

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 THE CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW TO INTERROGATORIES OF
UNITED STATES POSTAL SERVICE (USPS/OCA-T1-19-25)
(September 28, 2006)

The Office of the Consumer Advocate hereby submits the responses of James F. Callow to interrogatories USPS/OCA-T1-19-25, dated September 14, 2006. Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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USPS/OCA-T1-19.

Please refer to your response to USPS/OCA-T1 -5, subpart (b), where you confirm that you have not attempted to quantify the cost of the NSA to Washington Mutual. Please also refer to page 7, lines 9 to 10, 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."

- a) Please confirm that Washington Mutual Bank would benefit financially from the incentives the NSA will provide WMB for converting Standard Mail volume to First-Class Mail.
- b) In your judgment, is it possible to determine whether the WMB NSA will result in "mutual financial gain" to WMB and the Postal Service without attempting to quantify the costs of the agreement to WMB? If yes, please explain.

RESPONSE TO USPS/OCA-T1-19.

(a) Confirmed, assuming Washington Mutual enters "eligible" First-Class Mail, as that term is defined under the NSA.

(b) Yes. Quantifying the financial gain to Washington Mutual under the NSA has not been estimated by the Postal Service, or provided by Washington Mutual. Moreover, the Commission has not prepared, or required the Postal Service or NSA participants to provide, an estimate of financial gain. Nor in my judgment is it necessary in order to determine whether Washington Mutual will derive any financial gain. Since Washington Mutual can exit the agreement "without cause" at any time, expected financial gain to Washington Mutual is signified by its continued participation in this proceeding.

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USPS/OCA-T1-20.

Please refer to your response to USPS/OCA-T1-4, subparts (b) and (c). You state, "Washington Mutual's financial outcome may or may not be positive if the rate of customer responses 'does not increase.'" Please assume for the purpose of this interrogatory that the NSA induces WMB to shift 90 percent of its solicitation mail volume to First-Class Mail from Standard Mail. Additionally, please assume that all other variables remain constant except for the rate of customer responses WMB receives from its First-Class Mail solicitations.

- a) If the customer response rate referenced above were to decrease or remain constant after WMB converts its Standard Mail volume to First-Class Mail, could WMB experience a net positive financial outcome under the NSA?
- b) If the answer to subpart (a) is "yes," please explain how WMB could experience a net positive financial outcome under the NSA.
- c) Does the possibility that WMB's customer response rate might decrease under the NSA pose a financial risk to WMB?
- d) If your answer is to subpart (c) is "no" please identify any risks you have identified for WMB under the NSA.

RESPONSE TO USPS/OCA-T1-20.

(a) - (b) The Postal Service has selected one exogenous factor—the response rate of customers receiving Washington Mutual's solicitation letters—and assumed that rate will decrease or remain constant for First-Class Mail solicitation letters after implementation of the NSA. This is implausible in that the decrease in response rate is assumed to be present only after-rates, but not before-rates. Moreover, while customer response rates may differ as between First-Class Mail and Standard Mail, any exogenous factor that affects the response rate of customers receiving First-Class Mail solicitations will also affect the response rate of customers receiving Standard Mail solicitations in the same direction. Given the implausible nature of this interrogatory's

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assumption, Washington Mutual is unlikely to experience a net positive financial outcome.

(c) - (d) The Postal Service's assumed risk—that the customer response rate might decrease—is not a financial risk inherent to or associated with an NSA. The risk that Washington Mutual (or the Postal Service) may misestimate the customer response rate, or the risk of any other exogenous factor, is always present and is independent of whether Washington Mutual participates in an NSA or not. Thus, the Commission's statement regarding risk is accurate:

All risk related to volume forecasts used as the basis for unrestricted volume discounts is borne by the Postal Service and other mailers not party to the agreement. PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 5007, fn 21.

Moreover, for purposes of estimating the financial value of the agreement, I explicitly controlled for the effects of exogenous factors before-rates and after-rates in developing the Panzar analysis. Doing so precludes manipulation of exogenous factors to produce a desired or intended outcome, such as an assumption of the presence of exogenous factors after-rates, or the lack thereof, that differs from before-rates, or vice versa. As a result, the Panzar analysis produces an estimate of financial value that is based on volumes attributable to the discounted rates, rather than to exogenous factors. The Postal Service's hypothetical is not a *ceteris paribus* assumption, since the customer response rate is assumed relatively unfavorable to Washington Mutual after-rates, but relatively favorable before-rates.

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USPS/OCA-T1-21.

Please refer to your response to USPS/OCA-T1 -8, subparts (a)-(b), where you state that "A cross-price elasticity was not relevant to the development of the Panzar analysis presented in my testimony."

- a) Please define the term "cross-price elasticity" as you understand it.
- b) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB and that all exogenous factors and postage prices remain constant. Additionally, please assume that WMB converts its Standard Mail volume to First-Class Mail at the rate identified in the original filing. Please calculate the resulting cross-price elasticity and explain how you reached your result.
- c) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB and that all exogenous factors and postage prices remain constant. Additionally, please assume that WMB converts its Standard Mail volume to First-Class Mail at the rate identified in the original filing. Please confirm that a calculation of cross-price elasticity would be essential to an evaluation of WMB's mailing preferences. If you cannot confirm, please explain.

RESPONSE TO USPS/OCA-T1-21.

(a) A "cross-price" elasticity, or a cross elasticity of demand, "measures how sensitive [] purchases of *one* product (say X) are to a change in the price of some *other* product (say Y)." (Emphasis original). McConnell, Campbell R., *Economics* (10th Ed., 1987), 502. In general terms, a cross elasticity of demand can be described as follows:

$$E_{xy} = \frac{\text{Percentage Change in Quantity Demanded of X}}{\text{Percentage Change in Price of Y}}$$

More specifically, the cross-elasticity of demand is "the percentage change in the quantity of X purchased resulting from a 1 percent change in the price of Y." Ferguson,

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C. E., *Microeconomic Theory*, (1969), 86. Thus, the cross-elasticity of demand can be defined as:

$$E_{xy} = \frac{q_x}{Q_x} \bigg| \frac{P_y}{P_y}$$

where E_{xy} is the cross elasticity of demand for product x with respect to a change in price of product y , q_x is the change in the quantity of x , and p_y is the change in the price of y .

(b) – (c) The purpose of my testimony is to estimate the financial value of the Washington Mutual NSA to the Postal Service. The hypothetical is unrelated to my testimony in that it requests the calculation of a cross elasticity under circumstances where there is no agreement. Specifically, the hypothetical assumes “the Postal Service does not enter into an NSA with WMB and that *all*. . . postage prices remain constant.” (Emphasis added).

In order to estimate the financial value of the agreement, I did not consider the possibility of no agreement. Nor did I calculate a cross elasticity, or consider the role of such an elasticity in any evaluation of Washington Mutual's mailing preferences. In addition, as stated previously, a cross elasticity is not relevant to the development of the Panzar analysis in my testimony.

Moreover, the hypothetical cannot be answered as posited. Given the absence of *any* change in the price of First-Class Mail or Standard Mail, as stated in the hypothetical, the requested cross elasticity cannot be derived because the definition of a cross elasticity (see part (a), above) requires a change in price.

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USPS/OCA-T1-22.

Please refer to your response to USPS/OCA-T1 -11, subpart (d), where you confirm that it is possible to forecast future mail volumes without knowledge of future prices. Additionally, you state that "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.'"

- a) Please confirm that it is your understanding that the Postal Service uses trend analysis to forecast before-rates or after-rates mail volume.
- b) In your judgment, do you believe that a trend analysis which does not account for price changes can yield an accurate estimate of future mail volumes?
- c) Is the price of postage an important factor in developing a forecast of demand?
- d) To your knowledge, are there any other methodologies other than a trend analysis that would enable USPS or WMB to forecast future mail volume?

RESPONSE TO USPS/OCA-T1-22.

(a) Confirmed.

(b) In my judgment, a trend analysis that forecasts future mail volumes solely as a function of time does not account for price changes, and therefore cannot yield a reliable or accurate estimate of future mail volumes. The Postal Service apparently agrees, stating that "a simplified trend analysis ignores exogenous factors such as pricing changes, interest rates . . . competitors' strategies . . . and a host of other variables." Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 8.

(c) Yes.

(d) I don't know. To the extent there are, I did not consider them, and they are not used in my testimony. That said, the use of price elasticities is one methodology I

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am aware of that explicitly controls for the effects of exogenous variables in estimating future mail volumes. In my testimony, I used a price-difference elasticity.

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USPS/OCA-T1-23.

Please refer to your response to USPS/OCA-T1 -11, subpart (e). Additionally, please refer to your response to USPS/OCA-T1-14, subpart (c) where you state, "I did not develop a model of Washington Mutual's demand for First- Class Mail solicitation letters to estimate the effects of exogenous factors on Washington Mutual's before-rates and after-rates volume."

- a) Please confirm that your response to USPS/OCA-T1-11, subpart (e), is based solely on an evaluation of Washington Mutual's before-rates and after-rates volumes and the elasticities you identified in your response to USPS/OCA-T1 -11, subpart (e).
- b) Please describe all factors other than the elasticities you identified in your answer to USPS/OCA-T1 -11, subpart (e), that support your negative response to USPS/OCA-T1-11, subpart (e).
- c) Please identify the exogenous factor or factors that might cause WMB to shift its solicitation mail volume from Standard Mail to First-Class Mail.
- d) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB. For each factor identified in subpart (c) please describe how these factors would induce WMB to shift its solicitation mail volume from Standard Mail to First-Class Mail.
- e) Please confirm that you did not independently estimate the effect of exogenous factors on Washington Mutual's before-rates and after-rates mail volumes.
- f) In your judgment, is it possible to estimate the impact a change in an exogenous factor would have on mail volume without also estimating the effect of exogenous factors on before-rates and after-rates mail volumes? If your answer is yes, please explain.

RESPONSE TO USPS/OCA-T1-23.

- (a) Confirmed.
- (b) I considered none.
- (c) In my testimony, I listed a few exogenous factors from an infinite number of possible factors that might cause a shift in Washington Mutual solicitation mail volume.

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Probably the most important factors “include changes in corporate management, or changes in corporate financial goals or marketing strategies.” See my testimony at page 10, lines 1-4.

(d) - (e) I did not independently model the effects of exogenous factors on Washington Mutual’s mail volumes. Consequently, I do not know with certainty how Washington Mutual would respond to these exogenous factors. Nevertheless, whatever exogenous factor are identified, those factors will be present and affect Washington Mutual’s mail volumes with or without the NSA. Most problematic for the Postal Service, however, would be a change in corporate marketing strategy in which Washington Mutual decided to shift its solicitation mail volume from Standard Mail to First-Class Mail, and then concluded with the Postal Service a negotiated service agreement that featured discounted rates.

(f) No. As witness Ayub has testified, “If a variable causes a change in the before-rates forecast, holding all other factors equal, it should have a similar impact in the same direction on the after-rates forecast.” Tr. 2/28 (OCA/USPS-T1-1(d)).

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USPS/OCA-T1-24.

Please refer to your response to USPS/OCA-T1-15, subparts (a) - (d), where you state, "I don't know. Washington Mutual may convert its Standard Mail to First-Class Mail because of exogenous factors, with or without the NSA." Please revise your responses to USPS/OCA-T1-15, subparts (a) - (d), assuming that all exogenous factors remain constant.

RESPONSE TO USPS/OCA-T1-24.

In my response to USPS/OCA-T1-15(a) - (d), I assumed that all exogenous factors remain constant because such factors are always present and may cause Washington Mutual to convert its Standard Mail to First-Class Mail, "with or without the NSA." Thus, my answer remains the same.

Interrogatory USPS/OCA-T1-15(a) - (d) assumes that the Postal Service will automatically benefit from an NSA if, after the agreement is implemented, there is a subsequent increase in mail volume. However, it cannot be assumed that because the Postal Service enters into an NSA with a mailer and volumes increase that the increase was caused by the NSA. In doing so, the Postal Service commits the well known logical fallacy *post hoc ergo propter hoc*. It is entirely possible that the increase in mail volume was caused by exogenous factors, which exist with or without the NSA. Moreover, increased contribution benefiting the Postal Service and mailers not party to the agreement, above what would be realized absent a NSA, occurs only where additional mail volume is caused by the incentive to mail additional volume (because of the mailer's demand characteristics), and not because of exogenous factors.

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USPS/OCA-T1-25.

Please refer to your response to USPS/OCA-T1-16, subpart (a), where you state, "I define the phrase 'meaningful contribution' to mean institutional contribution to the Postal Service significantly greater than \$0." Please define the threshold for "significantly greater than \$0."

RESPONSE TO USPS/OCA-T1-25.

At a "threshold" (i.e., volume) of 521 million during each year of the agreement, the resulting institutional contribution of \$3.453 million would represent a "meaningful contribution" to the Postal Service "significantly greater than \$0." See my response to USPS/OCA-T1-16(b).