

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

POSTAL RATE AND FEE CHANGES, 2006

Docket No. R2006-1

RESPONSE OF UNITED STATES POSTAL SERVICE WITNESS BERNSTEIN
TO INTERROGATORY OF GCA (GCA/USPS-T8-8)
(August 8, 2006)

The United States Postal Service hereby provides the response of witness
Bernstein to the following interrogatory of GCA, filed on July 25, 2006: GCA/USPS-T8-
8.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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August 8, 2006

**RESPONSE OF POSTAL SERVICE WITNESS BERNSTEIN
TO INTERROGATORY OF GCA**

GCA/USPS-T8-8

Your interrogatory response GCA/USPS-T8-7 states, in part, that “I have worked on the creation of pessimistic and optimistic diversion scenarios, based on different assumptions about the growth in the use of the many drivers of electronic diversion.”

- a. Explain in detail the methodology used in the First Class pessimistic diversion scenario, identify how that scenario calculated the amount of electronic diversion, and identify the inputs used to account for “different assumptions about the growth in the use of the many drivers of electronic diversion.” Explain, further, whether the scenario used the same Internet variable used in the Thress’ econometric model used in this case.
- b. Explain in detail the methodology used in the First Class optimistic diversion scenario, identify how that scenario calculated the amount of electronic diversion, and identify the inputs used to account for “different assumptions about the growth in the use of the many drivers of electronic diversion.” Explain, further, whether the scenario used the same Internet variable used in the Thress’ econometric model used in this case.
- c. Explain in detail the methodology used in the First Class baseline diversion scenario, identify how that scenario calculated the amount of electronic diversion, and identify the inputs used to account for “different assumptions about the growth in the use of the many drivers of electronic diversion.” Explain, further, whether the scenario used the same Internet variable used in the Thress’ econometric model used in this case.
- d. To the extent not explained above, explain whether the First Class pessimistic, optimistic, and baseline scenarios utilized the same methodologies and explain what different assumptions, variables, or inputs account for the different models.
- e. To the extent not explained above, identify specifically and individually all of the referenced “many drivers of electronic diversion.”
- f. To the extent not explained above, provide the same information for a., b., c., and d. with respect to the pessimistic, baseline, and optimistic scenarios for total mail volume (as appear in the September 2005 Strategic Transformation Plan at p.8).
- g. Provide all documents that explain, discuss or set forth the pessimistic, optimistic, and baseline scenarios, including any communications from the United States Postal Service concerning same.

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RESPONSE:

a. - f. A purpose of the scenario analysis in the Strategic Plan is to provide postal management with a range of plausible future volumes around the baseline forecast. The baseline forecast is made in the same way as a rate case forecast. Econometric equations were estimated using data through 2005Q3. Forecasted values of the explanatory variables were made, and the impacts of those explanatory variables were projected based on the estimated volume elasticities. For example, economic variable projections were based on Global Insight's July baseline economic forecast. In Docket No. R2001-1, the forecasts of the electronic diversion variables were made by me. In R2005-1 rate case, 2005 Strategic Plan, and R2006-1 rate case, however, the electronic diversion variables were forecasted directly by Mr. Thress. Combining his diversion variable forecasts with the estimated elasticities of the diversion variables, a baseline forecast of electronic diversion is created. The baseline forecast is the forecast that reflects what is believed to be the most likely track that mail volume will follow in the future. It projects that electronic diversion will continue at approximately the same pace as it had been in recent years.

The pessimistic and optimistic scenarios for First-Class Mail are created by varying the economic variable forecasts and the projected level of electronic diversion. One step is to create pessimistic and optimistic projections of the economic variables. In the Strategic Plan forecast, the pessimistic economic scenario was created by assuming a return of the "jobless recovery" that existed in 2002 and 2003. The optimistic economic scenario was created by assuming a return to the economic boom that prevailed in the 1990s. Based on these two economic histories, future economic values are projected, and these become inputs into the scenario forecasts.

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In the case of electronic diversion, the pessimistic scenario projects greater annual future diversion than in the baseline forecast, while the optimistic scenario projects less annual future diversion. The analysis is not based on alternative projections of the diversion variables, but based on the establishment of conditions consistent with greater or lesser diversion. The reason behind this approach, as opposed to the approach used in creating economic scenarios, is to provide postal management with an understanding of the “states of the world” that would generate different levels of diversion. In other words, while people have an intuitive understanding of the features of a weaker or stronger economy (i.e., jobless recovery, economic boom) they are less inclined to have an intuitive understanding of what it means for ISP consumption expenditures, for example, to increase at a slower or faster rate than projected in the baseline forecast.

What conditions would be consistent with greater electronic diversion? One driver would be greater than projected Internet penetration or broadband adoption. Competition between Internet providers could intensify, access rates could fall, and adoption levels would in turn be greater than projected in the baseline. Other conditions consistent with greater electronic diversion would be an acceleration of the pace of electronic payments which in turn leads to more rapid adoption of the electronic presentment of bills and statements. Similarly, e-mail advertising could become a more effective medium, leading to greater losses of First-Class advertising mail.

The pessimistic level of annual diversion that is chosen is ultimately a judgmental exercise. The “inputs” to this projection are the understanding of the markets for First-Class Mail, the level of historical diversion (estimated econometrically) and the reasonableness of the final scenario forecast.

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The optimistic scenario is created in a similar way. What conditions would be consistent with a slowdown of electronic diversion? One possibility is that Internet penetration peaks out at near its current level, much in the way that cable TV penetration peaked at a level far less than universal access. Online banking and its related activities (electronic bill payment and presentment) could slow, perhaps because a major security breach deters people from conducting financial transactions online. E-mail advertising could succumb to the inefficiencies of clutter, and e-mail spam could become so prevalent that it undermines the effectiveness of legitimate advertising online. The optimistic level of annual diversion chosen for the Strategic Plan, like the pessimistic level, is a judgmental forecast.

Thus, the pessimistic and optimistic scenarios were developed to provide some understanding of the potential range of impact on projected mail volumes stemming from plausible variations in various underlying forecast drivers. The purpose of the scenario exercise was to estimate flow-through effects on volumes of the assumed variations if they were to occur, rather than attempt to assess the likelihood that they would occur. As such, no particular probabilities were assigned to those scenarios. At the time the baseline forecast was made and the scenario exercise was conducted, the baseline forecast was, by construction, the best available forecast of the most likely future volumes. The same holds true now for the rate case forecast presented by Mr. Thress.

g. The document attached electronically provides a detailed discussion of the 2005 Strategic Plan baseline, pessimistic, and optimistic scenario forecasts.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with Section 12 of the Rules of Practice and Procedure.

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