

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

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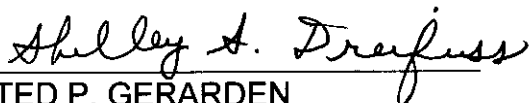
Postal Rate and Fee Changes, 2000)

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-T2-10-18)
(July 6, 2000)

The Office of the Consumer Advocate hereby submits the answers of Robert E. Burns to interrogatories USPS/OCA-T2-10-18, dated June 27, 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-T2-10-18

USPS/OCA-T2-10. Please refer to your response to USPS/OCA-T2-1(a), where you state: "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."

a. Please confirm that these utilities typically have positive equity. If you do not confirm, please explain.

b. What mechanisms, which are not available to the Postal Service, do not-for-profit utilities have to ensure their financial stability?

RESPONSE TO USPS/OCA-T2-10:

a. Municipally-owned and federal power authorities typically have proprietary capital, which is the equivalent to positive equity (although for purposes of ratemaking, it is considered to be the same as long-term debt). Sometimes, in the case of a municipally-owned utility, the proprietary capital is made up solely of retained earnings, with no investment by the municipality. In the case of cooperatively-owned utilities, the equivalent of positive equity would be memberships and patronage capital, provided by the cooperative owners, the users of the system.

b. Municipally-owned and cooperatively-owned utilities can issue tax-exempt bonds so long as the system is used for public purposes. The Postal Service can do the same. Municipally-owned utilities can also be subsidized from the municipal budget. However, I must point out that it is more common for municipally-owned utilities to have their retained earnings drawn upon by the municipality and applied to other municipal needs. Cooperatively-owned utilities can also create capital through membership and patronage capital, as well as obtain low-interest federal Rural Utility Service (formerly REA) loans. Federal power authorities also can issue low-interest,

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state-tax-exempt debt backed by the full faith and credit of the federal government, an
advantage shared by the Postal Service.

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USPS/OCA-T2-11. Please refer to your response to USPS/OCA-T2-3(a), where you state that "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."

a. Please provide a citation for the authority requiring the Postal Service to support its contingency requirement with a probability analysis of the type performed in the insurance industry.

b. Please confirm that the insurance industry probability analyses of the type you describe deal with the prediction of the number and severity of catastrophes in the future. If you do not confirm, please explain.

c. Please confirm that catastrophes have occurred in the past and will certainly occur in the future, the only question being their number and severity. If you do not confirm, please explain.

d. Please confirm that, in determining the required level of contingency, the Postal Service must take into consideration events that are totally unknown, and other events for which there is no history, such as volume erosion due to the Internet. If you do not confirm, please explain why these types of unknowns do not have to be considered.

e. Please confirm that items for which a history exists, such as natural disasters, lend themselves to probability analysis much more readily than items for which no history exists. If you do not confirm, please explain, and include in your answer how the Postal Service should model unknown events and events for which there is no history. Please state whether you have done or have had done any probability analysis similar to the type done by the insurance industry to support your recommended 1% contingency. If you have, please provide copies of any probability analyses you performed to support a 1% contingency.

f. Please confirm that your determination that a 1% contingency is adequate was based on a subjective interpretation of the various information you have provided. If you do not confirm, please provide the specific calculations which resulted in a 1% contingency.

RESPONSE TO USPS/OCA-T2-11:

a. I believe that a proper construction of past Commission statements leads to the conclusion that the Commission would wish to see the types of probability

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analyses that are performed in the insurance industry. For example, in Docket No. R87-1, the Commission articulated the standard for assessing a Postal Service proposal for a contingency: “management’s perception of . . . risks must be *articulated* to a *reasonable* degree in order to satisfy the substantial evidence requirement.” PRC Op. R87-1, para. 2073 (emphasis added). In the current proceeding, the Postal Service has refused to provide any documents or analyses that underlie its contingency proposal. Therefore, I believe that I can state justifiably that management has failed to “articulate” its reasons for proposing the increased contingency. Furthermore, I believe that the scant, subjective statements that have been made are not a “reasonable” method for determining the size of the contingency. Probability analyses, which would break down costs into their many component parts, hypothesize various scenarios that would cause costs to deviate from the projections already made in the roll-forward of costs, and assign probabilities for these events to occur, would constitute a “reasonable articulation” of the factors leading to a particular contingency.

Moreover, the Commission also advised the Postal Service that there is a “need for a more objective and systematic approach to determining and evaluating the Postal Service’s contingency needs.” *Id.*, para. 2116. This need would be satisfied by thorough, well-designed probability analyses.

In PRC Op. R76-1 at 53-54, the Commission stated that “[t]he contingency provision could be accounted for by a suitable post-audit procedure showing how far the actual costs have departed from the estimates.” In PRC Op. R77-1, the Commission stated, “Specifically, we believe that historical variance analysis will allow

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the Commission to project on a reliable basis the magnitude of adverse events befalling the Postal Service in any particular test year and thus provide a basis for the Commission to make allowance for these uncertainties Thus, we find appropriate the utilization of variance analysis as a starting point in evaluating the . . . contingency request.” The probability analysis and quantitative assessment that the insurance industry performs to determine its contingency reserve is analogous to the variance analysis required of the Postal Service for known, but uncertain and uncontrollable future risks. To the extent the Postal Service performed a variance analysis in this case, it explicitly did not base its contingency proposal on its analysis, but instead disavows the analysis. Therefore, the Postal Service does not have an appropriate starting point for making its contingency request.

b. Yes, probability analyses, which are closely related to a variance analysis, are used to predict the likely number, severity, and location of future catastrophes. They are, therefore, analogous to the type of variance analysis of known, but uncontrollable, risks that the Commission requires as a part of, indeed as a starting point, for a contingency reserve analysis.

c. Yes, catastrophes that are insurable events have occurred in the past and will occur in the future, with the question being their number, severity, and location. They are therefore known but uncontrollable events. The use of a quantitative assessment analysis allows insurance companies to isolate the causes of these events and to better predict their probability of occurrence, their number, severity, and location; and, in some instances to take appropriate steps to mitigate the risks posed by those

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future events. The proper use of variance assessment as an analytical tool might allow the Postal Service to better predict and control what was once considered to be unforeseen and uncontrollable events. As the Commission has stated, "the relative magnitude of unforeseen events, including external events, over the long run will tend to display a degree of predictability, based upon historical results." A properly performed variance analysis would allow the Postal Service to identify patterns of expenditures and revenue incurrence that might allow it to avert cost/revenue inequalities. In turn this would allow for smaller contingency amounts that lead to lower rates and an enhanced competitive position.

d. While the Postal Service may be able to take into account events that are totally unknown, it is important to bear in mind that the Commission will consider events that are "substantially certain to be" but not those that are "clearly speculative." PRC Op. R84-1, para. 1055. Furthermore, in Docket No. 87-1, the Commission observed that "the relative magnitude of unforeseen events, including external events, over the long run will tend to display a degree of predictability, based upon historical events." PRC Op. R87-1, para. 2077. Therefore, there are reasonable limits to the types of unknown events or uncertainties that ought to be given weight in the contingency analysis.

The fact that volume erosion from the Internet can be identified means that it is not unforeseeable nor unknown. I also disagree with the statement that there is no history of volume erosion due to the Internet. Volume erosion from the Internet simply had a short history when the volume analysis for the test year was performed. Indeed,

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Witness Tolley has taken such factors into consideration in his volume estimation procedure. See my testimony at 11, especially note 20.

While unforeseeable, unknown future risk must be accounted for in a contingency determination. Management's perception of those risks must be articulated to a reasonable degree in order to satisfy the substantial evidence requirement. To fulfill this requirement, the Commission suggested, in PRC Op. R87-1 at 36, that the Postal Service identify the set of events from which an intuitive sense of the risks might be drawn, consider the role of past experience in influencing the sensed magnitude and likelihood of the unforeseen risk, and indicate the importance of unforeseeable risks relative to recognized-but-unquantifiable risks. That analysis was not done.

e. I agree that items for which history exists lend themselves to probability and variance analysis more readily than for items for which no history exists. I also agree with the Commission, in Op. 87-1 at 37, that the relative magnitude of unforeseen events, including external events [and those that have no history], over the long run will tend to display a degree of predictability, based on historical events. The Postal Service should be able to identify with some degree of predictability the magnitude of unforeseen and external events. The variance analysis required by the Commission, in large part, fulfills this objective. Also, see my answer to interrogatory USPS/OCA-T2-12.

f. My determination that a 1% contingency is adequate is based in part on the objective variance analysis performed by Dr. Edwin Rosenberg. I used this as a

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starting point, then my analysis was influenced by the factors that Dr. Rosenberg cited: economic forecasts of continued vitality in the economy, low inflation, and low economic volatility. These point to keeping a low contingency of 1%. I rejected Witness Tayman's subjective analysis calling for more than a 1% contingency because it was unsubstantiated.

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USPS/OCA-T2-12. Please refer to your response to USPS/OCA-T2-3(c) where you state "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." Have you utilized the "forecasting methods" to which you referred to calculate a 1% contingency? If so, please provide the name of the "forecasting method," a description of the methodology it employs, and the specific calculations yielding a 1% contingency.

RESPONSE TO USPS/OCA-T2-12:

No. It is the primary responsibility of the Postal Service to use the most up-to-date analytical tools and the data, which is in their possession, to make an objective analysis of future costs; to do so in a fashion that could identify when risk mitigation devices, such as hedging can be used; and to engage in prudent management practices that home in on ways to deliver postal service at the lowest cost.

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USPS-T2-13. Please refer to your response to USPS/OCA-T2-4, where you state that "to find an estimate of the actual profit that is included in insurance rates, it is necessary to net out the net investment yield."

a. Please confirm that the question asked you "how much 'profit allowance' is typically included in insurance rates. If you do not confirm, please explain.

b. Please confirm that you have attempted to provide a different amount, *i.e.*, "the actual earned profit included in insurance rates." If you do not confirm, please explain.

c. Please explain net investment yield and how it is used.

RESPONSE TO USPS/OCA-T2-13:

a. Yes, I confirm that was the question.

b. I do not confirm that I have given a different answer from the one the question sought. In the insurance industry, a profit allowance does not come from insurance rates if it is the result of net investment yield. Further, the profit is only potential and not earned until the events that were insured against did not occur during the premium period. Profit from net investment yield comes principally from the investments that the insurance company makes on its cash flow from the unearned insurance premiums, that is, the insurance premiums for which there is still a potential liability. Any effort to compare insurance rate profits to postal rate profits would be comparing apples to pineapples.

c. See my answer in USPS/OCA-T-13(b). Again, most of the profit in casualty insurance typically comes from the net investment yield rather than from insurance rates; and, for some companies, insurance rates provide negative earned profits.

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USPS/OCA-T2-14. Please refer to your response to USPS/OCA-T2-5(a), where you state that "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." Is it your testimony that because the Postal Service was able to fund FY 99 Y2K costs through cost cutting in other areas and a re-programming of priorities that "the current contingency is sufficient"? Please explain fully and include in your explanation a discussion of what limitations there may be on cost cutting and re-programming of funds to offset unplanned adversities in the test year.

RESPONSE TO USPS/OCA-T2-14:

I believe that the ability of the Postal Service to, through prudent management of its resources, meet its Y2K remediation costs within its current 1 percent contingency while finishing FY 99 in the black, is one piece of evidence that the current contingency level of 1 percent is adequate. That the Postal Service was able to cut costs and reprogram priorities without any adverse effect on service is an example of how a lower contingency reserve will tend to keep the Postal Service prudent and efficient and provide it with a continuing incentive to eliminate waste. The only limitation that there may be on cost cutting and reprogramming of funds to offset unplanned for adversities in the test year or beyond is if the cost cutting and reprogramming adversely affect service rather than eliminate waste. On balance, however, there is a greater moral hazard of creating an environment for lax and inefficient management through setting the contingency level too high, rather than keeping it where it currently is.

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USPS/OCA-T2-15. Please refer to your response to USPS/OCA-T2-5(a), where you state that "management has input into salary levels, health care benefits, and labor contracts; and can project them fairly accurately into the future." You also state that "the one subjective perception of increased risk that Tayman articulated being an increasingly competitive environment was mostly taken into account by detailed volume forecasts."

a. Please confirm that some previous Postal Service labor contracts have been determined by binding arbitration and that Postal Service health benefit premiums are determined by the Office of Personnel Management. If you do not confirm, please explain.

b. Please confirm that the magnitude and timing of the impact of the increasingly competitive environment on mail volume is in a state of flux and while recognized, remains uncertain. If you do not confirm, please explain how a precise quantification of the impact can be known with certainty and how you know this impact was reflected in Postal Service volume forecasts used for this filing.

RESPONSE TO USPS/OCA-T2-15:

a. Yes, I confirm that some previous Postal Service labor contracts have been determined by binding arbitration. It is also my general understanding that health benefit premiums are determined by the Office of Personnel Management. See my answer to interrogatory USPS/OCA-T2-18(c).

b. I am unable to confirm this statement. As I pointed out in my testimony at 11, the Postal Service's volume witness took factors such as these into account. Witness Tolley states at 18 of USPS-T-6 that "the real price of important nonpostal alternatives, which include both direct competitor (UPS) and indirect competitors (like the price of newspaper advertising)" are used to develop the volume estimates. Another important consideration is that the 2001 test year is not a period of time that is very far into the future. It will actually be underway at the time the Commission issues its decision. (The test year begins October 1, 2000, while the Commission should issue

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its decision some time around November 12, 2000). According to the Commission, “[t]he closer the proximity of the test year” to the time forecasts are made tends to support a lower contingency. PRC Op. R94-1, para. 2042.

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USPS/OCA-T2-16. Please refer to your response to USPS/OCA-T2-5(b) and (c) where you state:

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 develop and use increasingly sophisticated objective means of risk analysis. 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.

a. Please provide a specific quotation in and citation to each of the Commission's Opinions in the last three omnibus rate cases (Docket Nos. R90-1, R94-1, and R97-1), stating an expectation regarding the use of "increasingly sophisticated objective means of risk analysis."

b. Please explain what "today's tools" are, when "today's tools" became available for use, and how you have used "today's tools" to support a 1% contingency.

RESPONSE TO USPS/OCA-T2-16:

a. PRC Op. R97-1 contained little discussion of the contingency, perhaps because the Postal Service had initially proposed, and the Commission eventually recommended, a contingency of one percent. However, the Commission did reject the Postal Service's eleventh-hour justification of a 1.5 percent contingency by characterizing it as "arbitrary" and a "plug figure." *Id.*, at para. 2030-31.

PRC Op. R94-1 approved the Postal Service's request for a 2 percent contingency, stating that the Postal Service had "openly and clearly articulat[ed] the rationale for its requested contingency allowance. . . ." Also, according to the Commission, the Postal Service "has fully presented management's reasons. . . ." *Id.*, para. 2037. More importantly, the Commission was convinced that a policy of "rate restraint," intended to "cause the Service to control and even reduce its costs," was

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desirable. *Id.*, para. 2038. The Commission continued: “a policy of rate restraint will most likely enforce more efficient and economical management . . . [i]nasmuch as a limited provision for contingencies contributes to rate restraint. . . .” I heartily support such a policy and note that my testimony at 6-7 articulates essentially the same principles.

In Docket No. R90-1, the Commission was critical of Postal Service testimony that “does not describe in any detail how managerial judgement was exercised.” Quoting from the witness’ response to an OCA interrogatory that unknowns were “subjectively considered” and the contingency was determined “judgmentally,” the Commission proceeded with its own analysis of the facts presented. PRC Op. R90-1, para. 2020. The Commission disagreed with the Postal Service’s view that the Commission “must” accept postal management’s judgment. Rather, the Commission insisted on independently examining the need for a contingency. *Id.*, at II-6, note 11. Of the facts put before the Commission, it was influenced by “projections offered by Postal Service witness Robertson . . . [of] weak economic growth” *Id.*, para. 2022. OCA Witness Rosenberg, on the other hand, cites economic forecasts of continued vitality in the economy, low inflation, and low economic volatility. These point to a low contingency.

b. Variance analysis and decision analysis techniques to name two have been available for at least a decade and need only be tailored to the Postal Service. Dr. Rosenberg used the objective variance analysis in his testimony to support a 1 percent contingency.

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USPS/OCA-T2-17. Please refer to your response to USPS/OCA-T2-8, where you state:

[T]he 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.

a. Please confirm that that the variables you mention, *i.e.*, improving or promoting service, withdrawing service, and advertising are only a few of the many variables that influence volume. If you do not confirm, please explain.

b. Please confirm that other variables, such as competition and the economy, also affect volume and are, to a large extent, outside the direct control of the Postal Service. If you do not confirm, please explain how the Postal Service can control its competitors and the economy.

RESPONSE TO USPS/OCA-T2-17:

a. I confirm that these are only some of the variables that influence volume, but they are important variables because they are within the Postal Service's control.

b. I confirm that the economy affects volume and that the economy is largely out of the Postal Service's control. I also confirm that competition from competitors affects values. However, while the Postal Service cannot control its competitors, it can aggressively meet the competition through proper pricing and marketing of competitive services.

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USPS/OCA-T2-18. Please refer to your response to USPS/OCA-T2-9, where you state:

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.

a. Have you done any analysis comparing the cost of additional overtime to the cost of additional health benefits? If your answer is other than no, please provide your analysis.

b. Are you recommending that the Postal Service handle any increasing workload by using overtime to avoid additional health benefit costs? If your answer is yes, how much additional overtime should the Postal Service use before hiring additional employees? Please explain how you reached your conclusion.

c. Please confirm that the cost of health benefit premiums (*i.e.*, the cost incurred per employee) is managed by the Office of Personnel Management (OPM).

RESPONSE TO USPS/OCA-T2-18:

a. No. I expect the Postal Service would do this.

b. I am recommending that the Postal Service consider the cost of handling increased workload through the use of overtime versus the cost of hiring additional employees and should act in a cost effective manner. Such an analysis should look not only at costs, but productivity.

c. Although I cannot definitively state that health benefit premiums are managed by OPM, it is my general understanding that this is correct. I wish to add that I believe it is reasonable to assume that OPM develops its estimates of future health

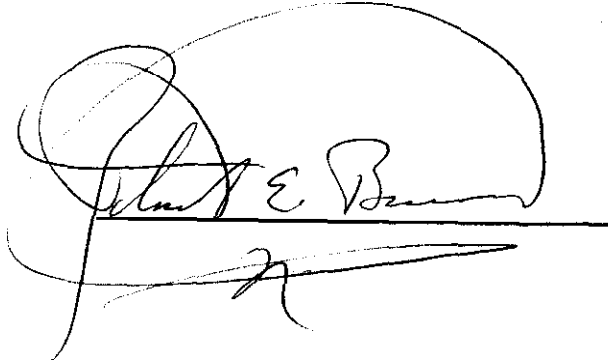
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benefit premiums with great care, very likely relying on relevant economic forecasts and indices of health care costs. The Washington Post (June 29, 2000, B2) recently published an article on a related topic – long-term care insurance – in which OPM officials were quoted as saying they “promise” that premiums for such insurance, scheduled to begin in late 2002, would be significantly lower than private companies’ premiums, and that the projection “is not ‘a made-up, pulled-out-of-the-air number.” Rather, “OPM checked with the Health and Human Services Department and a consultant before making its pledge of significantly lower premiums.” Therefore, health benefit premiums that are themselves founded upon careful analyses of costs should not be as liable to deviation from projected amounts as are estimates developed in a subjective, arbitrary, and judgmental manner.

DECLARATION

I, Robert E. Burns, declare under penalty of perjury that the answer to interrogatories USPS/OCA-T2-10-18 of the United States Postal Service, is true and correct, to the best of my knowledge, information and belief.

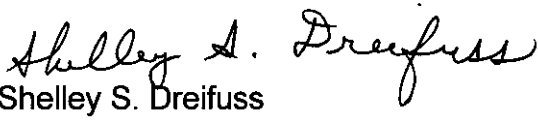
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A handwritten signature in black ink, appearing to read "Robert E. Burns", is written over a horizontal line. The signature is highly stylized and cursive, with a large loop at the top and a long, sweeping tail that extends to the right.

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
July 6, 2000