

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

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Docket No. R2000-1

ANSWERS OF THE OFFICE OF THE CONSUMER ADVOCATE
TO INTERROGATORIES OF THE UNITED STATES POSTAL SERVICE
WITNESS: JAMES F. CALLOW (USPS/OCA-T6-22-27)
(June 30, 2000)

The Office of the Consumer Advocate hereby submits the answers of James F. Callow to interrogatories USPS/OCA-T6-22-27, dated June 16, 2000. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,



TED P. GERARDEN

Director

Office of the Consumer Advocate

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ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-22. Please refer to page 4, lines 8-13, of your testimony, where you state:

Under my proposal, the single-piece First-Class ("SPFC") rate would be determined without regard to the "integer constraint." The rate paid by households, by contrast, would be set at a whole cent, as in the past. The SPFC integer rate would be set so that sufficient revenues would accumulate in a "reserve account" to permit the single-piece rate to remain the same for a period of two rate proceedings, a duration of approximately four years. In effect, the SPFC rate would be changed every other rate proceeding, with revenue generated during the first rate period covering any revenue deficiency in the second rate period.

- (a) Please explain how you would determine how much above the "unconstrained" rate the whole cent rate would be set in order to be "sufficient," and how much of a reserve would be appropriate to generate over the period of the first rate case. For example if the unconstrained rate were 33.8 cents, would the whole cent rate be set at 34 cents, 35 cents, or some other amount, and how much of a reserve should be generated? Please explain your answer fully.
- (b) Please confirm that the amount of difference between the unconstrained rate and the integer rate is limited to amounts equal to the difference between the unconstrained rate and the next higher cent and amounts equal to that difference plus some number of whole cents (for example if the unconstrained rate is 33.8 cents the difference between it and the actual rate paid by users would be limited to 0.2 cent, 1.2 cents, 2.2 cents and so on). If you do not confirm, please explain fully.

RESPONSE TO USPS/OCA-T6-22

(a) An illustration of the relationship between the "calculated" non-integer single-piece rate and the SPFC integer rate is shown in Table 13. See OCA-T-6, Part II, at 40. The amount of revenue generated in the first rate case period is the positive difference between the "calculated" non-integer single-piece rate and the SPFC integer rate multiplied by the volume of SPFC letters. In Table 13, the positive difference is 1 cent. This amount, multiplied by the volume of SPFC letters, generates \$1.027 billion in

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the SPFC Reserve Account during the first rate case period, assumed in this illustration to be FY 2001 and FY 2002. Of course, a larger or smaller difference than 1 cent would generate more revenue, or less revenue, respectively. The intent when selecting the SPFC rate would be to have the revenue generated during the first rate case period cover the expected revenue deficiency during the second rate case period. This would be accomplished by setting the SPFC rate so that the positive difference between the "calculated" non-integer single-piece rate and the SPFC integer rate in the first rate case was approximately equal to the negative difference between the "calculated" non-integer single-piece rate and the existing SPFC integer rate in the second rate case.

For the hypothetical posed in the question, where the "calculated" non-integer rate is 33.8 cents, a SPFC integer rate of 34 cents would be sufficient where the "calculated" non-integer rate in the second rate case would likely be 34.2 cents, or 0.2 cents more than the SPFC rate of 34 cents. The positive difference of 0.2 cents (34 cents - 33.8 cents) generates approximately \$209 million in the first rate case period, and offsets the expected revenue deficiency of approximately \$204 million produced by the negative difference of 0.2 cents (34 cents - 34.2 cents) in the second rate case period.

It should be noted that, in this hypothetical, the change in the "calculated" non-integer rate between the first and second rate case is only 0.4 cents (34.2 cents - 33.8 cents). To the extent postal costs are rising, or are expected to rise, more than 0.4 cents (assuming the same cost coverage) for single-piece First-Class letters during the

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two rate case periods, a 35 cent SPFC integer rate might be necessary in the first rate case to ensure sufficient revenues to cover the expected deficiency during the second rate case period.

(b) Confirmed, by definition, so that the SPFC rate can be set at a whole cent, or integer.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-23. Please refer to Exhibit USPS-9A.

- (a) What would be the impact on the after rates test year statement of revenue and expense under your proposal where the single-piece First-Class ("SPFC") rate is determined without regard to the "integer constraint? Please explain your answer.
- (b) Would the after rates net surplus (deficiency) increase by the amount of additional revenue generated by the difference between the unconstrained rate and the whole cent rate (i.e. the amount described by you as the "reserve account")? Please explain your answer.
- (c) If your answer to part (b) is yes, please confirm that the whole cent SPFC rate and the rates for all other classes of mail would result in revenues sufficient cover total accrued costs and a reasonable contingency, and would generate a net income equal to the prior year loss recovery plus an amount equal to the additional revenue that would result from the difference between the unconstrained rate and the whole cent rate. If your answer to part (b) is no, please explain how a reserve would be created without the generation of additional net income in the test year of the first rate case.

RESPONSE TO USPS/OCA-T6-23

(a) On the Statements of Revenue and Expense, a new line could be added after "Recovery Of Prior Year Losses" for the SPFC Reserve Account to show the estimated balance in the test year. A copy of Exhibit USPS-9A is attached.

(b) No. If the amount of the balance, positive or negative, in the SPFC Reserve Account appears as a revenue requirement item in the same manner as RPYL or Contingency, then there would be no effect on Net Surplus (Deficiency).

(c) The existence of the SPFC Reserve Account would have the same effect on Net Surplus (Deficiency) and on Net Income (Loss) as RPYL or Contingency. That is,

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the larger Operating Revenue on line 1 of USPS-9A would be offset by a new line appearing after line 27.

STATEMENTS OF REVENUE AND EXPENSE
(\$ IN MILLIONS)

USPS 9A

| LINE NUMBER | | FY 1998 ACTUAL | FY 1999 ESTIMATE 1/ | FY 2000 ESTIMATE | TEST YEAR B/R | TEST YEAR A/R |
|----------------|--|-------------------|------------------------|---------------------|------------------|-------------------|
| | REVENUE | | | | | |
| 1 | OPERATING REVENUE | 80,005.0 | 82,854.5 | 84,725.5 | 68,234.1 | 69,022.5 |
| 2 | APPROPRIATIONS | 87.3 | 71.2 | 84.4 | 87.1 | 87.1 |
| 3 | INTEREST INCOME | 44.5 | 28.5 | 27.4 | 27.2 | 27.2 |
| 4 | TOTAL REVENUES | 80,118.8 | 82,765.3 | 84,817.4 | 68,328.4 | 69,118.820 |
| | OPERATING EXPENSES | | | | | |
| 5 | POSTMASTERS | 1,710.4 | 1,757.1 | 1,803.2 | 1,878.3 | 1,889.4 |
| 6 | MANAGERS, SUPERVISORS & TECHNICAL PERSONNEL | 3,512.4 | 3,808.8 | 3,886.5 | 3,822.0 | 3,782.8 |
| 7 | CLERKS & MAILHANDERS | 17,848.1 | 18,318.8 | 19,011.2 | 19,442.5 | 19,118.1 |
| 8 | CLERKS, CAG K POST OFFICES | 8.4 | 8.8 | 8.3 | 8.7 | 9.8 |
| 9 | CITY DELIVERY CARRIERS | 12,078.2 | 12,670.2 | 12,888.3 | 13,787.1 | 13,838.1 |
| 10 | VEHICLE SERVICE DRIVERS | 467.3 | 489.8 | 497.6 | 523.0 | 511.9 |
| 11 | SPECIAL DELIVERY MESSENGERS | 71.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| 12 | RURAL CARRIERS | 3,878.2 | 3,887.2 | 4,153.8 | 4,389.8 | 4,355.8 |
| 13 | CUSTODIAL & MAINTENANCE SERVICES | 2,304.3 | 2,449.5 | 2,835.4 | 2,781.8 | 2,780.0 |
| 14 | MOTOR VEHICLE SERVICES | 873.1 | 882.5 | 708.8 | 724.3 | 722.7 |
| 15 | MISCELLANEOUS LOCAL OPERATIONS | 303.7 | 304.9 | 314.7 | 328.0 | 327.8 |
| 16 | CONTRACTURAL TRANSPORTATION OF MAIL | 4,242.2 | 4,278.6 | 4,559.1 | 4,755.1 | 4,819.8 |
| 17 | BUILDING OCCUPANCY | 1,439.4 | 1,507.0 | 1,583.7 | 1,633.7 | 1,633.7 |
| 18 | RESEARCH & DEVELOPMENT | 77.1 | 83.4 | 45.2 | 45.3 | 45.3 |
| 19 | EQUIPMENT MAINT. & MANAGEMENT TRAINING SUPPORT | 38.1 | 48.7 | 48.8 | 48.5 | 48.5 |
| 20 | SUPPLIES & SERVICES | 3,221.8 | 3,628.0 | 3,550.8 | 3,814.2 | 3,807.5 |
| 21 | HQ & AREA ADMIN. & CORPORATEWIDE PERSONNEL COSTS | 4,575.7 | 4,899.0 | 5,414.7 | 5,787.2 | 5,787.2 |
| 22 | DEPRECIATION, WRITE-OFFS, CLAIMS, & INTEREST | 3,533.2 | 3,719.8 | 3,784.8 | 4,274.8 | 4,150.0 |
| 23 | SUBTOTAL SEGMENTS 16, 18, AND 20 | 11,330.5 | 12,348.8 | 12,749.8 | 13,858.2 | 13,724.7 |
| 24 | FINAL ADJUSTMENTS | | 0.0 | 0.3 | 3.0 | 2.8 |
| 25 | TOTAL ALLOWED COSTS | 59,588.5 | 62,400.4 | 64,751.8 | 68,046.6 | 67,190.6 |
| | NET INCOME (LOSS) | 550.3 | 354.9 | 65.8 | (1,718.2) | 1,928.2 |
| 26 | CONTINGENCY | | | | 1,701.2 | 1,679.8 |
| | NET INCOME (LOSS) WITH CONTINGENCY | | | | (3,419.3) | 246.4 |
| 27 | RECOVERY OF PRIOR YEAR LOSSES | | | | 288.3 | 288.3 |
| 28 | TOTAL REVENUE REQUIREMENT | | | | 70,018.0 | 69,138.7 |
| 29 | NET SURPLUS (DEFICIENCY) | | | | (3,887.6) | (21.8) |

NOTE: NUMBERS MAY NOT ADD DUE TO ROUNDING

1/ Actual revenue and estimated accrued costs. Actual accrued costs and net income were \$82,391.8 and \$383.4 respectively.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-24. Please confirm that under your proposal, where the single-piece First-Class ("SPFC") rate is determined without regard to the "integer constraint," the rates of all other categories of mail would be higher by that amount required to make up the difference between the unconstrained SPFC rate and the rounded SPFC rate. If you do not confirm, please explain your answer.

RESPONSE TO USPS/OCA-T6-24

Not confirmed. There would be no shift in revenue from First-Class Letters to other mail classes or subclasses. As proposed, rates for workshare mail would be set by reference to the "calculated" non-integer single-piece rate, which would be determined based upon the litigated cost coverage for First-Class Letter Mail. See OCA-T-6, Part II, at 39. The SPFC integer rate would be selected so as to generate revenues greater than the "calculated" non-integer rate in order to permit the single-piece rate (paid by single-piece First-Class mailers) to remain the same for a period of two rate cases. A SPFC integer rate so selected would permit single-piece First-Class Mail to "break-even" over the two rate case periods using revenue generated during the first rate period to cover the expected revenue deficiency in the second rate period. Consequently, if adopted as intended, single-piece First-Class Mail would continue to bear its costs and appropriate mark-up, so as not to adversely affect other classes of mail. Moreover, rates for all other classes and subclasses of mail would be set in the same manner as in past proceedings.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-25. Please refer to the Postal Service's response to USPS/OCA-136 and confirm that the Postal Service indicated that its objective "is to extend the rate cycle for as long as possible in concert with the Board's policy on equity restoration." If you do not confirm please explain.

RESPONSE TO USPS/OCA-T6-25

Confirmed. However, it appears the Postal Service has operationalized its objective "to extend the rate cycle for as long as possible" to mean new postal rates will be in effect for a period of approximately two years. See OCA-T-6, Part II, at 34-35.

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USPS/OCA-T6-26. Please refer to page 46, lines 17-19, of your testimony, where you state: "I propose that in circumstances where the calculated single-piece rate in the second rate case is expected to increase by more than 1.5 cents above the existing SPFC integer rate, a change in SPFC rate would be warranted."

- (a) Please confirm that if the calculated single-piece rate in the second rate case is expected to increase by 1.4 cents or less, the existing SPFC integer rate would not be changed. If you do not confirm please explain.
- (b) If the calculated rate is 1.4 cents greater than the existing SPFC integer rate, how [] much revenue and net income would the Postal Service lose over the course of the second rate case period versus the amount that would be realized if the SPFC rate were increased by the indicated amount? If you are unable to quantify the amount of loss, please provide your best rough approximation and explain how it was calculated.
- (c) Would the pursuit of the Board's policy on equity restoration and the statute's breakeven requirement remain viable under such a scenario? Please explain your answer fully.

RESPONSE TO USPS/OCA-T6-26

(a) Partially confirmed. I proposed that the SPFC integer rate be changed in the second rate case (rather than maintaining the SPFC rate set in the first rate case) where the "calculated" non-integer rate was expected to increase by more than 1.5 cents above the existing SPFC rate as a suggestion, in part, to limit the volume shift between single-piece and workshare mail to approximately 5 percent. An increase in the "calculated" non-integer rate of 1.4 cents or less would also limit the volume shift between single-piece and workshare mail to approximately 5 percent. For that reason, an increase of 1.5 cent above the SPFC integer rate should be viewed as a suggestion. To the extent a volume shift between single-piece and workshare mail of more than 5 percent is not viewed as problematic, an increase in the "calculated" non-integer rate of

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more than 1.5 cents above the SPFC integer rate might be acceptable. Conversely, if a shift in volume of 5 percent (or less) is considered "too much," that suggests a "calculated" non-integer rate of less than 1.5 cents above the SPFC integer rate should be the limit. Ultimately, I would hope that the Postal Service and the Commission would collectively be able to agree on the circumstances under which an increase in the SPFC integer rate would be warranted for the second rate case.

(b) The size of the expected revenue deficiency in the second rate case period has meaning only in relation to the revenue generated during the first rate case period. The revenue generated in the first rate case period is intended to cover the expected revenue deficiency in the second rate case period. Consequently, another way to look at this question is to consider the size of the balance, positive or negative, in the SPFC Reserve Account at the end of the second rate case period. In the first rate case period, the SPFC integer rate might be 1.4 cents above the "calculated" non-integer rate (i.e., the difference is positive), producing a balance in the SPFC Reserve Account at the end of the first rate case period of approximately \$1.413 billion. In the second rate case period, the relationship might reverse, with the "calculated" non-integer rate now 1.4 cents more than the SPFC integer rate (i.e., the difference is negative). The balance in the SPFC Reserve Account at the end of the second rate case period would then be approximately -\$26 million (\$1.413 - \$1.439).

Alternatively, in the first rate case period, the SPFC integer rate might be set at 1.0 cent more than the "calculated" non-integer rate (i.e., the difference is positive).

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TO INTERROGATORIES USPS/OCA-T6-22-27

The balance in the SPFC Reserve Account at the end of the first rate case period would be approximately \$1.027 billion. If, in the second rate case period, the “calculated” non-integer rate is again 1.4 cents greater than the SPFC integer rate (i.e., the difference is negative), the balance in the SPFC Reserve Account at the end of the second rate case period would be approximately -\$431 million (\$1.027 - \$1.458). Of course, where the positive difference between the SPFC integer rate and the “calculated” non-integer rate is near 1.4 cents, more revenue is generated in the first rate case period and would cover more of the expected revenue deficiency in the second, resulting in a smaller negative balance. Conversely, as the positive difference between the SPFC integer rate and the “calculated” non-integer rate is much smaller than 1.4 cents, the result is a larger negative balance at the end of the second rate case period.

In my testimony, I proposed that the SPFC integer rate be changed at the time of the second rate case in circumstances where the “calculated” non-integer rate is expected to increase by more than 1.5 cents above the existing SPFC integer rate as a suggestion. Using 1.4 cents as the maximum (rather than 1.5 cents), changing the SPFC integer rate at the time of the second rate case would result in a positive balance of approximately \$622 million at the end of the second rate case period.

(c) Yes. Although I am not a lawyer, it is my understanding that the Postal Service views the Postal Reorganization Act’s “breakeven” requirement as a long-run objective to be achieved over a number of years. As proposed in my testimony, the rates for First-Class Letter Mail are intended to generate sufficient revenues to “break

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even” over two rate case cycles, a period of approximately four years, assuming the Postal Service adjusts rates every two years. To the extent the expected revenue deficiency in the second rate period is greater than the revenue generated during the first rate case period (i.e., there is a negative balance in the SPFC Reserve Account), the deficit would be of short-term duration, less than two years, as any positive balance in the SPFC Reserve Account would partially offset the expected revenue deficiency until the new SPFC integer rate is selected at the time of the third rate case. To the extent circumstances warrant a change in the SPFC integer rate at the time of the second rate case, there would be a positive balance in the SPFC Reserve Account at the end of the second rate case period—the Postal Service would not experience a deficit at all.

Similarly, in my view, the rate stability proposal can be pursued in conjunction with the Board’s policy statement on restoration of equity. A copy of the Board’s policy statement is attached. The second paragraph of the Board’s policy statement contemplates the possibility that circumstances will be such that equity restoration may not be achieved. My proposal considers a similar situation with respect to the SPFC Reserve Account; that is, the possibility that the revenue generated in the first rate case period is insufficient to cover the expected revenue deficiency in the second rate case period. Where the expected revenue deficiency in the second rate case period is large relative to the revenue generated in the first rate case period (i.e., there is a large negative balance in the SPFC Reserve Account), such that an increase in the

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"calculated" non-integer rate of more than 1.5 cents above the existing SPFC integer rate is likely, I propose that the SPFC integer rate be changed at the time of the second rate case proceeding. In effect, this would increase revenues, consistent with the Board's policy statement in paragraph two. Where the negative balance in the SPFC Reserve Account at the end of the second rate case period is smaller, the negative balance could be covered by a change in the SPFC Reserve Account at the time of the third rate case proceeding.

RESOLUTION OF THE BOARD OF GOVERNORS
OF THE
UNITED STATES POSTAL SERVICE
Resolution No. 95-9
Restoration of Equity and
Recovery of Prior Years' Losses

RESOLVED:

The Board of Governors hereby adopts the following Policy Statement affirming the Postal Service's commitment to the goals of breaking even over time and taking actions to improve its equity position. The Board intends to re-examine this Policy Statement on an annual basis.

POLICY STATEMENT ON RESTORATION OF EQUITY
AND RECOVERY OF PRIOR YEARS' LOSSES

- The Postal Service will plan for cumulative net income, in the period since implementation of the rates adopted in the most recent omnibus rate proceeding, *to equal or exceed the cumulative prior years' loss recovery target* for the same period. The cumulative prior years' loss recovery target is calculated by multiplying the test year amount for recovery of prior years' losses included in current rates by the number of years that will have elapsed since those rates were implemented.
- Whenever it is projected that the goal specified in the section above will not be met, the Board of Governors and Postal Service management, to the extent consistent with this policy objective and other pertinent policy considerations, will take actions which reduce costs and/or increase revenues.
- In the event that equity is projected to deteriorate due to the imposition of costs such as those imposed in prior *Omnibus Budget Reconciliation Acts*, the Board will determine whether to modify the goal specified above in order to prevent further deterioration of equity.

The foregoing resolution was adopted by the Board of Governors on July 10, 1995.


Secretary

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T6-22-27

USPS/OCA-T6-27. Under your proposal, would the indicated SPFC rate for the second rate case be determined based on estimated test year costs only or would it be based on test year costs less the amount of reserve calculated from the first rate case period? Please explain your answer.

RESPONSE TO USPS/OCA-T6-27

No. The *"calculated" non-integer single-piece rate* would be changed in both the first and the second rate cases, based upon the test year costs, revenues, cost coverage and volumes, etc., in each of the first and the second rate cases. The SPFC integer rate, at the time of the second rate case, would be maintained at the existing SPFC rate determined in the first rate case proceeding, except where the *"calculated" non-integer rate* is expected to be 1.5 cents greater than the existing SPFC rate. See OCA-T-6, Part II, at 45-46. At the time of the third rate proceeding, when it would again be time to change the SPFC integer rate, the *"calculated" non-integer rate* would be set in the same manner as in any rate proceeding, including test year costs, etc., in that proceeding. However, when the single-piece First-Class integer rate is set by the Commission, the balance in the SPFC Reserve Account, positive or negative, would be taken into account when selecting the new SPFC integer rate. See OCA-T-6, Part II, at 38.

DECLARATION

I, James F. Callow, declare under penalty of perjury that the answers to interrogatories USPS/OCA-T6-22-27 of the United States Postal Service are true and correct, to the best of my knowledge, information and belief.

Executed 6-30-00

James F Callow

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.


EMMETT RAND COSTICH

Washington, DC 20268-0001
June 30, 2000