

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001**

**EXPERIMENTAL RATE AND SERVICE
CHANGES TO IMPLEMENT NEGOTIATED
SERVICE AGREEMENT WITH
CAPITAL ONE SERVICES, INC.**

DOCKET No. MC2002-2

**RESPONSE OF CAPITAL ONE SERVICES, INC.
WITNESS STUART ELLIOTT TO INTERROGATORIES OF
AMERICAN POSTAL WORKERS UNION, AFL-CIO
filed on November 1, 2002
(APWU/COS-T2-1-7)**

Capital One Services, Inc hereby provides the response of witness Stuart Elliott to the following interrogatories of the American Postal Workers Union, AFL-CIO APWU/COS-T2-1-7, filed on November 1, 2002.

Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted

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Dated: November 12, 2002

RESPONSE OF CAPITAL ONE SERVICES, INC. WITNESS STUART ELLIOTT TO INTERROGATORIES OF AMERICAN POSTAL WORKERS UNION, AFL-CIO

APWU/COS-T2-1. Is it your understanding that the quarterly customer and solicitation mail figures that you present in Exhibit 2 covered all the types and sources of mail that will be covered under the proposed Negotiated Service Agreement between Capital One and the USPS? Does the customer mail include all customer mailings associated with the credit card business, auto loan business and other consumer loan business of Capital One Financial Corporation, its subsidiaries or affiliates or Capital One Services, Inc. or its subsidiaries or affiliates? Does customer mail include any customer mailings associated with the international credit card businesses of Capital One Financial Corporation, its subsidiaries or affiliates or Capital One Services, Inc. or its subsidiaries or affiliates? Does the customer mail include customer mailings for auto loans owned by other entities but serviced by Capital One Financial Corporation, its subsidiaries or affiliates or Capital One Services, Inc. or its subsidiaries or affiliates? If it does include any or all of these business segments, do you know what percent of the mail volume by FY and type is generated by each segment? If so, please provide this information.

ANSWER

APWU/COS-T2-1. It is my understanding that the figures for Customer Mail and First-Class Mail Solicitations presented in Exhibit 2 cover all the types and sources of mail that will be covered under the proposed Negotiated Service Agreement. I do not have a breakdown of the mail covered by the proposed Agreement that separates credit card, auto loan, and other consumer loan products, or that separates domestic and international products, or that separates mail under servicing arrangements and mail not under servicing arrangements.

Please note that in the Exhibit 2 originally filed with my testimony, the volume from a one-time customer mailing in October and November 2001 is erroneously included in the First-Class Mail Solicitations figures rather than the Customer Mail figures. In the errata filed for my testimony on November 1, 2002, the volume from this one-time mailing is removed from First-Class Mail Solicitations and noted instead as a footnote to the table.

In addition, please note that the figures in Exhibit 2 are monthly, not quarterly as stated in the interrogatory.

APWU/COS-T2-2. On page 3 of your testimony, you indicate that the 640 million pieces of customer mail in the Capital One projections represents growth of 9.8 percent from the estimated 583 million pieces (now revised to 581 million based on your response to OCA/COS-T2-5) of customer mail that was generated in FY2002. Mr. Jean, on page 4, of his testimony indicates that his forecast of 640 million pieces will represent virtually no growth in customer mail between FY2002 and FY2003. Please confirm that customer mail in your Exhibit 2 is defined the same way customer mail is defined by Mr. Jean on page 4 of his testimony. If you cannot confirm, please explain the difference in definitions. Please explain the difference in your numbers and Mr. Jean's for customer mail.

ANSWER

APWU/COS-T2-2. The Customer Mail figures in my testimony omit a one-time mailing in October and November 2001 related to a change in the contract between Capital One and its customers. In my testimony, the volume from this one-time mailing is erroneously included with the volume for First-Class Mail solicitations. This error is corrected in the errata filed for my testimony on November 1, 2002. The comparison between FY 2002 and FY 2003 Customer Mail figures made by Witness Jean in his testimony on page 4, lines 14-15, uses figures for FY 2002 that include the one-time mailing in October and November 2001.

APWU/COS-T2-3. On page 4 of your testimony, you indicate that the growth rates of the projected mail are supported by Capital One Financial Corporation's July 16th 2002 8-K filing with the SEC. In analyzing the Capital One mail volume did you consider different growth rates for different segments of the business of Capital One Financial Corporation, its subsidiaries or affiliates or Capital One Services, Inc. or its subsidiaries or affiliates in doing this analysis? On the same page of the 8-K quoted in your report, Capital One Financial Corporation makes the statement that "The somewhat lower loan growth in the second half of 2002 will also be accompanied by somewhat lower marketing expenditures." Did you estimate the relationship between the marketing activities of Capital One Financial Corporation, its subsidiaries or affiliates or Capital One Services, Inc. or its subsidiaries or affiliates and their subsequent new accounts? If you did what were the results?

ANSWER

APWU/COS-T2-3. Yes, I considered the impact of different growth rates for different segments of Capital One's business. In particular, I noted that the Business Outlook section of Capital One's July 16, 2002, 8-K filing explains that loan growth will be higher than account growth because of a shift towards higher-end accounts.

My Exhibit 7 includes a simple analysis of the relationship between Capital One's marketing activities and its subsequent new accounts, using the industry average solicitation response rate of 0.6 percent. As a background check for consistency when preparing my testimony, I also made some rough estimates of the net new accounts that will result during FY 2003 from Capital One's solicitations during FY 2003. These estimates suggest a level of net new account growth consistent with the 9.8 percent growth in Customer Mail from FY 2002 to FY 2003 reported in my testimony. (The 9.8 percent growth figure excludes the one-time mailing in October and November 2001, which is appropriate when comparing Customer Mail growth and account growth to judge their consistency.)

APWU/COS-T2-4. On page 4 of your testimony at 20-22, you state that since the levels of solicitation and customer mail projected by Capital One for FY2003 follow the Company's announced strategy, those projections are a reasonable estimate of the Company's mail volume. Since your testimony was filed, Capital One Financial Corporation has filed another 8-K with the SEC (on October 15, 2002). In the press release that accompanied that release, Nigel W. Morris, Capital One Financial Corporation's President and Chief Operating Officer states "We expect marketing to increase in 2003 as we take advantage of the attractive opportunities that we see in all major areas of our business including US card, installment and auto loans, and our international activities." Does this stated strategy still make you anticipate lower volumes of First Class solicitation mail in FY2003 than Capital One Financial Corporation, its subsidiaries or affiliates or Capital One Services, Inc. or its subsidiaries or affiliates mailed in FY2001? Please explain your assessment.

ANSWER

APWU/COS-T2-4. The quoted statement from the October 15, 2002, press release is consistent with the statement from the July 16, 2002, 8-K that I quote in my testimony on page 4, lines 14-15. As a result, the more recent quote does not suggest any need to update the volume projections for FY 2003 contained in my testimony.

APWU/COS-T2-5. You seem to be familiar with the work of USPS witnesses Tolley and Thress from the R2001-1 rate case. Their analysis discusses some potential tradeoffs between First Class solicitation mail and Standard solicitation mail. Did you consider such a tradeoff when doing your analysis of the change in First Class volume due to a change in the discount structure for First Class mail? Would you anticipate that Capital One would switch volume from Standard mail to First Class mail as a result of this agreement? If so, what would be the expected magnitude of such a switch?

ANSWER

APWU/COS-T2-5. I considered the possibility that Capital One would switch volume from Standard Mail to First-Class Mail as a result of the proposed agreement. However, as Witness Jean states in his testimony on page 3, lines 18-20, the Company does not believe that the size of this switch will be significant. I have not estimated the size of such a switch independently.

APWU/COS-T2-6. In your calculations, you have used the marginal price discount change in conjunction with the own price elasticities. Would you agree that the price elasticities have been calculated on data that show the price change for the entire volume rather than the price change for only a small part of the volume? Please provide your reasoning for using the price elasticities in this way.

ANSWER

APWU/COS-T2-6. I agree that the price elasticities have been calculated on data that show the price change for the entire volume. However, it is essential to understand that the resulting price elasticities are estimates about *marginal* changes in behavior. The importance of examining the behavior of economic decision makers at the margin is one of the basic insights of modern microeconomics.

If the marginal price of mail goes down for Capital One, then the Company will be able to make an adequate profit on lower-value solicitations that wouldn't generate an adequate profit at current postage rates. The price elasticity indicates how much of this marginal lower-value mail will be worth mailing when the marginal postage rate goes down.

On the other hand, for the higher-value mail that is already being sent at current postage rates, a reduction in postage won't have any effect on volume. In a simple single-price market, the only way for the Postal Service to obtain the lower-value mail from Capital One would be to offer a lower price on both higher-value and lower-value mail. However, with declining block rates, the Postal Service is using a more complex pricing system that effectively charges a higher rate for the higher-value mail and a lower rate for the lower-value mail. This more complex pricing mechanism allows the

Postal Service to provide the same marginal incentive for volume growth as with a single-price discount on all mail, while requiring that the discount be paid on only part of that mail.

APWU/COS-T2-7. You use a new account yield on solicitations of 0.6 percent in your calculations in Exhibit 7. Is that yield for First Class solicitations, Standard solicitations or a mix of both?

ANSWER

APWU/COS-T2-7. As indicated by footnote 8 of Exhibit 7, I am using the industry average solicitation response rate as a proxy for the New Account Yield from solicitations. It is my presumption that the BAIGlobal estimate of the response rate averages over all credit card solicitations by mail, including both First-Class Mail and Standard Mail. However, I do not have any details about the methods used by BAIGlobal to estimate this figure.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served six (6) copies of the foregoing document upon the United States Postal Service by hand in accordance with Section 12 of the Rules of Practice.

Timothy J. May

Dated: November 12, 2002