

UNITED STATES OF AMERICA
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

ANSWERS OF THE OFFICE OF THE CONSUMER
ADVOCATE TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE
WITNESS: J. EDWARD SMITH (COS/OCA-T1-1-12)
(January 6, 2003)

The Office of the Consumer Advocate hereby submits the answers of J. Edward Smith to interrogatories of Capital One Inc., dated December 26, 2002. Interrogatory COS/OCA-T1-4 has been redirected to the Office of the Consumer Advocate. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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ANSWERS OF OCA WITNESS J. EDWARD SMITH
TO INTERROGATORIES COS/OCA-T1-1-12

COS/OCA-T1-1. Please refer to pages 2 and 3 of your testimony where you discuss the elasticity study used by witness Elliott, your understanding of the drivers of Capital One's First-Class Mail volume, and your understanding of the composition of workshared First-Class Mail. Based upon your understanding of the drivers of Capital One's First-Class Mail volume and the composition of workshared First-Class Mail, is it your opinion that the own-price elasticity for Capital One's First-Class Mail is more likely to be higher than the own-price elasticity of other workshared First-Class Mail or lower than the own-price elasticity of other workshared First-Class Mail. Please describe the basis of your response in detail.

RESPONSE TO COS/OCA-T1-1.

I don't know. Capital One has not provided detailed information on the drivers of workshared First-Class mail or its composition in comparison to workshared First-Class mail in general.

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COS/OCA-T1-2. Please refer to the four line passage of your testimony beginning on page 2 at line 21, where you state that "... Capital One's Solicitation mail may be quite different from other workshared First-Class mail. Workshared mail could contain billing, customer communication, and possibly other types of mail in addition to solicitation mail; such is not, however, the case for Capital One's Solicitation mail." Please also refer to Exhibit 6 of Witness Elliott's testimony, where the after-rates increase of 15,458,969 pieces is calculated that you discuss in your testimony on page 2 at lines 14-17.

- (a) Please confirm that Witness Elliott applies the Postal Service price elasticity for workshared First-Class letters to the total projected FY 2003 First-Class Mail volume for Capital One.
- (b) Please confirm that the total First-Class Mail volume for Capital One includes billing and customer communication mail, in addition to solicitation mail.

RESPONSE TO COS/OCA-T1-2.

- (a) Confirmed that Witness Elliott used the Postal Service's elasticity for workshared First-Class mail on a combined basis for Capital One--i.e., Solicitation and Customer Mail combined. This approach appears to be based on the assumption that the two types of mail can be summed and, subsequently, a single elasticity for workshared First-Class mail can be used. Also, implicit in the procedure is that Capital One's Solicitation mail is not different from that of other workshared First-Class mail. This appears to be an unrealistic assumption in terms of Capital One's Solicitation mail and the Solicitation mail of other organizations.
- (b) Confirmed.

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COS/OCA-T1-3. Please refer to pages 2-3 of your testimony and Appendix G, page 1 of the Postal Rate Commission's Opinion and Recommended Decision from Docket No. R2001-1 and assume that the unit contribution of Capital One's First-Class Mail letters is equal to the unit contribution of First-Class Mail letters as a whole.

- (a) Please confirm that the FY 2003 unit contribution for the First-Class Mail Letter subclass as shown in Appendix G is 18.437 cents per piece. If not confirmed, please explain fully.
- (b) Please confirm that the maximum block discount included in the negotiated service agreement (NSA) is six cents per piece.
- (c) Please confirm that for every new First-Class Mail letter that Capital One mails in response to the volume discounts, Capital One's Test Year contribution to institutional costs will increase by at least 12.437 cents (18.437 cents minus no more than 6 cents). If not confirmed, please explain fully.
- (d) Please confirm, *ceteris paribus*, that if Capital One's own-price elasticity is higher than estimated by Dr. Elliott, then the volume-discount portion of the Capital One NSA will make a larger contribution to institutional costs than estimated by USPS witness Crum.

RESPONSE TO COS/OCA-T1-3.

- (a) Although I have not testified on the derivation of the 18.437 cents per piece figure, I confirm that I have seen the number as represented in the interrogatory.
- (b) Confirmed.
- (c) Not Confirmed. For mailings beyond the level of mailings that would have otherwise occurred the statement is correct. However, the volume discount commences below the level of mailings that would have otherwise occurred, creating a free rider problem, and these revenue losses offset revenue gains.
- (d) Confirmed as a matter of arithmetic.

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COS/OCA-T1-4. Please refer to page 3 of your testimony where you discuss the volume threshold.

- (a) Please confirm that, in general, worksharing discounts pass through a portion of Postal Service cost savings from the worksharing and that these discounts are not contingent on the mailer increasing its Test Year mail volume. If not confirmed, please explain fully.
- (b) Please confirm that the only discounts that Capital One is being offered in this case are volume discounts. If not confirmed, please explain fully.
- (c) Please confirm that if the threshold volume is set exactly equal to Test Year before-rates First-Class Mail volume, then Capital One will only receive a discount if it increases its volume in response to the volume discounts.
- (d) Is it your opinion that Capital One should not receive any discount from reducing Postal Service return costs unless Capital One also grows mail volume? Please describe your response in detail.

RESPONSE TO COS/OCA-T1-4.

Redirected to OCA.

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COS/OCA-T1-5. Please refer to Graph 1 of your testimony on page 7 and the corresponding statistics in Appendix 1. The time series labeled as "Solicitation" appears to be a mislabeled time series for "Total." The time series labeled as "Total" appears to be some multiple of the "Total" time series. Please provide a corrected graph.

RESPONSE TO COS/OCA-T1-5.

Graph 1 of the testimony is incorrect. A correct graph is denoted as Chart 1 in the accompanying file OCACOS. The correct graph served as the basis for the development of the testimony. During the final preparation of the testimony I attempted to enhance the graph and inadvertently changed the graph. This does not, however, change any of the conclusions: all use of the graph in the testimony was based on the correct graph.

Please note that errata filed on January 3, 2002, included a revised Graph 1.

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COS/OCA-T1-6. Please refer to Graph 2 of your testimony on page 8 and the corresponding statistics in Appendix 1. The time series labeled as "Solicitation" appears to be a mislabeled time series for "Total." The time series labeled as "Total" appears to be some multiple of the "Total" time series. Furthermore, the graph appears to provide 12-month moving totals rather than 12-month moving averages. Please provide a corrected graph.

RESPONSE TO COS/OCA-T1-6.

Graph 2 of the testimony is incorrect. A correct graph is denoted as Chart 2 in the accompanying file OCACOS. The correct graph served as the basis for the development of the testimony. During the final preparation of the testimony I attempted to enhance the graph and inadvertently changed the graph. This does not, however, change any of the conclusions: all use of the graph in the testimony was based on the correct graph.

The graph provides the average yearly mailings for a 12-month year on a moving total basis. Given that the interrogatory indicates some confusion, the title has been revised to provide the heading 12-Month Moving Totals, which is the thought that I was attempting to convey.

Please note that errata filed on January 3, 2002, included a revised Graph 2.

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COS/OCA-T1-7. Please refer to page 16 of your testimony at line 1 where you state, “[t]he regression results for Solicitation Mail are of poor quality.”

- (a) What is it about the regression results that indicates that they are of “poor quality”?
- (b) Conversely, what would be an indication of regression results that are not of “poor quality”?
- (c) In your regression analysis, did you fit any equations for Solicitation Mail that included a dummy variable that distinguished the eight-month period from October 2001 to May 2002? If yes, please provide the results and supporting documentation for all such equations. If no, please explain why you did not conduct such an analysis.

RESPONSE TO COS/OCA-T1-7.

- (a) I was concerned that the R squared statistics were low and that the time variables were statistically insignificant. Insignificance of the time variables is sufficient to eliminate the equations from consideration.
- (b) Some of the more important issues would be obtaining an adequate R square and statistically meaningful variables.
- (c) No. Such an analysis would have required the use of private unverifiable data. There is not sufficient information in this case to understand Capital One’s marketing strategy and plans. Accordingly, there is an insufficient basis upon which to evaluate which months, if any, should be modeled with dummy variables. When one obtains a regression result that one does not prefer, it is frequently possible to modify the equation to obtain a better result. However, there was no meaningful reason other than private unverifiable data upon which to justify such a modification. Accordingly, such an analysis was not performed for the time period mentioned, although there was some attempt to model specific months (rather than an extended time period). If the analysis had been performed, the analysis would have been of little value. There is no way to know what the value of a dummy variable should be when extrapolating the equation to the future.

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COS/OCA-T1-8. Please refer to pages 17-18 of your testimony where you describe your extrapolation approach to projecting mail volumes from previous year's mail volumes.

- (a) Please confirm that, ceteris paribus, your extrapolation approach will overstate projected mail volume if growth rates during the projected year are smaller than they were in previous years.
- (b) Please confirm that, ceteris paribus, your extrapolation approach will overstate projected mail volume if the mail volume in the base year used to extrapolate from is unusually high compared to previous growth trends.

RESPONSE TO COS/OCA-T1-8.

(a) Confirmed.

(b) Confirmed.

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COS/OCA-T1-9. Please refer to page 18 of your testimony at lines 1-7, where you describe projections for 2003.

- (a) Please confirm that your projections for Customer and Solicitation Mail are for FY 2003, not for calendar year 2003.
- (b) Please describe the period of time used to calculate the "growth rate of 2001-2002" referred to in lines 1-2 and lines 4-5.

RESPONSE TO COS/OCA-T1-9.

- (a) Confirmed.
- (b) See Sheet 1 of Excel file OCACOS. September 01/September 02 is the time frame. For growth rates, computations can be traced for Customer mail from Cell D69 to Cell D55, which is the annualized growth of cell C55; the cell C55 contains the formula. For Solicitation Mail, cell D70 is identical to cell C63, a 12 month annualized growth rate of Cell 61.

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COS/OCA-T1-10. Please refer to page 18 of your testimony at lines 8-12, where you describe an "alternative projection" of Solicitation Mail for 2003.

- (a) Please confirm that these alternative projections for Customer and Solicitation Mail are for FY 2003, not for calendar year 2003.
- (b) What is the Solicitation Mail volume for the 12 months ending September 2001 that you use to extrapolate for your 2003 projection?
- (c) What is the "growth rate for Solicitation mail over the period 2000-2001" that you use for your extrapolation? Please provide a derivation of this growth rate.

RESPONSE TO COS/OCA-T1-10.

- (a) Confirmed.
- (b) 788,930,179 pieces, cell G38 of OCACOS Sheet1.
- (c) In OCACOS Sheet 1 Cell F70 is cell D65, the product of cell C65 (cell 64, the 12 month growth rate ending Sept 2001 extrapolated for two years) and cell G38 (the Solicitation mail 12 month total ending Sept 2001).

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COS/OCA-T1-11. Please refer to Table 4 on page 18 of your testimony, where you provide the figures for your two projections for 2003. Please also refer to Exhibit 7 of Witness Elliott testimony.

- (a) Please confirm that the Solicitation Mail volume in your alternative projection is 636,977,327 pieces lower than your first projection of Solicitation Mail volume for 2003.
- (b) Please confirm that your alternative projection for Customer Mail volume for 2003 is the same as your first projection of Customer Mail volume for 2003.
- (c) Please confirm that, *ceteris paribus*, a lower level of Solicitation Mail is likely to lead to a lower level of growth in Customer Mail.
- (d) Please confirm that a reduction in Solicitation Mail volume by 636,977,327 pieces would result in 3,821,864 fewer new accounts, under the assumption of a 0.6 percent rate of new account yield from solicitations used by Witness Elliott in Exhibit 7.
- (e) Please confirm that 3,821,864 fewer new accounts would result in 23,886,650 fewer Customer Mail pieces, under the assumptions used by Witness Elliott in Exhibit 7 that an average account has 12.5 annual pieces of customer mail and that an average new account is active for half the year in which it is started.

RESPONSE TO COS/OCA-T1-11.

- (a) Confirmed
- (b) Confirmed
- (c) Confirmed on a *ceteris paribus* basis.
- (d) Confirmed that the computations are correct given the assumptions.
- (e) Confirmed that the computations are correct given the assumptions.

ANSWERS OF OCA WITNESS J. EDWARD SMITH
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COS/OCA-T1-12. Please refer to page 14 of your testimony at lines 23-24 where you state "It is not surprising, therefore, that the regression equations did not find a strong, increasing relationship between Solicitation mail and time."

- (a) Is there a statistically significant relationship between Solicitation mail and time in the volumes for the period from October 1998 to September 2001?
- (b) Is there a statistically significant relationship between Solicitation mail and time in the volumes for the period from October 2001 to May 2002?
- (c) Is there a statistically significant relationship between Solicitation mail and time in the volumes for the period from October 1998 to September 2001 when combined with the volumes for the period from June 2002 to September 2002?

RESPONSE TO COS/OCA-T1-12.

- (a) No statistically significant relationship based on the dataset from October 1998 through September 2002 was found; the relationship relative to September 2001 was not tested. The regression was not run for the time period.
- (b) No statistically significant relationship based on the dataset from October 1998 through September 2002 was found; the relationship relative to October 2001 and May 2002 was not tested. The regression was not run for the time period.
- (c) No statistically significant relationship based on the dataset from October 1998 through September 2002 was found. The regression was not run for the time period as stated in the interrogatory. See my response to COS/OCA-T1-7c.