

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

RESPONSES OF UNITED STATES POSTAL SERVICE TO INTERROGATORIES
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO
(APWU/USPS-1-2)

The United States Postal Service hereby provides its responses to the following interrogatories of the American Postal Workers Union, AFL-CIO: APWU/USPS-1, filed on November 14, 2002 and APWU/USPS-2, filed on November 15, 2002.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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November 25, 2002

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

APWU/USPS-1. You provided a preliminary FY2003 Integrated Financial Plan as a response to OCA/USPS-5 with a promise to follow-up with a by-AP spread after the audit was complete. Given the changes in Postal Services' financial outlook based on the revised CSRS findings, please provide a revised Integrated Financial Plan and AP spread based on changed pension funding assumptions.

RESPONSE:

The FY 2002 audit has not yet been completed. Because legislative change is required to revise funding of pension costs, it is premature to modify FY 2003 financial projections.

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

APWU/USPS-2. The proposed experimental Negotiated Service Agreement between the USPS and Capital One Services, Inc. is expected to last for three years. The proposed rates in the agreement may not be static over that time period. Under certain conditions, there are different discounts proposed for years 2 and 3 depending on mail volume in year 1. In addition, the Postal Service will be implementing new automation capabilities during this time period that USPS witnesses have indicated will decrease the Postal Services' costs of processing Undeliverable as Addressed mail. Since a reduction in those costs is one of the primary reasons that the Postal Service is willing to enter in to this NSA, it is not possible to adequately analyze this agreement without having a complete revenue and cost analysis for the full three years of this experiment.

- (a) Please provide an extended cost and revenue analysis, in the same detail as that already provided by witness Crum, that covers the full three years of this agreement.
- (b) Please include reasonable assumptions about the upcoming changes in the costs of handling UAA mail due to the implementation of the PARS system and provide all information that will support those assumptions.
- (c) If Capital One Services, Inc. is unable to provide volume assumptions for this time period, please make reasonable assumptions and provide documentation on how those assumptions were arrived at.
- (d) Please provide an analysis as to how the revenue and cost numbers would change if the circumstances were to occur that would trigger the discounts listed in III. F. of the agreement.

RESPONSE:

The Postal Service does not agree with the assertion within this question that adequate analysis of the proposal is not possible without a complete revenue and cost analysis for the full three years of the agreement. Recommended rates which last beyond the test year, into periods in which subsequent developments may cause potentially material changes in postal volumes, operations, and costs, are not only common in postal ratemaking, but are virtually universal. Nonetheless, the single period test year is established by the Commission's rules as the appropriate basis for analysis by the Commission when such changes in rates are proposed. The circumstances in this instance are really no different than those present in the overwhelming majority of Commission proceedings.

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

If the Postal Service had available all of the information necessary to construct the requested analysis by the same means as which the test year analysis was developed, debate as to whether it was necessary to present that information on the record might be fruitful. In fact, however, such information does not exist. In contrast with the FY 2003 information originally submitted in Docket No. R2001-1 and reused as the basis for the test year in this proceeding, no cost rollforward has been developed to generate cost estimates that would be applicable to the second and third years of this proposal. Similarly, no attempt to extend the forecast of Capital One's volumes to those years has been made, and no realistic foundation for any such extension exists.

In an attempt to be responsive to the request for some indication of how the proposal might play out in the later years of the agreement, however, the Postal Service has developed the following analysis.

a.-c. These subparts seek an extended analysis that corresponds to that initially provided by witness Crum, assessing the financial impact of the proposal in the test year. Witness Crum examined three types of impacts from the agreement – increased contribution from new mail, ACS return costs savings, and revenue leakage from the declining block discounts. Considering all three factors, witness Crum estimated that the net effect in the test year would be net increase in contribution to institutional costs of \$8.205 million. In response to this question, the Postal Service has sought to show the potential effects on the results presented by witness Crum under a series of hypothetical assumptions regarding the movement of costs and volumes during the second and third years of the agreement. Simply stated, those assumptions, in the absence of any more definitive information, are that the cost and volume factors which

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

drive witness Crum's results could plausibly rise or fall by 5 percent in the second year of the agreement, and an additional 5 percent in the third year. The purpose of this exercise is not to establish that movements of that magnitude represent the totality of possible post-test year developments, but rather to illustrate quantitatively what the effects would be of plausible variations in costs and volumes moving forward in time.

The results are shown on the first attached spreadsheet, labeled "Baseline Test Year." This spreadsheet shows the effect, on each of the three factors, and then on net, of movements in costs and volumes. To put the components of the spreadsheet in context, it may be useful to have Pages 1-4 of witness Crum's Attachment B available for comparison. The calculations are done so that separate results are obtained if costs and volumes move in the same direction, and if costs and volumes move in opposite directions. In each relevant instance, therefore, the results show what happens in each of four scenarios -- if volumes and costs both go up (V+,C+), if volumes go up but costs go down (V+,C-), if volumes go down but costs go up (V-,C+), and if both volumes and costs go down (V-,C-).

The first display in the spreadsheet is Volumes, which starts by presenting the TYAR and TYBR volume forecasts already on the record. Continuing, the spreadsheet shows for Year 2 of the agreement the volumes that would result if BR and AR volumes both increase or decrease 5 percent from their test year levels, and for Year 3, the volumes that would result if BR and AR volumes both increase or decrease 10 percent from their test year levels.

Using these volumes, the next display shows the first of witness Crum's factors, Increased Contribution from New Mail Volume. Increased contribution is the new

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

volume (i.e., the volume resulting from the agreement, or, in each year, AR volume minus BR volume), multiplied by the applicable unit contribution. The unit contribution calculation takes witness Crum's unit revenue of \$.2910 as a given, and subtracts the applicable unit cost, and the applicable discount. For each year, therefore, a unit cost that increases or decreases 5 or 10 percent must be applied. These are shown as, for example, Y2UC+, which signifies a unit cost in Year 2 which is 5 percent higher than the unit cost used by witness Crum for the test year (\$.1266), or Y3UC-, which signifies a unit cost in Year 3 which is 10 percent lower than the test year unit cost. (Throughout the spreadsheet, all Y2 numbers represent a change of 5 percent, and all Y3 numbers represent a change of 10 percent.) Note that this methodology does not presuppose any particular reason why unit costs would go up or down by any particular amount. It merely reflects what the results would be if the totality of factors that could affect unit costs result in a net change of the indicated amount. The last element of the calculation, the applicable discount, must be calibrated to the volume interval or intervals in which the new volume would fall, starting at BR levels and proceeding to the AR levels.

For the test year, witness Crum estimated an Increased Contribution amount of \$1.846 million. The attached spreadsheet shows that moderate cost and volume movements in years 2 and 3 would still yield results for those years similar to witness Crum's test year estimate. The cumulative and/or offsetting effects of changing discounts and changing unit costs produce results ranging from a high of \$2.076 million in Year 3 with a 10 percent increase in volumes and unit costs, and a low of \$1.645 million in Year 3 with a 10 percent increase in volumes and a 10 percent decrease in

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

unit costs. As noted, these results bunch fairly tightly around the original test year estimate.

The next display shows the second of witness Crum's factors, the ACS Return Costs Savings. Those savings are a function of the before-rates volume (a higher portion of which, without the agreement, would have been returned), and the unit cost difference associated with the reduction in returns. Witness Crum used a test year cost difference of \$.0093, and for purposes of this exercise, that figure has been adjusted as, for example, Y2CD-, which shows a cost difference for Year 2 of \$.0088, which is 5 percent less than \$.0093. Once again, no attempt is made to identify why the cost difference might change. One possible reason, for example, might be the introduction of the early phases of PARS. Additional information about PARS will be provided in response to APWU/USPS-T4-13, but while none of that information is amenable to explicit incorporation into this exercise, it bears noting at this point that the potential effects of PARS implementation could implicitly be encompassed in the change factors which are incorporated.

Another point to note about the cost difference figure is that, as derived by witness Crum, it is sensitive to the composition of the before-rates volume between customer mail and solicitation mail, because of the different return rates applicable to those two types of mail. If our hypothetically assumed exogenous 5 and 10 percent changes in Capital One's volume were evenly spread between customer mail and solicitation mail, it would have no effect on the cost difference figure utilized in these calculations. If the volume changes were more concentrated on solicitation mail,

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

however, the effect would be that increases in volume would increase the cost difference amount, and declines in volume would decrease the cost difference amount.

In witness Crum's attachments, the test year effect of the ACS Return Cost Savings was estimated at \$13.094 million. The results of our exercise once again show a fairly moderate range of variation around that figure, albeit a bit more variation than shown in the New Contribution Analysis. The high figure is \$15.844 million in savings, in Year 3 if both volumes and the cost difference go up by 10 percent, and the low figure is \$10.607 million in savings, also in Year 3, if both volumes and the cost difference go down by 10 percent.

The next display shows the third of the factors, Discount Leakage. Because the discount leakage is solely a function of the volume level, any variations in cost would have no effect on this factor, and the analysis is therefore simplified to two scenarios. The attachment shows the cumulative level of discounts at the respective before-rates volume levels. The spreadsheet calculates those amounts as the sum of the cumulative total of all discount intervals below the interval in which the last units of volume fall, plus the last applicable discount level times the number of pieces in that interval.

Witness Crum showed a test year Discount Leakage at forecast test year volume levels of \$6.735 million. At the assumed volume changes for Years 2 and 3, material changes in the discount leakage become apparent. The high figure is \$13.684 million with the volume increase in Year 3, and the low figure is \$1.266 million in Year 3 with a volume decrease.

The last display shows the combined effects of each of the three factors in each of our four scenarios for both Years 2 and 3. Witness Crum's estimate of the test year

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

summary impact was \$8.205 million. Our Year 2 results range from a high of \$11.042 million to a low of \$4.976 million. Our Year 3 results range from a high of \$13.361 million to a low of \$1.355 million. Quite importantly, therefore, this exercise suggests a positive financial impact in each year of the agreement under any of the four scenarios. Once again, the point here is not that we can guarantee a favorable impact, either in any given year, or cumulatively over the duration of the agreement. Instead, this exercise suggests that even a more comprehensive modeling exercise, that would (of necessity) be based on mechanistic application of fairly standard and relatively moderate assumptions, of the approximate magnitude incorporated into this exercise, would seem to be highly unlikely to change the conclusion that the combined impact of this agreement is likely to be positive. In other words, while there might be risks associated with this proposal relating to a variety of potential unforeseen circumstances, there is virtually no risk that the perceived test year benefits would inevitably (or even likely) be eroded in the later years of the experiment by the more mundane fluctuations in costs and volumes that typically are experienced broadly over time.

d. This part of the questions solicits an analysis that addresses the potential consequences of a decline in Capital One's volume in the test year (relative to the estimates provided in this case) that was so severe as to trigger the availability in Years 2 and 3 of the lower tier discounts set forth in section III.F. of the agreement. The second attachment to this answer, labeled "Alternate (Declining) Test Year," provides such an analysis, based on the same format as the analysis provided above. Initially, it may be useful to recall that, contrary to what perhaps may be implied in the question, low volumes in the first year of the agreement do not trigger "different" discounts, so

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

much as they would trigger additional discount tiers. The new tiers would be for volumes below 1.225 billion pieces, but the discounts for volumes above 1.225 billion pieces (which are in effect in the first year, and in each successive year regardless of first year volume) would remain unchanged. As shown below, however, even if triggered by declining first year volumes, the maximum cumulative value of the lower-tier discounts (as measured by Discount Leakage) would be insufficient to offset the inherent cost savings.

The first step in our hypothetical exercise is to assume test year volume levels that trigger the lower tier discounts. Selected for that purpose is a test year volume of 1 billion pieces, slightly below the 1.025 billion level that acts as the trigger. Note that TYBR and TYAR volumes are the same, as no discounts operate to expand demand. Next, we assume the changes in Year 2 and Year 3 before-rates volumes as assumed in our earlier exercise, 5 and 10 percent respectively. Because the lower discounts tiers are in effect under those scenarios in which volume increases, there is a price effect, and the after rates volumes are therefore projected using the same methodology employed by witness Elliott. (In Year 2, the before-rates volume is within the 1-cent discount tier, which represents a 3.44 percent price reduction, eliciting with the workshare elasticity a volume increase of 0.24 percent, or 2.52 million pieces. Similarly, in Year 3, the applicable discount is 1.5 cents, the price reduction is 5.15 percent, and the volume response is 0.37 percent, or 4.07 million pieces.) In those scenarios in which Year 2 and Year 3 volumes decline, there are no operative discounts, and before-rates and after-rates volumes are the same.

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

With these volumes, we can once again evaluate the three factors. For two of the factors, Increased Contribution and Discount Leakage, with assumed volume declines, there are no operative discounts, no discount-induced changes in volume, and therefore no financial effects for the volume-decline scenarios. For the volume-increase scenarios, there are the small discount-induced volume changes explained above, and therefore small amounts of Increased Contribution and Discount Leakage, in all instances in amounts less than \$1 million. The only truly material financial impact comes from the third factor, ACS Return Cost Savings, with savings ranging from \$7.5 million to \$11.3 million. Consequently, looking across all three factors, the range of summary outcomes closely parallels the Return Cost Savings, with the same low of \$7.5 million and the high of \$10.9 million.

It may be noted that, as mentioned above, the Return Cost Saving results are sensitive to relative changes in proportions of customer mail and solicitation mail, and lower volumes are likely to be associated with relatively lower portions of solicitation mail. Therefore, as all the volume levels in this alternative analysis are well below the baseline TYAR figure of 1.408 billion, the Return Cost Savings results may be viewed as perhaps somewhat overstated. Even if the Return Cost Savings were substantially overstated, however, it is obvious that they would still easily surpass the Discount Leakage. Recall that the absolute maximum amount of Discount Leakage associated in any year with the lower tier discounts would be \$3.5 million. (That is to say, if the lower tier discounts were triggered by test year volumes below 1.025 billion, but in a later year volume were to exceed 1.225 billion, the cumulative value of the 1.0-2.5 cent discounts for the volume between 1.025 and 1.225 billion pieces would be \$3.5 million.) The

RESPONSE OF UNITED STATES POSTAL SERVICE TO INTERROGATORY
OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

lowest generated figure for ACS Return Cost Savings, \$7.5 million, is more than twice that amount. Those figures, moreover, relate to volume levels well below 1.225 million pieces, and if the volume levels were to approach 1.225 billion in order to approach the maximum Discount Leakage of \$3.5 million, the ACS Return Cost Savings would rise correspondingly.

To summarize, if circumstances in the test year were such that the lower-tier discounts were operable in the later years, the predominant effect of the agreement would be the benefit of whatever ACS Return Savings accrued to the Postal Service, while the offset resulting from Discount Leakage would most likely be either none or minimal.

CERTIFICATE OF SERVICE

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

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November 25, 2002