one subjective perception of increased risk that Tayman articulated being an increasingly competitive environment was mostly taken into account by detailed volume forecasts. The uncertainty about electronic diversion in the future is supported by nothing more than one sentence speculating that the Internet may "be making inroads" into mail volume. More should be required to clearly articulate a subjective perception of uncontrollable risk. Certainly, there has been a failure to rationally connect potentially uncontrollable risks in the test year and the \$1.68 billion annual contingency request.

b. and c. The Postal Rate Commission has made clear that it expects the Postal Service to utilize increasingly sophisticated objective analysis of risks over time. Therefore, these questions are irrelevant to the current case; and, worse still, would ask the witness to engage in an anachronistic analysis, using today's tools, which were unavailable in the past, to measure the reasonableness of past decisions. Such an analysis violates logic and has been rejected by courts in other contexts.

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USPS/OCA-T2-6. Please refer specifically to USPS-T-15, Direct Testimony of Charles Holder in Docket No. R90-1.

a. Please confirm that the Postal Service determined that a contingency of 3.5% was necessary in Docket No. R90-1 and that this amount was recommended by the PRC. If you do not confirm, please explain why.

b. Do you consider that management's subjective perception of risks was reasonably articulated in Docket No. R90-1? If your answer is other than yes please explain why.

c. Please explain how management's subjective perception of risks related to the contingency in Docket No. R90-1 differs from its articulation of such risks in this Docket. If your answer is that one is more reasonably articulated than the other please explain by how much and how you arrived at your conclusion.

RESPONSE TO USPS/OCA-T2-6, parts a. – c.:

The Postal Rate Commission has stated its expectation that the Postal Service must study and learn about the risks that it faces over time and that develop and use increasingly sophisticated objective means of risk analysis. Objective risk analysis methods that were available ten years ago would be considered inadequate today. Any review of testimony from another case ten years ago would be an anachronistic (out-of-time) analysis that lacks relevance to today's case.

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USPS/OCA-T2-7. Please refer page 9, lines 3 and 4, of your testimony where you state that "Mr. Tayman devoted less than two pages—and no supporting information, data, or studies—to justify the \$1.68 billion annual revenue that the contingency represents." How many pages did Mr. Holder devote to this subject in Docket No. R90-1?

RESPONSE TO USPS/OCA-T2-7:

See my response to interrogatory USPS/OCA-T2-6.

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USPS/OCA-T2-8. Please refer to page 10, line 3, of your testimony, where you state: "Mr. Tayman states that volume growth is below historical norms and that the Postal Service plans a 1.5 percent workyear reduction in the test year. This is not an area outside of the Postal Service's control." Is it your testimony that volume growth is controllable by the Postal Service? If your answer is other than no, please explain how volume growth can be controlled by the Postal Service and provide the source of your information.

RESPONSE TO USPS/OCA-T2-8:

First, the Postal Service controls the rate of workyear reduction. Further, the Postal Service can take measures to control volume. The Postal Service can influence volumes by improving service or promoting certain services. It can decrease volumes by withdrawing service or not advertising.

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USPS/OCA-T2-9. Please refer to page 11, line 1, of your testimony where you state that "witness Tayman next cites health benefit cost increases at 'near double digit rates.' Once again, indices and forecasts exist for such costs, and they are not completely outside of management influence." Please explain how Federal Employees Health Benefit Program premiums are within postal management's influence. Provide the source of your information.

RESPONSE TO USPS/OCA-T2-9:

The amount the Postal Service pays in health premiums is not entirely outside of the Postal Service's control, because the Postal Service controls the number of employees that it hires. For example, if a large number of additional workhours are required to process volumes, the Postal Service has two options. It can hire new workers or it can increase the overtime hours of its existing workforce. If it chooses the latter, health premium costs will not increase at as fast a rate because health premiums only vary with the number of employees, not the number of hours each employee works. Other increases in health care benefits can be forecasted and are already incorporated in the Postal Service's forecasts.

DECLARATION

I, Robert E. Burns, declare under penalty of perjury that the answers to interrogatories USPS/OCA-T2-1-9 of the United States Postal Service are true and correct, to the best of my knowledge, information and belief.

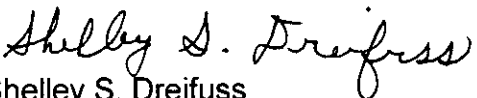
Executed

June 13, 2000

Robert Edward Burns
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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


Shelley S. Dreifuss

Washington, DC 20268-0001
June 20, 2000