

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

RESPONSE OF OFFICE OF THE CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW TO INTERROGATORY OF
WASHINGTON MUTUAL BANK (WMB/OCA-T1-6)
(October 4, 2006)

The Office of the Consumer Advocate hereby submits the response of James F. Callow to interrogatory WMB/OCA-T1-6, dated September 26, 2006. The interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,

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TO INTERROGATORY WMB/OCA-T1-6

WMB/OCA-T1-6.

Please refer to the charts you provided in response to WMB/OCA-T1-1(f), which show that, assuming an own-piece elasticity of zero and a price-difference elasticity of -0.8538 and ignoring the NSA's cost savings, the NSA will generate a significant net change in USPS contribution in each year at WMB's After Rates volume forecasts.

Please also refer to interrogatory WMB/OCA-T1-5 and your response to it. Albeit in different words, WMB/OCA-T1-5 asked you how large WMB's price-difference elasticity would need to be for the NSA to generate a positive net change in USPS contribution each year at WMB's After Rates volume forecasts (713 million in Year 1, 750 million in Year 2, and 785 million in Year 3). You responded to this interrogatory by providing estimates of the price-difference elasticities implied by WMB's Before-Rates and After-Rates volume forecasts if one makes the additional assumption that WMB's own-price elasticity is zero.

Assuming that WMB's own-price elasticity is zero, how large, according to a Panzar Analysis, must the price-difference elasticity be for the NSA to produce a positive USPS net change in USPS contribution at WMB's After-Rates volume forecasts? Please provide your underlying calculations. If you are unable to incorporate the NSA's cost savings into the "Panzar Analysis," please indicate that this is so and ignore the NSA's cost savings in performing the Panzar Analysis.

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I interpret this interrogatory to request calculation of a price-difference elasticity assuming Washington Mutual enters First-Class Mail solicitation letter volume that generates discounts equal to the estimated return cost savings of \$2.2 million, \$2.4 million, and \$2.7 million at the stated after-rates volume of 713 million, 750 million, and 785 million, respectively, in Years 1, 2, and 3 of the agreement.

The following information is known: Washington Mutual's after-rates (i.e., 713 million, 750 million, and 785 million) volume estimate for each year, the average revenue per piece for First-Class Mail solicitation letters (i.e., \$0.346) and Standard Mail letters (i.e., \$0.206), and the relevant negotiated discount (i.e., \$0.035, \$0.040, \$0.045,

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or \$0.050). In the absence of a stated before-rates volume, however, a new before-rates volume must be calculated for each year of the agreement.

At the third declining block discount (\$0.045) tier, solicitation letter volume of 54 million, 58 million, and 65 million generate discounts equal to \$2.2 million, \$2.4 million, and \$2.7 million, respectively, during Years 1, 2, and 3 of the agreement. This implies a new before-rates volume (or initial discount threshold volume) of 659 million (713 million – 54 million), 692 million (750 million – 58 million), and 720 million (785 million – 65 million) in Years 1, 2, and 3, respectively.

Given the above information, and assuming Washington Mutual's own-price elasticity for First-Class Mail marketing letters is 0, the form of the equation is

$$Q_0 = Q_1 \left(1 - \frac{d_0}{d_d} \right)^{E_d}$$

where E_d is the price-difference elasticity, Q_0 and Q_1 are the new before-rates (659, 692, and 720 million) and previously provided after-rates (713, 750, and 785 million) volume estimates, respectively, for each year, d_0 is the before-rates average marginal price difference between First-Class Mail marketing letters and Standard Mail letters (\$0.346 - \$0.206), and d_d is the after-rates marginal price difference at the relevant negotiated discount (\$0.346 - \$0.206 - \$0.045).

The price-difference (i.e., "discount") elasticity, E_d , the only unknown, can then be "backed-out" of the equation above by solving the following:

$$\ln Q_0 = \ln Q_1 + E_d \ln \frac{d_0}{d_d}$$

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The price-difference elasticities for each year, calculated in the attachment to this response at page 2, are presented the table below.

<u>YEAR 1</u>		<u>YEAR 2</u>		<u>YEAR 3</u>	
<u>AR Volume</u>	<u>Elasticity</u>	<u>AR Volume</u>	<u>Elasticity</u>	<u>AR Volume</u>	<u>Elasticity</u>
713 Million	-0.2035	750 Million	-0.2080	785 Million	-0.2233

It should be noted that the calculations presented above are not the Panzar analysis developed in my testimony, which estimates the increase or decrease in institutional contribution at each after-rates volume. Rather, the above calculations represent a variation of the “suggested framework” developed by the Commission in PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), paras. 5001-5038. Washington Mutual’s variation is the suggested use of its after-rates volumes to estimate a new before-rates volume—representing the difference between the after-rates volume and a volume that generates discounts equal to the return cost savings—and then calculating the resulting price-difference elasticity to judge whether the new before-rates volume is reasonable or not. As stated by the Commission:

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.

PRC Op. MC2005-3 (Bookspan), para. 4089, fn 110

Year 1			Year 2			Year 3		
Threshold		Discount	Threshold		Discount	Threshold		Discount
659,000,000	674,000,000	\$ 0.035	692,000,000	707,000,000	\$ 0.035	723,000,000	738,000,000	\$ 0.035
674,000,000	689,000,000	\$ 0.040	707,000,000	722,000,000	\$ 0.040	738,000,000	753,000,000	\$ 0.040
689,000,000	713,000,000	\$ 0.045	722,000,000	750,000,000	\$ 0.045	753,000,000	785,000,000	\$ 0.045
		\$ 0.050		-	\$ 0.050		-	\$ 0.050
-		\$ 0.050	-	-	\$ 0.050	-	-	\$ 0.050
-		\$ 0.050	-	-	\$ 0.050	-	-	\$ 0.055

Calculation of Discount Volume Where Discounts Equal Return Cost Savings

Return Cost Savings	Year 1	Year 2	Year 3
[1] Cost Saving	\$ 2,200,000	\$ 2,400,000	\$ 2,700,000
Discounts Earned			
[2] First tier (\$0.035)	\$ 525,000	\$ 525,000	\$ 525,000
[3] Second tier (\$0.040)	\$ 600,000	\$ 600,000	\$ 600,000
[4] Third tier (\$0.045)	\$ 1,075,000	\$ 1,275,000	\$ 1,575,000
[5] Discounts	\$ 2,200,000	\$ 2,400,000	\$ 2,700,000
Discount Volume			
[6] First tier	15,000,000	15,000,000	15,000,000
[7] Second tier	15,000,000	15,000,000	15,000,000
[8] Third tier	23,888,889	28,333,333	35,000,000
[9] Volume	53,888,889	58,333,333	65,000,000
[10] Rounded	54,000,000	58,000,000	65,000,000

Notes and Sources:

- [1] USPS-T-1, at 31
- [2] [6] * \$0.035
- [3] [7] * \$0.040
- [4] [1] - ([2] + [3])
- [5] [2] + [3] + [4]
- [6] 674,000,000 - 659,000,000; 707,000,000 - 692,000,000; 738,000,000 - 723,000,000
- [7] 689,000,000 - 674,000,000; 722,000,000 - 707,000,000; 753,000,000 - 738,000,000
- [8] [4] / \$0.045
- [9] [6] + [7] + [8]
- [10] [9] Rounded to nearest million.

"Price-Difference" (i.e., "Discount") Elasticity

		<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>	
		<u>Log (ln)</u>		<u>Log (ln)</u>		<u>Log (ln)</u>	
[1] New WMB BR Volume	Q_o	659	6.4907236	692	6.539586	720	6.5792513
[2] WMB AR Volume	Q_1	713	6.5694815	750	6.6200733	785	6.6656838
[3] Ave Rev FCM Mkt Ltrs/pc		\$0.346		\$0.346		\$0.346	
[4] Std Rev/pc		\$0.206		\$0.206		\$0.206	
[5] BR Ave Price Difference, FCM - Std Mail	d_o	\$0.140		\$0.140		\$0.140	
[6] Discount (third tier)		\$0.045		\$0.045		\$0.045	
[7] AR Marginal Price Difference	d_1	\$0.095		\$0.095		\$0.095	
[8] Ratio BR / AR Price Difference		1.4725804	0.3870162	1.47258	0.3870162	1.47258	0.3870162
[9] Natural Log			2.7183		2.7183		2.7183
"Discount" Elasticity	E_d	-0.2035		-0.2080		-0.2233	

Sources:

- [1] "Volumes" Worksheet, Line [10]
- [2] USPS-T-1, App A, Pg 2
- [3] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
- [4] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
- [5] [3] - [4]
- [6] USPS-T-1, App A, Pg 7
- [7] [5] - [6]
- [8] [5] / [7]
- [9] Natural Log