

**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

**REBUTTAL TESTIMONY
OF
STUART ELLIOTT
ON BEHALF OF
CAPITAL ONE SERVICES, INC**

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1 **Autobiographical Sketch**

2

3 My name is Stuart W. Elliott. I am a Vice President at SLS Consulting, a
4 consulting firm located in Washington, DC. SLS specializes in economic,
5 operational, and environmental analyses on behalf of the mailing community. I
6 have a B.A. in Economics from Columbia University and a Ph.D. in Economics
7 from the Massachusetts Institute of Technology. After my formal education, I
8 was a Research Fellow at Carnegie Mellon University, a Senior Analyst at
9 Project Performance Corporation (PPC), and a Senior Associate at
10 PricewaterhouseCoopers. While at PPC, I presented testimony in Docket No.
11 R2000-1 on behalf of the National Newspaper Association, the Recording
12 Industry Association of America, and Magazine Publishers of America. I also
13 presented direct testimony regarding Capital One's FY 2003 mail volumes in this
14 docket.

15

16 **1. Purpose and Scope of Testimony**

17

18 The purpose of this testimony is threefold. First, the testimony rebuts the
19 testimony of OCA witness Smith regarding Capital One's FY 2003 Before Rates
20 volume forecast. Second, it shows, based upon recent volume data, that Capital
21 One's FY 2003 Before Rates First-Class Mail volume is likely to be less than
22 originally estimated, not more (as suggested by witness Smith). Third, it
23 calculates the increase in contribution that would result from the negotiated
24 service agreement (NSA) based upon a lower FY 2003 First-Class Mail volume.

1 **2. Neither of Witness Smith's Extrapolation Approaches for Forecasting**
2 **Capital One's FY 2003 First-Class Mail Volumes Are Accurate. Therefore,**
3 **His Assessment of Capital One's FY 2003 Before Rates First-Class Mail**
4 **Volume Is Baseless.**
5

6 During cross examination, witness Smith admitted that his extrapolation
7 approach rendered a mail volume "number that lacks credibility in the
8 neighborhood of 2.2 billion." Tr. 7/1310. He further conceded that this
9 extrapolation approach will not "generate accurate mail volume forecasts under
10 the following circumstances: 1) if future growth rates do not resemble past growth
11 rates; 2) base year mail volumes are unusually low or high; or 3) marketing
12 strategies of the firm change." Tr. 7/1304.

13
14 However, Smith asserted that using an earlier base year (FY 2001) for
15 solicitation volumes, but otherwise using his extrapolation approach, somehow
16 solves these problems. Tr. 7/1313. He is wrong. His "alternative projection,"
17 which was based partially upon an earlier base year, is inaccurate because it
18 does not resolve the issue that "future growth rates do not resemble past growth
19 rates." Therefore, his assessment that Capital One's volume is at the "lower
20 range of possible outcomes," which he noted during cross examination was
21 based upon his alternative volume projection, is baseless. Tr. 7/1244, 1312.

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23

1 Specifically, in both of his approaches, OCA witness Smith used a significant
2 annual growth rate to project future customer mail volumes. Tr. 7/1257. The
3 annual growth rate for FY 2003, however, appears to be much lower. While the
4 actual growth rate from FY 2001 to FY 2002 was 24 percent, the annual growth
5 rate from calendar year (CY) 2001 to CY 2002 dropped to 17 percent. See
6 Exhibit 1. In fact, Exhibit 1 shows that Capital One's volume of customer mail
7 actually dropped from the first half of CY 2002 to the second half, which includes
8 the first quarter of FY 2003.

9

10 To forecast solicitation mail volumes in his alternative approach, witness Smith
11 applies an annual growth rate of 4.7 percent (the growth rate from FY 2000 to FY
12 2001) to FY 2001 volumes. Tr. 7/1284, 1290. This completely ignores the fact
13 that, as shown in Chart 1, the historical trend is, if anything, one of gradual
14 decline in First-Class Mail solicitation volumes.¹

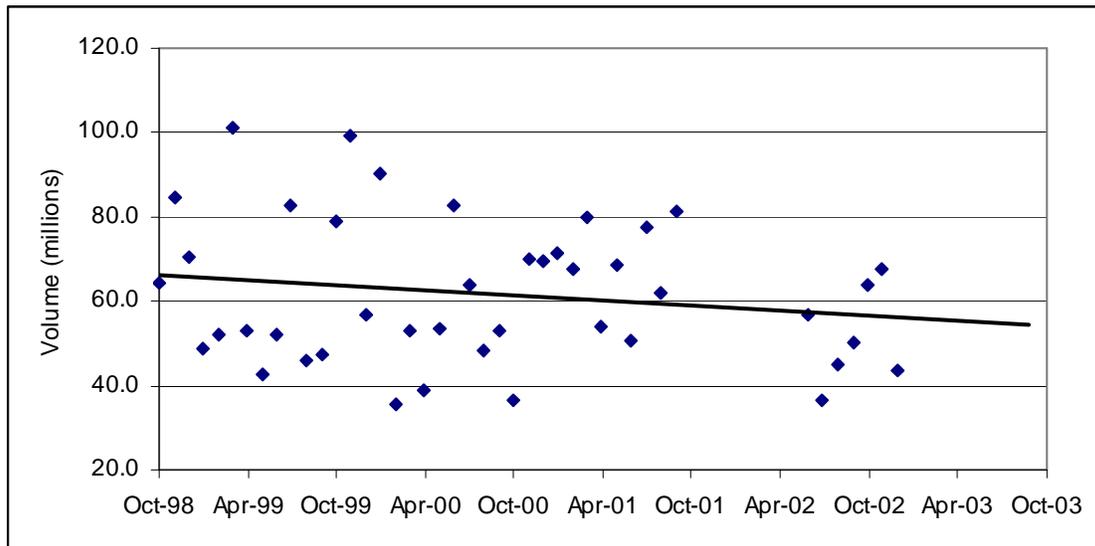
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¹ Note that the chart excludes the anomalous months following 9/11 discussed by witness Jean (Tr. 2/39) and in my direct testimony (Tr. 2/203-204)

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**Chart 1. Capital One First-Class Mail Solicitation Volume by Month
(Excluding Anomalous Post-9/11 Period)**



4

5 Source: Exhibit 1

6 Another indication of the inaccuracy of witness Smith’s forecasting approach is
7 that his forecast of Capital One’s October, November, and December First-Class
8 Mail volumes overstated Capital One’s actual volumes by 66 percent.

9 Specifically, in response to a Postal Service interrogatory, witness Smith
10 estimated that Capital One had mailed 527 million pieces of First-Class Mail in
11 October, November, and December of 2002 (Tr. 7/1289-1290), two-thirds more
12 than the 317 million First-Class Mail pieces that Capital One actually sent. As
13 shown in Table 1 below, his estimates significantly overstated both customer mail
14 (76 percent) and solicitation mail (58 percent). As witness Smith conceded, if his
15 forecasts for October, November, and December of 2002 were off by an extreme
16 degree, “it would suggest that this [forecasting] approach has failed.” Tr. 7/1323-
17 1324.

18

Table 1. Comparison of Actual FY 2003 October, November, and December First-Class Mail Volume With Those Projected by Witness Smith

Category	Actual [1]	Smith [2]	Difference (%) [3]
Customer	141,681,662	249,985,213	76.4%
Solicitation	175,437,720	277,227,649	58.0%
Total	317,119,382	527,212,862	66.3%

[1] Exhibit 1

[2] Tr. 7/1290

[3]= [2]/[1]-1

3. Capital One's First-Class Mail Volumes for the First Quarter of FY 2003 Imply a Before Rates First-Class Volume for FY 2003 of 1.210 Billion Pieces in the Absence of the Agreement.

As shown in Table 2, in the first quarter of FY 2003, Capital One mailed an average of 105.7 million First-Class Mail pieces per month. If Capital One continues at this pace for the rest of the fiscal year, its Test Year Before Rates First-Class Mail volume will be 1.268 billion pieces, significantly less than its initial FY 2003 Before Rates mail volume estimate of 1.408 billion pieces. Tr. 2/206. This suggests that Capital One's initial estimate was optimistic.

In fact, an analysis of historical volumes suggests that FY 2003 mail volumes are likely to be less than 1.268 billion pieces. Specifically, since the beginning of FY 1999, Capital One's monthly First-Class Mail volumes were higher in the first quarter than during the remainder of the fiscal year. In other words, as shown in Exhibit 2, Capital One has mailed more than 25 percent of its fiscal year volumes in October, November, and December.² Therefore, assuming that Capital One's

² Note that this holds true regardless of whether the anomalously high volumes of early FY 2002 are included or not.

1 mail volume will continue at Quarter 1 levels is likely to slightly overstate volume
 2 for the entire fiscal year, thereby generating a conservatively high FY 2003
 3 Before Rates volume forecast. Table 2 shows a FY 2003 forecast based on
 4 Quarter 1 volumes and the historical percentage of Quarter 1 volumes of 26.2
 5 percent for the years FY 1999 to FY 2001.³

6 **Table 2. FY 2003 Before Rates First-Class Mail Volume**
 7

Category	FY 2003 Average Q1 Monthly [1]	FY 2003 Forecast Total [2]
First-Class Mail Volume	105,706,461	1,210,249,622

8 [1] Actual Volumes from Table 1 divided by 3

9 [2] Exhibit 3, cells (4) and (5)

10

11 Finally, it is important to recognize that the FY 2003 forecast in Table 2 uses an
 12 estimate of the Quarter 1 volume percentage that was calculated using data from
 13 FY 1999 to FY 2001, a period of high growth in customer mail. This high growth
 14 would have increased customer mail volume in the later quarters of each fiscal
 15 year, thereby lowering the percentage of mail volume sent in Quarter 1. Since
 16 customer mail growth has slowed, Quarter 1's percentage of the full FY 2003
 17 volume is likely to be greater than 26.2 percent, implying that this forecast of FY
 18 2003 First-Class Mail volume in Table 2 is somewhat overstated.

19

20

³ Other possible versions of this same general approach result in similar projections. For example, an approach that uses the same historical period but calculates separate percentages for customer and solicitation mail results in total projected FY 2003 mail volume of 1.245 billion.

4. If Capital One’s Test Year Before Rates First-Class Mail Volume Is 1.210 Billion Pieces, Then the NSA Will Increase Capital One’s Contribution to Institutional Costs by \$11.4 Million, \$3.2 Million More Than the \$8.2 Million Estimated by Witness Crum.

Table 3 calculates the increase in contribution that will result from the NSA if Capital One’s FY 2003 Before Rates mail volume is 1.210 billion First-Class Mail pieces. At this volume, the NSA would result in no mail above the threshold of 1.225 billion pieces in FY 2003, which would result in no discount being paid to Capital One and therefore no After-Rates increase in mail volume.⁴ In Exhibit 3, I use the cost model presented by witness Crum (USPS-T-3, Attachment A , Page 2) to calculate that the NSA will reduce Capital One’s FY 2003 unit cost by 0.94 cents per piece, translating into an increase in Capital One’s contribution of \$11.4 million.⁵

Table 3. Test Year Contribution from NSA Based Upon Initial and Revised Volumes

Category	TYBR Volume	TYAR Volume	NSA Contribution
Initial [1]	1,408,000,000	1,423,458,969	\$8.2 million
Revised [2]	1,210,249,622	1,210,249,622	\$11.4 million

[1] Tr. 2/211; USPS-T-3, Attachment B
 [2] Table 2; Volume * ((24)-(25)) from Exhibit 3

⁴ Note that the projected mail volume of 1.210 billion is only 1.2 percent less than the threshold of 1.225 billion. Given the uncertainty in any mail volume projection, there is some chance that actual volume will turn out to be above the threshold, resulting in a discount being paid on some mail pieces and an After-Rates increase in mail volume.

⁵ Note that the only differences between Exhibit 3 and USPS-T-3, Attachment, Page 2 are the Before Rates volume figures. Electronic versions of my exhibits have been filed as COS-LR-4.

1 **5. CONCLUSION**

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3 Of course, we cannot forecast with certainty Capital One's Test Year volumes.

4 The real import of our new analysis, based on new volume data, is that the

5 established threshold of 1.225 billion in the NSA is a reasonable one -- one that

6 may or may not be met; and that predictions of volumes greatly in excess of that

7 threshold are devoid of any practical or theoretical substance.

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