Postal Rate Commission
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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 UNITED STATES POSTAL SERVICE TO ORAL REQUEST
OF COMMISSIONER GOLDWAY AT TR. 2/396–97

The United States Postal Service hereby provides its response to the request made by Commissioner Goldway at hearings on December 3, 2002. Tr. 2/396–97.

The question is summarized and is followed by the response.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Scott L. Reiter

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
(202) 268-2999 Fax -5402
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REQUEST: At this point in the transcript, Commission Goldway referred to an earlier discussion (Tr. 2/392-94) of the Postal Service's response to APWU/USPS-2, and requested that, in lieu of the assumed annual 5 percent rate of change in Capital One's First-Class volume used in that response, a similar additional analysis be provided focused instead on assumed 10 and 15 percent annual rates of change in volume.

RESPONSE:

The additional analysis making the requested adjustments to the analysis presented in response to APWU/USPS-2 is attached. It shows that, even under scenarios in which volume is assumed to change at annual rates of 10 and 15 percent, the Postal Service would be expected to receive cumulative net benefits over the full three years of the agreement under every scenario. In that sense, the attached analysis is consistent with that provided in response to APWU/USPS-2, which likewise indicated positive financial results under each scenario.

Before describing the analysis, however, it is necessary to explain why the Postal Service believes the annual volume changes (particularly volume increases) of the 10 to 15 percent range it assumes are far less likely than the 5 percent annual changes assumed in the earlier analysis. As Dr. Elliott testified (COF-T-2 at 4), Capital One has announced a corporate strategy involving a reduced level of asset and account growth relative to the growth of the last two years. These announcements, moreover, are not statements made by the company specifically to justify the terms of the proposed agreement, but are much broader statements made in widely-circulated financial statements to which close attention is paid by both potential investors and government regulators. Dr. Elliott testified that the level of solicitation mailing implicit in the volume projections utilized in this case is consistent with the announced corporate strategy. On the other hand, the level of solicitation mailing implicit in assumed annual volume growth rates of 10 and 15 percent could possibly raise questions regarding the company's adherence to its the corporate strategy announced in its securities filings. Given the current environment, expectation of such growth rates would not appear realistic. Moving into the future, while growth rates of that magnitude cannot be categorically excluded, they simply are far less likely than the more modest volume changes assumed in the earlier analysis.

Nevertheless, the requested analysis focusing on 10 and 15 percent annual volume changes is attached. Attachment One shows results assuming an annual volume change of 10 percent, and Attachment Two shows results assuming 15 percent. Each of these closely parallels the earlier analysis, in that each starts with new assumed volumes, and then shows the implications of those volumes on increased contribution from new mail volume, ACS return cost savings, and discount leakage. There is, however, one additional display in the new analysis. In the earlier analysis provided in response to APWU/USPS-2, the financial impact in each year under each scenario was positive, so that it was manifestly evident that the cumulative impact across all three years was likewise positive. With larger assumed before-rate volume growth, however, the financial impact in the last year of the agreement can become negative, and it is therefore necessary to aggregate the figures for all three years of the agreement before reaching a conclusion regarding the ultimate financial impact under each hypothetical scenario. That result is shown in an additional display labeled

“3-Year Cumulative Financial Impact,” which adds the derived figures for Years 2 and 3 under each scenario with witness Crum’s estimate of the financial benefit of $8.205 million in the Test Year.

Beyond that, the only other wrinkle is that, with the large assumed volume changes, it is necessary to refine the ACS return cost savings calculations. As noted in the response to APWU/USPS-2, those calculations are 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. In the earlier response, it was noted that the calculation included for ACS return cost saving was conditioned upon an assumed even spread of new volume between customer and solicitation mail, and that, if the new volume were concentrated in solicitation mail, the cost savings results would be higher. Under the requested assumptions, it is now no longer reasonable to postulate that, for example, a 30 percent volume increase or decrease could realistically be expected to be spread evenly between customer and solicitation mail.

To address this concern, a supplemental analysis has been conducted, which is presented in Attachment Three. This analysis assumes that the new volume is distributed between customer and solicitation volume in the same proportions as shown in Dr. Elliott’s Exhibit 7. In that Exhibit, of the total of 53.12 million projected pieces of new volume, Dr. Elliott calculated that 51.2 million pieces, or 96.4 percent, would be solicitation mail, and only 1.92 million pieces, or 3.6 percent, would be customer mail. For each new volume scenario, these proportions have been applied to the new volume (calculated as the difference between the assumed volume and 1.408 billion pieces used as the Test Year before-rates figure) to break out the new volume into customer and solicitation mail. As shown on Attachment Three, the customer mail projections thusly derived range from a high of 656 million pieces to a low of 625 million pieces, while the solicitation mail ranges from a high of 1194 million pieces to a low of 361 million pieces.

To calculate the applicable cost difference figure to use in the ACS return cost savings calculation for each scenario, the customer and solicitation before-rates volume figures for that scenario were substituted in witness Crum's Attachment A, page 2 spreadsheet for the customer volume (640 million) and solicitation volume (768 million) figures that he used. His spreadsheet, as modified, then produces different "current" and "after-rates" unit cost estimates, and the difference between those two figures has been recorded in Attachment Three in the column labeled "Cost Dif." Compared with witness Crum's original cost difference figure of .93 cents, the new figures range from .62 cents to 1.09 cents. As expected, the higher cost savings figures relate to the higher volume scenarios, in which the increased proportion of solicitation raises the potential for return cost savings. The cost difference figures in Attachment 3 are then plugged into the ACS Cost Savings calculations shown in Attachments One and Two.

Attachment One shows the results for the scenarios in which Year 2 volumes go up or down 10 percent, and Year 3 volumes go up or down 20 percent. In Year 2, the net impact is positive regardless of the direction in which volumes move, but in Year 3, the 20 percent increase in volume yields a negative impact. Across all three years of the agreement under the volume-increase scenario, however, the cumulative impact is still a positive $9.5 million. The positive gains from the Test Year and Year 2 more than offset the potential loss in Year 3. In comparison, the cumulative impact of the volume-decline scenario is a positive $28 million, reflecting expected gains across all three years of the agreement.

Attachment Two shows the results for the scenarios in which Year 2 volumes go up or down 15 percent, and Year 3 volumes go up or down 30 percent. The pattern of effects is the same as in Attachment One. Year 2 uniformly shows a positive impact, while Year 3 is negative under the volume-growth scenario. Cumulatively, however, both scenarios show a positive impact across all three years, with a gain of $0.7 million if volumes go up by the hypothesized amount, and a gain of $23.9 million if volumes similarly go down.

To summarize, the Postal Service believes that volume swings of the magnitudes assumed for purposes of this response are far less likely than the more modest changes assumed for purposes of the response to APWU/USPS-2. Volume swings of any magnitude, of course, can be either positive or negative. While information about the credit card market in general and Capital One in particular is available and may be useful, the Postal Service has no basis to make a specific prediction of what Capital One's exact First-Class Mail volumes might be in the last two years of the agreement. The analysis provided in response to APWU/USPS-2, however, showed that, within a range of relatively plausible scenarios, the Postal Service still stood to benefit in each year of the agreement. This analysis shows that, even with more extreme (and hence, substantially less likely) assumptions regarding volume swings, the Postal Service stands to benefit in every year if the direction of the volume swing is negative, and still stands to benefit overall if the direction of the volume swing is positive.

ATTACHMENT ONE
Q. Tr. 2/396-97

BASELINE TEST YEAR, 2ND YEAR VOLUME PLUS/MINUS 10%, 3RD YEAR PLUS/MINUS 20%

VOLUMES

TYBR	1,408,000
TYAR	1,423,459
Y2BR+	1548800
Y2BR-	1267200
Y2AR+	1565805
Y2AR-	1281113
Y3BR+	1689600
Y3BR-	1126400
Y3AR+	1708151
Y3AR-	1138767

INCREASED CONTRIBUTION FROM NEW MAIL VOLUME

Incr.Cont. =(Unit Rev ($.2910) - Unit Cost - Discount) *New Volume

TYUC	0.1266		
Y2UC	0.1266	Y3UC	0.1266

	Y2	Y3
V+	1860.336	1936.704
V-	1839.355	0

ACS RETURN COST SAVINGS

Savings = Cost Difference * Before-Rates Vol

TY Cost Difference = $.1359-$.1266 = 0.0093

Y2CD+	0.0099	Y3CD+	0.0105
Y2CD-	0.0085	Y3CD-	0.0075

	Y2	Y3
V+	15333.12	17740.8
V-	10771.2	8448

DISCOUNT LEAKAGE

Leakage = Before-Rates Vol * Applicable Discounts

	Y2	Y3
V+	13684	21876
V-	1266	0

SUMMARY FINANCIAL IMPACT ($000)

Total = Incr. Cont. + Cost Savings - Leakage

	Y2	Y3
V+	3509.456	-2198.5
V-	11344.56	8448

3-YEAR CUMULATIVE FINANCIAL IMPACT ($000)

V+	9515.96
V-	27997.56

ATTACHMENT TWO
Q. Tr. 2/396-97

BASELINE TEST YEAR, 2ND YEAR VOLUME PLUS/MINUS 15%, 3RD YEAR PLUS/MINUS 30%

VOLUMES

TYBR	1,408,000
TYAR	1,423,459
Y2BR+	1619200
Y2BR-	1196800
Y2AR+	1636978
Y2AR-	1209940
Y3BR+	1830400
Y3BR-	985600
Y3AR+	1850497
Y3AR-	996421.3

INCREASED CONTRIBUTION FROM NEW MAIL VOLUME

Incr.Cont. =(Unit Rev ($.2910) - Unit Cost - Discount) *New Volume

TYUC	0.1266		
Y2UC	0.1266	Y3UC	0.1266

	Y2	Y3
V+	1856.008	2098.095
V-	0	0

ACS RETURN COST SAVINGS

Savings = Cost Difference * Before-Rates Vol

TY Cost Difference = $.1359-$.1266 = 0.0093

Y2CD+	0.0102	Y3CD+	0.0109
Y2CD-	0.008	Y3CD-	0.0062

	Y2	Y3
V+	16515.84	19951.36
V-	9574.4	6110.72

DISCOUNT LEAKAGE

Leakage = Before-Rates Vol * Applicable Discounts

	Y2	Y3
V+	17652	30324
V-	0	0

SUMMARY FINANCIAL IMPACT ($000)

Total = Incr. Cont. + Cost Savings - Leakage

	Y2	Y3
V+	719.8475	-8274.54
V-	9574.4	6110.72

3-YEAR CUMULATIVE FINANCIAL IMPACT ($000)

V+	650.303
V-	23890.12

Attachment 3
Q. Tr. 2/396-97

COST DIFFERENCES AT NEW VOLUME LEVELS USED TO CALCULATE ACS RETURN COST SAVINGS

0.963855 **(Note 1)**			768000		640000		
0.036145 **(Note 2)**	TYBR	1408000					
	TYAR	1423459	Solicitation **(Note 3)**		Customer **(Note 4)**		Cost Dif. **(Note 5)**
15% / 30%	Y2BR+	1619200	203566.3	971566.3	7633.735	647633.7	0.0102
	Y2BR-	1196800	203566.3	564433.7	7633.735	632366.3	0.008
	Y2AR+	1636978	220701.5	988701.5	8276.308	648276.3	
	Y2AR-	1209940	190901.1	577098.9	7158.79	632841.2	
	Y3BR+	1830400	407132.5	1175133	15267.47	655267.5	0.0109
	Y3BR-	985600	407132.5	360867.5	15267.47	624732.5	0.0062
	Y3AR+	1850497	426502.8	1194503	15993.86	655993.9	
	Y3AR-	996421.3	396702.4	371297.6	14876.34	625123.7	
10% / 20%	Y2BR+	1548800	135710.8	903710.8	5089.157	645089.2	0.0099
	Y2BR-	1267200	135710.8	632289.2	5089.157	634910.8	0.0085
	Y2AR+	1565805	152101.1	920101.1	5703.792	645703.8	
	Y2AR-	1281113	122300.6	645699.4	4586.273	635413.7	
	Y3BR+	1689600	271421.7	1039422	10178.31	650178.3	0.0105
	Y3BR-	1126400	271421.7	496578.3	10178.31	629821.7	0.0075
	Y3AR+	1708151	289302	1057302	10848.82	650848.8	
	Y3AR-	1138767	259501.5	508498.5	9731.306	630268.7	

Note 1: Portion of New Volume that is Solicitation Mail, from Elliott Testimony, Exhibit 7, Line 7/Line 13
Note 2: Portion of New Volume that is Customer Mail, from Elliott Testimony, Exhibit 7, Line 12/Line 13
Note 3: First Column: Change amount based on solicitation proportion from Note 1and volume change from 1408000
Second Column: New Solicitation Volume = 768000 +/- Change amount from first column
Note 4: First Column: Change amount based on customer proportion from Note 2 and volume change from 1408000
Second Column: New Customer Volume = 640000 +/- Change amount from first column
Note 5: Cost Difference calculated as position (24) - position (25) when new before-rates customer and solicitation volume are substituted for 640000 and 768000 in positions (4) and (5) in witness Crum's Attachment A, Page 2 spreadsheet

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.

Scott L. Reiter

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260–1137
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