

UNITED STATES OF AMERICA  
Before The  
POSTAL RATE COMMISSION  
WASHINGTON, D.C. 20268-0001

Rate and Service Changes To Implement )  
Baseline Negotiated Service Agreement )  
With Washington Mutual Bank )

Docket No. MC2006-3

RESPONSES OF OFFICE OF CONSUMER ADVOCATE  
WITNESS JAMES F. CALLOW TO INTERROGATORIES OF  
UNITED STATES POSTAL SERVICE (USPS/OCA-T1-10-16)  
(September 13, 2006)

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The Office of Consumer Advocate hereby submits the responses of James F. Callow to interrogatories USPS/OCA-T1-10-16, dated August 30, 2006, as revised on August 31, 2006. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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RESPONSES OF OCA WITNESS JAMES F. CALLOW  
TO INTERROGATORIES USPS/OCA-T1-10-16

USPS/OCA-T1-10.

Please refer to page 3, lines 2 to 5, of your testimony. You state, "I propose application of an alternative financial model to the negotiated service agreement concluded between Washington Mutual Bank and the Postal Service, based upon the 'Panzar' analysis presented by the Commission in Docket No. MC2005-3."

- a) In developing your Panzar model, did you rely on the framework and guidance presented in the Opinion and Further Recommended Decision of the Postal Rate Commission (PRC) in Docket No. MC2004-3?
- b) Did you rely on any additional sources to develop your Panzar model? If yes, please identify those additional sources.

RESPONSE TO USPS/OCA-T1-10

(a) – (b). I relied on the framework and guidance presented in the Opinion and Further Recommended Decision in Docket No. MC2004-3, and additional sources, to the extent cited in my testimony.

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USPS/OCA-T1-11.

Please refer to page 26 of the PRC's Opinion and Further Recommended Decision in Docket No. MC2004-3 where it states, "The essence of the framework would be for the mailer and the Postal Service to establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (after-rates volumes). The proponents would negotiate a set of discounts that would demonstrably satisfy the Panzar inequality above for every possible after-rates volume within the range."

- a) Please confirm that, according to the PRC's Opinion and Further Recommended Decision in Docket No. MC2004-3, the Panzar test requires the proponents to "establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (after-rates volumes)." If you cannot confirm, please explain.
- b) In your judgment, what range of volumes would be considered "realistic" as you understand that term?
- c) In developing your Panzar model, did you estimate or assume a range of volumes that would be sent under the Washington Mutual NSA? If yes, please state your estimations or assumptions.
- d) In your opinion, is it possible to forecast future mail volumes without knowledge of future prices? If yes, please provide examples.
- e) In your judgment, did Washington Mutual provide a "realistic" forecast of its before-rates and after-rates mail volumes in its testimony (WMB-T-1)?

RESPONSE TO USPS/OCA-T1-11

(a) Confirmed.

(b) As stated in PRC Op. MC2005-3, para. 5012, quoted in part a., above, the framework is to be used by "proponents" during negotiations to "establish a wide range of potential volumes." The difference between the framework and the "Panzar" analysis was described by the Commission in PRC Op. MC2005-3 (Bookspan), para. 4089, fn 110:

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The Panzar analysis is not to be confused with the alternative approach model for designing declining block NSAs suggested by the Commission in its Opinion and Further Recommended Decision in MC2003-4, paras. 5001-38. The former is an analysis for evaluating the risk of loss, while the latter is a model for negotiating NSAs that uses the Panzar analysis in their design.

Since I am not participating in negotiating an NSA, I did not consider what range of volumes would be “realistic.”

(c) No.

(d) Yes. A trend analysis has been used in the past by the Postal Service as “a relatively simple approach . . . to predict future movements in mail demand.” Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 7.

(e) No. I estimated, and the Postal Service confirmed in response to OCA/USPS-T1-29(d), a “discount elasticity” of -0.8538 that was “backed-out” of Washington Mutual’s stated before-rates and after-rates point volume estimates using the average revenue for First-Class marketing letters, the Standard Mail revenue per piece, and the highest negotiated discount—assuming Washington Mutual’s own-price elasticity equals 0. This derived “discount elasticity” is more than 29 Standard Errors away from the “price difference” elasticity developed by witness Thress, calculated as follows:  $29.0883 \left( \frac{0.111483 - 0.85387166}{0.033187} \right)$ , where 0.111483 represents the absolute value of the “price difference” elasticity developed by witness Thress, 0.85387166 the absolute value of Washington Mutual’s derived “discount elasticity,” and 0.033187 the absolute value of the Standard Error developed by witness Thress.

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USPS/OCA-T1-12

Please refer to pages 24 to 27 of your testimony. On page 25, lines 4 and 5, of your testimony, you state, "I use net present value analysis to estimate the volume that would produce a return on investment equal to the Postal Service's 'cost of money.'"

- a) Please confirm that you compared the net present value (NPV) of the Postal Service's costs to the absolute discounts paid to Washington Mutual to estimate the Postal Service's return on investment under the NSA. If you cannot confirm, please explain.
- b) To estimate the Postal Service's return on investment under the NSA, did you also compare the NPV of the Postal Service's costs to the NPV value of discounts paid to Washington Mutual?
- c) Isn't it true that the comparison described in subpart (b) would yield a more accurate estimate of the Postal Service's return on investment than would the comparison described in subpart (a)? If no, please explain.

RESPONSE TO USPS/OCA-T1-12

(a) Not confirmed. As explained in my testimony in the cited pages, I calculated whether the present values of cash inflows exceed present values of cash outflows discounted at the Postal Service's "cost of money." In the case of the Washington Mutual NSA, cash inflows to the Postal Service consist of "new" contribution, less any discounts "earned" by Washington Mutual. Cash outflows consist of investment expenses (e.g., negotiation and litigation costs), and annual administrative costs. At 544 million in Year 1, the Net Present Value is \$49,302—indicating that cash inflows equal (approximately) cash outflows when discounted at the Postal Service's cost of money.

(b) Yes. See the response to part (a), above.

(c) Yes.

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USPS/OCA-T1-13

Please refer to pages 25 and 26 of your testimony. Using the costs you have estimated, please calculate the Postal Service's return on investment under the NSA if the agreement generated the following increases in contribution in Year 1:

- a) \$1,000,000.
- b) \$2,000,000.
- c) \$5,000,000.

RESPONSE TO USPS/OCA-T1-13

The net present value analysis in my testimony is based upon cash inflows during the entire three-year period of the Washington Mutual NSA. For purposes of this response, I therefore assume cash inflows of \$1 million for Years 1, 2, and 3 in response to part a); \$2 million for each year in response to part b); and, \$5 million for each year in response to part c). I also assume the cash outflows (i.e., negotiation, litigation, and annual administrative costs), and the discount rates of the net present value analysis remain the same.

- (a) The net present value is: \$2,155,116.
- (b) The net present value is: \$4,853,409.
- (c) The net present value is: \$12,946,849.

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USPS/OCA-T1-14

Please refer to page 11, line 10, of your testimony, where you state that, "Washington Mutual's volume estimates are not subject to replication."

- a) Have you attempted to develop independent forecasts of Washington Mutual's before-rates mail volume? If yes, please provide the results of your analysis.
- b) Have you attempted to identify exogenous factors that could cause an increase in the before-rates volume?
- c) If your answer to subpart (b) is yes, have you attempted to model the impact of these factors on the before-rates and after-rates mail volume? If no, please explain why you have not attempted to do so.
- d) Assume that an exogenous factor leads to increased mail volumes. Isn't it true that Washington Mutual would have to spend more money on postage to mail those volumes through the USPS? If no, please explain.

RESPONSE TO USPS/OCA-T1-14

(a) No.

(b) Yes. See my testimony at page 10, lines 1-4.

(c) No. I did not develop a model of Washington Mutual's demand for First-Class Mail solicitation letters to estimate the effect of exogenous factors on Washington Mutual's before-rates and after-rates volume.

(d) Yes. In the context of the Washington Mutual NSA, an exogenous factor (or factors) that increased solicitation letters volume would increase postage revenues to the Postal Service. However, based on the conditions assumed, such an increase in postage would occur with or without the NSA, resulting in the Postal Service receiving an increase in institutional contribution, but not from the NSA.

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USPS/OCA-T1-15

Please refer to page 7, lines 1 to 5, of your testimony. You state, "An essential requirement of any negotiated service agreement is mutual financial gain for both the Postal Service and the potential NSA partner. Mutual gain arises where the agreement generates additional contribution for the Postal Service resulting from the entry of additional mail in response to discounted rates offered to the participating mailer." Additionally, please refer to page 7, lines 21 and 22, and page 8, line 1, of your testimony. You state, "A 'win-win' outcome for the Postal Service and the participating mailer is also essential to reduce the risk of harm to mailers not party to the agreement, especially where such mailers are dependent on the monopoly services of the Postal Service."

- a) Assume that under this NSA Washington Mutual converts all of its Standard Mail volume to First-Class Mail resulting in \$10 million of increased contribution to the Postal Service.
  - I. In your opinion, would Washington Mutual's increased contribution under the NSA benefit the Postal Service? If no, please explain.
  - II. In your opinion, would Washington Mutual's increased contribution under the NSA benefit other mailers not party to the agreement? If no, please explain.
- b) Additionally, assume that the Postal Service did not enter into this NSA with Washington Mutual. Do you agree with the proposition that the opportunity cost of not pursuing this agreement with Washington Mutual is \$10 million? If no, please explain.
- c) In your opinion, would the Postal Service be in a better financial position under the hypothetical presented in subpart (a) or under the hypothetical presented in subpart (b)? If no, please explain.
- d) In your opinion, would other mailers not party to the agreement be in a better financial position under the hypothetical presented in subpart (a) or under the hypothetical presented in subpart (b)? If no, please explain.

RESPONSE TO USPS/OCA-T1-15

(a) – (d) I don't know. Washington Mutual may convert its Standard Mail to First-Class Mail because of exogenous factors, with or without the NSA.

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USPS/OCA-T1-16

Please refer to page 28, lines 2 to 6, of your testimony. You state in part, "This expected contribution is sufficient to recover the Postal Service's investment in the Washington Mutual NSA, and provide a meaningful contribution to institutional costs."

- a) Please explain what you mean by the phrase "meaningful contribution to institutional costs" as you use it in your testimony.
- b) Have you identified a minimum absolute value of increased contribution that will "provide a meaningful contribution to institutional costs"? If yes, please provide the analysis used to develop this number.

RESPONSE TO USPS/OCA-T1-16

(a) I define the phrase "meaningful contribution" to mean institutional contribution to the Postal Service significantly greater than \$0.

(b) Yes. At a volume of 521 million, the estimated financial benefit to Washington Mutual approximates the expected contribution received by the Postal Service during the three-year period of the agreement. The Postal Service's expected contribution is \$3.453 million, while Washington Mutual "earns" discounts of \$3.510 million. See my testimony at pages 27-28. At this volume, contribution to the Postal Service is approximately 100 percent, i.e., 98.4 percent ( $\$3.454 / \$3.510$ ) of Washington Mutual's discounts, and therefore provides a "meaningful contribution to institutional costs."