

OFFICIAL TRANSCRIPT OF PROCEEDINGS BEFORE THE POSTAL RATE COMMISSION

In the Matter of:)
)
EXPERIMENTAL RATE AND)
SERVICE CHANGES TO IMPLEMENT) Docket No. MC2002-2
NEGOTIATED SERVICE AGREEMENT)
WITH CAPITAL ONE SERVICES,)
INC.)

VOLUME #10

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POSTAL RATE COMMISSION

In the Matter of:)
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EXPERIMENTAL RATE AND)
SERVICE CHANGES TO) Docket No. MC2002-2
IMPLEMENT NEGOTIATED)
SERVICE AGREEMENT WITH)
CAPITAL ONE SERVICES, INC.)

Room 300
Postal Rate Commission
1333 H Street, N.W.
Washington, D.C.

Volume 10
Friday, March 7, 2003

The above-entitled matter came on for hearing
pursuant to notice, at 9:35 a.m.

BEFORE:

HON. GEORGE A. OMAS, CHAIRMAN
HON. DANA B. COVINGTON, VICE-CHAIRMAN
HON. RUTH Y. GOLDWAY, COMMISSIONER
HON. TONY HAMMOND, COMMISSIONER

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C O N T E N T S

REBUTTAL WITNESSES APPEARING:

ROBERT POSCH
B. KELLY EAKIN

<u>WITNESSES:</u>	<u>DIRECT</u>	<u>CROSS</u>	<u>REDIRECT</u>	<u>RECROSS</u>	<u>VOIR DIRE</u>
Robert Posch					
by Mr. Volner	1969	--	--	--	--
by Mr. Baker	--	1980	--	--	--
by Mr. Olson	--	2002	--	--	--
by Mr. Costich	--	2049	--	--	--
B. Kelly Eakin					
by Mr. Koetting	2060	--	--	--	--
by Mr. Costich	--	2107	--	--	--
by Mr. May	--	2136	--	--	--

<u>DOCUMENTS TRANSCRIBED INTO THE RECORD</u>	<u>PAGE</u>
Corrected rebuttal testimony of Robert Posch on behalf of PostCom, PostCom, et al. RT-1	1971
Corrected rebuttal testimony of B. Kelly Eakin on behalf of United States Postal Service USPS-RT-2	2063

1966

E X H I B I T S

<u>EXHIBITS AND/OR TESTIMONY</u>	<u>IDENTIFIED</u>	<u>RECEIVED</u>
Corrected rebuttal testimony of Robert Posch on behalf of PostCom, PostCom RT-1	1968	1970
Corrected rebuttal testimony of B. Kelly Eakin on behalf of United States Postal Service, USPS-RT-2	2060	2062
Declaration of James D. Wilson Correcting and Clarifying Response During Oral Cross-Examination	1967	1967
Answers of Newspaper Association of America Witness Christopher D. Kent to Interrogatories of Capital One Services, Inc.	1967	1967
Answer of Newspaper Association of America Witness Christopher D. Kent to Question Posed at Hearing	1967	1967

1967

P R O C E E D I N G S

(9:35 a.m.)

CHAIRMAN OMAS: Good morning. Today we will continue to receive testimony filed as rebuttal to the evidence presented in response to the proposed negotiated service agreement between the Postal Service and Capital One Services, Inc.

This morning we will hear testimony from PostCom et al. witness Robert Posch. We will also hear testimony from the Postal Service witness, B. Kelly Eakin.

As I mentioned yesterday, I want to try to clean up loose ends this morning. I have given the reporter for the transcript copies of three documents that I am admitting into evidence.

(The documents referred to were marked for identification and received into evidence.)

They are the errata submitted by the Postal Service Witness Wilson on February 5, the revised interrogatory answers submitted by Newspaper Association of America Witness Kent on February 21 that takes account of the Wilson errata, and the answer of the Newspaper Association of America Witness

DECLARATION OF JAMES D. WILSON
CORRECTING AND CLARIFYING RESPONSE
DURING ORAL CROSS-EXAMINATION

I, James D. Wilson, declare:

1. Recent analysis conducted by my staff at the National Customer Support Center (NCSC) in Memphis provides additional and corrected information that can assist the Postal Rate Commission as it considers the Postal Service Request in this docket. Moreover, this analysis leads me to conclude that my statement on the record that NCOA is only capable of correcting 25 percent of correctable addresses is incorrect. See Tr. 3/639. Instead the number, while not quantified with any precision, must be much higher.
2. As stated in my testimony, the 25 percent number was derived from dividing the percent of addresses that an NCOA run captures (4 percent) by the Census-derived rate at which Americans move (17 percent). At the NCSC we have used the 25 percent number for years as a conservative measure of the NCOA address correction rate in discussions with customers. The extent of conservatism, and the impropriety of comparing it to an annual move percentage, are explained below.
3. While reducing the percentage of Undeliverable-as-Addressed (UAA) mail has always been a goal of address management policies, in the past two years it has become a major focus of senior postal management and senior industry leaders. The Mailing Industry Task Force, which was chaired by John Nolan, Deputy Postmaster General, and Michael J. Critelli, the Chairman and CEO of Pitney Bowes, is one of the main reasons that a spotlight has been placed on the costs of UAA.

DECLARATION OF JAMES D. WILSON
CORRECTING AND CLARIFYING RESPONSE
DURING ORAL CROSS-EXAMINATION

4. In response to this high-level focus on UAA, the NCSC has been evaluating new ways to improve the percentage of the addresses that NCOA corrects. As a result of the scrutiny, the validity of the 25 percent number as an average NCOA correction rate was challenged by NCSC staff; indeed, it constitutes a substantial underestimate. The extent of this conservatism can be illustrated by examining the patterns of frequencies with which mailers run their mailing lists through NCOA. Among mailers who use NCOA to meet Move/Update requirements, NCOA must be used at least twice per year. So if a particular mailing list of 1000 is stable over a year, a four percent match rate on each of two NCOA runs six months apart means that a total of eight percent of the list would be corrected over a one-year period. Similarly, if a mailer uses NCOA once per month and four percent are corrected each month, a total of 48 percent would be corrected over a one-year period. As such, a system-wide match rate of four percent for all NCOA runs provides no basis for a useful comparison to the 17 percent annual move rate. It is inherently an “apples to oranges” comparison that lacks any real world meaning. The previous comparison of the NCOA match rate with the Census move rate involves different domains or events, which are both related to moves but do not necessarily correspond accurately to one another. A mailer who uses NCOA frequently will likely see lower match rates on a given run than a mailer who does not, notwithstanding the advantages to the Postal Service of more frequent NCOA matches. Consequently, without an appropriate aggregation of all NCOA mailers that accounts for the frequency of use, one cannot calculate an “average”

DECLARATION OF JAMES D. WILSON
CORRECTING AND CLARIFYING RESPONSE
DURING ORAL CROSS-EXAMINATION

annual correction rate and no basis for a comparison to an annual Census number exists.

5. My testimony in the Capital One case facilitated the debate about the validity of the 25 percent correction number. During oral cross-examination, I testified that NCOA corrects approximately nine billion addresses a year; I then acknowledged one could deduce that the 75 percent of addresses not corrected by NCOA would equal 27 billion. Tr. 3/642, lines 8-18. It was upon review of this part of my testimony in the context of the management challenge to improve NCOA performance that the invalidity of the 25 percent figure was recognized. We know that the amount of actual move-related UAA mail does not equal 27 billion pieces. In FY2002, the total number of forwards was about two billion and the total number of returns, both move and non-move related, was about one billion.

6. The Postal Service no longer relies on the 25 percent number because, as explained above, it is imprecise and a substantial understatement of the annual NCOA "correction rate".

**ANSWERS OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS CHRISTOPHER D. KENT TO INTERROGATORIES OF
CAPITAL ONE SERVICES, INC.**

COS/NAA-T1-21 On page 12 of your testimony, you state that "one might assume that the relationship between COS's forwarding and return rates corresponds to the average for all FCM." Isn't it the case that you actually mean that it corresponds to the ratio between forwarding and return rates? Please explain the logical rationale for linking the ratio (percent forwarded to percent returned) to Capital One's First-Class Mail and First-Class solicitations volumes? Please explain what there is about a high return rate for a mailer that would dictate that it would also have an abnormally high forwarding rate?

ANSWER:

Yes, I am comparing the ratio of COS's forwarding to return rate to the FCM forwarding to return rate ratio. The reason I think that Capital One's forwarding rate is high is because their address list quality is poor, as indicated by their return rate of 9.6% (**eight** times the FCM average). This is hardly surprising, given that Capital One has no relationship with the people on their solicitation lists. What is surprising is the contention made by the USPS that Capital One, despite the poor quality of their address lists, is somehow catching the vast majority of the address changes every year. The USPS justifies its assumption that Capital One's forwarding rate is equal to the FCM average on the grounds that COS uses the NCOA (National Change-of-Address) system to update its mailing lists every 60 days. Witness Wilson testified that NCOA does not catch all change of addresses (Declaration of James D. Wilson Correcting and Clarifying Response During Oral Cross Examination). According to witness Wilson, 17% of households move each year. It is difficult to believe that while COS has incorrect addresses for 9.6% of its solicitation targets (resulting in a returned piece), it somehow has sufficiently good addresses as to have only the FCM "average" rate of forwards. My rationale for linking the forwarding rate to the return rate is that both are related to poor address quality and if Capital One has a return rate 8 times higher than the FCM average, then one would expect the forwarding rate for the mail sent using those same address lists to be higher than the FCM forwarding rate.

**ANSWERS OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS CHRISTOPHER D. KENT TO INTERROGATORIES OF
CAPITAL ONE SERVICES, INC.**

COS/NAA-T1-32. Please refer to your response to COS/NAA-T1-5 where you state, "use of NCOA presumably should reduce the forwarding rate somewhat." Please provide your best estimate of the extent to which use of NCOA should reduce the forwarding rate, provide all underlying calculations, and describe your reasoning fully.

ANSWER:

Given that the Postal Service's own witnesses cannot quantify the NCOA match rate (Declaration of James D. Wilson Correcting and Clarifying Response During Oral Cross Examination), I cannot quantify the extent to which use of NCOA should reduce COS's forwarding rate.

REQUEST: At this point in the transcript (Tr. 6/1151-1152), Mr. May asked, "By what percentage would the Postal Service have had to overstate the unit cost of physical and electronic returns for this NSA to generate no additional contribution?"

RESPONSE:

Under the assumption that both the physical and electronic returns unit costs are 64% less than those calculated in USPS LR-1, the net contribution from the NSA will be -\$102,000. I note that the assumption must be that not only do the carrier preparation and clerk handling (the two cost components common to both physical and electronic returns) change in both cases, but that the cost components not common between the two types of returns must change at the same rate. It is much more likely that the magnitude of any mistakes in witness Crum's estimations differ between the two types of returns.

In fact, upon review of this issue, it appears that the electronic returns cost used in the justification of the proposed NSA may be too low. The source listed in USPS LR-1 for the eACS cost is Tab 3 of USPS LR-J-69, which shows two cost components of ACS notifications: ACS COA notification (\$0.0997/piece) and ACS nixie processing (\$0.2074/piece). These two cost components are then weighted by volume (COA notifications make up 58% of ACS notifications and nixie processing make up 42%) to develop the \$0.1450. Because ACS COA notification is the cost for notifications of forwards and ACS nixie processing is the cost for notifications of returns, the \$0.1450 cost is based primarily on the cost for notifications of forwards.

Because witness Crum is estimating the cost of electronic **returns** in LR-1, it would seem more appropriate to use the ACS nixie processing cost, rather than the weighted average of ACS COA notification (the cost for notifications of forwards) and ACS nixie processing (the cost for notifications of returns). In other words, the \$0.1450 would be replaced with \$0.2074 in the electronic returns cost and thus the total electronic returns cost would increase to \$0.3945.

ANSWER OF NEWSPAPER ASSOCIATION OF AMERICA
WITNESS CHRISTOPHER D. KENT TO QUESTION POSED AT HEARING

By simply making this change to the electronic returns cost, the net contribution of the proposed NSA is reduced to \$4,122,000 (from \$8.2 million).

As I stated throughout my testimony, the justification for the proposed NSA is based on costs that have not been demonstrated to be applicable to COS and cost savings that are likely overstated. This is yet another example of the questionable nature of these costs.

1 Kent to a question posed during his cross-examination
2 by counsel for Capital One, Inc. That answer also was
3 provided on February 21.

4 Does any participant have any procedural
5 matters to raise at this time?

6 (No response.)

7 CHAIRMAN OMAS: There being none, Mr.
8 Volner?

9 MR. VOLNER: Thank you, Mr. Chairman. The
10 Association for Postal Commerce, et al. call Robert
11 Posch.

12 (The document referred to was
13 marked for identification as
14 Exhibit No. PostCom et al.
15 RT-1.)

16 MR. VOLNER: Mr. Posch, do you have a
17 document entitled Testimony of Robert Posch on behalf
18 of PostCom, et al. in this docket in front of you?

19 CHAIRMAN OMAS: Excuse me. I need to swear
20 him.

21 MR. VOLNER: Pardon me? Oh, yes. I'm
22 sorry.

23 CHAIRMAN OMAS: Mr. Posch, will you raise
24 your right hand?

25 Whereupon,

1 ROBERT J. POSCH, JR.

2 having been duly sworn, was called as a
3 rebuttal witness and was examined and testified in
4 rebuttal as follows:

5 CHAIRMAN OMAS: Mr. Volner, you may now
6 proceed.

7 MR. VOLNER: Thank you, Mr. Chairman.

8 DIRECT EXAMINATION

9 BY MR. VOLNER:

10 Q You do have the document?

11 A I have it, yes.

12 Q Was that testimony prepared by you or under
13 your supervision?

14 A Yes, it was.

15 Q And you adopt it as your testimony in this
16 case?

17 A Yes, I do.

18 MR. VOLNER: Mr. Chairman, I'm going to hand
19 two copies of the testimony to the reporter, and I ask
20 that it be admitted in evidence in the record.

21 CHAIRMAN OMAS: Is there any objection?

22 (No response.)

23 CHAIRMAN OMAS: Hearing none, I will direct
24 counsel to provide the reporter with two copies of the
25 corrected rebuttal testimony of Robert Posch. That

1 testimony is received and will be transcribed into
2 evidence.

3 (The document referred to,
4 previously identified as
5 Exhibit No. PostCom et al.
6 RT-1, was received in
7 evidence.)

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POSTCOM, ET AL. RT-1

**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

TESTIMONY OF ROBERT POSCH
ON BEHALF OF POSTCOM, et al.

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POSTCOM, ET AL. RT-1

**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

TESTIMONY OF ROBERT POSCH

My names is Robert Posch. I am testifying in this matter in my capacity as a member of the Board of Directors of the Association for Postal Commerce ("PostCom"). I do so on behalf of PostCom, The Direct Marketing Association, and the Parcel Shippers Association ("PostCom et al"). I am Senior Vice President, Legal, Postal and Governmental Affairs for Bookspan, have more than 20 years of experience in direct marketing and postal matters, and have previously testified before this Commission.

The purpose of my testimony is to explain why PostCom, et al. believe that Negotiated Service Agreements – bilateral agreements between the Postal Service and an individual mailer – should be affirmatively encouraged. In so doing, I hope to answer the suggestions, made in this proceeding, that it is better to convert company-specific agreements into more broadly available rate categories. We urge the Commission to reject this concept. I will show that, from a business perspective, Negotiated Service Agreements and niche classifications are not the same thing. Each serves a legitimate, different purpose in the postal environment.

I further will explain – again, from a business perspective – the type of information the Commission can reasonably expect to be provided by companies that enter into Negotiated Service Agreements and why we believe that the Commission should accept subclass average costs, subject to known adjustments, and should not insist upon precision in modeling and forecasting in the NSA setting. The views I set forth below are based on extensive discussions that have occurred during meetings of the various organizations that are sponsoring this testimony, as well as at public forums such as last summer’s Postal Summit and in discussions my company has had with the Postal Service on this topic. It is not our purpose to address the specifics – the types and depth of discounts, the volume triggers and other details – of the agreement between Capital One and the Postal Service which is under consideration here. Those matters are specific to the two parties and are beyond the scope of this testimony

A. Why NSAs Are Important From A Business Perspective.

The mailing industries have long recognized that the use of average costs to develop rates and discounts is not going to suit the needs and interests of all the mailers who might otherwise be able to qualify their mail for a particular rate category. Average price signals do not meet the needs of mailers whose particular business model or cost structure does not closely replicate the average. Average price signals will be false for those mailers. That is, in part, why the existing worksharing initiatives and optional services are not fully utilized by mailers. From an industry perspective, this poses something of a dilemma: on the one hand, mailers recognize that the more worksharing they engage in, and the more efficient optional services they use, the better off the postal system as a whole will be; on the other, mailers cannot rationally respond to rate

incentive if the cost to the mailer -- including capital and other costs -- is greater than the savings in postage costs they will realize, given their particular business operational and cost structures.

NSAs are a vehicle for resolving this dilemma. Niche classifications are another. While it seems to be the view of some participants in this proceeding that there is no real distinction between the niche classification and a NSA, we in the industry do not see it that way. The essential difference between the niche classification and an NSA is that in the former case, it can be reasonably and confidently expected that the incentive to be proposed will be responsive to the needs of a group of mailers. The co-palletization proposal that the Commission recently favorably recommended is an example of this. In that case, there was a known group of mailers whose mail has closely similar cost and operational conditions; the size of the group was limited, but the arrangement was plainly of interest to more than one mailer. By contrast, an NSA involves contract rates that are worked out between a particular mailer and the Postal Service so that the obligations imposed on the mailer and the incentives that are offered in exchange are tailored to meet the particular needs and operational requirements of that company, and it is not known whether there may be other mailers with closely comparable needs and comparable mail characteristics.

From a business perspective, the distinction is important for the following reasons. If an arrangement that was worked out and tailored to meet the needs of a particular mailer is opened up to a broader group of mailers with dissimilar mail or mailing practices, the business dynamics of the original arrangement will be altered. That is, by prematurely opening up an NSA, the cost savings the Postal Service expects

to realize will be reduced and/or the corresponding incentives it is able to offer will be diminished. The result may be that the value of the arrangement is so altered and the price signal so changed, to reflect the characteristics of a larger group of potential users, that the incentive no longer serves the interests of the original NSA party or of the Postal Service. And, there can be no assurance that the incentive serves the interest of any other potential user. This kind of unpackaging of the terms of an NSA and attempting to convert the NSA into one or more general rate schedules makes no sense since it serves no mailer or Postal Service interest.

In sum, company-specific arrangements are important to the mailing industry because they provide mail users with the opportunity to configure rate and worksharing arrangements that are consistent with their particular business model, while at the same time yielding benefits to the Postal Service that, in turn, accrue to the system as whole.

There seems to be a concern that if the Commission were to favorably recommend a company-specific arrangement, this would be “unfair” because of the unknown possibility that other mailers -- whose mailing and mailing practices virtually replicate that of the NSA participant -- would be willing and able to undertake the same obligations in exchange for the same rate benefits as those contained in the contractual arrangement with the original mailer. We do not see this as a problem. We believe that the Postal Service will act in good faith to extend the terms and conditions of an NSA, once approved, to other mailers -- if there are any -- who have closely comparable mail, meet the eligibility thresholds and are able and willing to assume all the obligation embodied in the original arrangement. In fact, timidity in recognizing the value of NSAs can have unintended consequences that are economically inefficient. For example, I am

informed that, at present, there is only one mailer participating in the Commission approved Priority Mail Presort experiment. The fact that there is now only one mailer participant suggests that it might have been better to structure that arrangement as an NSA in the first instance and then develop variations on the NSA with perhaps different obligations and incentives to reflect the differences in the needs and interests of those who initially participated in that experiment but have since dropped out.

B. The Commission Should Not Demand Unrealistic and Impractical Cost Projections Volume and Cost Information From NSA Participants.

Because they are company-specific, the type of information that an NSA participant and the Postal Service will be able to provide to the Commission to justify and explain the arrangement is necessarily going to differ from the type of the information used by the Postal Service in omnibus rate cases. The suggestion has been made in this docket that the Postal Service and an NSA participant should have to model the costs of the NSA mailer and determine the volume elasticities for that particular mailer in order to support or justify the agreement. This is unrealistic for several reasons.

First, most mailers – even very large ones – do not engage in the type of econometric forecasts that the Postal Service performs in connection with its rate cases. While it might be theoretically possible for mailers to supply raw data to the Postal Service and have the Postal Service do the modeling, many mailers do not collect or retain the data that the Postal Service would need to perform modeling and forecasting at the level of specificity expected in omnibus rate cases. Further, even if the data are available or could be collected in a form suitable for modeling with rate case specificity, the transaction costs to the Postal Service and the private sector NSA participant would

be such as to completely wipe out the benefits that both parties arrangement expect to realize.

This does not mean that the Postal Service and NSA participants must or should rely on average subclass costs without regard to the costs or elasticities of the individual mailer. To the extent that the difference between company-specific costs or elasticities and subclass averages are readily ascertainable and demonstrable, they should be taken into account in formulating the terms of the negotiated service arrangement. Of course, the fact that these types of adjustments should be made further counts against opening of the terms of an NSA to a larger group of mailers: the adjustment to average cost may well differ for every mailer in the larger group.

A somewhat different problem arises concerning the appropriate use of the Test Year in proceedings involving NSAs. By their very nature, all NSAs require the participant mailer to agree to change the way it has conducted business with the Postal Service with respect to the matters that are subject to the NSA. The mailer has to take the risk that it will be able to meet its obligations under the NSA and have sufficient time to recover both the upfront and ongoing costs it will incur under the contract. The result is that it is unlikely the Commission will ever see an NSA which terminates at the end of the Test Year. In fact, the 3-year period essentially required by the experimental rules will itself have an inhibiting effect in some large and complex deals.

The fact that an NSA will continue for a period that goes beyond the end of a Test Year should not change the way the Commission uses the Test Years to judge the arrangements. Rates set in an omnibus rate case often last beyond the end of the Test Year.

Since the Commission's rate case determinations are based on Test Year information, we see no reason why that should be different in the context of an NSA.

In the context of NSAs, the question the Commission needs to address is not whether this is the "best deal" the Postal Service or the private sector participant could get. The Commission's responsibility is simply to see to it that the deal does not harm the interests of other stakeholders and, in one fashion or another, adds value to the bottom line. The Commission can and should accept the proposition that the normal negotiation process yields the best deal that the parties could get in all of the circumstances and that process yields a result that benefits both parties. If it were not, one or the other of the parties would have refused the deal and there would be nothing for the Commission to consider.

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.

Respectfully submitted,

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February 25, 2003

1 CHAIRMAN OMAS: This now brings us to oral
2 cross-examination. Two parties have requested oral
3 cross-examination, Newspaper Association of America
4 and Val-Pak Direct Marketing Systems, Inc. and Val-Pak
5 Dealers Association, Inc.

6 Mr. Baker, you may begin.

7 MR. BAKER: Thank you, Mr. Chairman.

8 CROSS-EXAMINATION

9 BY MR. BAKER:

10 Q Good morning, Mr. Posch.

11 A Good morning, Mr. Baker.

12 Q I'd like to start by asking you a couple
13 questions about Bookspan.

14 A Sure.

15 Q My understanding is that it's a partnership
16 of some form between AOL-Time Warner's Book of the
17 Month Club and Doubleday Direct. Is that correct?

18 A It's AOL and Doubleday Direct, Inc.

19 Q Okay. And Doubleday Direct is owned by
20 Bertlesmann?

21 A Yes. Bertlesmann, Inc.

22 Q Okay. And basically you're in the business
23 of book clubs whereby the books are delivered to users
24 by mail or some alternative?

25 A Correct. We're I believe the twenty-second

1 largest postal customer.

2 Q Okay. Are you the largest book club, as far
3 as you know?

4 A Yes. Of primary business book clubs, yes.
5 There are other competitors, but we are, yes.

6 Q Okay. And are your competitors other book
7 clubs, or is it retailers and Amazon.com and folks
8 like that?

9 A We would be in direct marketing, while some
10 of the other sellers are in different other forms.
11 There is a legal distinguishment because our customers
12 all have to be members. We don't sell books directly
13 the way an Amazon or Barnes&Noble.com or a catalog
14 would.

15 It's very traditional, since 1924. You sign
16 up for a certain amount of books. You buy some
17 others. You receive a variety of catalogs targeted to
18 your interests. You know, we have book clubs ranging
19 from book of the month to erotic to evangelical to
20 military to history. We cover the whole gamut.
21 There's about 50 clubs.

22 Q Okay. And one joins the club in response to
23 a solicitation either by mail or magazine or newspaper
24 clipping or some such place where there's been a
25 promotion that invites the person to join?

1 A Correct.

2 Q And have you been with Bookspan or its
3 predecessor for how long, 20 years or more?

4 A Twenty years or more.

5 Q Okay.

6 A It gets on in years.

7 Q Time flies.

8 A Yes.

9 Q All right. I want to turn at this point and
10 direct your attention to your testimony at the bottom
11 of page 3 that carries over to the top of page 4.
12 Have you had a chance to turn to that, please?

13 A Yes, I have.

14 Q All right. Here you are discussing in this
15 paragraph, and you can take a moment to review it if
16 you'd like. I'll characterize it as a deficiency or a
17 shortcoming you see in the use of average costs in
18 setting postal rates.

19 I want to focus your attention particularly
20 on the line at the bottom of page 3 that carries over.
21 You say, "Mailers cannot rationally respond to rate
22 incentives if the cost to the mailer, including
23 capital and other costs, is greater than the savings
24 in postal costs that they would realize, given their
25 particular operations."

1 I think I understand your point there; that
2 if it costs, you know, \$10 to reconfigure your system
3 and you earn a five cent discount that's not worth it
4 to the mailer. Is that correct?

5 A Correct.

6 Q Okay. Are you intending to say here that
7 postage rates or discounts should be based on the cost
8 to the mailer?

9 A No. The intent here is just to distinguish
10 why carving out NSAs targeted to an individual
11 customer approach can at times be much more
12 advantageous than having a broader niche discount
13 because the post office may not be able to do a one
14 size fits all.

15 That might preclude other would-be users
16 from coming in and, therefore, that hurts the post
17 office because the post office loses the volumes, as
18 well as the cost cutting potential.

19 Q Well, if a mailer can do I'll call it
20 function X -- just do something, and we'll call it X
21 -- and that incurs a cost of Y in order to do that and
22 as a result of that the Postal Service can save Z
23 cents in handling that piece, in your view should the
24 rate for that for the mailer be based on Y, the cost
25 to the mailer, or Z, the cost avoided by the Postal

1 Service?

2 A Are you speaking now of an NSA?

3 Q Any discount or an NSA. It could be an NSA.
4 It could be a work sharing discount.

5 A Because the NSA presumably would be
6 negotiated, and it really isn't an either/or.

7 Q Right. Okay. What about a discount set by
8 the Commission or a niche classification discount?

9 A A niche classification? Could you repeat
10 the question?

11 Q All right.

12 A I think there is a difference between the
13 two.

14 Q So you're saying a function, X, and in the
15 case of a niche classification it would cost a mailer
16 Y to do the function, and the Postal Service would
17 avoid costs of Z.

18 A Right.

19 Q Would you recommend the Commission base the
20 size of the discounts in the niche classification on
21 the mailer's cost, Y, or the Postal Service's cost
22 savings of Z?

23 A I hate to use -- a general thing. I'd
24 recommend the Commission would adopt the standards
25 that would be most attractive to bring in the most

1 users if you're now speaking of a niche discount.

2 I think I cite on page 4 or 5 the priority
3 mail discount which was done, but is only right now
4 being used by one postal customer. Again going back
5 to the advantages of NSAs at times over niche
6 discounts is sometimes the post office may not
7 understand individual customers, but by negotiating
8 with them they would. Therefore, it would make it
9 more of interest to individual customers.

10 Q Let's go back to the niche classification.
11 I think it's easy to imagine that the Postal Service
12 could make any discount very attractive by, you know,
13 setting the discount at \$5 or some very large number.
14 That would make it really attractive, but would that
15 be in the best interests of the Postal Service?

16 A No.

17 Q Okay. And that would be because the Postal
18 Service would lose more money than it saves
19 presumably?

20 A If that was the case, correct. Yes, unless
21 somehow volume made up for it.

22 Q Okay. When it comes to an NSA, changing to
23 an NSA where the mailer is going to do function X and
24 it costs it Y to do so and the Postal Service avoids
25 costs, Z, your position is the rate should be

1 negotiated without the criteria set in advance as to
2 where it should fall?

3 A My understanding is there's pretty broad
4 criteria parameters which an NSA must hurdle. Maybe
5 I'm having a hard time saying -- if the answer is
6 somehow -- again, I'm not sure where the question is
7 going because --

8 Q Well, my question --

9 A As I say, I can break out, as I've tried to
10 do, an NSA. That would overcome that problem because
11 the post office's costs are more transparent to the
12 individual negotiating firm, and they could work
13 together.

14 Q Well, if you were in a position of
15 negotiating an NSA with the Postal Service and you
16 knew what it cost you to do function X --

17 A Right.

18 Q -- and the Postal Service thinks that by
19 your doing X it would save costs, Z, what are you
20 going to push for as the rate in the best interest of
21 your company?

22 A Well, obviously advocating in that
23 situation, yes.

24 Q Okay.

25 A The bottom line is when you negotiate with

1 the post office in this case you want for them what
2 you need to make a certain thing happen.

3 Q Well, you would want a rate that's at least
4 greater than Y. You want a rate that more than
5 compensates you for your effort.

6 A Yes.

7 Q Okay. And if the Postal Service is willing
8 to agree to a rate that for some reason doesn't make
9 it whole that's not your problem. That's its problem.
10 Is that right?

11 A I guess so.

12 Q Yes. Okay.

13 A I've not found the post office to be that
14 generous, but --

15 Q There is some dispute on the record of
16 exactly how generous they have been in this instance,
17 but that's beyond the scope of your testimony, I
18 think.

19 I'm interested because at the bottom of page
20 4, and you carry over to 5, you have a phrase about,
21 "By prematurely opening up an NSA, the cost savings
22 the Postal Service expects to realize would be
23 reduced, and the incentives it could offer would be
24 diminished." You go on to say, "That would really no
25 longer serve the interests of the regional NSA party."

1 Do you mean to say there that if the Capital
2 One NSA were made open, which is your word, to others
3 that the Postal Service would no longer reap the cost
4 savings it thinks it's going to get from Capital One?

5 A No.

6 Q Okay. Are you assuming the terms would be
7 changed?

8 A Nothing in this testimony addresses the
9 merits of the Capital One deal.

10 Q Yes. So you're assuming that if the Capital
11 One deal were somehow opened up it would be on
12 somewhat different terms than the current Capital One
13 deal? Is that correct?

14 A Again, there are no assumptions made on the
15 Capital One deal. I mean, I was asked to talk about
16 NSAs in general and why the industry supports them,
17 why NSAs at certain times are preferable to niche
18 discounts and why they're a different animal, but not
19 to speak on the merits of Capital One's individual --

20 Q Can you think of a situation where a niche
21 classification would be preferable to an NSA?

22 A If the costing worked for many mailers, yes.
23 I mean, the goal of an NSA is to give -- there's many
24 goals.

25 It's fundamental fairness to the post

1 office, first of all, because the bottom line is the
2 largest facilitator of direct marketing in the United
3 States is the post office, and it should be allowed to
4 operate as a direct marketer. It can do this in
5 Europe. NSAs and all that are permitted in Europe.
6 They're not permitted here for different reasons.

7 The NSAs permit the post office to learn
8 more about its customers. As a direct marketer,
9 that's fundamental to what all direct marketers do.
10 Our whole thing is test, test, test. Every direct
11 marketer lives by that mantra. The post office needs
12 more flexibility to test different classifications
13 with individual mailers, and then it contributes the
14 overall growth volumes and all the other stuff.

15 Now, in more broad cases obviously a niche
16 is more preferable if it works for a broad range of
17 people. Sometimes it does. Again, it helps to have
18 the post office have individual customer input on
19 things like that.

20 Q Well, a niche, by being broader, is less
21 tailored by definition than an NSA for a single
22 customer, correct?

23 A Presumably, yes.

24 Q Yes. And so if a niche classification as
25 offers, rates or discounts that are based upon a wider

1 group than simply one customer mailer, then they would
2 be less beneficial to a mailer who's not quite the
3 average one. Am I making the point clear?

4 If you do an NSA for one customer and it's
5 sort of tailored for that customer, if it's broadened
6 to apply to two or three other customers on slightly
7 different terms your point is that might be less
8 valuable to the first customer. Is that right?

9 A I'm not sure if that's how niches actually
10 do come about, you know, because I'm not sure there's
11 necessarily a first customer who proposes the niche.
12 I think that's one of the differences between the
13 negotiate service agreement because an NSA --

14 Q Maybe I mis-spoke. With an NSA then the
15 first customer certainly brings it up. There's a deal
16 for a first customer.

17 A Yes.

18 Q And if an NSA is broadened, unless it's kept
19 on the same identical terms, it presumably would be
20 somewhat less valuable to the initial mailer, wouldn't
21 it? Isn't that inherent in any averaging?

22 A That's sort of speculative. You can say --
23 I mean, go along with the speculation maybe. If it's
24 advantageous to the post office, generally it's
25 advantageous to the mailers anyway because the health

1 of the post office is important to us with the volumes
2 and everything else like that, but if you're going
3 from a specific to a general, no. It might actually
4 get better. I'm not sure what you were trying to get
5 to.

6 Q Let me ask it this way.

7 A I mean, I think the next paragraph down sort
8 of answers what --

9 Q I'm going to get to the next paragraph very
10 shortly. So you're saying if a mailer can negotiate
11 an NSA with the Postal Service that's a good deal for
12 it and presumably for the Postal Service maybe.

13 Are you saying that if that arrangement were
14 opened, broadened, made a niche classification, made a
15 permanent classification open to a broader group of
16 people, that would be an undesirable thing because
17 there's probably less benefit to the first mailer? Is
18 that the gist of this?

19 A I mean, our position is that basically the
20 post office has no incentives not to open these up.
21 If not very unique, they would want to open them up.
22 If it was very unique there's a different advantage to
23 the post office, and that's that they will get under
24 the experimental rules information about that
25 particular market or marketer by working with them.

1 There's also a preferable advantage to the
2 post office with NSAs, and they pick up from both
3 their employees and in general morale because by
4 working closely with customers they pick up some of
5 the goodwill of that individual customer, but I don't
6 see any incentive, you know, for the post office not
7 to open it up if it's not totally unique, but it's
8 hurting individual mailers that's speculative.

9 Q Is it your understanding the Postal Service
10 would be willing to negotiate lots of similar NSAs?
11 If this one were approved or an NSA with some other
12 company were approved, the Postal Service would be
13 willing to negotiate similar ones with other mailers?

14 A If it's in the interest of the post office
15 and the individual mailer. We would hope so, yes.

16 Q I mean, I can see how you would say that
17 thinking if you were in their shoes that's how you
18 would think, but do you have any indication from the
19 Postal Service that they would do that?

20 A Over the last few years they've said that.
21 Their transformation plan indicates that. The efforts
22 they've put into negotiating a few of these recently
23 indicates that.

24 Q I won't ask the one I wanted to ask about
25 those. Anyway, let's look at the bottom of page 6

1 here. No. Actually it's the first paragraph under B
2 on page 6.

3 A Okay.

4 Q I'm looking at the last sentence in the
5 first paragraph. "The suggestion has been made in
6 this docket that the Postal Service and an NSA
7 participant should have to model the cost of the NSA
8 mailer and go on and determine the volume elasticity
9 of that mailer in order to support and justify the
10 agreement."

11 By "model the cost of the NSA mailer," what
12 costs are you referring to as being modeled?

13 A Let me read this again.

14 (Pause.)

15 A I wonder when somebody did this. I think it
16 was referring to our own when we were doing ours. In
17 general, the mailers and the post office approach cost
18 at times with different criteria.

19 Q Well, let me give you two choices here and
20 see if one or the other was what you were thinking
21 about here.

22 By modeling the costs of the NSA mailer, are
23 you suggesting that the contention is being made here
24 that in the one we're now considering the Postal
25 Service and Capital One should figure out what it cost

1 Capital One to prepare and deal with its mailings and
2 base the NSA on that, or Alternative 2 would be the
3 Postal Service should figure out what it costs it to
4 handle the Capital One mail that's subject to the NSA.

5 Are we talking about the Postal Service's
6 cost of handling Capital One's mail or Capital One's
7 cost?

8 A Okay. Leaving out the specifics of the
9 Capital One, the element of negotiation implies you
10 have your mutual costs, and you try to reach a common
11 denominator. There isn't any particular one cost
12 standard.

13 Q Well, I guess then I'm trying to get a
14 better understanding of who made the suggestion in
15 this docket that you're referring to in the testimony
16 and what you thought it was.

17 A From our own personal experience, because
18 we've also been involved in this Bookspan, you know,
19 when we negotiated with the post office it was often
20 the basis of cost and all that.

21 That's one reason why the cost criteria is
22 negotiated. It's hard to establish a single benchmark
23 at least in the beginning of the negotiations.

24 Q So you've been in negotiations with the
25 Postal Service for a possible NSA on your own?

1 A Yes.

2 Q Are those still ongoing?

3 A It's on hold pending discussions you're
4 having here.

5 Q Okay. Do you think it's relevant to the
6 Commission's consideration of an NSA what the mailer's
7 own costs are in preparing the mail in accordance with
8 the terms of an NSA?

9 MR. VOLNER: Are you asking -- I'm going to
10 interpose an objection to that question.

11 MR. BAKER: Okay.

12 MR. VOLNER: Are you're asking relevance
13 from a businessman's perspective, or are you asking
14 relevance from a legal standard?

15 He is a lawyer. He's not testifying as a
16 legal expert on postal matters, although he is one.

17 MALE VOICE: That's a good legal answer.

18 MR. BAKER: Well, Mr. Chairman, at the
19 bottom of page 6 the witness has a discussion here to
20 the point where he seems to be saying mailers do not
21 have the data to do econometric forecasts of their own
22 mailings of the type of Postal Service does on its
23 part.

24 He says while it might be theoretically
25 possible for mailers to supply data to the Service and

1 have the Postal Service do the modeling, many mailers
2 don't do that. I guess what my question really boils
3 down to is whether he thinks or it's his testimony
4 that that sort of modeling should be done for an NSA
5 for this case.

6 MR. VOLNER: I think the testimony speaks
7 for itself, Mr. Chairman.

8 CHAIRMAN OMAS: Yes. Mr. Posch?

9 THE WITNESS: Yes?

10 CHAIRMAN OMAS: Can you address that
11 question?

12 THE WITNESS: The criteria comes down to the
13 fact that there's no one size criteria fits all.
14 Number two, the post office will come to you with
15 certain criteria which they use which would be
16 different than ours.

17 One of the reasons we have these, from
18 personal experience in this case -- not Capital One's,
19 of course -- but is so they can find out information
20 about the mailer's own costs, which then facilitates
21 their costs. In the course of negotiations they will
22 change their opinion at times too.

23 BY MR. BAKER:

24 Q Do you believe that when the Postal Service
25 proposes an NSA to this Commission for its

1 consideration that the Postal Service should know what
2 its costs are in handling the mail subject to the NSA?

3 A I would say they certainly do. I would
4 assume they do, and I would say just from personal
5 experience in negotiating with them they're very good
6 at this. We can disagree with them, but they would
7 know their costs.

8 Q I think you said you think they do. My
9 question was more do you think they should?

10 MR. VOLNER: Again, I'm going to object.
11 Are you asking him whether as a matter of law they
12 should?

13 CHAIRMAN OMAS: Would you repeat your
14 question, Mr. Baker?

15 MR. BAKER: He is testifying here about the
16 kind of costs as a businessman he thinks the Postal
17 Service should have. I'm asking him actually not as a
18 matter of law, but as a matter of a businessman here.

19 THE WITNESS: The question is straight up.
20 The question is straight up. Should they know their
21 costs? Of course.

22 MR. BAKER: Okay. Fine.

23 BY MR. BAKER:

24 Q Could you turn to page 8 --

25 A Sure.

1 Q -- of your testimony in your conclusion
2 paragraph where you say that, "The Commission's
3 responsibility is simply to see to it that the deal
4 does not harm the interest of other stakeholders and
5 in one fashion or another adds value to the bottom
6 line."

7 I assume you're not testifying there as to
8 what the law requires the Commission to do, but rather
9 you're testifying as a businessman. Is that correct?

10 A Correct.

11 Q All right. Now, who are "other
12 stakeholders?"

13 A Okay. In this case obviously the mailers,
14 other mailers.

15 Q What do you mean in this case, the Capital
16 One case?

17 A No. In the case with testimony. I mean,
18 obviously you can get into the broader stakeholder is
19 the post office, but this was meant to say it
20 shouldn't harm the interests of other mailers.

21 Q Do other stakeholders, in your view, include
22 competitors of the mailer who gets an NSA?

23 A Other mailers, yes.

24 Q What about competitors who don't use the
25 mail?

1 A Well, I'm not sure where that goes since
2 we're speaking of something, you know, for the health
3 of the post office and the health of its own customers
4 and the universal service, cost control and everything
5 else like that.

6 I'm not sure why worrying about a non-mail
7 user would necessarily come into the discussion.
8 Maybe you've got to rephrase the question.

9 Q I thought the question was very clear. So
10 you just don't know whether the phrase "other
11 stakeholders" in your testimony refers to competitors
12 of the NSA mailer?

13 A Again, if we're speaking solely --

14 MR. VOLNER: I think he's answered the
15 question, Mr. Chairman.

16 THE WITNESS: Yes.

17 MR. VOLNER: He has said, and you can have
18 it read back, that he does not see why non-mailers
19 would come into the equation.

20 CHAIRMAN OMAS: Move on, Mr. Baker.

21 BY MR. BAKER:

22 Q Let me ask it this way. Yes or no? Do
23 other stakeholders include in your testimony
24 non-mailing competitors of the NSA mailer? Yes or no?

25 A I'd say no.

1 Q Thank you.

2 A Yes.

3 Q I want to ask you about "harm the interests
4 of other stakeholders." Who is Bookspan's biggest
5 book club rival? Is there one?

6 A We have rivals in book clubs. We have other
7 competitor rivals. Rodale has book clubs. There are
8 other book clubs. Even our partner has other book
9 clubs, and then we would also consider ourselves in
10 competition with other mailers such as Amazon and
11 Barnes&Noble.com; not in the same level legally in
12 competition, but we sell books through direct channels
13 and use the mail.

14 Q Just out of curiosity as a businessman here,
15 if Rodale, you mentioned, got an NSA that reduced its
16 rates for its book shipments by say 10 percent, to
17 pick a figure out of the blue, and you didn't and by
18 its terms it wasn't really open to you, would that
19 harm your interests?

20 A If it was unique to them and we couldn't
21 participate. There's a lot of things which people can
22 do which might harm your interests, but if it's not
23 something we could use then it really wouldn't be our
24 decision. It would be a decision between the post
25 office and another customer, assuming it was so unique

1 to them.

2 I have a hard time seeing say in the parcel
3 area or something if they could create an NSA that
4 wouldn't be open to others, but, if it was, again the
5 purpose of an NSA is to get information from
6 individual customers. If in the hypothetical Rodale
7 had some information to provide the post office that
8 was mutually advantageous cost wise, contributed to
9 volume, overheads, the whole thing, indirectly we
10 benefit.

11 I mean, we look upon this. Bookspan has no
12 stake in the Cap One deal. Again, I can't comment,
13 but if the Cap One deal enriches the overall postal
14 system either through increased volumes or cost
15 cutting or other information, all mailers benefit
16 because we are all stakeholders in the universal
17 system at the lowest rates possible and the best
18 service possible.

19 Q Would you have a competitive concern if
20 Rodale was to be able to ship books at a lower cost
21 than you could?

22 A If they worked out something that was
23 totally unique, we would go back to the post office
24 and approach them, or we would speak to our postal
25 counsel, Ian Volner, to see if it was open to others,

1 depending on how it is written.

2 MR. BAKER: Well, speaking to Mr. Volner is
3 always a wise idea, but I have no more questions, Mr.
4 Chairman.

5 CHAIRMAN OMAS: Thank you, Mr. Baker.

6 Mr. Olson?

7 MR. OLSON: Thank you, Mr. Chairman.

8 CROSS-EXAMINATION

9 BY MR. OLSON:

10 Q Mr. Posch, William Olson representing
11 Val-Pak.

12 A Hi.

13 Q Hi. I just want to begin with a question
14 following up on what Mr. Baker said. You were talking
15 about advantages that could come from an NSA to the
16 Postal Service by getting additional information from
17 the mailer that they were doing the NSA with. Could
18 you elaborate on that?

19 A My understanding is one of the
20 attractivenesses to the post office of these and the
21 reason the experimental rules are there is so that the
22 post office can do experimentation with individual
23 customers ideally if it's so able to and find out
24 information it could use both for itself and for its
25 general customer base in general.

1 Q And if the only benefit to the Postal
2 Service were information, would that be enough to
3 justify an NSA do you think?

4 A Well, we live in an information economy. I
5 mean, that's a cliché, but if the postal management
6 and their counsel believe that information was leading
7 to something larger down the road that would
8 facilitate them, sure. Acquiring information is value
9 if it has further down the line transferable value.

10 Q Even if it did not add to the bottom line of
11 the Postal Service as a result of that particular NSA?

12 A Again, I'm not sure why they would go ahead.
13 I mean, to get information that they lacked on, yes.
14 Information would have no benefit.

15 I'm not sure if you went before the PRC with
16 it it would be all that sellable, but I don't think
17 they would just do information for information's sake
18 and just say we're all better informed people now and
19 our jobs are richer. No.

20 It would have to be information that would
21 lead to either a gain with that individual mailer or a
22 gain that down the road they could use in other
23 aspects of the business.

24 Q Let me ask you to turn to the beginning of
25 your testimony, page 2. There you identify I guess

1 who you are submitting this testimony on behalf of.
2 You say, "I do so on behalf of PostCom, DMA and Parcel
3 Shippers Association."

4 Are those the three mailing entities on
5 whose behalf you filed this testimony?

6 A Yes. Correct. We happen to be members of
7 those, too, Bookspan itself.

8 Q As well as Bookspan?

9 A No, not as well as Bookspan. No. Bookspan
10 would be there. I'm just saying Bookspan is an active
11 member of these groups.

12 Q Oh, I see.

13 A Yes. We're in DMA and PostCom.

14 Q Okay. And you have been expressly I guess
15 authorized by DMA and Parcel Shippers and PostCom to
16 appear as their witness today?

17 A Yes, I have. Through their counsel, too.

18 Q I'm sorry? Through?

19 A Well, again the answer is yes.

20 Q Okay. And you say at the end of the
21 paragraph on page 2 of your testimony that you
22 previously testified. I just went in and searched for
23 your name and saw that you provided rebuttal testimony
24 in R94-1 for MMA and MASA at that time on what you
25 called the multiplier effect of standard mail.

1 A Correct. Among other things, yes.

2 Q Do you mean among other subjects of that
3 testimony?

4 A Yes. I remember Ed Glina was here and that,
5 but yes. That was one of the themes certainly, and it
6 was about -- which is very applicable to NSAs because
7 the multiplier effect and one of the reasons we are
8 attractive in that situation --

9 Q That's not actually my question.

10 A Okay.

11 Q All I'm trying to get at is were there other
12 occasions where you testified before the Commission?

13 A No. I've testified in other postal hearings
14 like an arbitration and places like that. I did that
15 last year.

16 Q On behalf of the Postal Service?

17 A I believe I was on behalf of the Postal
18 Service, yes. It was a customer's perspective on the
19 arbitration process.

20 Q On page 2 then at the beginning of the
21 second paragraph you say, "The purpose of my testimony
22 is to explain why PostCom et al. believe that
23 NSAs...should be affirmatively encouraged," correct?

24 A Correct.

25 Q Is that a statement of your and those

1 organizations' endorsement of NSAs without any
2 qualification, or are there qualifications on that
3 broad endorsement?

4 A Well, we endorse the post office having as
5 much latitude as they're permitted. There are, of
6 course, legal restrictions and all that, the
7 experimental rules and different other parameters
8 under it, but, if anything, we would be happy if the
9 post office had more flexibility.

10 Q So you want the Postal Service to have
11 maximum flexibility in deciding when to enter into an
12 NSA, and you would urge the adoption of all of those
13 NSAs?

14 A I'd take out the word maximum, I mean,
15 because it's an undefined term, but we would be very
16 happy if the post office had more ability to operate
17 like another targeted marketer and work closer with
18 our customers so that they would get more information
19 to grow their business better rather than always being
20 trapped into more cookie cutter type rates and all
21 that.

22 I mean, there's a purpose for niche
23 classifications, too, but we believe it would be in
24 the health of the post office if they dealt with more
25 mailers individually.

1 Q Well, the sense I got, and I could find the
2 language later in your testimony, is that you believe
3 that if the Postal Service enters into it you can
4 presume it's in their best interest. If the mailer
5 enters into it, you can presume it's in their best
6 interests, and that's the way in which these ought to
7 be evaluated by the Commission.

8 A Okay.

9 Q Is that correct?

10 A It's not an exact quote, but I would say
11 yes. If both parties are in negotiation of a basic
12 contract, a meeting of the minds, and then they come
13 before the PRC and say, you know, we've reached an
14 agreement that we believe this is mutually
15 advantageous.

16 Q And you believe the Commission should defer
17 to that agreement?

18 A The Commission has certain standards, and
19 I'm not going to preclude what they should be doing,
20 but I would certainly say that we would be hopeful
21 that the Commission would look at the very best
22 interests of the post office and growing their
23 business and making it more flexible.

24 It's part of the old transformation plan
25 theme and everything else like that. If it makes

1 sense for the post office, then, yes, to give it
2 latitude in approving it you can trust that the postal
3 management is acting in the best interests of the post
4 office.

5 Q Okay. Let's go to a little later in that
6 paragraph. At the beginning of the next sentence you
7 say, "I hope to answer the suggestion made in this
8 proceeding that it is better to convert company
9 specific agreements to more broadly applicable rate
10 categories." Do you see that?

11 A Yes.

12 Q And then you say in the next sentence, "We
13 urge the Commission to reject this concept. I will
14 show from a business perspective NSAs and niche
15 classifications are not the same thing." Do you see
16 that?

17 A Yes.

18 Q Okay. I just want to make sure I understand
19 your testimony here. Are you saying that a niche
20 classification is the same thing as a rate category?

21 A No. I'm saying what the sentence said.
22 What we're trying to do, the only purpose of coming
23 here, is just as an industry witness to say there are
24 times when a one size fits all niche classification
25 may not be in the interest of the post office and

1 individual mailers.

2 Q Let me just go over these two sentences. On
3 the one hand you say, "I hope to answer suggestions
4 that it is better to convert company specific
5 agreements, NSAs, into more broadly available rate
6 categories," so you talk about NSAs versus rate
7 categories, correct, in that sentence?

8 A As. An NSA should not be viewed immediately
9 as, you know, can it be watered down to one size fits
10 all. It has a purpose at times for individual
11 customers to deal with the post office.

12 Q That's not my question, though. I'm just
13 trying to understand your testimony.

14 A Okay.

15 Q You say it's better to convert company
16 specific agreements. You're dealing with the issue of
17 whether --

18 A No. I didn't say that.

19 Q No, no, no. I'm sorry.

20 A Okay.

21 Q I didn't mean to -- I was just trying to
22 take a phrase out. You're dealing with NSAs versus
23 rate categories in the first sentence. In the second
24 sentence --

25 A The problem --

1 Q Let me finish the question.

2 A Okay.

3 Q In the second sentence you're talking about
4 NSAs versus niche classifications. In other words,
5 you juxtapose NSAs in one sentence with rate
6 categories to one with niche classifications.

7 My question to you is is it your
8 understanding that niche classifications are the same
9 as rate categories?

10 A I'm not sure now because -- okay. Yes.
11 Again, jumping through here, as I said, and reading in
12 context as opposed to taking out phrases.

13 All this is saying here is there's a purpose
14 for an NSA, and there's a purpose for a niche
15 discount. Every NSA shouldn't be immediately looked
16 at as something to just, you know, broaden. We should
17 be encouraging the individual customers to deal and
18 let it stand on its own merits.

19 Q I think Mr. Volner before in his comments on
20 an objection said that you were an attorney. Is that
21 correct?

22 A Yes.

23 Q And are you also an economist --

24 A No.

25 Q -- or have other training in postal costs or

1 business costs?

2 A No.

3 Q So you're not here as a cost witness?

4 A No. No. I'm just here as an advocate for
5 NSAs.

6 Q I understand that.

7 A Right.

8 Q That's clear. When you spoke with Mr. Baker
9 a few minutes ago about the discussions your company
10 had with the Postal Service about NSAs, and I don't
11 want to ask you any specifics about that, of course,
12 but I want to ask you. Did you personally participate
13 in discussions with the Postal Service?

14 A Yes, I did. Yes, I did. I'm sorry. Yes, I
15 did.

16 Q And in those discussions did the topic come
17 up as to whether your company, Bookspan or any of its
18 subdivisions, had unique mailing practices?

19 A Yes, and things that we could uniquely do
20 together. We had certain talents that we could offer
21 the post office that they found interesting, at least
22 to proceed negotiating with us.

23 Q And so I take it from what you say you
24 discussed with them extra things that your company
25 could do that weren't required that would save the

1 Postal Service money?

2 A Yes. Again, under Ian's supervision,
3 because he was our counsel, we were very much framing
4 around the experimental rules, but yes. It was
5 designed around certain things that we could offer to
6 them on an experimental basis that they would find
7 unique information from on a cost effective basis.

8 Q During those discussions, did you ever
9 discuss how the Postal Service's costs of handling
10 your company's mail might differ from the Postal
11 Service's costs in handling another company's mail?

12 A I'm sure it came up. I wouldn't have been
13 the lead on that. We had a couple financial guys also
14 involved who obviously know a lot more than I do on
15 this topic. I believe the post office also had a
16 couple people who knew finance.

17 Q Okay. Let me ask you to turn to the next
18 page and --

19 A Three or four? Three or four?

20 Q Three. I'm sorry.

21 A Okay.

22 Q The lines aren't numbered in your testimony,
23 but if you go down to line 3, I think, it says that
24 your testimony has to do with, "...why we believe the
25 Commission should accept subclass average costs

1 subject to known adjustments and should not insist
2 upon precision in modeling and forecasting in the NSA
3 setting," correct?

4 A I'm just going to quick read it in context.

5 Q Sure.

6 (Pause.)

7 A Okay.

8 Q Getting back to Mr. Baker's discussion with
9 you there, are you talking about the Postal Service's
10 cost or the mailer's cost? Obviously the Postal
11 Service's cost, I take it.

12 A Yes, and integrating. Their cost basically,
13 but also integrating somewhat with the customer.

14 I mean, this again was from personal
15 experience on a give and take that we ourselves had
16 with them, and in our give and take we both found that
17 as the discussions proceeded we changed our ideas on
18 what respective things cost mutually.

19 Q What do you mean when you say subject to
20 known adjustments?

21 A In our case, we were discussing sortation
22 and returns and things like that. We gave them
23 certain specifics and other things to just show how
24 some of their initial estimates and all that might
25 have differed from ours.

1 Q Estimates of Postal Service costs or
2 Bookspan's costs?

3 A Bookspan's.

4 Q Okay. I'm trying to understand the
5 sentence. You are talking about -- let me read the
6 whole sentence so that --

7 A Okay.

8 Q -- we don't miss anything. "I will further
9 explain, again from a business perspective, the type
10 of information the Commission can reasonably expect to
11 be provided by companies that enter into NSAs and why
12 we believe the Commission should accept subclass
13 average costs subject to known adjustments and should
14 not insist upon precision in modeling and forecasting
15 in the NSA sentence." That's the whole thought,
16 correct?

17 A Right.

18 Q Okay. Now, from that I take it you mean
19 that the Commission should accept the Postal Service's
20 testimony supporting an NSA based on average costs and
21 not ask for mailer specific costs. Isn't that what
22 you're saying?

23 A Well, again let me refresh on this. The way
24 we were doing it, since it was being framed as an
25 experiment, some of the traditional costing models

1 might not have worked by doing certain other things
2 that we were proposing to do, so we were --

3 Again, the nature of an experiment is
4 chartering unchartered waters, so some of the costing
5 models and all that we were looking at were more
6 assumptive than traditionally accepted.

7 Q Okay. Let me go back to basics. Your
8 testimony is from the industry that you represent a
9 general support of NSAs before this Commission,
10 correct?

11 A Correct.

12 Q And I think you said with Mr. Baker that
13 your testimony is not meant to be a specific
14 commentary or in fact endorsement of this particular
15 NSA because that's not what you studied, correct?

16 A What I'm speaking of -- I'm sorry. When I
17 was speaking of personal experience, I was speaking of
18 our own negotiations with Bookspan.

19 Q Right.

20 A I wasn't speaking of the NSA before the PRC
21 right now.

22 Q Right. In fact, your testimony doesn't
23 really provide a specific endorsement of this NSA,
24 correct? You're giving general policy advice to the
25 Commission as to how to --

1 A I'm giving suggestions. I don't give the
2 Commission policy advice. The bottom line is yes.

3 I would not speak -- Capital One has able
4 counsel I believe also in the room and other people.
5 I can't speak on that. Our position is just that NSAs
6 in general has been the industry position, but not
7 speaking for Capital One.

8 Q Then putting aside Cap One and just focusing
9 on your recommendations, suggestions to the Commission
10 as to how they ought to handle NSAs that come before
11 it, from what you say here I seem to read that you say
12 the Commission should accept Postal Service testimony
13 when it offers average costs subject to known
14 adjustments, not insisting on modeling and forecasting
15 to get mailer specific costs.

16 Is that a fair paraphrase? Mr. Volner
17 thinks so. He's nodding yes.

18 A It's a fair phrase, yes.

19 Q Okay.

20 A I mean, what the gist of this was is we
21 should not hold an NSA basically, because of its
22 experimental nature, the same way we do other
23 classifications because there is a certain leap in the
24 dark here.

25 Q Okay. Can you help me understand? Let me

1 summarize what I think you told me and see if it's
2 correct.

3 I think you told me that the phrase "subject
4 to known adjustments" derives from your experience at
5 Bookspan in negotiating an NSA with the Postal Service
6 about Bookspan's specific costs, not Postal Service
7 costs.

8 A Well, I meant in the give and take of our
9 negotiations both sides presented costs and everything
10 else to make the thing work, but then you would enter
11 subjective areas that if we were going to do these
12 proposals that we had to the Postal Service they were
13 necessarily tests and so it became a little bit
14 greater. I mean, the model could not be as precise as
15 in some other types of testimony.

16 Q I'm going to try one more time to clarify
17 what input you're giving the Commission on what types
18 of costs you think they should use.

19 Do you believe that the Commission should
20 accept the Postal Service's use of average costs
21 period?

22 MR. VOLNER: Mr. Chairman, I'm going to
23 object. First of all, the question has now been asked
24 and answered about four different times, and now what
25 he's doing, which is why I didn't object to the

1 earlier characterization, is he's parsing the sentence
2 and creating different pieces to it.

3 I think the testimony speaks for itself.
4 You've read the testimony to him. If you're asking
5 him to explain more fully what subclass average costs
6 mean or what costs mean he's answered that. He said
7 it means both. He said four times now that it's in
8 the iteration of the process of negotiation.

9 CHAIRMAN OMAS: Mr. Olson, why don't we try
10 to rephrase it again? Let's try one more time.

11 MR. OLSON: Yes, sir.

12 BY MR. OLSON:

13 Q Is it your testimony that you're
14 recommending that the Commission generally accept
15 subclass average costs subject to known adjustments
16 when it considers and approves a proposed NSA, as
17 opposed to mailer specific costs?

18 A Well, when you read the whole sentence, and
19 this is why I think there's just some -- you know,
20 we're providing the information by the companies on
21 the NSAs, and then we negotiate with the post office.

22 Some of the traditional types of costs
23 change. In creating an experimental type model, other
24 things will change. I mean, it isn't -- we do provide
25 data which then they act on, and they make a

1 supposition, you know.

2 Q Are you done?

3 A Yes.

4 Q Okay. Let me ask you to look at the first
5 sentence of Section A on the same page. You say, "The
6 mailing industries have long recognized that the use
7 of average cost to develop rates and discounts is not
8 going to suit the needs and interests of all mailers
9 who might otherwise be able to qualify their mail for
10 a particular rate category," correct?

11 A Yes.

12 Q Okay. Does that mean that the use of
13 average cost could create a problem for mailers?

14 A Yes. A little later we used I believe it's
15 the priority discount in which only one mailer is
16 participating in, so yes.

17 Some of the average costing, as opposed to
18 targeted agreements, if you average out you can
19 average out some of the participation because the
20 investment and all that becomes less attractive to
21 make.

22 Q I have to say I'm confused now. I hope you
23 can help me understand.

24 If up above on page 3 you indicate the
25 Commission should accept subclass average costs

1 subject to known adjustments, why do you say down
2 below that the use of average costs are not going to
3 suit the needs of mailers, and yet you recommend them?

4 A No. Earlier I was speaking of the NSAs and
5 experimental mail. Here we're speaking now of more
6 general, and we're making an advocacy of the NSAs.
7 It's a different thought and a different argument.

8 Here again, we were talking earlier about
9 what's going to be presented to the Commission in an
10 NSA format after negotiations. Here we're going back
11 to the average cost model, why average costs don't
12 necessarily work for mailers in general on certain
13 types of classifications.

14 Q But you talk about in the second section
15 under A here, the second sentence we're referring to.
16 You talk about the use of average costs to develop
17 rates and discounts.

18 A Go to the next sentence.

19 Q Don't you mean by the Commission?

20 A Read it in context. I mean, the bottom line
21 we go down is that they don't meet the needs. I mean,
22 it's a declarative sentence that they don't meet the
23 needs of mailers. Therefore, some of these -- go to
24 the next sentence. The existing work sharing
25 initiatives are not utilized by mailers.

1 I mean, if you keep going the thing flows,
2 unlike again we're making argument for the NSAs, and
3 we're saying in certain cases why the NSA works in
4 particular because by broadening certain types of
5 things to make a one size fits all, in certain cases
6 it fits no one.

7 There is a difference between an advocacy
8 for NSAs earlier and then distinguishing again why
9 NSAs are superior in certain circumstances than a
10 niche classification. Not that there isn't time for
11 both and not that they don't have equal validity, but
12 with the post office's only ability right now or to
13 date -- they don't have NSAs.

14 The bottom line is since they only have
15 these, many mailers are precluded from involving
16 themselves in these. The post office is losing. It's
17 been cited elsewhere that 25 percent of the current
18 post office costs have been reduced through work
19 sharing, so it's encouraging for the post office to
20 encourage work sharing, but a one size fits all
21 classification at times based on average costs won't
22 facilitate that.

23 That's why if you read these sentence by
24 sentence okay, but read the entire paragraph. I think
25 your questions are answered in the next three

1 sentences.

2 Q Well, the sentence immediately after the one
3 we've been discussing says, "Average price signals do
4 not necessarily meet the needs of mailers whose
5 particular business model or cost structure does not
6 closely replicate the average price. Average price
7 signals will be false for those mailers."

8 A Wait a minute. Hold on. Again, the word
9 necessarily isn't there, and there's no qualification
10 there. Also, in context, yes, the rest of the
11 sentence holds.

12 Q I'm sorry. Did I read the word
13 "necessarily" by accident?

14 A Yes. I mean, I didn't know if there was any
15 purpose to that, but, I mean, it just wasn't in the
16 sentence.

17 Q I'm sorry. I didn't mean to.

18 A Okay.

19 Q I meant to just read it the way it was. I'm
20 not that clever.

21 Then it says, "Average price signals will be
22 false for those mailers. This in part is why the
23 existing work sharing initiatives and operational
24 services are not fully utilized by the mailers,"
25 correct?

1 A Correct.

2 Q Okay. So when an NSA comes before this
3 Commission, the Commission has to determine what type
4 of costs it's going to look at, and it has to set
5 policy, and you're recommending policy, as I
6 understand, to the Commission or suggesting.

7 I'm trying to understand if you think it's
8 better to use mailer specific costs or average costs
9 when the case comes before this Commission.

10 MR. VOLNER: Mr. Chairman, I'm going to
11 object again. He is again characterizing the
12 testimony by eliding a rather important qualifier.

13 MR. OLSON: All right. I'll put that in.
14 Let me put it in, Mr. Volner.

15 MR. VOLNER: Put it in.

16 MR. OLSON: I'll put it in. Okay.

17 MR. VOLNER: Then I would object on the
18 grounds you've asked and had that question answered
19 about nine times, but I'll let it go again.

20 BY MR. OLSON:

21 Q Are you recommending the use of subclass
22 average costs subject to known adjustments or mailer
23 specific costs?

24 A Both. I mean, again I read back to you.
25 Further, I will explain because we've got to put this

1 in perspective. You keep taking -- I mean, it's not
2 to be argumentative with you, but I will further
3 explain again.

4 From a business perspective, the type of
5 information the Commission can reasonably expect to be
6 provided by companies that enter into NSAs. You are
7 arguing the second half of the sentence and
8 continuously left out the first half.

9 I mean, the companies obviously had input
10 into this data. We're not saying that the post
11 office, you know, took this from whole cloth, but this
12 as I said, when Ian mentioned nine times earlier, I
13 came back twice -- I believe it's on the record -- to
14 read the first sentence of this page in context. It's
15 the same thing here in context.

16 One is an NSA before the Commission. The
17 second thing we're currently on is a non-NSA and why
18 the average costs in the abstract don't facilitate
19 mailers. The earlier paragraph presupposes a company
20 input into the postal model. We have to keep coming
21 back to the companies had the input, you know.
22 Leaving out half a sentence and then debating the
23 other half, you know, doesn't give it a context.

24 I mean, these are completely different
25 arguments. One is an NSA comes before the Commission

1 after it's been negotiated with an individual client
2 and the post office. The other one is a separate
3 issue on why a lot of work sharing that the post
4 office would like to do with the mailers is being
5 foreclosed because the post office doesn't have enough
6 flexibility.

7 Then we go into some of the real realities
8 of that, and that is the post office is basically
9 confined into offering what it would like to have for
10 a broad variety of mailers, but it may preclude a lot
11 of mailers for different investment reasons and other
12 things.

13 An NSA also gives the mailer a time
14 incentive to invest in these things. Therefore, if
15 you have a three to five year predictability pattern
16 you can then make the investment, but other
17 classifications you're not sure they'll even be around
18 and so there's a disincentive there, too.

19 Q Okay. Let me find one other sentence to
20 draw your attention to in contrast to this. This is a
21 new one.

22 A Okay.

23 Q Page 7, the top paragraph, the first full
24 paragraph. "This does not mean...", and lest there be
25 any confusion about context I'll read from the

1 beginning of the paragraph.

2 A All right.

3 Q "This does not mean that the Postal Service
4 and NSA participants must or should rely on average
5 subclass costs without regard to the costs or
6 elasticities of the individual mailer. To the extent
7 that the differences between company specific costs or
8 elasticities and subclass averages are readily
9 ascertainable and demonstrable, they should be taken
10 into account in formulating the terms of the NSA,"
11 correct?

12 A Correct.

13 Q Okay. Is that a concise thought that I can
14 ask you a question about?

15 A Sure. I believe that goes back to page 3.

16 Q Okay. What do you mean by "readily
17 ascertainable and demonstrable" with respect to costs?
18 "Company specific costs which are readily
19 ascertainable and demonstrable." Can you give us an
20 illustration of what you mean by that?

21 A Again, the post office would have their
22 averages. Bookspan would have its specific costs, and
23 they might differ, you know.

24 I mean, the company specific would be
25 Bookspan, and the subclass averages would be taken as

1 defined averages across the subclass say in a bound
2 printed matter situation or something like that.

3 Q Isn't it possible that the Postal Service
4 could have company specific costs in terms of their
5 costs of handling your mail, and it wouldn't be
6 Bookspan's costs; it would be Postal Service costs,
7 but it would be the Postal Service's costs of handling
8 your mail?

9 A They would have their cost, yes, and, as you
10 know from many rate proceedings, the costs are often
11 debated. I mean, one of our arguments is for more
12 transparency in costs and everything else.

13 One of the advantages of the NSA is when the
14 costs can be overlaid with a particular client they
15 can become more transparent. The post office may have
16 assumptions, too, on what it costs to service us, you
17 know, but we may be able to show differences in
18 costing.

19 Q If the Postal Service has the costs of
20 handling Bookspan's mail on an NSA, should those costs
21 be used or the average costs?

22 A For an NSA?

23 Q Yes.

24 A Well, the Bookspan costs should be inputted
25 in, and then if the post office can make it work in a

1 variety of different ways, including experimental
2 nature, they could have it going back to original
3 point of information.

4 Yes. They should use what it would take,
5 assuming it would go forward. I mean, it has to be
6 profitable for the post office. Assuming we could
7 make the cost argument, we meaning Bookspan in the
8 specific, and their economists would agree with us
9 then, yes, in that case I think that they could go
10 forward with these arguments under this experiment.

11 Q Let me clarify that what we're talking about
12 is Postal Service costs of handling Bookspan's mail.

13 A Right.

14 Q You used the phrase Bookspan's costs, and I
15 want to make sure that we're --

16 A No, no, no. What I'm saying is, and I'm no
17 expert at postal rate hearings either, but I obviously
18 follow them. There's often debates between what the
19 post office presumed its costs were and what the
20 industry will, and we have mutual economists.

21 In the NSA, the post office will look at our
22 business model in particular and see maybe there are
23 different things in handling. I mean, I'm no expert
24 at this, but, you know, the sequencing and all the
25 stuff that goes into putting stuff on pallets, you

1 know, and all the other stuff. The world can change
2 on average costs of delivering a parcel versus
3 Bookspan particulars.

4 You can go deeper, you know, sortations.
5 You can pick up discounts. You can do other things.
6 I mean, that's what work sharing has proven over the
7 years that we could change the cost dynamics of the
8 post office. They would have certain assumptions, and
9 for work sharing we prove that we might be able to do
10 it in a different way that would facilitate them
11 better.

12 Q Okay. At the top of page 6 -- let's change
13 topics slight. At the top of page 6 you talk about
14 the priority mail presort experiment that this
15 Commission approved previously --

16 A Right.

17 Q -- and which is ongoing. You say in the
18 second line, page 6, "The fact that there is now only
19 one mailer participant suggests that it might have
20 been better to structure the arrangement as an NSA in
21 the first instance and then develop variations on the
22 NSA with perhaps different obligations and incentives
23 to reflect the differences in the needs and interests
24 of those who initially participated in that
25 experiment, but have since dropped out," correct?

1 A Yes.

2 Q I didn't add "necessarily"?

3 A No.

4 Q Okay. Good. When I read that, I just want
5 to make sure the degree of your familiarity with that
6 experiment. Are you aware that a report was filed
7 just last I think perhaps September or October by the
8 Postal Service with the Commission on the status of
9 the experiment? Did you see that report?

10 A No, I didn't.

11 Q Did you --

12 A I don't have any great expertise. I just
13 cited this example because it was an example of
14 something that the post office invested some time on,
15 and in the end they only had limited participation and
16 so the argument being is maybe it would have been more
17 beneficial for the post office to have just negotiated
18 with this client individually, and it might have been
19 a better deal for that individual client, and then
20 maybe with a client specific NSA it might have been
21 broadened to more customer friendly use by other
22 customers.

23 Q Do you know how many applicants there were
24 originally for the presort proposal?

25 A I only know the final result. I'm sorry.

1 No, I don't.

2 Q Okay. And if that were a substantial
3 number, would that surprise you if it were over 25,
4 for example?

5 A I think it would make the case because if 25
6 people were honestly looking to involve themselves and
7 only one person made the finish line then I think that
8 makes the case for more customized approaches rather
9 than broad brush.

10 Q Are you familiar with the amount of the
11 three increases in priority mail rates that occurred
12 in 2001 and 2002?

13 A Generally.

14 Q Do you know what the percentage increase
15 was?

16 A No, not off the top of my head. Also, we're
17 not a major user of priority mail. You know, I know
18 they were higher.

19 Q Are you aware of the fact that people
20 dropped out of this program because they dropped out
21 of using priority mail?

22 A Okay. Maybe it wasn't attractive to them.
23 It goes back to the original point.

24 Q But the priority mail wasn't attractive to
25 them, not the priority mail presort, correct?

1 MR. VOLNER: Are you characterizing what
2 happened?

3 MR. OLSON: Yes.

4 MR. VOLNER: Well, then I'm going to object
5 to the question. I mean, if you want to ask him
6 whether he knows that's fine.

7 BY MR. OLSON:

8 Q Do you know that?

9 A I said like two minutes ago I took the
10 example out because presumably the post office goes
11 through a great effort to create services for the
12 clients, but in many cases the clients can't afford
13 the investment because it wasn't done with individual
14 client input.

15 Q Let me ask you this. Does it make any
16 difference if a mailer leaves priority mail presort
17 because it found the presort benefits to be inadequate
18 versus leaving prior mail because the rate structure
19 went fluey with three rate increases in 18 months?
20 Isn't there any difference between those two?

21 A Well, every other mailer had three increases
22 in 18 months also, you know, so if you had a sound
23 business model it might have been -- again, I'm not
24 sure if this is even in evidence whether that's why
25 they left, whether it was less attractive.

1 If it had been more customized, and this is
2 just with no information but hypothetically. If it
3 was more customized and there was initial cost
4 incentive to be in there, but one of the problems I
5 mentioned about 10 minutes ago, and I think you're
6 agreeing with me now, is --

7 Q Well, let me just --

8 A No. Wait a minute. Let me finish.

9 MR. VOLNER: Let him finish his answer.

10 MR. OLSON: No. I'm not sure you're
11 answering the question I asked.

12 THE WITNESS: I am.

13 MR. OLSON: I'll move to strike it if you
14 answer along these lines.

15 THE WITNESS: I am providing the answer you
16 requested.

17 MR. OLSON: No. You're not answering the
18 question I asked.

19 THE WITNESS: Okay.

20 BY MR. OLSON:

21 Q This has to do with priority mail. I think
22 you just said that you're speculating, and it has to
23 do with a hypothetical. Isn't that correct?

24 A Well, since I mentioned --

25 Q Is that correct?

1 A I said five minutes ago I wasn't familiar
2 with the particulars of why the individual customers
3 left. I'm not sure anyone knows whether it was the
4 model or the price increase.

5 Q Have you read the January 17, 2003, report
6 to the Commission on the priority mail experiment?

7 A Since I said five minutes ago and I said a
8 minute ago that --

9 Q Well, I asked you about September.

10 A No. I said I'm not familiar with the
11 dynamics of priority mail. The illustration stands.
12 We have one user.

13 MR. OLSON: Mr. Chairman, may I get an end
14 to the response to a question that isn't pending?

15 BY MR. OLSON:

16 Q Let me ask you to turn to page 4 of your
17 testimony. In the full paragraph that appears on that
18 page you discuss that a niche classification might be
19 appropriate in certain circumstances and that an NSA
20 might be appropriate in other circumstances, correct?

21 A Correct.

22 Q Okay. About five lines down in that
23 paragraph I think you say, "The essential difference
24 between the niche classification and an NSA is that in
25 the former case it can be reasonably and confidently

1 expected that the incentive to be proposed will be
2 responsive to the needs of a group of mailers,"
3 correct?

4 A Correct.

5 Q Okay. When you say group, is there a
6 minimum number you have in mind?

7 A No.

8 Q Two or more?

9 A Okay. That's safe. Sure.

10 Q Okay. When a new classification is
11 proposed, do you believe that the Postal Service
12 always knows with precision the number of mailers that
13 might be interested in using it?

14 A Obviously I think the question answers
15 itself. No.

16 Q Okay.

17 A That goes back to our debate on page 6.

18 Q If the Postal Service were to have
19 reasonably strong assurance that say three, four or
20 five mailers would respond positively to a particular
21 new product, would you suggest that that be a niche
22 classification or an NSA?

23 A A group of mailers? It's probably more
24 conducive to a niche. The NSA again is a unique
25 situation where you're on uncharted waters for the

1 post office to get information or whatever or there's
2 a unique situation to be worked out with an individual
3 client.

4 Q At one point I recall you talked about
5 prematurely opening up an NSA, and I think it was on
6 page -- here. It's the last line of page 4.

7 You say, "That is, by prematurely opening up
8 an NSA, the cost savings the Postal Service expects to
9 realize will be reduced and/or corresponding
10 incentives it is able to offer will be diminished,"
11 correct?

12 A The sentence is correct. I'll just read the
13 context.

14 Q Right.

15 A Okay. That preceded by the earlier
16 sentence, yes, is correct.

17 Q Go ahead and read whatever you think
18 necessary to put a context to it.

19 A Oh, no. I mean, the sentence preceding it.
20 Again, it qualifies so we're not just taking a
21 sentence out mid paragraph.

22 Q Well, let's read it.

23 A Okay.

24 Q I'll read it. I hope I don't add any words.
25 "If an arrangement that was worked out and tailored to

1 meet the needs of a particular mailer is opened up to
2 a broader group of mailers with dissimilar mail or
3 mailing practices, the business dynamics of the
4 original arrangement will be altered."

5 Then you say, "That is, by prematurely
6 opening an NSA, the cost savings the Postal Service
7 expects to realize will be reduced..." and the
8 incentives would be diminished. I'm paraphrasing the
9 end of the sentence there.

10 A Right.

11 Q Okay. Correct?

12 A Correct.

13 Q Okay. How do you tell when an NSA is mature
14 so that it is not prematurely opened up?

15 A That would be an interesting point. We
16 haven't had one. It would be a certain firm invests a
17 lot, and then the terms would be back and changed.
18 Going to the paragraph above that, in the earlier
19 paragraph, "By contrast, an NSA involves contract
20 rates," et cetera, et cetera.

21 The key to the NSA is giving the primary
22 negotiator some sort of time and space incentive to
23 time. Now, assuming that there was -- you can qualify
24 an NSA to protect yourself by having a most favored
25 firm type language in it where you can basically say

1 if it's changed in other ways you would pick this up,
2 you know, if it benefits a later client or something
3 like that.

4 If the terms are somehow changed and your
5 overall advantage is diluted from the negotiations or
6 someone gets a better deal, it's changed the original
7 premise that you went in and made the investment on.

8 Q Why would you care if someone else got a
9 better deal? Is it a matter of fairness? Is that
10 what you're saying?

11 A Let's see.

12 Q If someone else got a better deal, would
13 that be unfair?

14 A It might be unfair to the original
15 negotiator, but you can protect yourself from that in
16 basic contracts.

17 Q By putting in a clause that says that --

18 A That would be one way, yes.

19 Q -- if the Postal Service were to give this
20 similar discount to anyone else you would get the
21 benefit of it?

22 A Right.

23 Q Do you know if there's such a provision in
24 the --

25 A I'm just reading the rest of the paragraph.

1 Q Okay. Sure.

2 A Okay. Again, I think my answer would be the
3 end sum, which is the paragraph after the mid
4 paragraph here, the sentence being discussed.

5 Q I'm sorry. What sentence?

6 A No. I'd like to do paragraphs. In other
7 words, read the one paragraph in context, and then the
8 paragraph afterwards which sums up, you know.

9 "In sum, the company's specific arrangements
10 are important to the mailing industry because they
11 provide mail users with the opportunity to configure
12 in work sharing arrangements that are consistent with
13 their particular model."

14 If it's open in a way that dilutes it, it
15 dilutes the expectations.

16 Q So in other words, the work that the first
17 NSA participant did to advance the notion would be
18 diminished by opening it up to other similarly
19 situated mailers?

20 A Well, I'm not sure that's what the second
21 sentence says. Let me see.

22 MR. VOLNER: Mr. Chairman, I'm going to have
23 to object to the question.

24 THE WITNESS: But I -- I'm sorry. Sorry.

25 MR. VOLNER: He's mischaracterizing the

1 testimony. That's not what he said.

2 THE WITNESS: Right.

3 MR. OLSON: It's a question.

4 THE WITNESS: No. We made the earlier
5 qualification. "Not similarly situated." That was
6 added.

7 The earlier qualifications, and I'll read
8 the first sentence in context. "If an arrangement
9 that was worked out and tailored to meet the needs of
10 a particular mailer is opened to a broader group of
11 mailers with dissimilar mail or mailing practices."

12 MR. OLSON: Thank you.

13 THE WITNESS: I mean, we can't just keep
14 jumping from sentence to sentence and not read the
15 stuff in context.

16 MR. OLSON: We read the whole sentence.

17 THE WITNESS: Yes, but then you were
18 characterizing something that was never said by either
19 of us.

20 BY MR. OLSON:

21 Q My first question that I asked you was how
22 do you know when an NSA is mature so that you're not
23 prematurely opening it up, and I think what you said
24 -- correct me if I'm wrong -- is you need to preserve
25 some benefit for the first mailer who does the work of

1 getting the NSA to begin with. Is that correct?

2 A Yes, but I also said earlier that it's hard
3 to define because we never had one. To say when it's
4 premature is difficult.

5 Q But there is some notion you have in mind
6 that --

7 A Yes, and that's what I said. If it's opened
8 up to companies or people with dissimilar, it could
9 dilute it.

10 That's a judgment call once we have an NSA,
11 you know, that's really there, as opposed to
12 speculation, NSAs that we've never dealt with before.
13 It's just, you know, a caveat type thing if you read
14 the paragraph in context and then read the second
15 paragraph in context with that.

16 Q If the Postal Rate Commission uses average
17 costs in establishing the amount of savings in an NSA,
18 how would opening the matter up to mailers with
19 dissimilar mailing practices and dissimilar costs
20 affect the amount of the NSA?

21 MR. VOLNER: Mr. Chairman, I hate to do
22 this, but again I have to object. Are we going to go
23 back to paragraph 2 where he says "subject to known
24 adjustments," and are we again eliding that clause?

25 I mean, if you want to ask him about the

1 testimony I certainly have no objection.

2 MR. OLSON: I'll be glad to add those words.

3 MR. VOLNER: If you want to ask him about
4 where the testimony leads, I have no objection. If
5 you want to recharacterize the testimony, put your own
6 witness on.

7 MR. OLSON: I'm happy to add those words,
8 Mr. Volner.

9 Adding your words from early in your
10 testimony, "subject to known adjustments," as an
11 adjective phrase describing average costs.

12 THE WITNESS: It's just we keep hopping
13 around. It's just trying to keep a context to this
14 thing.

15 BY MR. OLSON:

16 Q Do you have the question in mind?

17 A I'm trying to find the point in paragraph 2
18 to read back. I mean page 2. I'm sorry.

19 THE WITNESS: Ian, I'm not sure. What was
20 the point?

21 MR. VOLNER: I think you better read the
22 question back.

23 THE WITNESS: I meant the point you just
24 cited to read.

25 MR. VOLNER: It's in that same paragraph.

1 It's in the first paragraph on page 3 --

2 THE WITNESS: Okay.

3 MR. VOLNER: -- I think is what he's
4 referring to. I'm not sure, to tell you the truth.

5 THE WITNESS: Okay.

6 MR. VOLNER: Why don't you reframe the
7 question, counsel?

8 MR. OLSON: Anything else, Mr. Volner?

9 MR. VOLNER: No, sir.

10 BY MR. OLSON:

11 Q Here's my question. It goes to the bottom
12 of page 4.

13 A Right.

14 Q It discusses the danger of prematurely
15 opening an NSA because the cost savings to the Postal
16 Service might be less, and the incentives it could
17 offer would be diminished, correct? That's the
18 danger?

19 A Yes.

20 Q Okay. And then in the sentence before it,
21 which you said was critical to understanding it, so
22 let's look at that. You say the problem is opening it
23 to mailers with dissimilar mail or mailing practices,
24 correct?

25 A Correct.

1 Q Now, isn't the key there that mailers with
2 dissimilar mail or mailing practices would have
3 different costs, different Postal Service costs
4 associated with handling their mail? Isn't that your
5 point?

6 A Yes. They might have either internal --
7 yes. They might have different costs, yes.

8 Q Okay. And if --

9 CHAIRMAN OMAS: Mr. Olson? Excuse me.

10 MR. OLSON: Yes, sir?

11 CHAIRMAN OMAS: How much longer?

12 MR. OLSON: Forty-five seconds.

13 CHAIRMAN OMAS: Okay. Thank you.

14 BY MR. OLSON:

15 Q If the Commission uses average costs subject
16 to known adjustments as you recommend on page 3 -- did
17 I get that right, Mr. Volner? Okay.

18 What difference would it make if the NSA
19 were opened up to other mailers with dissimilar mail
20 and mailing practices?

21 A Okay. I'm sorry. Is this paragraph A on
22 page 3?

23 Q Mr. Posch, the only thing I'm doing on page
24 3 is grabbing the lines --

25 A But by jumping in and out of sentences and

1 everything else sometimes, I mean, things can change.
2 I'm trying to read these sentences in the context of
3 each paragraph and then put them back in the other
4 paragraph, if you know what I mean.

5 Q I don't mean this to be a trick question.
6 All I'm saying, sir, is you're recommending on page 3
7 the Commission accept subclass average costs subject
8 to known adjustments.

9 A Okay.

10 Q And then you're talking about if they do
11 that you talk about the danger of opening up an NSA to
12 other mailers, a broader group with dissimilar mail or
13 mailing practices, which you just said the key was
14 they had different costs

15 What would it matter if you used average
16 costs subject to -- let me get it right -- known
17 adjustments?

18 A Okay. Again, the cost structure they're
19 using is provided by the particular company, the type
20 of information provided by the company that's entering
21 into the NSA. Now we're bringing in companies who are
22 not part of that agreement with different cost
23 structures. It does change the model.

24 Q If the Postal Service proposal is predicated
25 on its costs, its own estimate of its own costs for

1 handling the average of what you call the subclass,
2 subject to known adjustments --

3 A Right.

4 Q -- what difference does it matter if it
5 allows some other similar mailers into it that might
6 have somewhat different mail, somewhat different
7 mailing practices and somewhat different costs?

8 A Okay.

9 Q My 45 second ends now.

10 A The similar mailers would probably be
11 permitted to come in. Again, we keep coming back to a
12 sentence that wasn't there. We said if the
13 arrangement was worked out to meet the broader group
14 with dissimilar mail. Obviously we said dissimilar
15 because similar mail would have been a different
16 situation.

17 I mean, we jump from sentence to sentence.
18 We don't use all the words, and then we qualify the
19 words differently. We never said similar. We said
20 dissimilar and contrast it. Dissimilar, no. Similar,
21 yes.

22 Q At the risk of going beyond 45 seconds, in
23 this context let's just take this case and see if you
24 can answer it.

25 You've said you're not an expert on this

1 case, but if there were a mailer like Cap One who had
2 a 10 percent UAA rate and another mailer had a five
3 percent UAA rate and another one had a 20 percent UAA
4 rate and yet the costs of the NSA were not related to
5 the Postal Service's cost specific to any particular
6 mailer, why would it matter if mailers with five
7 percent, 10 percent, 20 percent UAA rates were allowed
8 to participate?

9 MR. VOLNER: Mr. Chairman, I'm going to
10 allow him to answer the question, but --

11 MR. OLSON: Good.

12 MR. VOLNER: -- I do want to point out that
13 there's no resemblance between the question and the
14 testimony or where the testimony goes.

15 CHAIRMAN OMAS: Mr. Posch, try to answer the
16 question, please.

17 THE WITNESS: Well, I'd answer it by, first
18 of all, precluding the use of the term Capital One
19 because I don't want in any way to presume to speak
20 for Capital One.

21 Then if you could just -- I'm sorry --
22 rephrase the thing again? Put it in general, Company
23 A, B and C.

24 BY MR. OLSON:

25 Q If there were to be an NSA that attempted to

1 recognize Postal Service cost savings associated with
2 handling first class mail, electronic UAA mail
3 electronically as opposed to by physical return of the
4 mail piece.

5 A Why not say parcels? We might be safer
6 talking.

7 Q Well, we don't have the same rules about
8 free forwarding and undeliverable as addressed, so I
9 don't think I can. If you don't know the first class,
10 I guess I'll --

11 A Yes. Again, I'm not trying to be evasive on
12 this, but we were supposed to just endorse NSAs,
13 secondly endorse the distinguishment at times between
14 NSAs and niches.

15 To get into specific subcategories of first
16 class, my background is parcels and standard A and
17 things like that.

18 MR. OLSON: Thank you, Mr. Chairman.

19 CHAIRMAN OMAS: Thank you, Mr. Olson.

20 It's about 11:05. Why don't we take our
21 midmorning break and come back about 11:15 and
22 complete this witness? Thank you.

23 (Whereupon, a short recess was taken.)

24 CHAIRMAN OMAS: Mr. Olson, is there any
25 follow up cross-examination?

1 Mr. Costich?

2 MR. COSTICH: Thank you, Mr. Chairman.

3 CROSS-EXAMINATION

4 BY MR. COSTICH:

5 Q Mr. Posch, I'd like to get back to the
6 prematurely opened up issue.

7 MR. VOLNER: Introduce yourself, Rand,
8 please, so the witness knows who you are.

9 MR. COSTICH: I'm Rand Costich. I represent
10 the OCA.

11 BY MR. COSTICH:

12 Q I'd like to get back to the issue that you
13 were discussing with Mr. Olson concerning premature
14 opening up of an NSA.

15 If you could look at page 5 of your
16 testimony at the top of the page? The first full
17 sentence there reads, "The result may be that the
18 value of the arrangement is so altered and the price
19 signal so changed to reflect the characteristics of a
20 larger group of potential users that the incentive no
21 longer serves the interests of the original NSA party
22 or of the Postal Service."

23 Are you saying that that would be the
24 inevitable result of opening up an NSA to other
25 participants?

1 A I don't want to be redundant. If we read
2 the whole paragraph in context, they are not other
3 participants. They'd be dissimilar companies with
4 dissimilar models, so that would change the question a
5 bit because it wouldn't be just any other participant.

6 Number two would be the inevitable result?
7 No. Again, we don't have experience to work from
8 since we've never had this adventure before of a
9 completed NSA, but obviously it wouldn't be the
10 inevitable experience.

11 In this paragraph it proceeds sentence by
12 sentence, and so other participants have to be
13 qualified by dissimilar participants. As we said,
14 mailers with similar mail or mailing practices, so
15 dissimilar is a key qualifier that proceeds the next
16 few sentences.

17 Q All right. Let's stick to dissimilar
18 participants.

19 A Okay.

20 Q If an NSA were opened up to dissimilar
21 participants without altering the benefits of the
22 original NSA to the original contractors, the Postal
23 Service and the one other mailer, would there still be
24 an objection to opening up the NSA?

25 A It would depend on a particular fact

1 circumstance. I don't think there's a particular -- I
2 don't know. I'm trying to think of a hypothetical.

3 Q Are you aware that the OCA has proposed
4 opening up the NSA at issue in this case?

5 A No. No.

6 MR. COSTICH: I have no further questions,
7 Mr. Chairman.

8 CHAIRMAN OMAS: Thank you, Mr. Costich.
9 Commissioner Goldway?

10 COMMISSIONER GOLDWAY: Yes. Thank you. I
11 just have a question.

12 When you talk about an agreement that
13 includes average costs, those are clearly in the
14 public domain, something that the Postal Service
15 discloses, and then you said known adjustments.

16 I wasn't quite clear, in spite of all the
17 questioning, what you meant by known adjustments
18 except that they related somehow to the specific
19 business.

20 THE WITNESS: Yes.

21 COMMISSIONER GOLDWAY: Would those known
22 adjustments be submitted to the Postal Rate Commission
23 as part of the NSA for our approval, or do you
24 consider them proprietary and they would not be
25 available for us to consider in reviewing the NSA?

1 THE WITNESS: This I can speak on my own
2 company particularly. We entered into confidentiality
3 agreements when we first negotiated, this being
4 Bookspan, not Capital One.

5 I would have just assumed under the normal
6 proprietary things that these would have been in the
7 agreement. As part of the justification of the NSA we
8 had come to the PRC, and they would have been public
9 knowledge.

10 COMMISSIONER GOLDWAY: Thank you.

11 CHAIRMAN OMAS: Commissioner Hammond?

12 COMMISSIONER HAMMOND: You're here today on
13 behalf of a good number of mailing organizations whose
14 members are often competing with each other?

15 THE WITNESS: Correct.

16 COMMISSIONER HAMMOND: I wanted to ask you a
17 question as a representative of mailers that are often
18 in competition with other mailers.

19 Many mailers don't project their own mail
20 volumes econometrically, and that's certainly
21 understandable. Yesterday we had a witness from the
22 Postal Service testify that the Postal Service has to
23 have a pretty good idea of what volumes a mailer
24 normally sends before it offers a mail volume
25 discount. Would you agree that that is reasonable?

1 THE WITNESS: Speaking again in our own
2 particular negotiations, we provided that data. I
3 would say yes, it would be reasonable.

4 COMMISSIONER HAMMOND: Okay. Then let's
5 assume that the Postal Service agrees to a volume
6 discount as part of an NSA with one mailer, but then
7 they refuse to give a similar volume discount to a
8 second one because that competing mailer can't produce
9 sufficient information to enable the Postal Service to
10 estimate its volume.

11 My question is this. If you're mailer
12 number two, the one that can't get an equivalent
13 volume discount, are you being treated unfairly?

14 THE WITNESS: Again, speaking as an
15 industry, we all gain. If individual mailers gain,
16 the post office gains because of volume cost.

17 Number two, speaking now personally because
18 I can't speak for the rest of the industry on this
19 question. In our case this is the normal way you
20 would do any business deal, you know, with a supplier.
21 You'd have to provide certain data.

22 If it wasn't available, other people in
23 other fields might not enter into it with you either,
24 so, yes, you're precluded because you don't have
25 sufficient data upon which in this case to establish a

1 public record. I don't think it would be unfair. You
2 could hire someone who could produce that data for
3 you.

4 COMMISSIONER HAMMOND: Okay.

5 THE WITNESS: Again, I can only speak for my
6 own. I don't want to speak for the industry on this,
7 but, you know, we have to keep so much data and all
8 this for all these other reasons.

9 COMMISSIONER HAMMOND: Right.

10 THE WITNESS: You know, even for our own
11 mail sortation. Many of us are geared for drop ship
12 mail. A lot of us have this data, and if we didn't
13 have it there are economists in the field who could
14 assemble it and form that that the post office deems
15 appropriate.

16 This is myself speaking for my own feelings
17 with the postal attorneys and economics people on NSA.
18 I couldn't speak for the rest of the industry on what
19 data they have.

20 COMMISSIONER HAMMOND: Okay. Well, then I
21 guess to the heart of my question. If you're mailer
22 number two, the one that's been denied the volume
23 discount, are you entitled to some sort of proof that
24 your competitor provided more reliable volume
25 information than you could produce?

1 THE WITNESS: Okay. Speaking personally, I
2 would say at a hearing you'd have a right, yes, if you
3 were objecting to something to get the data and be
4 told by the post office why your data wasn't
5 sufficient enough upon which for them to do a model to
6 bring to the PRC the way the other Company A did, but
7 that's not speaking as an administrator. That's
8 speaking my own personal opinion.

9 COMMISSIONER HAMMOND: Okay. All right.
10 That's all my questions, Mr. Chairman.

11 CHAIRMAN OMAS: Commissioner Covington?

12 COMMISSIONER COVINGTON: Good morning,
13 Witness Posch.

14 THE WITNESS: Good morning, Commissioner.

15 COMMISSIONER COVINGTON: First of all, I
16 wanted to follow up on the question that Commissioner
17 Hammond just posed to you.

18 On behalf of I would say PostCom, the DMA
19 and the Parcel Shippers Association, I would consider
20 you all to be in my terms pretty much heavy hitters in
21 the postal arena. Can you clarify? Weren't you or
22 your group not the least bit concerned about Capital
23 One's lack of historical volume?

24 THE WITNESS: I'm not sure I can speak on
25 that, I mean, certainly as a group. I mean, can I

1 speak on that? I'm not sure if that's within the
2 bounds of what I was asked to talk about. I mean, I
3 was only asked to speak on why the industry supports
4 NSAs and everything, but not on particulars.

5 COMMISSIONER COVINGTON: Okay. Which means
6 that you couldn't answer my second question. Did you
7 or did anyone in your consortium look at or consider
8 the physical and electronic information on Capital
9 One's UAA mail?

10 THE WITNESS: I definitely couldn't, no.
11 Sorry.

12 COMMISSIONER COVINGTON: Okay. Let me ask
13 another question, which I figure you're not going to
14 be able to answer.

15 NSAs have been successfully employed in
16 other regulated industries.

17 THE WITNESS: Yes.

18 COMMISSIONER COVINGTON: Now, you should be
19 able to answer that.

20 THE WITNESS: I believe they have, yes.

21 COMMISSIONER COVINGTON: Okay. Now, do you
22 or does your group that you're representing here today
23 have any additional idea?

24 It doesn't have to be particularly Capital
25 One, or it doesn't necessarily have to be a negotiated

1 service agreement and/or niche classification, but do
2 you have any additional idea how something distinct
3 like this for operational could be a good relationship
4 with any company that wanted to do something with the
5 United States Postal Service?

6 THE WITNESS: Do you mean a relationship
7 with the post office that was client related that
8 wasn't a legal NSA?

9 COMMISSIONER COVINGTON: Right.

10 THE WITNESS: I'm not sure if the post
11 office is permitted to do any other client related
12 things. I mean, even the NSA is still unchartered
13 territory. I'm not sure we could go to Mr. McBride or
14 someone and say we would like to do the following
15 because they're not free to negotiate like Bookspan
16 could negotiate with Donnelly or another company like
17 that.

18 I think the NSA format is something we've
19 been trying because at least in my mind it's the only
20 way we could approach the post office legally at this
21 time.

22 COMMISSIONER COVINGTON: Okay. At this
23 time.

24 THE WITNESS: I know there are suggestions
25 of a proposal to the Presidential Commission. I've

1 read some of that testimony about giving the post
2 office greater flexibility with clients and all that,
3 but again I'm not an expert on all of this.

4 I'm not aware of any other way we could
5 approach the post office as Bookspan and say we've got
6 the following good ideas, and if you agree with us
7 could we do this outside of your supervision on the
8 Postal Rate Commission and a formal structure like the
9 NSA.

10 COMMISSIONER COVINGTON: Based on your
11 expertise and your knowledge of postal regulations,
12 and I would assume particularly because of your work
13 at Bookspan you are familiar with discounts?

14 THE WITNESS: Yes.

15 COMMISSIONER COVINGTON: Discounts that the
16 Postal Service offers.

17 A hypothetical question. If the Postal Rate
18 Commission gives approval as far as this
19 classification request is concerned, do you think
20 Capital One would be able to actually reduce postal
21 costs?

22 THE WITNESS: Not on the specifics, but on
23 anecdotal literature. The post office is strongly
24 supporting this deal. We strongly support the help of
25 the post office.

1 They believe for a variety of reasons, both
2 cost reasons for knowledge reasons and also for
3 precedent reasons, I believe. I can't speak for the
4 post office in that respect, but, yes, it would help
5 the whole mailing industry.

6 COMMISSIONER COVINGTON: Okay. Thanks,
7 Witness Posch.

8 That's all I have, Mr. Chairman.

9 THE WITNESS: Thank you, Commissioner.

10 CHAIRMAN OMAS: Thank you, Commissioner
11 Covington.

12 Mr. Volner, would you like some time with
13 your witness?

14 MR. VOLNER: Mr. Chairman, there will be no
15 redirect.

16 CHAIRMAN OMAS: No redirect. All right.

17 Mr. Posch, that completes your testimony
18 here today. We appreciate your contribution to the
19 record, and we thank you for being with us. You're
20 now excused.

21 THE WITNESS: Thanks for the courtesies.
22 Thank you, sir.

23 (Witness excused.)

24 CHAIRMAN OMAS: Mr. Koetting, would you
25 introduce our next witness this morning?

1 MR. KOETTING: Thank you, Mr. Chairman. The
2 Postal Service calls its next witness. Dr. Kelly
3 Eakin.

4 CHAIRMAN OMAS: Dr. Eakin, would you raise
5 your right hand, please?

6 Whereupon,

7 B. KELLY EAKIN

8 having been duly sworn, was called as a
9 rebuttal witness and was examined and testified in
10 rebuttal as follows:

11 CHAIRMAN OMAS: Mr. Koetting?

12 (The document referred to was
13 marked for identification as
14 Exhibit No. USPS-RT-2.)

15 DIRECT EXAMINATION

16 BY MR. KOETTING:

17 Q Could you please state your full name and
18 position for the record?

19 A My name is Brian Kelly Eakin, and I am a
20 vice president of Christiansen Associates in Madison,
21 Wisconsin.

22 Q Dr. Eakin, I've handed you a copy of a
23 document entitled Rebuttal Testimony of B. Kelly Eakin
24 on behalf of the United States Postal Service, which
25 has been labeled as USPS-RT-2. Are you familiar with

1 this document?

2 A Yes. This is testimony that I prepared.

3 Q Are there any library references or work
4 papers associated with this document?

5 A No, there are not.

6 Q Do you have any changes that you would like
7 to make in the testimony today?

8 A Yes. I have two minor corrections that I
9 would like to --

10 CHAIRMAN OMAS: Dr. Eakin, would you push
11 the mike up and speak a little more directly into it?

12 THE WITNESS: Yes. I have two minor
13 corrections. They both occur on page 15. On page 15,
14 line 19, the number 12.8 percent should be 13.28
15 percent, and on line 23 the number \$307,000 should be
16 \$298,000.

17 BY MR. KOETTING:

18 Q Are those two changes reflected in the copy
19 of the testimony that you have?

20 A Yes, they are.

21 Q And with those changes, if you were to
22 testify orally today would this be your testimony?

23 A Yes, it would be.

24 MR. KOETTING: Mr. Chairman, the Postal
25 Service has two copies of the rebuttal testimony of B.

1 Kelly Eakin on behalf of the United States Postal
2 Service designated as USPS-RT-2 and request that they
3 be admitted into evidence in this proceeding.

4 THE WITNESS: Without objection. I will
5 direct counsel to provide the reporter with two copies
6 of the corrected rebuttal testimony of B. Kelly Eakin.
7 That testimony is received into evidence and should be
8 transcribed.

9 (The document referred to,
10 previously identified as
11 Exhibit No. USPS-RT-2, was
12 received in evidence.)

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

EXPERIMENTAL CHANGES TO
IMPLEMENT CAPITAL ONE NSA

Docket No. MC2002-2

REBUTTAL TESTIMONY
OF
B. KELLY EAKIN
ON BEHALF OF
UNITED STATES POSTAL SERVICE

February 25, 2003

TABLE OF CONTENTS

AUTOBIOGRAPHICAL SKETCH	i
I. PURPOSE OF TESTIMONY	1
II. THE ECONOMICS OF THE CAPITAL ONE NSA	1
II.A. Summary of the NSA Terms.....	1
II.B. The Capital One NSA Incorporates Efficiency Features and Provides Correct Incentives for Increased Use of First-Class Mail.....	3
III. THEORETICAL AND EMPIRICAL ISSUES	6
III.A. The Limited Relevance of Pareto Improvements and Pareto Optimality ...	6
III.B. The Relevance of Interdependent Demands	7
III.C. Quantifying the Financial Impacts of the Capital One NSA	8
III.C.i. <i>Estimation of the Direct Impacts</i>	10
III.C.ii. <i>Discussion of the Secondary Impacts</i>	11
III.C.iii. <i>Estimation of the Secondary Impacts</i>	14
III.C.iv. <i>Effect of Secondary Impacts on the Contribution Estimate</i>	19
III.D. Assessment of the Alternative Put Forth by OCA Witness Callow.....	19
IV. EXPERIENCES FROM OTHER REGULATED INDUSTRIES	20
IV.A. Pricing Structures in Other Regulated Industries.....	21
IV.A.i. <i>Examples of Non-Linear Pricing</i>	22
IV.A.ii. <i>Examples of Optional Tariffs</i>	24
IV.A.iii. <i>Examples of Negotiated Contracts</i>	25
IV.B. The Regulatory Experience in Other Industries.....	27
V. OBSERVATIONS ON THE CAPITAL ONE NSA	29
Figures 1A and 1B.....	33
Table 1	34
Appendix 1: Curriculum Vita.....	35

1 **AUTOBIOGRAPHICAL SKETCH**

2 My name is B. Kelly Eakin and I am a Vice President at Christensen Associates.
3 I received a B.A. degree in history from the University of Texas at Austin in 1978 and a
4 Ph.D. degree in economics from the University of North Carolina at Chapel Hill in 1986.
5 My areas of economic expertise are in the regulation and organization of industry, the
6 theory of production and cost, environmental economics, health economics and applied
7 microeconomics in general. I have worked at Christensen Associates since 1994, where I
8 have been primarily involved in economic issues facing the energy sector, particularly the
9 electricity industry. Prior to joining Christensen Associates, I worked as an economist
10 for the Economic Research Service of the U.S. Department of Agriculture from 1992 –
11 1994, where I developed expertise in environmental economics. From 1985 – 1992, I
12 was an Assistant Professor of Economics at the University of Oregon. In this capacity I
13 taught graduate and undergraduate courses in microeconomics, production economics,
14 industrial organization, regulation of industry, and health economics. I also was active in
15 the direction of research by graduate students in the Department of Economics and the
16 College of Business. I have published several scholarly articles in refereed academic
17 journals and in electricity trade journals. I have co-edited two books on pricing issues in
18 the electricity industry. My curriculum vita is attached as Appendix 1.

1 **I. PURPOSE OF TESTIMONY**

2 I have been retained by the Postal Service to address economic issues raised,
3 primarily by Professor Panzar (JCP-T-1, Tr. 8/1571-1790), in the proceedings concerning
4 the negotiated service agreement with Capital One Services, Inc. (henceforth called the
5 Capital One NSA or simply NSA). My testimony has four remaining sections. Section II
6 deals with the economics of the Capital One NSA. Section III addresses theoretical
7 issues and empirical questions that have arisen in these proceedings. Section IV
8 discusses similar pricing arrangements and regulatory experiences in other regulated
9 industries. Section V summarizes my observations about the Capital One NSA in the
10 context of regulation and competition.

11
12 **II. THE ECONOMICS OF THE CAPITAL ONE NSA**

13 In this section of my testimony, I present my understanding of the Capital One
14 NSA and the Postal Service's objectives in negotiating this agreement. I also comment
15 on the economic structure of the NSA and assess how effective it will likely be in
16 achieving the Postal Service's objectives. I discuss how the Capital One NSA terms are
17 consistent with Professor Panzar's suggestion that NSAs should be an opportunity to
18 improve the Postal Service's economic efficiency (Tr. 8/1645), and state why I believe
19 the Capital One NSA is in the public interest.

20 **II.A. Summary of the NSA Terms**

21 My understanding of the Capital One NSA primarily comes from my reading of
22 the proposed agreement and the direct testimonies of Postal Service Witnesses Plunkett
23 (USPS-T-2) and Crum (USPS-T-3). As I understand it, the Capital One NSA has two

1 main provisions. First, the agreement calls for Capital One to receive electronic
2 notification about its undeliverable First-Class Mail solicitations instead of physical
3 return of the pieces. Second, the agreement provides a declining block rate structure for
4 Capital One's presorted First-Class Mail¹ volume beyond an annual threshold level.

5 The main parameters of the declining block rate structure are the threshold level,
6 the block sizes, and the block prices (or discounts). The threshold is the greater of 1.225
7 billion pieces of First-Class Mail or 90 percent of the average volume of Capital One's
8 presorted First-Class mailings for FY2000, FY2001, and FY2002. The current presorted
9 First-Class Mail rates would apply to all pieces of mail up to the threshold. The declining
10 block structure begins with a 3.0 cent per-piece discount on the first block of 50 million
11 pieces greater than the threshold of 1.225 billion pieces, followed by a series of
12 *additional* 0.5 cent per piece discounts on additional blocks. The second and third blocks
13 beyond the threshold are each sized at 50 million pieces of mail. The fourth, fifth, and
14 sixth blocks are sized at 75 million pieces of mail. The seventh and final block, for all
15 pieces of mail beyond 1.6 billion, receives a total discount of 6.0 cents per piece. If the
16 threshold is greater than 1.225 billion pieces, then the current rates apply to all pieces up
17 to the threshold, and additional pieces will be priced according to the discount schedule
18 described above (i.e., the threshold has changed, but the other block boundaries remain
19 the same).

20 My understanding is that the Postal Service's objectives in this NSA are to
21 increase net revenues (i.e., contribution) and to retain and increase Capital One's First-

¹ Unless otherwise noted, all references to Capital One's First-Class Mail refer to First-Class Mail categories covered by the NSA.

1 Class Mail volume, with an increase in net revenues leading to a reduction in the overall
2 burden on postal ratepayers. (USPS-T-2, p.1)

3 **II.B. The Capital One NSA Incorporates Efficiency Features and Provides**
4 **Correct Incentives for Increased Use of First-Class Mail**

5 The Capital One NSA is economically sound. The NSA implements a
6 customized product that preserves the benefits Capital One receives from using presorted
7 First-Class Mail, while the Postal Service avoids the costs of a bundled attribute (physical
8 return of pieces that are undeliverable-as-addressed) that apparently provides Capital One
9 little or no value. The NSA also represents an efficiency-improving application of a non-
10 linear pricing structure.

11 The opportunity for efficiency with declining block rates comes from the ability
12 to move marginal prices in the direction of marginal costs. With a uniform tariff, as
13 exemplified by existing postal rate schedules, the total contribution to the recovery of
14 “fixed” (or institutional) costs from any given mailer is achieved by including a markup
15 over marginal cost within the uniform price paid for each unit by that mailer (as well as
16 all other mailers). At any given volume level for that mailer, the total contribution is
17 simply the sum of the unit contribution for each piece mailed. In theory, at least, it would
18 be possible to receive that same amount of total contribution as a lump sum payment
19 from the mailer, and then charge the marginal rate on each unit mailed equal to the
20 marginal cost. Such an arrangement would be expected to increase efficiency, because
21 the mailer would be expected to generate volumes up to the level where the marginal
22 value to the mailer of the last piece equals the marginal cost to the Postal Service of
23 providing that unit of service. In contrast, under the uniform tariff, the mailer equates

1 marginal value of the last piece with the marginal cost of that unit *plus* the markup for
2 contribution, which normally would lead to inefficiently low mail volumes.

3 In a declining block rate structure, there is no lump sum payment. But the total
4 contribution generated from the units consumed by the mailer below the threshold at
5 which the lower rates start can play the same role as a lump sum payment would in the
6 above hypothetical rate structure. If the threshold is set exactly at the same given volume
7 from which expected total contribution has been calculated under the status quo, the
8 marginal rate beyond that could be dropped all the way to marginal cost, and the expected
9 result on efficiency would be the same as under the lump sum payment structure
10 hypothesized above.

11 If the threshold for declining block rates were to equal or exceed Capital One's
12 "before rates" volume (i.e., that would have been mailed in the absence of the NSA), the
13 contribution under the NSA from units below the baseline (before rates) volume equals
14 the total contribution expected in the absence of the NSA. In the NSA, the threshold
15 volume is less than the before rates volume, so the contribution from units below the
16 baseline is less than the contribution on those volumes in the absence of the NSA by an
17 amount called the "discount leakage" by Witness Crum. However, this is not the only
18 source of contribution in the NSA. While the rates in the declining blocks under the
19 Capital One NSA move in the direction of marginal costs, they are still materially above
20 the level of marginal costs estimated by Witness Crum. Therefore, in contrast to the case
21 where the marginal rate equals marginal cost, additional contribution would be generated
22 by units above the threshold in the Capital One NSA. Moreover, it is my understanding

1 that the expected return cost savings from the Capital One NSA exceed the estimated
2 discount leakage under Capital One's original volume forecast.

3 The NSA provides the correct incentives to retain Capital One's First-Class Mail
4 volume, and for Capital One to increase its usage by reducing Capital One's marginal
5 price of First-Class Mail *relative* to other forms of solicitation. Thus, Capital One will
6 have incentives to increase its use of First-Class Mail for solicitation and to defer any
7 switch to electronic presentation of customer bills. In addition to providing the proper
8 incentives, the NSA creates an overall efficiency gain by reducing the gap between the
9 marginal price and the marginal cost of Capital One's First-Class Mail while increasing
10 the expected contribution from Capital One as compared to the existing uniform rate
11 structure. It is in that sense that the NSA represents an efficiency-improving application
12 of a non-linear pricing structure. That is, more social value results from the NSA.

13 The Capital One NSA is in the public interest because the agreement creates value
14 that is shared widely across groups of postal customers. The most significant source of
15 value is the cost-reducing substitution of electronic notification for physical return of
16 Capital One's undeliverable-as-addressed pieces. The other significant source of value
17 comes from the more efficient pricing structure. Thus, following Professor Panzar's
18 guidance to "look at the whole package" (Tr. 8/1685), the Capital One NSA has a
19 positive expected contribution. The value created is shared between Capital One and the
20 Postal Service. Because the Postal Service operates on a break-even basis, its gains are
21 shared by all postal customers. (See also JCP-T-1 p. 5, Tr. 8/1580.)

22

1 **III. THEORETICAL AND EMPIRICAL ISSUES**

2 In this section of my testimony, I address several theoretical issues raised in this
3 proceeding. Also, consistent with the Postal Rate Commission's questioning of other
4 witnesses, I try to move from the theoretical to the empirical. I identify the relevant
5 parameters needed to assess the financial impacts of the NSA, and, by a synthesis of the
6 evidence already presented in this proceeding, I develop reasonable empirical bounds for
7 the secondary or indirect impacts. Finally, in this section, I comment briefly on the
8 alternative proposal put forth by OCA Witness Callow.

9 **III.A. The Limited Relevance of Pareto Improvements and Pareto**
10 **Optimality**

11 The concepts of Pareto improvements and Pareto optimality have little direct
12 relevance to the consideration of the Capital One NSA (or with other NSAs, for that
13 matter). To constitute a Pareto improvement, a change in the Postal Service's rate
14 structure must benefit at least one party and harm no one else. Professor Panzar
15 concluded in his cross-examination that making a Pareto improvement is a "really
16 extraordinary achievement in economic policy setting" (Tr. 8/1736). I would venture to
17 say it would be an impossible achievement. With numerous interrelated parties,
18 including the Postal Service's customers and competitors, any change in the Postal
19 Service's rate structure will adversely impact at least one party and thus not be a Pareto
20 improvement. Making Pareto improvement a criterion for changing pricing structures
21 would literally paralyze the Postal Service with respect to price changes. Thus, these
22 concepts are not relevant to consideration of the Capital One NSA because, in pragmatic
23 terms, they are unattainable criteria. A more appropriate criterion, as Professor Panzar

1 noted in his oral testimony (Tr. 8/1764-1765), is whether the NSA will generate a net
2 surplus that can broadly benefit mailers.

3 **III.B. The Relevance of Interdependent Demands**

4 In Professor Panzar's direct testimony, he raised market demand interdependence
5 as a theoretical concern for evaluating the desirability of NSAs. He focuses on the fact
6 that the demand curves faced by Capital One and each of its competitors for their
7 respective final products cannot be assumed to be independent. Consequently, the
8 derived demands by each of these firms for postal services would not generally be
9 independent.

10 The interdependence of the demands among Capital One and its competitors
11 implies a potential indirect financial revenue impact to the Postal Service from
12 implementing the Capital One NSA. In his written testimony Professor Panzar described
13 a situation in which, because of demand interdependence, the Capital One NSA would
14 lead to a decrease in mail volumes from direct competitors of Capital One and that this
15 would reduce the direct net revenue gain from the NSA, other things equal (JCP-T-1 pp.
16 15-16, Tr. 8/1590-1591). However, Professor Panzar has also recognized the advertising
17 nature of solicitation mail to Capital One and its competitors, and concluded that it would
18 be plausible that both Capital One and its competitors could consume more postal
19 services as a result of the Capital One NSA (Tr. 8/1788-1789). In either case, the
20 interdependency of the demands between Capital One and its competitors produces only
21 a secondary or indirect financial impact. However, the net indirect effects may increase
22 the net revenue generated by the NSA, not just reduce it.

1 Interdependent demands also exist among different postal services (e.g., First-
2 Class Mail and Standard Mail), between alternative marketing media (e.g., postal
3 services, telemarketing, other print media, internet), and between alternative delivery
4 services (e.g., postal services, UPS, FedEx). These interdependent demands have
5 received less discussion in this proceeding, but I believe they are the more relevant in
6 evaluating the Capital One NSA.

7 Currently, mail volumes, and in particular high-contribution First-Class Mail
8 volumes, are under increasing competition from alternative messaging media, especially
9 from electronic media such as the Internet. Other more traditional messaging media,
10 including television advertising, are also substitutes for credit card solicitation mail.
11 Similarly, some portions of the First-Class mailstream, including credit card solicitations,
12 face internal competition from the lower-contribution Standard Mail. Consequently, the
13 Postal Service's central task of revenue management requires consideration of these
14 interdependent demands when pricing initiatives such as NSAs are contemplated. The
15 Capital One NSA recognizes the existence of these interdependencies, and creates the
16 opportunity to respond to them appropriately. The Capital One NSA makes First-Class
17 Mail pricing more competitive to Capital One while actually increasing the contribution
18 received from this customer.

1 **III.C. Quantifying the Financial Impacts of the Capital One NSA**

2 I now address the question “Under what conditions would the Capital One NSA
3 result in a net revenue gain to the Postal Service?” To answer this question, it is useful to
4 decompose the financial impact of the Capital One NSA. There are five identifiable
5 financial impacts from the Capital One NSA. These impacts are illustrated in Figures 1a
6 and 1b. Figure 1a represents three direct financial impacts of the Capital One NSA on
7 the Postal Service, which Postal Service Witness Crum identifies and analyzes (USPS-T-
8 3). In this figure, P represents the average First-Class Mail rate without the NSA, P'
9 represents the NSA discounted rate applying to volume greater than the threshold
10 quantity, C is the average variable cost (and also the marginal cost) of Capital One’s
11 First-Class Mail without the NSA and C' is the average variable cost (and also the
12 marginal cost) of Capital One’s First-Class Mail under the NSA. The threshold volume
13 where the declining block rates start is q_T . Capital One’s “before rates” or baseline
14 volume is q_0 , and q_N is Capital One’s “after rates” volume.

15 Area 1 represents lost contribution that occurs if the threshold quantity where
16 declining block rates start is set below the baseline volume level Capital One would have
17 mailed in the absence of the NSA. Postal Service Witness Crum has labeled this
18 “discount leakage.” Note that the Area 1 lost contribution is zero if the threshold is
19 above the Capital One’s baseline volume. Area 2 represents the cost savings resulting
20 from replacing costly physical returns with less costly electronic information. Witness
21 Crum has labeled this “ACS Return Cost Savings.” Area 3 represents the incremental
22 contribution that results from the increase in Capital One’s mailing volume induced by
23 the declining block price structure. Witness Crum calls this “Increased Contribution

1 from New Mail Volume." Figure 1b represents the secondary or indirect effects of the
2 Capital One NSA, discussed above, from the reactions of Capital One's competitors. If
3 the Capital One NSA causes competitor volume to decrease from Q_0 to Q_N , then there is
4 a "secondary leakage" represented by Area 4. On the other hand, if the NSA actually
5 induces increased competitor volume from Q_0 to Q'_N , then there is a "secondary
6 contribution" represented by Area 5.
7 Now to answer the question, the Capital One NSA would result in a net revenue
8 gain to the Postal Service if the Cost Savings (Area 2) plus the Direct Increased
9 Contribution (Area 3) plus the Secondary Contribution (Area 5) is greater than the
10 Discount Leakage (Area 1) plus Secondary Leakage (Area 4).
11 **III.C.1. Estimation of the Direct Impacts**
12 I now discuss the data and assumptions needed to quantify each of these impacts.
13 To calculate Area 1 (Discount leakage), one needs to have values for the baseline
14 quantity (q_0), the threshold quantity (q_T), the First-Class Mail rate without the NSA (P),
15 and the discounted rate (P'). The NSA specifies the threshold quantity, the boundary
16 quantities, and the prices. Only q_0 needs to be estimated. The estimation of q_0 may or
17 may not require making assumptions about elasticities.
18 To calculate Area 2 (Cost Savings) one needs to have values for the baseline
19 quantity (q_0), and the per-unit cost savings from changing the terms of the First-Class
20 Mail service Capital One will receive to those of the NSA ($C-C'$).
21 To calculate Area 3 (Direct Increased Contribution) one needs to have values for
22 the discounted prices (P'), the baseline quantity (q_0), the boundary quantities that separate
23 the blocks, the average variable cost under the NSA (C'), and the quantity that Capital

1 One would mail under the NSA (q_N). The NSA specifies the discounted prices and the
2 boundary quantities. The baseline quantity needs to be estimated, but may not require
3 making assumptions about elasticities. The “after rates” quantity q_N also needs to be
4 estimated, which can be done by combining an assumption about Capital One’s price
5 elasticity of demand for First-Class Mail with data on P , P' , and q_0 .

6 Areas 1, 2, and 3 are estimated in Witness Crum’s testimony (USPS-T-3 at 2-6).
7 Those estimates are: Discount Leakage (Area 1) = \$6.7 million; Cost Savings (Area 2) =
8 \$13.1 million; and Direct Increased Contribution (Area 3) = \$1.8 million. It is from these
9 estimates that the Postal Service arrives at its estimated \$8.2 million increase in
10 contribution resulting from the Capital One NSA (USPS-T-2 p. 5, USPS-T-3 p. 6).

11 ***III.C.ii. Discussion of the Secondary Impacts***

12 Witness Crum’s estimate of total contribution gain implicitly assumes a zero
13 value for the secondary impacts represented by Area 4 and Area 5. As discussed in this
14 section, such an assumption is a reasonable one to make.

15 Calculating point estimates for these secondary impacts is problematic, but
16 plausible bounds can be estimated. In attempting to place reasonable bounds on the
17 secondary impacts, it is useful to distinguish between “customer mail” sent by credit card
18 companies and “solicitation mail.”² Customer mail refers to business correspondence
19 with an existing customer (e.g., monthly statements) and as such could be described as
20 “production” inputs. Solicitation mail refers to marketing mail designed to secure new
21 accounts (e.g., invitations/applications sent out). I believe that secondary leakage (Area

² This distinction was also made by Witness Elliott in his calculation of volume growth resulting from the NSA. See Tr. 2/205 and Tr. 2/212.

1 4) mainly involves customer mail, while secondary contribution (Area 5) mainly involves
2 solicitation mail.

3 The secondary leakage described by Professor Panzar occurs when the decrease in
4 marginal mailing costs to Capital One leads to a reduction in the final market price for
5 credit services (JCP-T-1 pp. 14-19, Tr. 8/1589-94). Such a price drop would normally
6 increase the net quantity demanded of credit services, and consequently increase the net
7 quantity demanded of postal services, assuming postal services are a "normal" input.
8 However, the net increase would involve a shift of customers to Capital One products
9 from Capital One competitors. Because the underlying cause of the secondary leakage
10 (Area 4) is the shift in customers, I expect it would mainly involve customer mail.

11 Secondary contribution (Area 5), in contrast, would arise through the strategic
12 response of Capital One's competitors to an increase in Capital One's advertising.
13 Industrial economics theory suggests that Capital One's increasing solicitation mail (or
14 advertising) is likely to induce competitors to respond with similar increases of their own
15 (Tr. 8/1751-1755 and Tr. 8/1787-1789). Thus, secondary contribution would mainly
16 involve solicitation mail, as well as mail volumes resulting from the generation of new
17 accounts by Capital One's competitors.

18 Neoclassical production theory tells us that the extent of secondary leakage
19 depends on the production technologies used by Capital One and its competitors in
20 providing credit card services, the prices received by Capital One and by its competitors
21 for credit card services, the prices paid by Capital One and its competitors for production
22 inputs, and the extent of direct competition between Capital One and other firms in the
23 market for credit card services. Much of the information needed to construct a point

1 estimate of the secondary leakage would be private information of Capital One's
2 competitors. However, it is possible to set bounds because under competitive
3 assumptions, a complete offset of Capital One's customer mail volume increase is the
4 limiting "worst case" of the secondary leakage. In actuality, the offset is likely to be less
5 than the increase in Capital One's First-Class customer mail, in part because Capital
6 One's increased solicitation mail is likely to induce some customers to obtain an
7 additional credit card rather than merely switching credit card companies.

8 The factors that determine the secondary contribution are also difficult to
9 precisely quantify. They include the extent of competition in the market for credit cards
10 and the strategic dispositions of Capital One and its competitors. Again, some data
11 needed to calculate secondary contribution are not likely to be available for proprietary
12 reasons. Detailed analysis of the forecasted interdependent demands is unlikely to
13 provide insights valuable enough to warrant the cost and delay generated by such
14 analysis.

15 The bad news is that calculating Area 4 and Area 5 is problematic. The good
16 news is that the secondary leakage and the secondary contribution effects depicted in
17 Figure 1b tend to offset each other. Given the advertising nature of the mail volumes in
18 question, the decline in some competitors' volumes in response to any increases in
19 solicitation mail by Capital One would likely be offset by increased volume by other
20 competitors who respond to Capital One's increased volumes with additional advertising
21 mail of their own. Thus, these secondary effects are not likely to significantly affect the
22 net financial impact of the NSA negatively. The Postal Service has taken a pragmatic

1 approach to evaluating the NSA by weighing the sum of Area 1 against the sum of Area 2
2 and Area 3 (implicitly assigning the sum of Area 4 and Area 5 a value of zero).

3 ***III.C.iii. Estimation of the Secondary Impacts***

4 The Postal Rate Commission and others in this case have asked for guidance on
5 establishing bounds for these secondary effects. (See, for example, Tr. 8/1760-1761 and
6 Tr. 8/1773.) Using data put forth by the Postal Service and Capital One in this
7 proceeding (USPS-T-3, COS-T-2), I am able to establish such bounds for Area 4 and
8 Area 5. In doing so, I identify the variables determining the results and the assumptions
9 made about the values of these variables.

10 Area 4 represents the secondary leakage that could result from Capital One
11 competitors reducing customer mail as the credit card industry re-establishes equilibrium
12 after the NSA is implemented. Since customer mail is business correspondence with
13 existing customers, I assume the mail volumes at issue, for both Capital One and its
14 competitors, are presorted First-Class Mail. Furthermore, I assume that Capital One's
15 competitors pay Capital One's average rate for First-Class Mail prescribed by the existing
16 uniform tariff.

17 Witness Elliott (COS-T-2, Exhibits 6 and 7, Tr. 2/211-212) offers two methods
18 for estimating by how much Capital One will expand its First-Class customer mail under
19 the NSA. In one scenario – the source of the 15.5 million piece incremental after rates
20 volume for Capital One – Witness Elliott applies the -0.071 own-price elasticity for
21 workshared First-Class Mail to the baseline customer mail volume, resulting in an
22 increase of 7 million pieces of customer mail (Tr. 2/211). In the alternative scenario,
23 Witness Elliot assumes Capital One's pre-existing customer mail volumes are perfectly

USPS-RT-2

1 price inelastic, but that the -0.388 Standard Mail elasticity is applicable to Capital One's
 2 First-Class Mail solicitation volume. He then derives the increment of customer mail by
 3 estimating the new accounts generated by the additional solicitations and pieces mailed
 4 per account, resulting in an estimate of 1.92 million pieces of additional customer mail
 5 (Tr. 2/212). For purposes of establishing a "worst case scenario" for the secondary
 6 leakage, I am using the 7 million piece estimate for the increase in Capital One's
 7 customer mail from the NSA.

8 The largest possible offset under competitive market assumptions is an exactly
 9 offsetting reduction of customer mail by Capital One's competitors. If this were the case,
 10 then the Postal Service would have secondary leakage of about \$1.1 million dollars as
 11 Capital One's discounted First-Class Mail displaces its competitors' undiscounted First-
 12 Class Mail.³ The "best case scenario" for Area 4 is that the offset is essentially zero.
 13 This could occur under a variety of imperfect competition situations, for instance if the
 14 effect of the Capital One NSA on the price of credit card services was too trivial to
 15 induce competitors' customers to switch to Capital One. In this case, the secondary
 16 impact would be \$0. The middle case is that there is 50 percent offset, in which case the
 17 resulting leakage would be about \$550,000. It should be noted that in Witness Elliot's
 18 method 1, to generate 7 million additional pieces of customer mail from 8.432 million
 19 additional solicitations would require a response rate of ~~12.8~~ ^{13.28} percent, more than 20 times
 20 the industry average of 0.6 percent used in Witness Elliot's alternative method. Thus,
 21 even in the full offset case, I would expect the secondary leakage to be well below the
 22 \$1.1 million figure. Using the 1.92 million piece alternative estimate, for instance, the
 23 secondary leakage under the worst case full offset scenario is only ~~\$307,000~~ ^{\$218,000}.

1 The calculation of the bounds for Area 5, secondary contribution, is a little more
2 involved, but still relatively straightforward. Secondary contribution primarily represents
3 changes in competitors' solicitation mail that could result in response to increased
4 solicitation mailings by Capital One resulting from the NSA. The basic calculation of
5 this impact requires multiplying the induced increase in competitors' solicitation mail
6 volume by the average margin on that volume. Estimating the increase in competitors'
7 solicitation volume requires an estimate of Capital One's increase in solicitation mail as a
8 result of the NSA, a model of how competitors react in response to increased solicitation
9 mailings by Capital One (ignore, partial match, exactly match, more than match), and the
10 unit contribution on the competitors' solicitation mail. Thus, my estimates of the Area 5
11 bounds are given by the following equation:
12
$$\text{Secondary Contribution (Area 5)} = m * \Delta q_s * \alpha * \mu$$

13 where m is the unit margin (contribution) on competitors' increased solicitation mail, Δq_s
14 is the increase in Capital One's solicitation mail as a result of the NSA, α is a parameter
15 indicating how competitors respond in terms of increased advertising in reaction to
16 increased solicitation mailings by Capital One, and μ is a parameter indicating how the
17 competitors' advertising response translates into mail volumes. While the exact values of
18 the α and μ terms would be difficult to measure, primarily because they would depend on
19 private information of Capital One's competitors, it is possible to set reasonable bounds
20 on them using some basic economics.
21 The α parameter mainly captures a strategic response of Capital One's
22 competitors, and would thus depend on Capital One's market share and the concentration

³ The \$1.1 million figure is derived in Table 1, attached to the end of the testimony.

1 of the credit card industry. This effect will normally be positive and will tend to be larger
2 to the extent Capital One and some of its competitors are large enough to take each
3 other's actions into account. For example, $\alpha=0$ implies no interactions, $\alpha=1$ implies a
4 matching advertising response by competitors, and $\alpha>1$ implies a more-than-matching
5 response as would occur in an advertising "war."

6 The μ parameter will be positive if mail is a "normal" advertising input—i.e., if
7 the total amount of advertising increases, mail advertising will increase to some extent.
8 Just as Capital One has choices in the advertising media it may employ to solicit new
9 customers, competitors also have many alternative advertising media to choose among in
10 responding to increased solicitation mailing by Capital One. Thus, $\mu = 0$ implies no
11 response in the form of increased solicitation mail, and $\mu = 1$ implies that the response is
12 entirely in the form of mail.

13 I assume that the average margin on this volume is 12 cents (implying a blend of
14 First-Class Mail and Standard Mail). An assumption about the price elasticity of demand
15 is needed to calculate Δq_s , in order to estimate the change in Capital One's solicitation
16 volume to which competitors would be responding. As was the case with the secondary
17 leakage, I employ Dr. Elliott's estimates to quantify Δq_s . Two values have been put forth
18 by Dr. Elliott. The "low" estimate is 8.4 million additional Capital One solicitations from
19 Dr. Elliott's Exhibit 6 (Tr. 2/211), and the "high" estimate is 51.2 million additional
20 Capital One solicitations from his Exhibit 7 (Tr. 2/212). I construct "worst case," "best
21 case," and "middle case" scenarios using each of Dr. Elliott's values of Δq_s .

22 The "worst case scenario" for secondary contribution (Area 5) is for there to be no
23 competitor mail response ($\alpha = 0$ and/or $\mu=0$) in which case Area 5 would equal \$0

1 independent of Capital One's increased solicitation volume. The "best case scenario" for
 2 Area 5 assumes the high estimate for Capital One's solicitation mail volume increase, and
 3 exact matching of solicitation mail by competitors ($\alpha = 1$ and $\mu=1$).⁴ In this best case,
 4 Area 5 would be \$6.144 million. The two middle cases assume a 50 percent match by
 5 competitors ($\alpha \times \mu = 0.5$). In the low volume "middle case" Area 5 would be \$504,000.
 6 In the high volume "middle case" Area 5 would be about \$3.1 million.

7 Combining the bounds and middle cases for Area 4 and Area 5 provide the
 8 empirical bounds and middle cases for the secondary effects, which have heretofore only
 9 been presented as theoretical possibilities. Given the assumptions identified above, the
 10 lower bound is -\$1.1 million for the Area 4 and Area 5 secondary impacts represented in
 11 Figure 1b. The upper bound estimate for the Area 4 and Area 5 impacts is about \$6.1
 12 million in additional contribution. The more realistic middle case estimates are about
 13 -\$46,000 and \$2.55 million. Incorporating the worst and best case scenarios for the
 14 secondary impacts into the Postal Service estimates of the direct impacts creates a range
 15 of \$7.1 million to \$14.3 million for the increase in total contribution resulting from the
 16 Capital One NSA, as summarized in Table 1.

17 The lower bound estimate for the secondary impact presented above is fairly well
 18 established as a worst case. To occur, it would require complete offset of competitors'
 19 First-Class customer mail, and also would require no competitive response to increased
 20 solicitation mail by Capital One. The values for the middle cases and the upper bound
 21 depend on demand elasticity estimates, as well as values for m , α and μ . The margin m

⁴ It is possible that an acceleration in a solicitation mail war could occur, in which the "best case scenario" would be one in which $\alpha > 1$ and $\mu=1$. This results in the secondary contribution being even greater than that given in the case of $\alpha = 1$. Given the difficulty in determining whether the credit card market

1 and Capital One's volume response should be subject to measurement or econometric
2 estimation in principle, but it is unlikely that sufficient information would be available to
3 estimate α and μ .

4 ***III.C.iv. Effect of Secondary Impacts on the Contribution Estimate***

5 The "worst case" adjustment to account for secondary impacts would reduce the
6 contribution gain from the Capital One NSA to about \$7.1 million. A more realistic
7 "middle case" would range from approximately zero to a modest positive secondary
8 impact on total contribution. Thus, the Postal Service's estimate of \$8.2 million of
9 increased contribution can be viewed as a reasonable middle case estimate.

10 **III.D. Assessment of the Alternative Put Forth by OCA Witness Callow**

11 My understanding of Witness Callow's alternative proposal is that it has two main
12 thrusts. First, it calls for making the terms similar to those of the Capital One NSA
13 available to any presorted First-Class Mail customers approved by the Postal Service (Tr.
14 7/1361). For the declining block rate structure proposed by Witness Callow, the
15 threshold level would be based on the customer's volume or other publicly available data
16 employed by the Postal Service, and the discount block boundaries would be scaled
17 according to the threshold volume level. Second, Witness Callow's proposal bounds the
18 incremental volume that receives the discounted rate at 15 percent of the threshold
19 volume.

20 The economic properties of Witness Callow's proposal are not as desirable as
21 those of the Capital One NSA. There is considerable financial risk in the broad offering
22 of an optional tariff. Optional tariffs are subject to an "adverse selection" problem that

conditions would lead to this acceleration scenario, I have not considered it as the "best case scenario" in this analysis.

1 has the potential of eroding revenues and harming other ratepayers (see Section IV.A.ii,
2 below). Mailers with pre-existing plans to increase their volumes would have the
3 strongest incentives to obtain the declining block discounts, but those plans would
4 usually be private information. So, it is far from clear how the Postal Service would set
5 the threshold values to avoid unnecessary revenue erosion without resorting to
6 negotiation or private information.

7 Another significant problem with Witness Callow's proposed tariff is that, in
8 bounding the number of pieces eligible for the block discounts, it establishes an
9 *increasing* block pricing structure beyond 15 percent of the customer-specific threshold.
10 This occurs because the marginal discount is first reduced, and eventually eliminated, as
11 volumes increase beyond 15 percent of the threshold (Tr. 7/1494). Thus, once the
12 maximum discount is reached under Witness Callow's proposal, the marginal price
13 reverts to the uniform price. While the volume increment at which these effects occur is
14 large relative to the projected volume increase for Capital One, it may not be the case for
15 all mailers who might seek to take part in the rates proposed by Witness Callow. The
16 discount limit is undesirable from a pricing efficiency standpoint, as it undoes the
17 marginal incentives for additional mail volumes and the efficiency gains from reducing
18 the difference between price and marginal cost.

19 20 **IV. EXPERIENCES FROM OTHER REGULATED INDUSTRIES**

21 In this section I draw on my knowledge of other regulated industries to provide
22 examples of pricing structures similar to the Capital One NSA. I also provide insights

1 from the regulatory processes in these industries, including the pragmatism of pilot or
2 experimental programs when introducing a new pricing arrangement.

3 **IV.A. Pricing Structures in Other Regulated Industries**

4 Other regulated (network) industries have pricing structures similar to the Capital
5 One NSA. The Capital One NSA actually embodies three related features that are found
6 in pricing arrangements in other industries. These features are the optional tariff, the
7 negotiated or specialized contract, and the application of a non-linear pricing structure.
8 There are numerous pricing examples from other regulated industries of each of these
9 features, as well as combinations of these features. Other regulated industries with these
10 types of pricing structures include electricity, local telephone service, water, and other
11 utilities.

12 These other regulated industries are similar to the Postal Service in that they all
13 have a diverse mix of customers (e.g., residential, industrial, business, government) who
14 rely on their services. Also like the Postal Service, these industries all have network
15 features, a relatively high fixed cost structure (reflective in part of the network costs),
16 relatively low marginal costs, and a history of average embedded cost pricing.
17 Consequently, prices in these industries must be significantly greater than marginal costs
18 (often by a factor of 2 or more) for firms to breakeven financially. Furthermore, the
19 services in these industries have traditionally been standardized products that only
20 recently are being considered in terms of the cost of the bundled attributes compared to
21 the benefits perceived by the customers. Creating customized product bundles based on
22 customer value, and pricing them with incentives to increase volume, benefits all
23 customers. This is the spirit of the Capital One NSA.

1 **IV.A.i. Examples of Non-Linear Pricing**

2 Non-linear pricing refers to a broad family of pricing structures in which the
3 marginal price paid does not equal the average price paid. In contrast, uniform (or linear)
4 pricing has a constant per-unit price.

5 Several examples of non-linear pricing can be found in regulated and unregulated
6 industries. Most regulated utilities (electricity, water, local phone service) have a basic
7 bill structure that includes *a customer charge and a usage charge*. The customer charge
8 can offset some of the overhead and reduce the per-unit markup of marginal cost required
9 to break even.

10 *Block pricing structures* have been a common pricing structure in the electricity
11 pricing industry the last thirty or so years. With declining block pricing, the customer
12 faces a series of price decreases on incremental usage. The desirability of this structure is
13 that gains can be obtained from more efficient marginal pricing (i.e., the marginal price is
14 closer to the marginal cost) while maintaining the collection of fixed costs fairly across
15 customers. There have also been some instances of *increasing* block pricing in electricity
16 and water pricing. The rationales for this type of structure have been to encourage
17 conservation and to shift the collection of fixed cost contribution to larger customers and
18 away from small residential customers. The disadvantage of increasing block-pricing
19 structures is that, for the most part, they result in more inefficient pricing (i.e., they
20 increase the difference between marginal price and marginal cost). In principle, the
21 desired reallocation of fixed cost contributions can be achieved more efficiently with
22 pricing structures other than increasing block pricing.

1 *Two-part real-time pricing* is a dynamic pricing structure in electricity that
2 appeals to large industrial and commercial customers that have some flexibility in their
3 usage patterns. As suggested by the name, with two-part real-time pricing the customer's
4 bill has two parts. First, the customer is billed for hourly baseline usage at the standard
5 tariff. The baseline typically is the customer's one- to three-year historical average usage
6 in a given hour. The second part of the customer's bill is incremental or decremental
7 usage in each hour priced at an hourly "real-time" price that closely reflects dynamic
8 hourly marginal cost. The customer's incremental usage is billed at the real-time price.
9 For decremental usage, the customer receives a per unit credit at the real-time price.
10 Adders are typically included in the real-time price for incremental usage, thus generating
11 additional contribution.

12 Georgia Power and Duke Power have the largest two-part real time electricity
13 pricing programs in the United States, and they are the programs with which I am most
14 familiar. These programs have three strong similarities to the Capital One NSA. First,
15 they are optional. Customers can always choose to stay with the standard tariff. Second,
16 the baseline load is customer-specific and billed out at the existing rate. This guarantees
17 existing contribution is maintained. Third, the product is "unbundled" of an attribute that
18 costs more than the value received by the customer. In the case of electricity, the
19 standard product is the commodity electricity along with price insurance (i.e., the price is
20 guaranteed). Two-part real-time pricing essentially unbundles the price insurance from
21 the electricity product. Those who choose two-part real-time pricing would rather self-
22 insure against price risk than pay the premium included in the standard tariff.

1 *The fixed bill*, common in local telephone service and now being introduced to
2 residential electricity and gas customers, is a limiting case of non-linear pricing. With the
3 fixed bill, there is a flat fee and no per unit charge. In local telephone service, the flat fee
4 is typically the same to everyone in a customer class (e.g., residential). With gas and
5 electricity service, the fixed bill is determined on a customer-specific basis. The fixed
6 bill product includes a price premium that covers both the induced usage (sometimes
7 called “moral hazard”) and the usage uncertainty (primarily weather driven). The
8 rationale for this product is to provide the customer with a simple product and insure
9 them against the bill impacts of extreme weather. The product somewhat disconnects the
10 marginal usage decision from marginal cost, but the customer is willing to pay more than
11 the actuarially-fair price for the convenience and bill certainty. Thus, the introduction of
12 this product is value creating.

13 ***IV.A.ii. Examples of Optional Tariffs***

14 As Professor Panzar concisely stated in his written testimony, optional tariffs
15 “allow customers to choose between an established tariff and an alternative outlay
16 schedule” (JCP-T-1, p. 3). Optional tariffs are common in other regulated industries.
17 They have the appeal that the well-informed customer likely cannot be made worse off if
18 the new tariff is voluntary. However, the flipside of the optional tariff coin is that
19 “adverse selection” could lead to revenue erosion and ultimately harm other ratepayers
20 who must make up the lost revenue. This is why it is important to verify that the optional
21 tariff is indeed likely to increase net revenue.

22 One example of an optional tariff is the alternative bill plans commonly offered
23 for local telephone service. One plan might have a low monthly charge (say \$5) and a

1 per call charge (say 7.5 cents). The alternative plan might have a flat monthly charge
 2 (say \$20). Given these pricing parameters, the customer who expects to average less than
 3 200 calls per month would choose the per call plan, while the customer who expects to
 4 average more than 200 calls per month would choose the flat fee plan.

5 Several other examples can be found in the electricity industry. Most of the
 6 innovative pricing programs in the electricity industry are also voluntary or optional
 7 tariffs. These voluntary pricing programs include *declining block pricing*, *time-of-day*
 8 *pricing*, *two-part real-time pricing*, *fixed bill pricing programs*, and *special contracts*
 9 (analogous to NSAs).

10 **IV.A.iii. Examples of Negotiated Contracts**

11 Negotiated contracts have become more common in the electricity industry over
 12 the past two decades. I am familiar with examples in Colorado, Florida, Georgia,
 13 Missouri, and New York.⁵ I believe it very likely that they exist in many more, if not
 14 most states. In the Colorado examples, the special contracts are filed with the Public
 15 Service Commission, similar to the process underway with the Capital One NSA. In the
 16 examples from the other states, a special tariff or rider gives the utility the authority to
 17 engage in negotiating special contracts. Typically the details of the special contract are
 18 confidential, but subject to regulatory oversight. In each case, eligibility requirements are
 19 specified and in some cases the objectives and contract criteria are made explicit.

⁵ The specialized contract tariffs and riders can be found at the following websites: Colorado (Xcel Energy) http://www.xcelenergy.com/docs/corpcomm/pseo_elec_entire_tariff03_01_24.pdf pp. 209-228; Florida (Gulf Power) <http://www.southerncompany.com/gulfpower/pricing/pdf/cis.pdf> pp.1 -3; Georgia (Georgia Power) <http://www.southerncompany.com/gapower/pricing/gpc-pdf/section-g.pdf> (1 page); Missouri (Kansas City Power and Light) <http://www.kcpl.com/motariff.pdf> pp. 99-103; and New York: (Niagara Mohawk) http://www.dps.state.ny.us/ets/pdf/1004_207c1_990929_effective.pdf pp. 744-748.

1 Customers eligible for special contracts tend to be non-residential customers and the
2 customers with these special contracts typically are larger industrial enterprises. The
3 contracts generally have had a definite or limited duration.

4 In these special contracts, the objective of the customer is mainly to lower their
5 average cost of electricity. The primary objective of the utility is to maintain as much
6 contribution as possible from the customer. The utility offers the special contract to
7 respond to a customer's specific needs, and as a vehicle for responding to competitive
8 pricing situations in the increasingly competitive energy services market. As with the
9 NSA, contribution can be enhanced through increased usage and by reductions in the cost
10 to serve the customer. A secondary, yet significant, objective of the utility and the
11 regulator is to retain the customer because of the general regional economic benefits the
12 customer provides, such as employment and the ripple effect from other support
13 businesses. Because of the contribution-maintaining characteristic, two-part pricing
14 structures often provide the framework for the contracting parties to pursue their
15 objectives. As a result, many of the specialized contracts in the electricity industry
16 involve two-part pricing.

17 While the details of the special electricity contracts are typically confidential
18 between the contracting parties, the contracts in the states mentioned have been subject to
19 regulatory approval. Historically, retail electricity markets have been regulated and
20 remain so in most states. Some states have open (competitive) retail markets with little or
21 no regulatory oversight of special contracts. However, the trend toward open retail
22 markets has stalled in the last three years. So, regulators by and large still scrutinize

1 negotiated contracts and optional tariffs in electricity. Likewise, specialized contracts for
2 local telephone service remains subject to state regulation.

3 **IV.B. The Regulatory Experience in Other Industries**

4 State regulatory bodies face issues similar to those faced by the Postal Rate
5 Commission in the Capital One NSA case. The state regulators of these other industries
6 typically are concerned with both the economics and the fairness of new rates schedules
7 and specialized contracts. Consequently, they seek answers to the following types of
8 questions:

- 9 a. What is the effect on the utility's net revenue?
- 10 b. What are the impacts on the utility's other ratepayers?
- 11 c. What is the justification for the proposed pricing schedule?
- 12 d. How does the proposed pricing schedule impact efficiency?
- 13 e. How does the proposed pricing schedule balance the need for pricing and
14 product flexibility with the need for protecting the captive customer?
- 15

16 I believe several pragmatic lessons can be drawn from the regulatory experiences
17 in these other industries. First, *establish the relevant reference case*. The status quo
18 might not be the relevant reference case. While a customer's historic usage provides an
19 obvious focal point for a reference case, there are reasons why it might not represent what
20 would occur in the absence of the proposed pricing agreement. A customer might have a
21 competitive alternative. In the case of electricity, this competitive alternative can range
22 from fuel-switching to self-generation to physical relocation of the plant to another
23 service territory. Alternatively, the customer may have plans to expand or contract usage,
24 even if no change in price structure is implemented. Uncertainty and asymmetric
25 information rest at the core of the problem of the relevant reference case. Uncertainty

1 can be dealt with through scenario analysis. Asymmetric information, however, remains
2 an inherent problem, for the customer may have incentives for not revealing all it knows
3 in the negotiating process. Nevertheless, regulators do need to make some best guess
4 about the relevant reference case.

5 Second, *conduct simple comparative impact tests using the relevant reference*
6 *case*. This involves calculating the various financial impacts of introducing a new pricing
7 structure or implementing a special contract. For the Capital One NSA, this would
8 involve quantifying the areas identified in Figure 1a (which the Postal Service has done)
9 and Figure 1b. Some of the impacts (e.g., Area 4 and Area 5 in Figure 1b) might be
10 secondary and difficult to quantify. For these amounts, educated assumptions may have
11 to suffice.

12 Third, *establish workable evaluation criteria*. A likely first criterion, as suggested
13 by Professor Panzar (Tr. 8/1764-1765) would be that total economic value increases. A
14 second screening criterion could be that no customer group be adversely affected by more
15 than a certain amount.

16 Finally, *use experimental or pilot programs*. There will undoubtedly be a lack of
17 precision and disagreements on the financial impacts of a new price structure. Under a
18 pilot or experimental program, a seemingly beneficial program can advance, while
19 additional relevant information can be collected and analyzed. There are three main
20 benefits of a pilot program. One, it allows a beneficial program to be put into place in a
21 timely manner. Two, it provides a safeguard against making a big mistake. If the
22 program turns out to be unwise, it can be cancelled. And three, it provides a cost-

1 effective method of obtaining market research measures that allow refinement of the
2 program prior to making it permanent.

3 During the pilot, the Postal Service should attempt to collect data relevant to
4 quantifying the financial impacts illustrated in Figures 1a and 1b. Most important are:
5 securing historical data on Capital One's First-Class Mail and Standard Mail volumes and
6 Capital One's percentage of returned First-Class Mail prior to the NSA; measuring
7 changes in Capital One's First-Class Mail and Standard Mail volumes after the NSA is
8 implemented; measuring changes in Capital One's percentage of undeliverable First-
9 Class Mail after the NSA is implemented. Additionally, to the extent possible, it would
10 be desirable to monitor trends in solicitation mail volumes by the credit card industry as a
11 whole.

13 **V. OBSERVATIONS ON THE CAPITAL ONE NSA**

14 I conclude my testimony by making five observations about the Capital One NSA
15 in the context of regulation and competition.

- 16 1. *The Capital One NSA appears to be in the public interest.* The Capital One
17 NSA creates value that can be shared widely across all postal customers. A
18 conservative, middle-of-the road estimate of the created value retained by the
19 Postal Service is \$8.2 million. While this is a seemingly modest amount, this
20 represents about a 3 – 4 percent increase in the total contribution received
21 from Capital One's First-Class Mail volume. The Postal Service's financial
22 situation would be dramatically improved if this level of contribution increase
23 could be achieved from all customers.

- 1 2. *The Capital One NSA displays both product and price flexibility.* Product and
2 price flexibility are quintessential attributes of a nimble business entity. The
3 Capital One NSA creates a new product (First-Class Mail with electronic
4 notification in lieu of return) and effectively applies a non-linear pricing
5 structure to maintain and increase First-Class Mail volume. Product and price
6 flexibility, subject to pragmatic regulatory oversight, are essential for the
7 Postal Service to respond to the increasing competitive pressures it faces.
- 8 3. *Other Postal Service customers are likely to request similar NSAs.* It seems
9 likely that other customers, especially competitors of Capital One, will request
10 similar NSAs. This fact alone provides a strong incentive for the Postal
11 Service to be aggressive in pursuing increased contribution from the Capital
12 One NSA. The Postal Service needs to be prepared for these requests.
13 Requests for similar NSAs present the Postal Service with additional value-
14 creating opportunities in the public interest. If the Postal Service can
15 negotiate increases in contribution similar to those implied by the Capital One
16 NSA, then the Postal Service should be looking forward to additional NSA
17 requests.
- 18 4. *NSAs and innovative pricing structures are important in regulated industries.*
19 Two key challenges facing a regulated industry are obtaining the greatest
20 value from the industry's resources (i.e., static efficiency), and, over time,
21 increasing the value obtainable from those resources through process and
22 product innovations (i.e., dynamic efficiency). The history of regulation
23 shows that when regulation denies firms price and product flexibility, these

1 challenges are not met, the industry ultimately suffers overall, and becomes
2 severely handicapped against unregulated alternatives. However, by allowing
3 customized service and innovative pricing, pragmatic regulation can help
4 regulated industries replicate the desirable features of competition while
5 protecting the public interest. Pricing structures that get price closer to the
6 marginal cost result in static efficiency. NSAs or specialized contracts
7 provide a vehicle for both cost and product innovation. The Capital One NSA
8 displays all three of these desirable features—improved pricing efficiency,
9 cost innovation, and product innovation.

10 5. *The Capital One NSA compares favorably to similar arrangements in other*
11 *industries.* As in other regulated industries, the Postal Service is facing
12 increasing competitive pressure from competitive alternatives. In these other
13 industries, the objective often turns out to be how to minimize the loss of
14 contribution and the negotiation process is one of concession. However, the
15 Postal Service has turned the competitive challenge into an opportunity.
16 Because of the Capital One NSA, the Postal Service significantly increases the
17 contribution received from one of its largest customers; that customer receives
18 more total value from its use of the postal services, and that customer is more
19 likely to retain and expand volume (and contribution).

20 In summary, the Capital One NSA creatively introduces a value-creating new
21 product and effectively applies non-linear pricing. It has the potential of achieving the
22 objectives of increasing net revenues, and maintaining and possibly increasing First-Class

- 1 Mail volume. The end result is greater efficiency so that Postal Service resources yield
- 2 more social value.

Figure 1a. Analysis of NSA Effects on Capital One Contribution

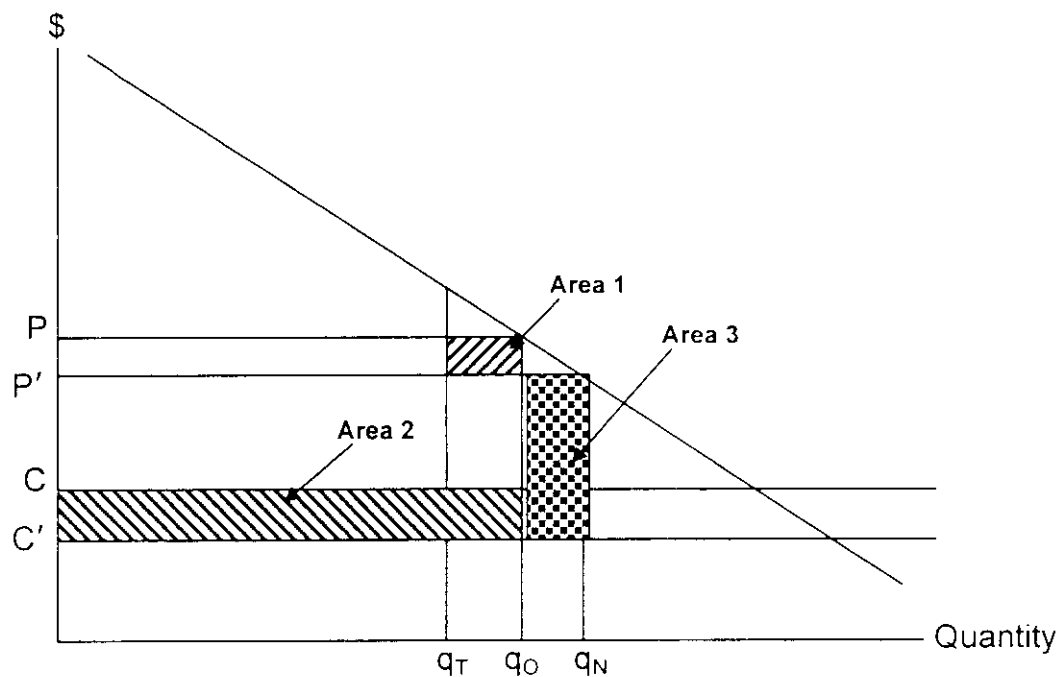


Figure 1b. Analysis of NSA Effects on Contribution from Capital One Competitors

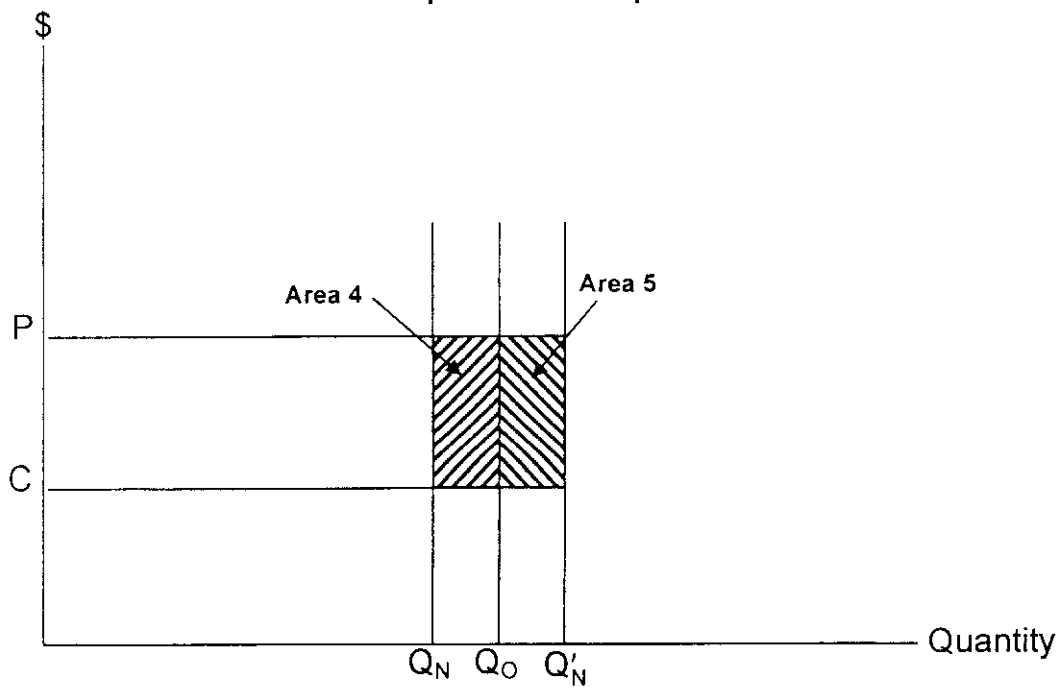


Table 1: Estimates of Total Contribution of the Capital One NSA, Including Secondary Effects (all figures in millions)				
	Worst Case Scenario	Middle Case Scenario	Best Case Scenario	
Secondary Leakage (Area 4) ¹	-\$1.1	-\$0.55	\$0.0	
Secondary Contribution (Area 5) ²	\$0.0	\$0.5 (low elasticity) \$3.1 (high elasticity)	\$6.1	
Total Secondary Effects ³	-\$1.1	-\$0.05 (low elasticity) \$2.6 (high elasticity)	\$6.1	
Discount Leakage (Area 1) ⁴	-\$6.7	-\$6.7	-\$6.7	
Cost Savings (Area 2) ⁵	\$13.1	\$13.1	\$13.1	
Direct Contribution (Area 3) ⁶	\$1.8	\$1.8	\$1.8	
Total Contribution ⁷	\$7.1	\$8.2 (low elasticity) \$10.8 (high elasticity)	\$14.3	

Worst Case = 7,000,000 * (0.291 - 0.1359); Middle Case = 3,500,000 * (0.291 - 0.1359); Best Case = 0 * (0.291 - 0.1359); where 0.291 is the First-Class per unit revenue from Capital One (USPS-T-3, Attachment A, page 1), and 0.1359 is the average variable (marginal cost) paid by Capital One (USPS-T-3, Attachment A, page 2).

-Worst Case = 0.12 * 8,400,000 * 0; Middle Case (low) = 0.12 * 8,400,000 * 0.5; Middle Case (high) = 0.12 * 51,200,000 * 0.5; Best Case = 0.12 * 51,200,000 * 1 * 1; where the 0.12 margin is obtained by taking a weighted average of the First-Class and Standard Mail margins = 0.15 * (2/3) + 0.1 * (1/3).

¹Secondary Leakage + Secondary Contribution.

²USPS-T-3, Attachment B, page 3.

³USPS-T-3, Attachment B, page 2.

⁴USPS-T-3, Attachment B, page 1.

⁵Discount Leakage + Cost Savings + Direct Contribution + Total Secondary Effects.

Appendix 1. Curriculum Vitae**B. Kelly Eakin**

RESUME

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Academic Background:

Ph.D., University of North Carolina at Chapel Hill, 1986, Economics
Dissertation: Estimating Allocative Inefficiency with a Non-Minimum Cost Function:
An Application to U.S. Hospitals
B.A., University of Texas at Austin, 1978, History

Positions Held:

Vice President, Laurits R. Christensen Associates, Inc., 1997-present
Senior Economist, Laurits R. Christensen Associates, Inc., 1994-1997
Economist, U.S. Department of Agriculture, Washington, DC, 1992-1994
Assistant Professor, Department of Economics, University of Oregon, 1985-1992

Fields of Specialization:

Microeconomics, Industrial Organization, Regulation, Environmental and Resource
Economics, Health Economics

Professional Experience:

I specialize in the economic and financial aspects of competitive product pricing. I have experience with the organization and regulation of industry, and environmental economics. My major projects in the energy industry include the development of innovative pricing and service designs, assessment of customer price responsiveness and product choice, and analysis of competitive impacts of restructuring proposals.

Major Projects:

Project Manager, Load Resources and Customer Price Responsiveness Study for the Public Utilities Commission of Texas

Project Manager, comprehensive pricing strategy project for a retail energy provider in a deregulating Canadian market.

Project Manager, New strategies for electricity product development and wholesale pricing for a public power entity.

Co-Author, "A New Strategic Direction in Retail Electricity Product Development and Pricing."

Project Manager, Developing an analytical tool for retail product design and pricing.

Project Manager, Costing and pricing of ancillary services.

Project Manager, Real Time Pricing at three major U.S. utilities.

Recent Conference Presentations and Workshops:

Connecting Wholesale and Retail Electricity Markets, Conference Organizer and Chair, Electric Utilities Consultants, Denver, 2002.

"Effective Demand Response," Electric Utility Consultants conference on Connecting Wholesale and Retail Markets, Denver August 2002.

Retail Strategies that Connect Wholesale and Retail Market, Workshop Organizer and Instructor, Electric Utility Consultants conference on Connecting Wholesale and Retail Markets, Denver August 2002.

"What Do We Expect Electricity Markets to Achieve?" Edison Electric Institute Market Design School, Madison, WI, July 2002.

The Price Builder's Workshop, Developer, Coordinator, and Co-presenter of EPRI Workshop, December 2001.

"Connecting Retail and Wholesale Electricity Markets," Edison Electric Institute Conference of Market Restructuring, Washington, DC, September 2000.

Retail Pricing for Competitive Power Markets: The Fundamentals of Unbundled Pricing (Course 1), and *Designing Market-Based Retail Prices* (Course 2), Course Developer and Co-presenter, Infocast Conference, September 2000.

The Unbundling and Restructuring of Electricity Prices, Developer and Presenter of EPRI Workshop, July 2000.

USPS-RT-2
Appendix 1

"The Challenge of Low Cost Power," presentation at EPRI International Energy Pricing Conference, July 2000.

The Energy Service Provider in a Competitive Retail Market, Developer, Coordinator and Co-presenter of EPRI Workshop, May 2000.

Postal Service Regulatory Reform, Session Organizer and Chair, American Economic Association Meeting, January 2000.

Market-Based Pricing and the Product Mix Model, Developer, Coordinator and Co-presenter of EPRI Workshop, October 1999.

Pricing for Retail Markets, Developer and Co-presenter of pre-conference workshop, The Center for Business Intelligence Conference on *Pricing Power Products and Services*, October 1999.

"Building a Retail Portfolio to Meet Diverse Customer Needs," presentation at The Center for Business Intelligence Conference on *Pricing Power Products and Services*, October 1999.

"Strategic Pricing of Retail Products in a Competitive Industry," presentation at American Public Power Association (APPA) *Business and Financial Workshop*, September 1999.

Pricing a Retail Product Mix, Developer, Coordinator and Lead Presenter of EPRI Workshops, June and September 1997; February, March, June, and October 1998; April 1999.

"Risk Based Pricing: Creating Value by Sharing Risk," International Business Communication Conference on *Unbundling Retail Rates*, Cambridge MA, September 1998.

"Creating a Profitable Product Mix," Electric Utility Consultants *Electric Utility Business Environment Conference*, Denver June 1998.

"Retail Applications of the Forward Price Curve," presentations at EPRI Forward Price Curve Workshops, May and September 1997; February 1998.

"Product Differentiation, Customer Segmentation and risk-Based Pricing," EPRI Power Markets and Resource Management, *Making Money in Energy Markets*, Houston, October 1997.

"Products, Contracts and Profits," EPRI Power Markets and Resource Management, *Achieving Success in Evolving Electricity Markets*, Indianapolis, 1996.

"Forward Plus Spot, Alias Two-Part Real Time Pricing," EPRI Power Markets and Resource Management, *Advanced Market-Based Products Workshop: Constructing Advanced Pricing Products*, Atlanta, October 1996.

Real Time Pricing, Co-developer and Presenter of EPRI Workshops, May and June 1995.

Publications:

"Demand Response and the FERC Standard Market Design NOPR," *EnergyPulse*, January 8, 2003 (with S. Braithwait).

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"Is Market Based Pricing a Form of Price Discrimination?" in *Electricity Pricing in Transition*, A. Faruqui and K. Eakin, eds., Kluwer Academic Press, Amsterdam 2002.

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"Summer in San Diego: A Shock for Consumers. An Epiphany for Electricity," *Public Utilities Fortnightly*, September 15, 2000, (with A. Faruqui).

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U.S. Dept. of Health and Human Services, Agency for Health Care Policy and Research

1 CHAIRMAN OMAS: This now brings us to oral
2 cross-examination. One participant, the Office of
3 Consumer Advocate, has requested oral cross-
4 examination.

5 Mr. Costich, would you please begin?

6 MR. COSTICH: Thank you, Mr. Chairman.

7 CROSS-EXAMINATION

8 BY MR. COSTICH:

9 Q Good morning, Dr. Eakin.

10 A Good morning.

11 Q Since we're on page 15, we might as well
12 start there. At line 5, you mention a worst case
13 scenario for secondary leakage. Do you see that?

14 A Yes, I do.

15 Q Would you mind summarizing what secondary
16 leakage is?

17 A Sure. Secondary leakage is a result of
18 interdependent demands. It comes about if, because of
19 the Capital One NSA, Capital One expands its customer
20 base at the expense of its competitors.

21 The competitors, having a smaller number of
22 customers or fewer customers, would consequently have
23 less customer mail. That's the primary source of
24 secondary leakage.

25 Q At line 8 you say, "Under competitive market

1 assumptions, the largest possible offset isn't exactly
2 offsetting reduction of customer mail by Capital One's
3 competitors." Do you see that?

4 A Yes, I do.

5 Q Why do you say that the largest possible
6 offset would be one for one between Capital One and
7 its competitors?

8 A If the Capital One NSA is implemented and as
9 a result Capital One does achieve discounted postal
10 rates on some of its mailings and, therefore, expands
11 its operation, but that expansion of its customer base
12 were to come strictly at the expense of its
13 competitors, then that is the case where all of the
14 new customers of Capital One would have been
15 customers, former customers, of its competitors.

16 However, that's the worst case scenario
17 because there are other scenarios where they can
18 expand their customer base by a customer getting a
19 Capital One credit card without giving up the
20 competitor's credit card, so it's just the worst case
21 is you literally switch rather than get an additional
22 credit card.

23 Q Have you ever heard of a consumer having
24 more than one credit card?

25 A I think I've heard of that.

1 Q Would it be at least conceivable that a
2 consumer with more than one credit card would open an
3 account with Capital One and abandon all of his other
4 prior accounts?

5 A Anything is possible. That's a possibility.

6 Q Would that be a worse case than your worst
7 case scenario?

8 A As I have listed it here, if the impact of
9 this were to be that a customer responded to Capital
10 One's solicitation and as a result dropped more than
11 one company, then that description alone would be a
12 more than one to one offset.

13 Q Could you turn to page 16? At line 12 you
14 have an equation for secondary contribution. Do you
15 see that?

16 A Yes, I do.

17 Q Would you mind summarizing what secondary
18 contribution is?

19 A Yes. Secondary contribution is another
20 result of interdependent demands among competitors,
21 Capital One and its credit card competitors.

22 If as a result of the Capital One NSA
23 Capital One increases its solicitation mail, then a
24 very likely strategic competitive response of its
25 competitors is to match at least partially the

1 increased solicitation effort that Capital One has put
2 out. This will be done to prevent the erosion of
3 market share and profits.

4 Part of that increase of the solicitation
5 effort by Capital One's competitors will probably be
6 in the form of increased solicitation mail by Capital
7 One's competitors. That's the source, the primary
8 source, of Area 5 in my figure called secondary
9 contribution.

10 Q Your equation indicates that secondary
11 contribution is the product of four different
12 parameters. Is that correct?

13 A That is correct.

14 Q I'd like to focus on your alpha parameter.
15 Could you describe what that does?

16 A Yes. As I state in my testimony on page 16,
17 line 14, following that equation, alpha is a parameter
18 indicating how competitors respond in terms of
19 increased advertising reaction to those increased
20 solicitation mailings by Capital One, so how they
21 respond in terms of their own increased solicitation
22 effort.

23 Q And you have bounded alpha between zero and
24 one? Is that correct?

25 A I have established a reasonable lower bound

1 of alpha at zero and a reasonable upper bound of alpha
2 at one.

3 Q I'd like to examine the possibility that
4 alpha is negative. If alpha is negative, your
5 secondary contribution becomes a secondary leakage,
6 correct?

7 A Alpha being negative is an unlikely case.
8 If it were negative, then that equation would be a
9 negative value, or it would be a leakage.

10 Q Could you look at page 17. At lines 1
11 through 3 you say, "This effect will normally be
12 positive," and here we're talking about alpha,
13 correct?

14 A Let me start at the beginning of the
15 paragraph on the previous page and read it.

16 (Pause.)

17 A Okay. Yes, I do say that.

18 Q Okay. Alpha will be positive and will tend
19 to be larger to the extent Capital One and some of its
20 competitors are large enough to take each other's
21 actions into account. I take it we're not talking
22 about perfect competition here?

23 A That is correct. The bigger either Capital
24 One is or the bigger, the more concentrated the
25 industry is, the more likely participants are going to

1 notice rivals' activities, actions.

2 Q Is this type of a market situation referred
3 to as oligopoly?

4 A That's a broad, middle ground term between
5 monopoly and perfect competition.

6 Q Is there a standard concept of equilibrium
7 for an oligopoly market?

8 A The description of equilibrium in an
9 oligopoly market is not as sort of tightly defined or
10 as exactly defined as it is in the market structures
11 of perfect competition or of pure monopoly, so there
12 can be a variety or a range.

13 There's not a unanimous equilibrium or
14 unanimous view of the exact form that equilibrium
15 takes in oligopoly.

16 Q Are you familiar with the term Cournot
17 equilibrium?

18 A I am familiar with that term.

19 Q Is that a concept of equilibrium that would
20 be useful in analyzing the likely value of alpha?

21 A I did not use Cournot analysis or Cournot
22 equilibrium analysis in the testimony that I prepared
23 and put forth to establish these bounds. It may or
24 may not have applicability and it carries with it
25 certain assumptions, so it's hard for me at this point

1 to say yes or no.

2 Q Are you familiar with the concept of
3 Stackelberg equilibrium?

4 A I am familiar with the concept.

5 Q I guess I won't repeat my earlier questions.
6 Are you familiar with the concept of Nash equilibrium?

7 A I am familiar with that concept.

8 Q Are you familiar with leader/follower models
9 of oligopoly?

10 A I am familiar particularly with the
11 Stackelberg type situation. I view that as a leader/
12 follower model.

13 Q If one were to apply that model in this
14 situation, would it be possible that alpha would be
15 negative?

16 A I did not apply that analysis or go through
17 that exercise in establishing these bounds, but I
18 again believe that the situation of a negative alpha
19 is a very unusual case.

20 Q In a leader/follower situation, is it
21 correct that the entity or player described as a
22 follower attempts to maximize profit subject to the
23 behavior of the leader?

24 A I wouldn't state it exactly that way.
25 Again, I would probably refer back to a textbook to

1 get a more precise definition, but the way I would
2 state that is that the follower accepts a leader's
3 action as a given.

4 Q In that situation, is it at least possible
5 that your alpha could turn out to be negative?

6 A Again, that's not the analysis or the
7 framework that I used to establish these reasonable
8 bounds, so I can't right now say no, that it's not
9 possible, but I do believe it would be a very unusual
10 case.

11 Q If we just talk in words instead of
12 optimizing behavior, is it possible that in this case
13 some of Capital One's competitors simply accept
14 Capital One's behavior and then attempt to maximize
15 their own profits?

16 In that situation, is it not possible that
17 such competitors allow Capital One to extract market
18 share and actually become smaller and advertise less?

19 A Again, in the situation that is being
20 described here, the likely response to a competitor
21 who observes Capital One increasing its solicitation
22 effort and in fact taking away market share, a
23 competitor will observe their market share eroding and
24 connect it with the increased solicitation effort of
25 Capital One.

1 The likely strategic response to shore up
2 their profits, to stem the erosion, will be to
3 undertake a solicitation effort of their own to
4 counter the solicitation effort of Capital One.

5 Q If such a competitor increases its
6 advertising that will increase its costs, correct?

7 A Yes.

8 Q And if nothing else happens, that reduces
9 its profit, correct?

10 A Again, the nothing else happening. If you
11 mean if they aren't losing market share to Capital
12 One, then yes, their profit would be going down.

13 What is happening is because Capital One is
14 undertaking its solicitation effort, something else is
15 happening. They are losing market share. That's why
16 they will undertake an increased solicitation effort
17 of their own to stop that erosion.

18 Q Well, is the company attempting to maximize
19 market share or maximize profit?

20 A In the explanation I just gave, they are
21 focused on profit.

22 Q And you do not think it likely that the
23 company could forego any advertising or any increased
24 advertising and end up with a higher profit, even
25 though it has a smaller market share?

1 A If the chain of events is set off by the
2 Capital One NSA, which causes Capital One to increase
3 its solicitation mailings, then the response by
4 competitors will not be to cut back to increase their
5 profits because they could have done that before, but
6 by assumption they haven't because they were
7 maximizing profit prior to the Capital One NSA.

8 Instead, the competitors will be seeing if
9 the Capital One solicitation effort is effective that
10 they will be losing some of their customers to Capital
11 One, and, consequently, there will be the benefit of
12 stemming that erosion if they were to undertake
13 increased solicitation of their own.

14 Q And you don't think it would ever be a
15 profit maximizing move to reduce expenses, including
16 advertising expenses, rather than to attempt to engage
17 in an advertising war?

18 A If it were, they would have done it already
19 regardless of the Capital One NSA.

20 Q Could you look at page 19? I would direct
21 your attention to the bottom portion of the page where
22 you're discussing the alternative proposed by Witness
23 Callow.

24 At the very bottom of the page starting on
25 line 21 you say, "There is considerable financial risk

1 in the broad offering of an optional tariff." Then
2 you say, "Optional tariffs are subject to an adverse
3 selection problem..." On the next page it says,
4 "...that has the potential of eroding revenues and
5 harming other rate payers."

6 What is it about the broad offering that
7 brings about this adverse selection phenomenon?

8 A The adverse selection resulting from the
9 broad offering comes from establishing the threshold
10 where the discounts begin by the use of the historical
11 data in setting that in stone.

12 There is always uncertainty about what the
13 actual so-called before volumes are, but there's also
14 asymmetric information. Once that threshold is
15 established or mandated by the rule that is put forth
16 in Witness Callow's proposal, then those mailers who
17 know with their private information that in fact they
18 are going to go beyond that threshold will be instant
19 winners.

20 There will be, if you want to call it, a
21 leakage if they take the deal, whereas those mailers
22 who know or are fairly certain that they will not meet
23 that threshold quantity won't benefit from the deal,
24 and they won't take the deal, so you will have only
25 those who you will have a leakage from that take the

1 deal, and you won't have the other side take it.

2 That's the danger of offering it broadly is
3 that it's a self-selection. Instant winners take the
4 deal, and, since it's optional, those who don't
5 benefit from it don't take it.

6 Q Is it more the existence of, as you call it,
7 a rule for qualifying that creates the problem, as
8 opposed to the broad offering?

9 A It's the combination of the two, the fact
10 that a specific threshold or threshold rule is
11 established and also that the offering is made broadly
12 available or is made available to all, but it's
13 optional. It's that entire package that creates the
14 adverse selection problem.

15 Q Do you have an understanding of what the
16 rule is that Witness Callow has proposed?

17 A My understanding of it is presented in the
18 testimony. That describes my understanding, so I will
19 just summarize my understanding of it, which is on
20 page 19 of my testimony in lines 11 through 19.

21 I say there's two main thrusts for my
22 understanding. First, it calls for making the terms
23 similar to those of Capital One NSA available to any
24 presorted first class mail customers approved by the
25 Postal Service, and then, second, it proposes bounds

1 on the incremental volume that actually qualifies for
2 the discounts.

3 Those are the two components that my
4 testimony focuses on, so beyond that I don't comment.

5 Q Well, the rule that Witness Callow has for
6 setting the threshold, the rule that presumably
7 attracts the winners and repels the losers, is that
8 the Postal Service must set the threshold based on
9 publicly available, historical information.

10 With that kind of flexibility, won't the
11 Postal Service be able to detect potential applicants
12 who are attempting to take advantage of it; that is,
13 the applicant who knows he's going to have a big surge
14 in volume and, therefore, would like to get a nice,
15 low threshold?

16 A I think I have covered that question in my
17 testimony. I'll try to expand a little bit on that,
18 but if you look at page 20, lines 2 through 6,
19 basically following up on the adverse selection, I
20 say, "Mailers with preexisting plans to increase their
21 volumes would have the strongest incentives to obtain
22 the declining block discounts, but those plans would
23 usually be private information."

24 So, it's far from clear how the Postal
25 Service would set the threshold values to avoid

1 unnecessary revenue erosion without resorting either
2 to the negotiation or to the private information, so
3 that's where I think the context of a negotiated
4 service agreement is superior through that negotiation
5 process, that bargaining process, to flush out more of
6 the relevant information, some of which may be public,
7 but some which may be private.

8 The proposal, as I understand it, that has
9 been put forth by Witness Callow calls for reliance
10 strictly on public information, but the truth may be
11 more held in the private information.

12 Q What incentive does the company with private
13 information about its plans have to reveal those plans
14 in negotiations?

15 A That is part of the negotiation process, and
16 so to reach a mutually beneficial deal there may be an
17 incentive to be forthcoming with some information to
18 get the deal moving along.

19 Q So the applicant who wants to negotiate his
20 own separate contract for some reason reveals private
21 information that is harmful to him in terms of the
22 ultimate outcome, but the applicant whose threshold is
23 going to be based on historical information withholds
24 that information and somehow makes the Postal Service
25 worse off? Is that what you're saying?

1 A No, that's not what I'm saying. The
2 applicant revealing private information is made better
3 off if it creates a mutually beneficial deal to be
4 arrived at and signed.

5 Q That's what I don't understand. If the
6 applicant has private information about its plans to
7 increase volumes, wouldn't its story be to the Postal
8 Service my plans are to decrease volumes if you don't
9 give me a rate break?

10 A This is part of the negotiation process, and
11 if, you know, unreasonable or uncredible information
12 is provided, well, then one party may say forget it
13 and walk off. There's no deal. Then the party
14 doesn't benefit.

15 There is an incentive to reveal private
16 information, and I have not been part of any of the
17 NSA stuff, negotiations, but I presume and from what
18 I've briefly seen in testimony that private
19 information has been revealed. The reason it has been
20 revealed is to try to reach a mutually beneficial
21 deal.

22 Q When you say private information has been
23 revealed, can you describe how anyone would verify the
24 truth of that private information?

25 A That is beyond my area of expertise, but

1 it's what you rely on your negotiating team, your side
2 of the negotiating team, to do. That's their job.

3 Q On page 20 you also criticize the volume cap
4 that Witness Callow has. Do you see that?

5 A Are you referring to the paragraph that
6 starts on line 7?

7 Q Yes.

8 A Okay. Yes. I'm with you there.

9 Q At line 13 you say that, "The volume
10 increment at which these effects occur," that is the
11 volume where the cap actually takes effect, "is large
12 relative to the projected volume increase for Capital
13 One."

14 Can we agree that the 15 percent volume cap
15 that Witness Callow has in his proposal will have no
16 effect on Capital One's participation in the NSA?

17 A No. I don't know what Capital One's
18 feelings are on that, so I can't say yes or no to
19 that.

20 Q In a couple places you've referred to
21 elasticities that Witness Elliott used in making
22 volume projections. Do you recall that?

23 A Yes. If you could get me to the page it
24 would help, or I can find it.

25 Q I've written down the elasticities and not

1 the page numbers. I'm sorry. Does negative .071
2 sound familiar?

3 A Oh, it does sound familiar.

4 Q Negative .388? Does that sound familiar?

5 A Yes, it does.

6 Q If those elasticities in fact have any
7 relevance to Capital One's reaction to the block
8 discounts, can you indicate what kind of a price
9 decrease would be necessary to produce a 15 percent
10 increase in their volume?

11 A That can be done. I haven't done it, and I
12 hesitate to do arithmetic on the fly here.

13 Q Well, with an elasticity of negative 0.071
14 is there any price decrease that could produce a
15 volume increase of 15 percent over the threshold that
16 Capital One has?

17 A Can you restate that question or reask it?
18 Can I hear it again?

19 Q Let me try it a different way.

20 A Okay.

21 Q You've summarized what Witness Elliott had
22 done in your discussion of the leakage, the secondary
23 leakage and the secondary contribution.

24 The volume that Capital One or that Witness
25 Elliott projected that it would provide under an

1 elasticity of negative 0.071 was approximately 15
2 million pieces, about one percent of its -- is that
3 one percent? A small percent of its threshold volume.

4 With an elasticity that is that low, even a
5 doubling of the price discounts would only produce in
6 the neighborhood of 30 million pieces, correct?

7 A Yes. I see where you're going with this I
8 think. If it would take 10 to 15 times that 15.5 to
9 hit the 15 percent threshold, okay, that may in fact
10 be a long ways off and very unlikely.

11 I would just hesitate to latch onto a
12 specific elasticity number and then say that it holds
13 as you extrapolate a long ways away, but with that
14 caveat the 15 percent volume or the 15 percent bound
15 that we're talking about here does seem a long ways
16 away.

17 Turning back to the pages we started on on
18 this discussion where you've pointed it out to me
19 earlier on page 20, I do say in fact on page 20, line
20 13, "...while the volume discount at which these
21 effects occur is large relative to the projected
22 volume for Capital One," so it is a long ways away for
23 Capital One.

24 Q Yes. You go on to say, "...but it may not
25 be the case for all mailers who might seek to take

1 part in the rates proposed by Witness Callow."

2 Isn't this going to be a long way for any
3 first class mailer, given the average elasticity of
4 first class presort mail?

5 A Again, I don't know that there are not very
6 elastic mailers out there. If there are, this 15
7 percent bound may not be that far off.

8 Q If there are such elastic first class
9 presort mailers out there, do you think the Postal
10 Service would know who they were?

11 A I don't know. I don't know whether they
12 would know who they are or not, I mean.

13 Q Did you inquire of the Postal Service
14 whether they knew of any highly elastic first class
15 presort mailers?

16 A No, I did not.

17 Q And they didn't volunteer any information
18 like that to you?

19 A No.

20 Q Do you understand the reason for the 15
21 percent cap that Witness Callow has proposed?

22 A My understanding of the rationale put forth
23 with respect to that 15 percent bound is to limit the
24 so-called leakage exposure.

25 Q Is limiting the leakage exposure a benefit

1 to the Postal Service?

2 A Here I hesitate to focus on just that one
3 component because the threshold in that area called
4 leakage or direct leakage is not a loss of value, but
5 it's a transfer of value from the Postal Service to
6 Capital One.

7 As such, it's a part of the mix of
8 negotiating tools to create a deal that is mutually
9 beneficial to all parties, so to focus on that one
10 component and then try to limit exposure on one
11 component is not what I would necessarily say is the
12 end objective.

13 Q Well, the problem with that particular
14 component is nobody knows what its value is, correct?

15 A There is uncertainty in what the actual
16 before rates truly are. I mean before volumes truly
17 are.

18 Q And if Capital One has in fact convinced the
19 Postal Service that its volumes are going to be quite
20 a bit lower than what Capital One plans to do, doesn't
21 that direct leakage become quite large?

22 A Again, the size of it is a relative matter,
23 but to the question of how to limit that exposure I
24 think rather than restricting a component, one of the
25 pieces that is used in a negotiation process, a more

1 effective, practical way to restrict this exposure is
2 through what is proposed in the Capital One NSA, a
3 pilot or an experimental program with a limited
4 duration of which during which time you watch what
5 happens.

6 If it turns out that it looks like it was a
7 case of so-called abuse, that they said one thing and
8 it turned out to be another, you pull the plug.

9 Q Have you ever had occasion to buy a new car?

10 A Yes.

11 Q Has that been a pleasant experience that you
12 look forward to doing again?

13 A I've done it so infrequently I've been
14 pretty excited about it.

15 Q Is it your experience that you immediately
16 tell the salesman how much you're willing to pay for
17 the car?

18 A No. I try not to.

19 Q In fact, nobody has an incentive to do that
20 in negotiations, do they?

21 A No, but at those times I wanted to come away
22 with a new car, and I did, and I've been pretty happy
23 about it.

24 Q Could you look at page 24 of your testimony
25 at lines 18 through 21? Here you're still talking

1 about the adverse selection problem, correct?

2 A In this paragraph I sort of present
3 so-called two sides of the optional tariffs. The
4 optional tariffs have the upside that you aren't
5 forcing anybody to do anything they don't want to
6 because they're optional, but the flip side of that is
7 that you introduce the possibility of the adverse
8 selection.

9 Q Does the possibility of the adverse
10 selection essentially eliminate the usefulness of
11 optional tariffs?

12 A No. It's just that one needs to be aware of
13 the adverse selection possibility or probability that
14 there will be some adverse selection, and so optional
15 tariffs aren't totally without risk themselves. One
16 just needs to take that into consideration in
17 developing value enhancing arrangements.

18 Q In the proposal of Witness Callow, do you
19 know whether there is a requirement that the Postal
20 Service find that there is a high likelihood of a net
21 increase in revenue from anyone's participation?

22 A I read Witness Callow's direct testimony,
23 and then I summarized the essential elements that I
24 was talking about in my written testimony here.

25 What you describe sounds familiar, and I

1 presume the answer is that that is in there, but I
2 can't -- I didn't put it down here, and I don't recall
3 right offhand. If it is, it's in there.

4 Q If there is such a provision that the Postal
5 Service must satisfy itself of the likelihood that a
6 participant will generate net revenue for the Postal
7 Service, does that reduce this risk from adverse
8 selection that you've talked about?

9 A I don't think it reduces the risk that you
10 may have an adverse selection problem. It just says
11 that there's a screen later that may make what is
12 proposed not get approved because it doesn't pass that
13 criteria because in fact it causes revenue erosion
14 rather than net revenue increase.

15 I don't think that the fact that you throw
16 in a caveat that says it's got to add to net revenue
17 doesn't decrease the structural problem of adverse
18 selection.

19 Q It only reduces the financial consequences
20 of that adverse selection? Is that what you're
21 saying?

22 A No. It wouldn't reduce the financial
23 consequences. It would reduce whether the proposal
24 could actually be implemented if it had to pass that
25 criteria.

1 Q If a proposal has to pass that criteria or
2 if an applicant has to pass that criterion, what
3 difference does it make if that person was an adverse
4 selector?

5 A Well, if that criteria has to be passed on
6 an applicant by applicant basis, you're right back at
7 the asymmetric information problem that is, you know,
8 at the beginning or what is the truth.

9 The fact that you rely on public
10 information, that you rely on historical information,
11 still doesn't establish, you know, what's there in
12 truth and so there's sort of no way in that sense to
13 verify it, and those who will choose the deal will be
14 more likely to be ones who had, you know, inside
15 information that in fact they were planning to grow.

16 The fact that you just put a requirement in
17 that says everybody who participates has to add to net
18 revenue doesn't solve the problem that in fact they
19 might not.

20 Q And they might not because they don't reveal
21 all of their private information? Is that what you're
22 saying?

23 A They might not because the rule that
24 established what the threshold was isn't a perfect
25 indicator of what their true before rates volume would

1 be.

2 Q Well, it's seldom that folks deal with
3 perfect indicators, is it?

4 A Very seldom.

5 Q What you and I are really getting down to is
6 the question of whether negotiation or meeting this
7 requirement of providing net increase in revenue is
8 more likely to produce correct information. Would you
9 agree with that?

10 A In general, yes.

11 Q Could you look at page 25?

12 A Okay.

13 Q On the bottom half of this page you start a
14 discussion of negotiated contracts that you're
15 familiar with. Is that correct?

16 A (Non-verbal response.)

17 Q In these contracts that you're familiar
18 with, do you recall whether a large customer of a
19 public utility ever made threats when seeking a
20 negotiated rate?

21 A Again, I was not in on the negotiation so I
22 can't firsthand say yes, I remember so and so
23 threatened.

24 The word threat, I would just say that what
25 is explicit in the authorizations in these different

1 jurisdictions is a recognition that these negotiated
2 contracts are valuable instruments to help public
3 utilities help increasing competitive pressures, which
4 is sort of I think might be where you're going with
5 threats; that the customer says I need a lower rate.
6 Otherwise I'm going to relocate my plant outside of
7 your jurisdiction.

8 Q You've heard of that, have you?

9 A Yes.

10 Q Have you heard of a large customer actually
11 negotiating a contract with a different utility within
12 the same state and then having that go to the public
13 utility commission for approval?

14 A In the examples that I am familiar with and
15 that I have cited in my testimony I don't believe that
16 was the case, so to sort of be absolutely technically
17 correct on the answer I have to say no, but I will go
18 further to say but it would not surprise me that that
19 happens.

20 Q How can the public utility that is being
21 victimized here determine whether a threat like that
22 is credible or not?

23 A Okay. Well, I don't think I ever used the
24 word victimized or anything, so I just want to make
25 clear that's your term, not mine.

1 Then the establishment of whether that's
2 credible or not is again part of the give and take of
3 any business relationship where you have basically
4 parties who have adversarial positions, but
5 nevertheless they have a common desire to reach into
6 mutually beneficial territory, which is the nature of
7 all trade or all business interactions.

8 Q In the situation where the large customer
9 says I'm moving the plant to the state next door, the
10 utility that loses that customer is going to lose
11 either way after that, correct?

12 A I think I know what you're asking, but could
13 you ask that again?

14 Q Once a large customer announces its intent
15 to move, to become a non-customer, the utility is not
16 going to be better off no matter what it does. Is
17 that correct?

18 A I would hesitate to totally agree with that
19 for two reasons. One is that it's sort of what is the
20 relevant reference case when you're saying better off,
21 but I think if we're saying the relevant reference
22 case is that if some alternative rate is not developed
23 they're out of here then they'll be better off by
24 developing the alternative rate. I mean, that's
25 possible.

1 Okay. But, interestingly enough, there are
2 cases where this situation arises, and it spurs
3 innovation similar to the innovations that we might
4 see in the Capital One NSA with a cost innovation or a
5 more innovative pricing structure, so the fact that
6 you started out with this so-called threat may end up
7 with the development of a better product that is
8 customized to this customer to where in fact their
9 usage of the product actually goes up, and there's an
10 overall increase even given the historic reference
11 case, much less the alternative I'll leave the state
12 reference case.

13 That's the second reason I hesitate to
14 absolutely say it's bad news when the customer makes a
15 threat. Sometimes it's a wake up call and innovation
16 kicks in, and when it's all done both parties are
17 better off and it wouldn't have happened had not that
18 threat initially been made.

19 Q Can you give a specific example of that that
20 you're familiar with?

21 A What I can do is refer to my testimony of my
22 description of the two-part real-time pricing
23 programs. Particularly I'm familiar with the ones in
24 Georgia. As a result of -- I mean, it's not a special
25 contract there, but there are other special contracts

1 that have two-part real-time pricing.

2 As a result, after the program was put in
3 place the marginal price of electricity is lowered
4 significantly so that there is enough expansion by the
5 customer that their average price of electricity comes
6 down significantly, but the margin to the utility or
7 the net revenue contribution actually increases.

8 Because of the structure of the two-part
9 program the original contribution is maintained, but
10 then the lower incremental price causes a net
11 expansion. The customer gets a lower average price
12 and, therefore, says okay, I won't leave the state, or
13 okay, I won't put in self-generation capacity, but the
14 utility at the end of it has solved their problem and
15 ended up with more net revenue.

16 Q That's a situation where the utility would
17 have been better off if it had come up with the idea
18 itself, isn't it?

19 A It is.

20 MR. COSTICH: I have no further questions,
21 Mr. Chairman.

22 CHAIRMAN OMAS: Thank you, Mr. Costich.

23 Is there any follow-up cross-examination?

24 MR. MAY: Is there no other direct
25 examination?

1 CHAIRMAN OMAS: No other.

2 CROSS-EXAMINATION

3 BY MR. MAY:

4 Q The OCA was asking you about the Callow
5 proposal. To the extent that you're familiar with it,
6 he described some of the terms of it.

7 If you'll accept for purposes of this
8 question, in case you're not exactly familiar with it,
9 under the Callow proposal it would be possible to get
10 a volume discount, even though theoretically you had
11 zero returns of physical returns. All of your mail
12 was 100 percent delivered.

13 There is the possibility that under the
14 Callow proposal a mailer would create no savings
15 whatsoever to the Postal Service through the improved
16 and savings on not having to make physical returns
17 because there are no physical returns for this mailer.
18 Or, take the average case. You'd only have a one
19 percent return.

20 In that case, since it is theoretically
21 possible that the Postal Service will have zero
22 savings from the deal, wouldn't you say it's actually
23 a prudential measure for the Callow proposal to bound
24 with a 15 percent stop loss the amount of revenue
25 leakage, which could be horrendous, if they had

1 miscalculated the actual volume they expect from this
2 mailer since there will be no savings, unlike the
3 Capital One case, to help pay or offset that revenue
4 leakage?

5 Viewed in that light, isn't the Callow 15
6 percent bounding proposal prudential?

7 A I think early on in the question you asked
8 if I would say it was prudent, and I would say no, I
9 don't come to that conclusion.

10 I have not focused on either the facts or
11 what you stipulate about the costs or the lack of cost
12 savings because of no returned mail and that, so I did
13 not analyze that situation at all so I can't really
14 say that I would say that was prudent or not prudent.

15 Let me come back to the point of my critique
16 of the proposal on that 15 percent bound is that by
17 putting that 15 percent bound in there you are going
18 from the efficiency improving declining block rate
19 structure. You're turning around and then going to an
20 increasing block rate structure, which is
21 reintroducing pricing in efficiency. It's moving in
22 the wrong direction as long as the block price is
23 still above the marginal cost, which it seems to be.

24 That is the economic criticism is that it is
25 an efficient structure by which the perhaps worthwhile

1 pursuit of risk mitigation is pursued and that there
2 are likely better ways, more efficient ways, to
3 mitigate that risk rather than reintroducing pricing
4 efficiency.

5 Q Well, granted your testimony is that it's an
6 inefficient pricing structure. Nevertheless, given
7 the possibility, the very real possibility that there
8 will be zero savings from the Callow proposal and the
9 great likelihood, according to your testimony, that
10 there will be adverse selection in who utilizes this,
11 then as a practical matter do you not have to have
12 some bound to prevent the Postal Service from
13 sustaining huge losses of revenue?

14 A Again, the vast majority of my thinking and
15 effort has been in analyzing the Capital One NSA. The
16 Callow proposal I make three comments on as far as why
17 it has some undesirable properties, which I think we
18 are in agreement with here, but I hesitate to go
19 further than that because I haven't prepared to go
20 further than that in my testimony.

21 MR. MAY: That's all, Mr. Chairman.

22 CHAIRMAN OMAS: Thank you. Anyone else?

23 (No response.)

24 CHAIRMAN OMAS: Mr. Eakin, I have one brief
25 question for you.

1 In your testimony you discuss some possible
2 effects of the NSA on competitors of Capital One. You
3 describe a scenario in which those competitors might
4 lose some customers to Capital One, and you respond by
5 increasing the amount of advertising mail they send.

6 In a scenario where there are fewer
7 customers who are spending more on advertising, it
8 would seem that those competitors have been harmed.
9 How would you suggest that the Commission judge the
10 extent of that harm, and how might we take that into
11 consideration in weighing the total benefits of this
12 NSA?

13 THE WITNESS: The competitors in that
14 scenario definitely are worse off than they were prior
15 to the implementation of the Capital One NSA. It is a
16 secondary effect, but it is one that is very worthy of
17 consideration and other regulatory bodies in similar
18 analogous situations have also, you know, been
19 concerned about the impact on those competitors.

20 The way that has commonly been used in those
21 situations and what I in direct answer to your
22 question here would recommend is that you look for or
23 that similar opportunities be presented to those
24 competitors.

25 I think I cover this in one of my final

1 observations on page 30 where I say, "Other postal
2 customers are likely to request similar NSAs," and
3 that's the channel by which these competitors, their
4 harms are in essence addressed. They can come forward
5 and request similar NSAs.

6 I say in that paragraph on that Point 3 that
7 the Postal Service needs to be prepared for these
8 requests, and if they can negotiate a deal similar to
9 what is apparently negotiated in this case they should
10 look forward to those requests to get a significant
11 increase in contribution.

12 CHAIRMAN OMAS: Thank you.

13 Mr. Koetting, would you like some time with
14 your witness?

15 MR. KOETTING: Could I just have a minute,
16 Mr. Chairman?

17 CHAIRMAN OMAS: I'll allow you that.

18 (Pause.)

19 MR. KOETTING: We have no redirect, Mr.
20 Chairman.

21 CHAIRMAN OMAS: Thank you. Dr. Eakin, that
22 completes your testimony here today. We would like to
23 thank you very much for your contribution to our
24 record, and you are excused.

25 THE WITNESS: Thank you.

1 CHAIRMAN OMAS: Thank you very much.

2 (Witness excused.)

3 CHAIRMAN OMAS: That, ladies and gentlemen,
4 concludes the hearing today, and we now stand
5 adjourned.

6 (Whereupon, at 12:50 p.m. the hearing in the
7 above-entitled matter was concluded.)

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REPORTER'S CERTIFICATE

DOCKET NO.: MC2002-2
CASE TITLE: Experimental Rate and Service Changes
to Implement Negotiated Service
Agreement with Capital One Services
HEARING DATE: March 7, 2003
LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the United States Postal Rate Commission.

Date: March 7, 2003



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