

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

Docket No. R2000-1

Postal Rate and Fee Changes, 2000

**ANSWERS OF ALLIANCE OF NONPROFIT MAILERS
WITNESS JOHN HALDI TO
INTERROGATORIES USPS/ANM-T1-8-9**

The Alliance of Nonprofit Mailers ("ANM") hereby submits the answers of its witness John Haldi to interrogatories USPS/ANM-T1-8 and 9. Each question is stated and followed by its answer.

Respectfully submitted,



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USPS/ANM-T1-8. Please refer to page 10 of your testimony, where you state that:

A basic optimization problem faced by every firm is the selection of a cost-minimizing mix of inputs for producing a given quantity and quality of outputs at a given set of input prices. . . . Firms that produce a given volume and quality of outputs with a cost-minimizing mix of inputs are said to be operating on the efficiency frontier or production-possibility frontier. Firms that adopt a more costly mix of inputs are said to be operating inefficiently.

a. Throughout your testimony, you are critical of what you term the Postal Service's "failure" to test for cost-minimization. In the real world, do you believe that there is any test or analysis the Postal Service could attempt which would ever offer any realistic prospects of proving to the satisfaction of participants in postal ratemaking (including yourself) that the Postal Service is actually operating on the efficiency frontier, as you have described that condition above? If so, please provide full details on what that test is, what data would be required, and how the test should be conducted.

b. Assume hypothetically that the Postal Service did conduct an analysis or test to determine whether its operating plan was actually cost minimizing, and such analysis or test indicated that the Postal Service was *not* operating on the efficiency frontier (i.e., was "operating inefficiently"). What would be the significance of this result for postal ratemaking, in light of your acknowledgment (pg. 11) that the "standard here is not the perfection of 20/20 hindsight," that even "the best managers must work with incomplete data and uncertain projections," and that "[f]airness entitles management decisions to a certain amount of deference"?

c. Please confirm that postal management, without resort to the formal results of a global test of whether the Postal Service's operating plan was or was not cost minimizing at any given historical point in time, can identify specific opportunities to improve efficiency going forward, can develop plans and commit resources to capture those cost savings, and can incorporate the effects of such cost reduction and productivity enhancing programs in the revenue requirement in postal rate cases submitted to the Postal Rate Commission. If you do not confirm, please explain fully.

Response:

a. The question misstates my position. I am not asking the Postal Service to perform any global test of economic efficiency, to prove that it is operating precisely at the margin of the efficiency frontier, or to disprove the existence of any of the myriad potential inefficiencies from which a firm may

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suffer. Determining whether a particular firm is operating at its efficiency frontier would require a precise specification of its production function. I doubt that the available data would ever permit an analyst to specify the exact production function of any real-world firm, let alone a firm as large and complex as the Postal Service. Even requiring the Postal Service to provide qualitative evidence of the absence of inefficiency in each facet of its operations would be asking the Service to disprove the existence of a needle in a \$69 billion-a-year haystack. Such a standard of perfection would be impossible to enforce or administer, and I do not propose that the Commission hold the Postal Service to it.

The efficiency analysis I propose is much more narrowly focused. Specifically, when another participant offers credible evidence that a particular aspect of the Postal Service's management or operations suffers from a significant inefficiency, the Service should have the burden of refuting this evidence. If the Postal Service fails to do so, the costs caused by the efficiency should be excluded from the Postal Service's revenue requirement, and should not be attributed to individual classes and subclasses of mail. This type of scrutiny is not dissimilar to the internal scrutiny routinely performed by well-managed businesses in the private sector, or the iterative process for improving Postal Service efficiency sketched out in part c of your question.

I also understand that other regulatory agencies have also applied a similar standard of scrutiny in enforcing the "honest, economical and efficiency" standard as embodied in other regulatory statutes for nearly a century. Under the existing regulatory standard, I understand that ratepayers and other intervenors bear the initial burden of coming forward with evidence of particular areas of inefficiency in the operation of the regulated monopoly. If they come

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forward with such evidence, the regulated monopoly has an opportunity to defend itself and its practices. The standard thus demands credible evidence of inefficiency, and in no way holds the monopolist to a standard of perfection.

My testimony for ANM in this case identifies a significant area of inefficiency in the processing of flat-shaped mail. The unit costs of processing flat-shaped mail have risen in real terms for several years, as indicated by the inflation-adjusted unit cost data submitted in response to POIR No. 4. This trend alone is strong evidence of inefficiency: wage-adjusted unit costs should not increase for any product, especially an important product such as flats, for any prolonged period of time.¹ Moreover, the Postal Service's own witnesses and data have revealed several obvious explanations for this trend of rising costs: widespread shortages of space at Postal Service facilities (coupled with the extensive and prolonged utilization of annexes, with their admitted higher costs and inefficiencies), a widespread shortage of flat sorting capacity over a prolonged period of time, and massive reductions in the managerial ranks in tandem with reductions in the level of capital investment. With tell-tale data like

¹ The efficiency frontier depends upon the state of technology at any given time. Innovations tend to obsolete existing technology, and a characteristic of the efficiency frontier is that over time it either stays where it is (absent any technological change), or it expands. This means that the situation should remain unchanged or improve—certainly not get worse. To give a down-to-earth illustration of this somewhat theoretical discussion, if one looks back over the Postal Service's last 200 years, the efficiency frontier for transportation has undergone remarkable change, and the Postal Service has adapted (and continues to adapt) to such change. Horses and horse-drawn vehicles used for long-distance inter-city transportation of First-Class Mail were replaced with passenger trains during the latter half of the 19th century. In the 20th century, those passenger trains were replaced by trucks (for shorter hauls), along with airplanes (for longer hauls).

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these, determining that the Postal Service has failed to engage in economical and efficient management hardly requires a cutting-edge econometric study.

b. The answer depends on the strength of the evidence of inefficiency. If the evidence of inefficiency is weak or equivocal, Postal Service management certainly should get the benefit of the doubt. Furthermore, as explained in preceding part a, I do not believe that the Commission should reduce the Postal Service's revenue requirement merely because the Service has failed to attain theoretical perfection. The inefficiency identified in my testimony, however, is neither ambiguous nor trivial nor merely theoretical. When the Postal Service persists in operating inefficiently in the face of clear signs that it is doing so (e.g., wage-adjusted unit costs that continue increasing), then the significance of this result for postal ratemaking should be—as it is in all other regulatory forums—for the Commission to reduce the revenue requirement by the amount of the established inefficiency. The practical results of such action will be (i) to relieve ratepayers of the burden of subsidizing the inefficiency, and (ii) to reduce the Postal Service's stated profits in Test Year which, through its EVA variable pay program, may reduce managerial bonuses, thereby holding management accountable for the results. The Postal Service will still have ample cash flow and borrowing authority to execute its operating plan.

c. Confirmed. And without resort to the formal results of a global test of whether the Postal Service's operating plan was or was not cost minimizing at any given historical point in time, management should also be able to measure unit costs, identify inefficiencies as they emerge, and take timely corrective actions going forward so as to recapture known levels of efficiency and bring inflation-adjusted unit costs back down to previous levels, so that such higher

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inflation-adjusted unit costs would not be incorporated into the revenue requirement in postal rate cases submitted to the Postal Rate Commission.

USPS/ANM-T1-9. With respect to your proposed "remedy" of a disallowance of 1.2 cents per unit of outside-county Periodicals mail:

a. Please clarify that this proposed amount is independent of any of the contested costing methodological issues in this proceeding, and that you would advocate its application regardless of the costing methodologies adopted by the Commission.

b. Please clarify which of the following most nearly describes your proposal:

(i) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses), to reflect more fully the Postal Service's identified cost reduction programs, in order to arrive at a better estimate of what you believe *actual* Periodicals unit costs will be in the Test Year.

(ii) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses), to reflect identified (by you or someone else) cost reduction programs (in addition to the cost reduction programs identified by the Postal Service), in order to arrive at a better estimate of what you believe *actual* Periodicals unit costs will be in the Test Year.

(iii) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses), to reflect some as yet unidentified cost reduction programs (in addition to the cost reduction programs identified by the Postal Service), in order to arrive at a better estimate of what you believe *actual* Periodicals unit costs will be in the Test Year.

(iv) this amount constitutes what you believe the Commission should subtract from the unit costs, in addition to the cost savings (moving from the Base Year to the Test Year) already acknowledged by the Postal Service (either in its filing or in subsequent interrogatory responses) to reflect the Postal Service's identified cost reduction programs, in order to arrive at a better estimate of what you believe Periodicals unit costs hypothetically should be, regardless of what *actual* Periodicals unit costs will be in the Test Year.

c. Please confirm that the specific amount of the "remedy" (1.2 cents per unit) is based exclusively on your Tables 7 and 8, and its calculation is in no way related to any of the analysis you have presented in sections III or IV of your

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testimony. If you cannot confirm, please show mathematically exactly how any of the matters discussed in those sections affected the calculation of your "remedy."

Response:

a. First, I reemphasize that the wage-adjusted unit costs submitted in response to POIR No. 4 are the basis from which I developed my proposed remedy. I cannot attest to whether those costs were produced on a consistent methodological basis, but I would presume so. As such, the recorded increases in unit costs represent undeniable declines in productivity arising from the many problems discussed in my testimony.

Next, let me state that I draw a distinction between a "contested methodological" *issue* and a "contested methodological" *amount*. To my way of thinking, methodological issues include issues such as (i) the use of volume variable versus attributable costs, or (ii) the use of single subclass stop methodology for attributing city carrier street time. A contested *amount* would be a difference of opinion, for example, as to how much should be included in the Test Year for savings from the AFSM 100.

With these distinctions in mind, the answer is that my proposed remedy is independent of any of the contested methodological issues in this proceeding, as I am not concerned with reducing unit cost via some change in costing methodology. At the same time, however, it is not independent of some of the contested amounts (see my response to part b, *infra*, for further discussion on this point).

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b. Of the four choices proffered, your number (iv) comes closest to my proposal, which focuses on the standard of "honest, economical and efficient management"—i.e., what Periodicals unit costs ought to be under this standard, not what actual Periodicals unit costs will be in the Test Year. When the regulated monopolist can be shown to have failed to meet the above standard, it should not be allowed to recover the costs of inefficiency, even if actually incurred.

Let me clarify my position with respect to the question of what Periodicals unit costs ought to be in the Test Year. My response to USPS/ANM-T1-8 pointed out that the standard is not one of perfection. As shown in my testimony, Table 7, page 43, development of my remedy covered the years 1993 through Base Year 1998, while your question in (iv) raises the issue of cost savings from Base Year to Test Year. As pointed out in part a, supra, my proposed remedy is based on the decline in productivity and resulting increase in cost arising from failure of the Postal Service to meet the "honest, economical and efficient" standard. To the extent that the Postal Service has acknowledged its failings (either in its filing or in subsequent interrogatory responses) and has reflected cost reductions through its own increased productivity, it would amount to double counting to include my proposed remedy at the full amount along with these cost savings. Specifically, in Test Year the Postal Service is now belatedly installing additional flat sorting capacity to help overcome the accumulated shortfall since 1992. I suggest that all programmed cost savings for Periodicals from the AFSM 100s (some of which may also be included under "Equipment and Productivity Enhancement") be offset against my proposed remedy to avoid give the Service all benefit of doubt on this issue and avoid any possible double counting.

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c. The analysis in sections III and IV of my testimony show that the Postal Service has failed to meet the standard of "honest, economical and efficient" management, and that a remedy of the type which I propose is called for. The specific amount of my proposed remedy is developed in Table 7 and 8 of my testimony.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document on all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

David M. Levy

July 3, 2000

DECLARATION

I, John Haldi, declare under penalty of perjury that the foregoing answers are true and correct, to the best of my knowledge, information, and belief.


John Haldi

Dated: 6-30-00