

USPS-T-3

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001**

**EXPERIMENTAL CHANGES TO
IMPLEMENT CAPITAL ONE NSA**

Docket No. MC2002-2

**DIRECT TESTIMONY
OF
CHARLES L. CRUM
ON BEHALF OF
UNITED STATES POSTAL SERVICE**

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LISTING OF ATTACHMENTS

Attachment A First-Class Mail Presort Costs and Revenues

Attachment B Financial Impacts of NSA

Associated Library Reference

USPS-LR-1/MC2002-2: Estimated Physical and Electronic Information Return Costs for Capital One UAA Mail

This library reference contains printed and electronic documentation of the spreadsheets necessary to estimate both the physical return unit costs and electronic information return unit costs.

1 **Direct Testimony**
2 **of**
3 **Charles L. Crum**

4
5 **AUTOBIOGRAPHICAL SKETCH**
6

7 My name is Charles L. Crum. I have worked for the Postal Service in a variety of
8 positions since 1995. From 1995 through 2000, I worked as an Economist in the
9 Product Cost/Special Studies office within Finance. During 2001, I was a Business
10 Process Specialist in Corporate and Business Development measuring the revenues
11 and costs of the Postal Service's new business ventures. Since the beginning of 2002, I
12 have been an Economist in the newly formed Pricing Innovation group under Pricing
13 and Classification/Marketing.

14 I have testified before the Postal Rate Commission (PRC) on several previous
15 occasions. In Docket No. R97-1, I developed the cost testimony supporting the
16 proposed Parcel Post dropship discounts including DDU (Destination Delivery Unit),
17 DSCF (Destination SCF), and OBMC (Origin BMC). That testimony also provided the
18 analysis presenting the cost difference between Standard Mail parcels and flats in
19 support of the Standard Mail parcel surcharge introduced as a result of that docket. In
20 addition I produced updated analyses of DBMC Parcel Post cost savings and Bound
21 Printed Matter Carrier-Route Presort cost savings. See Docket No. R97-1, USPS-T-28.

22 In Docket No. R2000-1, I created the cost analysis supporting the proposed
23 Bound Printed Matter destination entry discounts. That testimony also updated the
24 cost basis for the Standard Mail dropship discounts, the Periodicals dropship discounts,

1 the Standard Mail parcel surcharge, and the Bound Printed Matter Carrier Route presort
2 discount. See Docket No. R2000-1, USPS-T-27.

3 Prior to joining the Postal Service, I was employed by Westvaco Corporation
4 between 1989 and 1995 in a series of increasingly responsible positions within both the
5 Fine Papers and Envelope divisions. My duties were in the areas of
6 financial/cost/economic analysis, accounting, management, quality, systems, pricing,
7 and administration at several plant locations throughout the United States. My final
8 position with Westvaco was as Administrative Manager (Controller) at the Indianapolis
9 Envelope Plant.

10 I earned a Bachelor of Science degree, cum laude, in Engineering Operations
11 from North Carolina State University and a Master's of Business Administration from the
12 Fuqua School of Business at Duke University.

1 **I. PURPOSE OF TESTIMONY AND GUIDE TO RELATED DOCUMENTATION**

2 The purpose of my testimony is to estimate the financial impact on the Postal
3 Service of the Negotiated Service Agreement (NSA) executed by the Postal Service and
4 Capital One Services, Inc. (Capital One). My testimony describes the data inputs,
5 presents the financial impact of the NSA, and supplies witness Plunkett (USPS-T-2)
6 with analysis necessary to support his testimony.

7 This testimony relies on the data provided by Capital One witnesses Jean and
8 Elliott (COS-T-1 and COS-T-2, respectively), Postal Service witness Wilson (USPS-T-
9 4), and the agreement itself which is Attachment G to the Request. I also rely on
10 USPS-LR-1/MC2002-2 which I am sponsoring and which is closely associated with my
11 testimony.

12 **II. USPS FINANCIAL IMPACTS OF THE PROPOSED NSA**

13 **A. Background**

14 My testimony presents the three items that determine the estimated value of this
15 NSA to the Postal Service:

- 16 1. Increased Contribution from Additional Mail Volume
- 17 2. Cost Savings from Conversion to ACS
- 18 3. Discount Leakage

19 As shown in the agreement and in Attachment B, page 3 of my testimony, the
20 Postal Service is proposing declining block rate discounts for Capital One starting above
21 an initial annual threshold of 1.225 billion First-Class Mail pieces. Based on these
22 discounts and the testimony of witnesses Jean and Elliott regarding the volume
23 response of Capital One to the proposed discount structure, the Postal Service expects

1 to see new First-Class Mail volume which will result in additional contribution to
2 institutional cost. The calculations showing the estimated new contribution based on
3 additional mail volume are more fully described in Section B of my testimony below.

4 The second item determining the estimated value to the Postal Service is cost
5 savings resulting from conversion by Capital One from physical return of its solicitation
6 mail pieces to the use of Address Change Service (ACS). Rather than having its
7 undeliverable-as-addressed (UAA) solicitation mail pieces physically returned, Capital
8 One will be receiving address correction information primarily electronically through the
9 ACS system. The ACS system is described more fully in the testimony of witness
10 Wilson. Conversion to ACS saves the Postal Service the cost of returning UAA
11 solicitation pieces through the mail stream back to the location where Capital One would
12 have processed return mail. The cost savings are more fully described in Section C of
13 my testimony below.

14 The final element determining the estimated value of the NSA to the Postal
15 Service is discount leakage. This is the revenue reduction due to the proposed
16 discounts on pieces that Capital One would have mailed in the absence of any
17 discounts from the NSA. It is the only measured element that has a negative impact on
18 the financial summary and is described in Section D of my testimony below.

19

20 **B. Increased Contribution from New Mail Volume**

21 As discussed in the testimony of witness Jean, Capital One uses First-Class Mail
22 for two main business needs: it sends solicitations to potential new customers and
23 statements and other mail to existing customers (customer mail). The Postal Service

1 and Capital One expect the proposed discounts to result in additional First-Class Mail
2 volume from Capital One. Capital One witness Elliott presents the test year before
3 rates and test year after rates volume forecasts at Exhibit 6 of COS-T-2. For the test
4 year, which is fiscal year 2003, witness Elliott estimates a net increase of 15,458,969
5 pieces.

6 Given the estimated additional First-Class Mail volume as a result of the NSA,
7 that volume is then multiplied by the estimated unit contribution of the additional pieces
8 to project the increase in contribution expected from the new volume. My Attachment A
9 develops the revenue and cost components needed to calculate the unit contribution of
10 the additional mail volume. The estimated average test year unit revenue for Capital
11 One First-Class Mail is calculated by multiplying the FY 2001 Capital One presorted
12 First-Class Mail volume mix (Attachment A, page 1) by the current rates. The resulting
13 estimated Capital One First-Class Mail presort unit revenue is \$.2910 (Attachment A,
14 page 1).

15 Estimated Capital One First-Class Mail presort test year unit costs are developed
16 in Attachment A, page 2 of my testimony. I assume that the Capital One unit costs by
17 rate category equal the Postal Service unit costs by rate category. For example, I
18 assume that Automation 3-Digit Presort Letter unit costs for Capital One are the same
19 as the Automation 3-Digit Presort Letter unit costs for the Postal Service. To find the
20 unadjusted Capital One average unit cost, I multiply the rate category unit costs by the
21 known proportion of Capital One volume in each rate category to calculate a weighted
22 average. To find the total Capital One average unit cost, I adjust the calculated unit
23 cost based on the known difference between Capital One solicitation and customer mail

1 return rates and the postal subclass average. Attachment A, page 2 shows Capital
2 One's estimated unit costs both before implementation of the NSA rates and after
3 implementation of the NSA rates. The Capital One test year after rates First-Class Mail
4 presort estimated unit costs are \$0.1266.

5 Once we have the volumes, revenues, and cost, the contribution calculation is
6 relatively straightforward. The estimated contribution per piece from new mail volume is
7 the difference between unit revenue and costs ($\$0.2910 - \0.1266) less the proposed
8 discount (from the appropriate range in the declining block rate table). Since both the
9 test year before rates volume and the test year after rates volume are within the 1.375
10 billion to 1.450 billion "block" of the proposed discount table where the discount is 4.5
11 cents, the additional unit contribution of new mail volume is $\$0.1194$ ($\$0.2910 - \0.1266
12 $- \$0.045$). To calculate the total increased contribution from new mail volume, I multiply
13 the lower end of the additional mail volume estimate of 15.458969 million pieces (COS-
14 T-2, Exhibit 6) by the unit contribution of $\$0.1194$. This provides a total contribution
15 estimate from Capital One new mail volume of \$1.8 million. The detailed calculations
16 are also shown in Attachment B, page 1 of my testimony.

17

18 **C. Address Change Service (ACS) Return Cost Savings**

19 As part of the agreement, Capital One will accept ACS in place of physical
20 returns for its First-Class Mail solicitations (Refer to Attachment G of Request). This will
21 result in cost savings to the Postal Service by replacing costly physical returns with less
22 costly electronic information. USPS-LR-1/MC2002-2 describes the estimated Capital
23 One physical First-Class Mail return costs and the estimated Capital One electronic

1 “return” unit costs. This library reference is based on the testimony of Postal Service
2 witness Abdirahman (USPS-T-42) in Docket No. R2001-1.

3 Estimating the savings associated with conversion to ACS requires several
4 steps. First, the physical return costs need to be calculated. As shown on page 1 of
5 USPS-LR-1/MC2002-2, the estimated Postal Service cost of physically returning Capital
6 One First-Class Mail is 53.47 cents per piece. This cost was calculated by taking the
7 estimated cost of physically returning a mail piece as calculated in USPS-LR-J-69 (from
8 Docket No. R2001-1) and adjusting it to remove the costs associated with collection of
9 postage due which is not applicable to Capital One First-Class Mail pieces.

10 Second, the cost of electronic “returns” must be calculated. Page 2 of USPS-LR-
11 1/MC2002-2 shows that the estimated cost of electronically handling Capital One UAA
12 mail from point of return as 33.21 cents per piece. This cost is calculated by adjusting
13 the electronic Address Correction Service costs provided by Postal Service witness
14 Abdirahman in Docket No. R2001-1 (USPS-LR-J-69) to include costs that ACS mail
15 pieces incur prior to actual electronic Address Correction Service processing. The
16 difference between the cost of physically returning the mail piece and electronically
17 handling the UAA mail piece provides the estimated unit cost savings of 20.26 cents.
18 However, not every piece of UAA mail bearing the Change Service Requested (CSR)
19 endorsement will receive an electronic notice. Witness Wilson (USPS-T-4) estimates
20 that 85 percent of UAA pieces with a CSR endorsement are successfully handled
21 electronically and the physical piece is not returned.

22 Another item necessary to calculate the return cost savings is the Capital One
23 return percentage for its solicitation volume. This was shown to be 9.6 percent (COS-T-

1 1). This is relevant because, as discussed above, Capital One has agreed to accept
2 ACS handling for its endorsed First-Class Mail solicitation pieces. For each solicitation
3 piece found to be UAA, the Postal Service will save the difference between the cost of
4 physical returns and the cost of electronic ACS notification.

5 I use the factors above to calculate the returns adjusted unit cost for both test
6 year before rates and the test year after rates. My Attachment B, page 2, calculates
7 the total ACS return cost savings as \$13.1 million.

8

9 **D. Discount Leakage**

10 Discount leakage measures the discounted revenue associated with the declining
11 block rates for mail volume that Capital One would have mailed even in the absence of
12 the proposed NSA. It is equal to the test year before rates First-Class Mail volume
13 forecast less the volume in each tier of the declining block rate table times the
14 applicable discount. Attachment B, page 3 of my testimony fully describes the
15 calculation and presents the total estimated discount leakage of \$6.7 million.

16

17 **E. Summary**

18 In summary, the total net value of the proposed NSA to the Postal Service is the
19 additional contribution from new mail volume plus the savings due to Capital One's
20 conversion to ACS returns minus the leakage from discounts. As shown in my
21 Attachment B, page 4, I estimate the net test year value of the proposed NSA to be \$8.2
22 million. This estimate is conservative because I have used the minimum estimated new
23 Capital One volume of 15 million provided by witnesses Jean (COS-T-1) and Elliott

1 (COS-T-2). Using the higher end of the additional volume estimate provided by
2 witnesses Jean and Elliott (53 million) results in a calculated value to the Postal Service
3 from this NSA of about \$12 million in the test year.

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