

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 2005)

Docket No. R2005-1

RESPONSES OF VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

WITNESS ROBERT W. MITCHELL TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE (USPS/VP-T1-1-8)

(August 19, 2005)

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc.

("Valpak") hereby submit responses of witness Robert W. Mitchell to the following
interrogatories of the United States Postal Service: USPS/VP-T1-1-8, filed on August 5, 2005.

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

Respectfully submitted,

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USPS/VP-T1-1.

Please confirm that, all other things held equal, the Postal Service's Fiscal Year (FY) 2006 financial results would improve by approximately \$3.1 billion if there were no escrow expense pursuant to Public Law 108-18. If you do not confirm please explain fully.

RESPONSE:

I am not in a position to provide confirmation concerning the behavior of the Postal Service's financial reporting system. However, it would be my expectation — in fact I think it is virtually axiomatic — that a reduction of approximately \$3.1 billion in any cost component, any cost category, or any collection of costs, including the escrow expense, since it is approximately \$3.1 billion, would, *ceteris paribus*, improve the Postal Service's financial results by approximately \$3.1 billion, for any year selected, including projected FY 2006. This assumes a situation of “no escrow expense” means the expense is removed from its status in the income statement as an operating expense and nothing is put in its place, *pari passu*. I am also assuming that holding “all other things ... equal” means no changes are allowed in any other factors affecting costs or revenues, and not that all other things are equal to each other.

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USPS/VP-T1-2.

Witnesses Potter and Tayman have testified that the new rates proposed in this case will not be implemented before January 2006, resulting in an actual net loss in FY 2006. Please confirm that, all other things held equal, under the Postal Service's proposals in this case, delay in implementation of the proposed rate increases beyond January 2006 will increase the actual net loss for that fiscal year. Please explain any negative response.

RESPONSE:

I am not in a position to provide quantification in any detail of the financial effects on the Postal Service of one rate implementation date versus another. It would be my expectation, however, consistent with own-price elasticities of demand in the neighborhood of those estimated by Postal Service witness Thress (USPS-T-7), that an implementation after January 2006 instead of January 2006 would result, *ceteris paribus*, in a lower net income for FY 2006, with the understanding that net income can be positive or negative.

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USPS/VP-T1-3.

In either FY 2004 or FY 2005, did the Postal Service incur an expense in the form of an obligation to put funds into escrow, similar to the obligation for FY 2006 imposed by PL 108-18?

RESPONSE:

My general understanding is that there was a kind of tradeoff, involving approximately the same level of funds, under which an obligation to reduce previously outstanding debt existed for FY 2004 and FY 2005, and an obligation to pay into an escrow exists for FY 2006. Whether these are “similar” depends on one’s point of view. At the least, I would view them as related. Also, it bears noting that (a) the previously outstanding debt has, for all practical purposes, been paid off, so continuation of the arrangement for FY 2004 and FY 2005 would seem to be pointless, and (b) the debt payments and the escrow payments are made from the same revenue stream.

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USPS/VP-T1-4.

Based on your experience, and your knowledge and understanding of the development of proposals for the Postal Service in rate cases, please confirm that developing proposals and support for an across-the-board approach to pricing would require less time than developing proposals and support for a conventional approach to pricing.

RESPONSE:

Whether you mean elapsed calendar time or the total of dedicated work hours, I believe what you suggest is basically correct, but it is not the whole story. Several factors make either dimension of time a less-than-critical issue. (1) Moving the Postal Service in one direction or another has been described as a process of redirecting something much larger than an aircraft carrier. Under such conditions, reasonably accurate financial projections can be made and deficit situations do not generally arise unexpectedly. It is the case, therefore, that the need for rate filings can usually be identified early enough to allow the requisite work to be done. (2) Much of the work needed for a rate case either is or should be on-going. (3) In fact, even for this case, a full financial analysis was presented, all of the customary special cost studies were prepared, a full volume projection was done, and a full roll forward was done. (4) The missing link seemingly is a process of a few knowledgeable rate people using all of this information to develop specific rates, and discuss them with higher levels of management. The Postal Service has such people. Also, my experience has been that some of the rate work is based on drafts of the cost work, and that other parts of the rate work can be done at the same time that the final touches are being put on the cost studies and the library references. In terms of my own experience at the Postal Service in designing rates for the subclasses now called

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Standard and Periodicals, I can say that I have accommodated late adjustments in cost results with no more than an additional day's worth of work on testimony and workpapers.

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USPS/VP-T1-5.

On page 16 of your testimony, you state:

“[A]rguments that the Postal Service has a financial interest in implementing rates a month or so sooner lack merit. The Postal Service has had full control over the timing of this case and it has known of the escrow requirement since P.L. 108-18 was enacted on April 23, 2003. Borrowing options are available to allow flexibility and to smooth things out over time. Neither a desire for a settlement nor a hurry to realize increased revenue is a credible justification for an ATB approach.” (footnote omitted).

- (a) Is it Valpak’s position that the Postal Service should have filed a request for recommendations on rate increases earlier than April 8, 2005?
- (b) Is it Valpak’s position that the Postal Service should have filed a request for recommendations on rate increases later than April 8, 2005?
- (c) Is it Valpak’s position that the Postal Service should have exercised its “borrowing options” to delay the filing of a request for recommendations on rate increases? Please explain any negative responses.

RESPONSE:

a.-c. None of these represent specific Valpak positions. My view is (i) if a rate case had to be filed, it should have been a full, normal case, (ii) there is no basis for, and no real way to fund, one category of expenses one way and another category of expenses another way, and (iii) the Postal Service should have had no real difficulty in working out any associated problems of timing and financing.

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USPS/VP-T1-6.

On pages 15 and 16 of your testimony, you state:

“But adopting a particular rate approach in hopes of facilitating a settlement, rather than according to the requirements of the Act, simply is not appropriate ratemaking. Put another way, increasing the likelihood of achieving a settlement is not one of the non-cost factors in the Act.”

- (a) If the “requirements of the Act,” as you describe them, were hypothetically otherwise met, is it your position that the Act’s ratemaking scheme would not permit the Postal Service or the Commission to consider the prospects of settlement in relation to the Postal Service’s financial condition in evaluating the Postal Service’s proposals and in recommending and approving increases in postal rates and fees? Please explain any affirmative response.
- (b) Assuming “the requirements of the Act” were met, list and explain every reason for concluding that consideration of settlement in relation to the Postal Service’s financial condition would not be “appropriate ratemaking.”

RESPONSE:

- a. I find the logic flow of your question to be difficult, but I think you are trying to get to this question: If the “requirements of the Act,” as you describe them, were hypothetically otherwise met, is it your position that in evaluating the Postal Service’s proposals and in recommending any rate or fee increases, including attention to any settlement efforts or to any resulting settlement, the Act’s ratemaking scheme would not permit the Postal Service or mailers or the Commission to consider the Postal Service’s financial condition?

There is a difference between the “requirements of the Act” and my view of the “Act’s ratemaking scheme.” I have not argued that the Postal Service’s filing

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violates any principle of law, nor have I argued that the Commission's review cannot recognize any financial situation that exists. But as a practical matter, the ratemaking scheme as implemented by the Commission requires that cases be examined thoroughly, relative to the Act, and that current costs be fully recognized. I do not think the Postal Service's filing in the instant docket meets this test, which is to say that this case as filed does not adequately recognize current costs and the guidance in the Act. Also, particularly in regard to the issue of the Postal Service's financial position, I believe: (1) the Postal Service should be able to time its filings so that the financial situation is not serious; and (2) the financial situation presented in this case is not serious enough to require that it be given considerable weight relative to other factors.

In addition, there is a difference between (i) selecting an across-the-board approach because it is believed most likely to lead to a settlement and a rapid response from the Commission, instead of because it is believed to be aligned in the best possible way with the scheme in the Act, and (ii) once an approach has been selected and a case has been filed, allowing the Postal Service's financial condition to be considered as the case is handled by all parties and the Commission. The former seems more problematic than the latter. See also my responses to DMA/VP-T1-5(a) and USPS/VP-T1-4.

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- b. See my response to part a of this question for a discussion of the difference between the “requirements of the Act” and the “ratemaking scheme” under the Act. I have not taken the position that the financial condition should not be considered, but rather that it should not exist and that it should not be given much weight. As I explain in my response to DMA/VP-T1-5(a):

there may be a reason why expedition is not one of the non-cost factors of the Act, at least not one expressly identified. If needing additional revenue soon trumped other considerations, there would be no ratesetting process at all. That is to say, expedition conflicts with and weakens the review contemplated by the Act. Whether expedition is a valid goal for the Postal Service must be viewed in the context of shortchanging the ratesetting process and the role of the Commission. Viewed in this way, Postal Service steps to expedite may not be a good thing. As explained on lines 6 and 7 of page 16 of my testimony: “Borrowing options are available to allow flexibility and to smooth things out over time.” In the scheme of things, I do not view the financial consequences of one rate case schedule or another to be troublesome or unmanageable.

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USPS/VP-T1-7.

On page 17 of your testimony, you state:

“Focusing on settlement as a goal in such a situation introduces a dynamic that may be out of line with appropriate ratemaking. It is altogether possible that the Postal Service, in negotiating with intervening parties, who may represent the interests of some mailers to the neglect of others, will find that it can achieve settlement by proposing rates that it cannot justify as most appropriate, in hopes that the Commission will do little more than certify that the rates in the settlement are within a range allowed by law instead of being the best for the nation. The incentives of such a dynamic are unacceptable and should not be allowed to dictate the nation’s postal rates and fees.”

- (a) Does your reference to “appropriate ratemaking” refer to anything other than the requirements and policies of the Postal Reorganization Act (title 39, United States Code)? Please identify and explain all factors influencing appropriate ratemaking that are not encompassed by the Act.
- (b) Please identify specifically each and every provision of the Act that permits consideration in ratemaking of the “dynamic” that you describe.
- (c) Is it your understanding that the Postal Service's rate and fee proposals in Docket No. R2005-1 were developed through negotiations?

RESPONSE:

- a. Please see my response to USPS/VP-T1-6(a) for a discussion of the difference between the requirements of the Act and my view of the Act’s ratemaking scheme. The Postal Reorganization Act is the reference point I have in mind, along with the associated rules and conventions of the Commission. In my view, the Act created the Commission as an expert agency, gave it certain guidance and certain latitude, and contemplated that it would, under that guidance and within that latitude, develop and apply defensible, state-of-the-art principles, in full view of all that regulatory theory and practice have to offer.

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The Commission has done just that, which provided the basis for the Commission saying in its opinion in Docket No. R94-1: “The Postal Service’s request for a general, across-the-board rate increase in this docket departs from the pricing principles established in Docket No. R90-1 on which current rates are based.” (*Op. & Rec. Dec.*, Docket No. R94-1, ¶ 1063.) In the same case, the Commission also said: “The Postal Service’s across-the-board filing is inconsistent with cost-based ratemaking. The request ignores changing differences in costs between the classes of mail, includes no analysis of changing cost patterns within subclasses; and would result in substantial changes in the allocation of institutional costs among the subclasses of mail. The Service’s rate proposal ignores changes in attributable costs.” (*Ibid.*, ¶ 1017.) It is these kinds of principles to which I refer. I do not contend, however, that these principles are “not encompassed by the Act.”

- b. It is true that I believe the Postal Service strayed from a process of recognizing current costs and giving full recognition to the policies and factors in the Act, as developed further and implemented by the Commission, and that I believe it not to be in the best interests of the Postal Service or the nation for the Postal Service to have done this. The Commission should be aware that such things (as straying) are possible, which makes it all the more important for the Commission to judge the case on its merits and not be swayed by arguments that

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the Postal Service and participants adhering to a settlement agreement want the rates in the agreement. But I have not contended that the Commission should base its recommendation on anything other than the record and its judgment as developed and implemented over time in this and other cases, under the authority of the Act.

- c. I do not know the extent to which the Postal Service did or did not negotiate with mailers prior to filing this case. I recall considerable before-the-filing discussion at various mailer meetings and in the postal press about the case's across-the-board character and about the Postal Service's interest in settlement, and early on some discussion to the effect that the average increase proposed could be larger than 5.4 percent. I also know that witness Potter observed that one of the justifications for the across-the-board "approach is the likelihood that it will enhance the prospect for settlement." (USPS-T-1 at 5, ll. 15-16.) It seems clear, then, that even if the Postal Service did not negotiate directly with mailers, it did communicate its interest in achieving settlement and it did have an understanding of how the process of seeking a settlement might play itself out.

Note that my response to part b of this question explains that the Commission should consider this case on its merits and that I do not see any reason for the

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Commission to focus on its perception of the process of the Postal Service that generated the filing. Communicating with customers is, on the whole, a good thing and I do not mean to suggest that it should not occur.

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USPS/VP-T1-8.

Is willingness to enter into a settlement agreement adopting a particular set of rates an indication of the impact of those rates on mailers and other participants adhering to the agreement?

RESPONSE:

Most observers would probably agree, as I do, that “willingness to enter into a settlement agreement adopting a particular set of rates” is “an indication” of the acceptability of the rates involved, and I would presume that “participants adhering to the agreement” have considered the effects of the rates. But concern over effects might be a key factor leading to an unwillingness to sign an agreement only when the effects seem larger than average on their face, which cannot happen in an across-the-board proposal. On the other hand, such an willingness may not be enough to satisfy the Act’s requirements.

Several observations are important. (1) The obligation of the Commission is to consider the interests of all mailers, regardless of whether they are represented in a particular case. (2) It is possible for participants to be organizations representing rather broad collections of mailers. If such organizations believe updating costs and examining the bases for the proposed rates will do little more than make some members worse off and some better off, they may decide not to raise questions. (3) Mailers seeing no proposals for classification or other structural changes, and feeling that it would be difficult to introduce such proposals, might have reduced interest in a full examination of the issues. In other words, improvements in rates normally have differential effects on mailers, so a case without improvements is less likely to cause concern over effects. (4) In any settlement arrangement, it seems likely that at

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least half of the participants would believe they might be made worse off by what is sometimes referred to as a “full blown” case. These parties would provide the Postal Service with a base for a settlement. (5) Under these conditions, it seems possible that only a limited number of parties would see potential benefit from a full proceeding.