Postal Rate Commission
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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268B0001

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| RATE AND SERVICE CHANGES TO IMPLEMENT FUNCTIONALLY EQUIVALENT NEGOTIATED SERVICE AGREEMENT WITH DISCOVER FINANCIAL SERVICES, INC. | Docket No. MC2004-4 |

RESPONSES OF THE UNITED STATES POSTAL SERVICE WITNESS AYUB TO INTERROGATORIES OF THE OFFICE OF THE CONSUMER ADVOCATE
(OCA/USPS-T1-1-9)
(July 20, 2004)

The United States Postal Service hereby provides its responses to the following interrogatories the Office of Consumer Advocate: OCA/USPS-T1-9, filed on July 9, 2004.

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

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

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July 20, 2004

OCA/USPS-T1-1. Please refer to 611.1 of Attachment A to the Request containing proposed DMCS language implementing the Discover NSA.

(a) Please confirm that Discover's eligible First-Class Mail customer correspondence may consist of letter-shaped and flat-shaped pieces. If you do not confirm, please explain.

(b) Please confirm that Discover's eligible First-Class Mail solicitations may consist of letter-shaped and flat-shaped pieces. If you do not confirm, please explain.

RESPONSE:

(a) Confirmed, although my understanding from our negotiations is that any flat-shaped customer correspondence mail Discover has is de minimis.

(b) Confirmed although my understanding from our negotiations is that all of Discover's solicitation mail is letter shaped.

OCA/USPS-T1-2. Please refer to 611.2 of Attachment A to the Request containing proposed DMCS language implementing the Discover NSA.

(a) Please explain how the 350 million-piece minimum was determined.

(b) Please explain how the $250,000 figure was determined.

RESPONSE:

(a) This figure was arrived through negotiations between Discover Financial Service (DFS) and the Postal Service.

(b) This figure was arrived through negotiations between DFS and the Postal Service. DMM G911.2.1.f provides that agreements comparable to the Capital One agreement must have a transactional penalty or minimum payment.

OCA/USPS-T1-3. Please refer to 611.33 of Attachment A to the Request containing proposed DMCS language implementing the Discover NSA. Please define the term “domestic gross active accounts” as that term is used in 611.33

RESPONSE:

The term "domestic gross active accounts" refers to all DFS customers who reside within the United States of America and have received a statement within the past year.

OCA/USPS-T1-4. Please refer to Attachment F of the Request, which contains the NSA between the Postal Service and Discover, Article II. A. Please provide citations to the “applicable Federal laws and Postal Service operating instructions” with respect to Postal Service disposal of the physical returns of Discover.

RESPONSE:

DFS' physical returns will be disposed of in the same way as all other disposed mail. Conditions that currently regulate the Postal Service disposal of Standard Mail apply to all classes of mail. The general policies are contained at section 691 et seq. of the Postal Operations Manual. Additional information on disposal methods were addressed in Presiding Officer’s Information Request Number 3 in Docket No. MC 2002-2.

OCA/USPS-T1-5. Please refer to you testimony at page 9, lines 6-9, where it states "the threshold adjustment [will serve] to mitigate the risk that exogenous factors will result in threshold levels that do not provide the appropriate incentive for marketing mail.

(a) Please identify and describe the "exogenous factors" referred to in the passage quoted above.

(b) Please explain why it is important to address or limit the effects of exogenous factors through the threshold adjustment.

RESPONSE:

(a) The term exogenous factors as related to above deals with variables that could increase or decrease the amount of statement or operational mail. Examples of these exogenous factors could be:

- Response rates were to change such that DFS had a larger statement customer base next year;

- Inactive accounts were to become active and thus begin to receive statements; and

- Greater emphasis of cross-sell of products increases the number of customers receiving statements.

The list of exogenous factors that could increase or decrease statement/operation mail is endless but as described in part (b) the Postal Service believes the threshold adjustment mechanism addresses these variables.

(b) The threshold adjustment factor is intended to ensure that any increases or decreases in statement or operational mail alone do not provide the volumes necessary for DFS to obtain the price incentives. If, for example, DFS' customer base were to increase by 2 million users in one year, that in basic terms could mean an increase of

24 million statements. While the statement volume alone could not reach the thresholds it could mean the difference between the DFS receiving a 4 cent or 4.5 cent discount.

OCA/USPS-T1-6. Please refer to you testimony at page 10, lines 4-5, which states "it is unlikely the Postal Service's exposure from misestimation could exceed the expected ACS savings from the Discover NSA."

(a) Please identify and describe all types of "misestimation" referred to in passage quoted above.

(b) On what basis do you make the claim in the passage quoted above? Please provide any documentation supporting the basis for your claim.

RESPONSE:

(a) The term "misestimation" as referred to in my testimony at page 10, lines 4-5 deals with the concept that even if any of the variables used by Discover to develop their volume forecast were to change, the Postal Service has identified the range of outcomes for those possibilities.

(b) The basis for my statement above is that valuing the NSA at different levels of marketing mail volume (the more volatile component of the forecast), and holding all other variables constant, results in the Postal Service having exposure (leakage) only in extreme cases. Please see the table that follows:

| % Change in Marketing Volume | USPS Value (millions) |
|---|---|
| -20% | $6.1 |
| -10% | $5.8 |
| 10% | $4.6 |
| 20% | $3.8 |
| 30% | $2.9 |
| 50% | $0.6 |
| 75% | ($2.6) |

OCA/USPS-T1-7. Please refer to you testimony at page 6, lines 13-18, and Tables 1, 2 and 3, below showing the incremental volume blocks for Capital One, Bank One, and Discover, respectively.

In Table 1, relating to Capital One, the "% Change" column shows a decline from 4.1% to 3.9% to 3.8 % in the first three incremental volume blocks. The decline repeats itself in the next three volume blocks, although starting at a higher level, 5.5% to 5.2% to 4.9%. A similar pattern is exhibited in Table 2 relating to Bank One. In the case of Discover, however, the decline is monotonic, as shown in the "% Change" column in Table 3. Please explain the rationale for having larger volume blocks associated with lower discounts and vice versa.

TABLE 1
Incremental Volume Blocks - Capital One NSA

| Volume Range | | Change | % Change | Discount |
|---|---|---|---|---|
| 1,225,000,000 | 1,275,000,000 | 50,000,000 | 4.1% | $0.030 |
| 1,275,000,001 | 1,325,000,000 | 49,999,999 | 3.9% | $0.035 |
| 1,325,000,001 | 1,375,000,000 | 49,999,999 | 3.8% | $0.040 |
| 1,375,000,001 | 1,450,000,000 | 74,999,999 | 5.5% | $0.045 |
| 1,450,000,001 | 1,525,000,000 | 74,999,999 | 5.2% | $0.050 |
| 1,525,000,001 | 1,600,000,000 | 74,999,999 | 4.9% | $0.055 |
| 1,600,000,001 | above | | | $0.060 |

Source: Docket No. MC2002-2, Request of the United States. Postal Service for a Recommended Decision on Experimental Changes to Implement Capital One NSA, Attachment B, Rate Schedule 610A.

TABLE 2
Incremental Volume Blocks - Bank One NSA

| Volume Range | | Change | % Change | Discount |
|---|---|---|---|---|
| 535,000,000 | 560,000,000 | 25,000,000 | 4.7% | $0.025 |
| 560,000,001 | 585,000,000 | 24,999,999 | 4.5% | $0.030 |
| 585,000,001 | 610,000,000 | 24,999,999 | 4.3% | $0.035 |
| 610,000,001 | 645,000,000 | 34,999,999 | 5.7% | $0.040 |
| 645,000,001 | 680,000,000 | 34,999,999 | 5.4% | $0.045 |
| 680,000,001 | above | | | $0.050 |

Source: Docket No. MC2004-3, Request of the United States. Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement a Functionally Equivalent Negotiated Service Agreement with Bank One Corporation, Attachment B, Rate Schedule 612A.

TABLE 3
Incremental Volume Blocks - Discover NSA

| Volume Range | | Change | % Change | Discount |
|---|---|---|---|---|
| 405,000,000 | 435,000,000 | 30,000,000 | 7.4% | $0.025 |
| 435,000,001 | 465,000,000 | 29,999,999 | 6.9% | $0.030 |
| 465,000,001 | 490,000,000 | 24,999,999 | 5.4% | $0.035 |
| 490,000,001 | 515,000,000 | 24,999,999 | 5.1% | $0.040 |
| 515,000,001 | above | | | $0.045 |

Source: Docket No. MC2004-4, Request of the United States. Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement a Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Attachment B, Rate Schedule 611A.

RESPONSE:

The incremental volume blocks and the corresponding price incentives were negotiated by DFS and the Postal Service. These different incremental blocks, among the agreements, reflect the fact that each mailer has unique decision and mailing characteristics, and the structure agreed upon by DFS satisfies their needs.

OCA/USPS-T1-8. Please refer to your testimony at page 8, lines 11-12, and the Commission's opinion in Docket No. MC2002-2, at pages 68-70.

(a) Please confirm that the Postal Service developed an analysis of the type described by the Commission with respect to Discover's future demand for First-Class solicitation mail. If so, please provide the analysis. If not please explain.

(b) Please explain how each incremental volume block relates to Discover's future demand for First-Class solicitation mail so as to provide an incentive to increase the incremental volume of solicitation mail.

RESPONSE:

a) The Postal Service did not fit a demand curve for Discover as illustrated in the Commission's opinion in Docket No. MC2002-2, at pages 68-70. As I noted in my testimony, I relied on the analysis of Postal Service witness Eakin (USPS-RT-2) from MC2002-2

b) Witness Giffney's testimony (DFS-T-1) describes the overall effect of the agreement on Discover's demand.

OCA/USPS-T1-9. Please refer to your testimony at page 8, lines 11-12, and the Commission's opinion in Docket No. MC2002-2, at pages 71-73.

(a) Please confirm that the Postal Service has developed an analysis of the type described in the Commission's opinion with respect to Discover. If you do confirm, please provide the analysis. If you do not confirm, please explain.

(b) Please explain how, in the absence of an analysis referred to in part (a) above, the Postal Service has avoided the "design defects" described in the Commission's opinion with respect to the declining block rates applicable to Discover under the NSA.

RESPONSE:

a) Not confirmed. The analysis was not done, in part, because NSA rules do not require this type of analysis. More importantly, the analysis from the Commission's opinion in Docket No. MC2002-2, at pages 71-73, relates to an NSA that is comprised solely of declining block rates, as it does not account for the ACS savings. The Commission's rules, however, appropriately focus the financial analysis on the financial impact of the NSA, which would necessarily require an analysis of the total impact, not just the impact of two components (leakage and new contribution.)

b) The "design defects" described in the Commission's opinion appear to consider declining block rates absent other considerations. As I have explained on pages 10-11 of my testimony, the ACS cost savings provisions should generate a considerable net benefit to the Postal Service. The economic effect of the NSA cannot be meaningfully analyzed without considering this benefit. As the Discover NSA also produces net contribution gains from ACS savings it has a different design, and therefore would not be subject to the same defects. In Appendix A of my testimony, I

show that, based on the volume threshold, Discover's volume projections and estimated cost savings, even with "leakage" the net contribution received by the USPS increases.

## CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

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