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POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268–0001

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

INITIAL BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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In accordance with Presiding Officer's Ruling No. MC2004-4/3 (August 25, 2004), the United States Postal Service hereby submits its brief in support of its request for a recommended decision in the instant docket.

I. Procedural History

On June 21, 2004, the United States Postal Service filed with the Postal Rate Commission (“Commission”) the Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees To Implement Functionally Equivalent Negotiated Service Agreement With Discover Financial Services, Inc. (“Request”). The Request was filed in accordance with 39 U.S.C. §§ 3622 and 3623.

The Postal Service requested that the Commission issue a recommended decision to the Governors of the Postal Service regarding proposed new language in the Domestic Mail Classification ("DMCS") and Rate Schedule to implement the terms of a Negotiated Service Agreement ("NSA") that the Postal Service signed with Discover Financial Services, Inc. ("DFS" or "Discover"). The Postal Service pointed out that this new NSA shared material terms and conditions with the baseline NSA with Capital One Services, Inc. (Capital One), recommended by the Commission in Docket No. MC2002-2.[1] The Postal Service requested the Commission to find the Discover NSA to be "functionally equivalent" to the "baseline" Capital One NSA under its recently promulgated rules. *See* PRC Order No. 1391 (February 11, 2004)); Rule 196, 39 C.F.R. § 3001.196.

[1] Pursuant to Postal Service Board of Governors Resolution No. 03-8, the rates, fees, and classifications recommended by the Commission in Docket No. MC2002-2 were formally implemented on September 5, 2003.

The Postal Service supported its Request with the written direct testimony of witness Ali Ayub (USPS-T-1) and other documents, including exhibits, submitted pursuant to the Commission's Rules of Practice and Procedure, especially 39 C.F.R. §§ 193 and 196. Also on June 21, 2004, DFS, as a co-proponent, filed a notice of appearance, along with the written direct testimony of witness Karin Giffney (DFS-T-1).

Noting that the rules for consideration of functionally equivalent NSAs provide opportunities for limitation of issues, and comparatively rapid resolution, compatible with participants' sufficient exercise of their due process rights, the Postal Service filed a Proposal for Limitation of Issues that outlined its expectations regarding the issues presented by its Request. *See* United States Postal Service Proposal for Limitation of Issues. The Postal Service also requested establishment of settlement procedures. *See* Request of United States Postal Service for Establishment of Settlement Procedures. DFS supported both of these proposals. *See* Statement of Support of Discover Financial Services, Inc. (DFS) for the Postal Service's Request to Establish Settlement Procedures and the Postal Service's Proposal for Limitation of Issues. In addition, the Postal Service filed a listing of testimony from Docket No. MC2002-2 on which it intended to rely in this case. *See* Compliance Statement, Attachment E.

By Order No. 1410, issued on June 24, 2004, the Commission noticed the Postal Service's Request and designated the instant proceeding as Docket No. MC2004-4. The Commission gave interested parties until July 12, 2004, to intervene in the proceeding, requesting that notices of intervention indicate whether the participant was seeking a hearing. The Commission designated Shelley S. Dreifuss, the Director of its Office of the Consumer Advocate ("OCA"), to represent the general public. The

Order also named Postal Service counsel as settlement coordinator, and set July 14, 2004 as a date for the first settlement conference, and July 15, 2004 as the date for the prehearing conference.

Twelve parties have participated in this proceeding as intervenors -- Alliance of Nonprofit Mailers ("ANM"), American Bankers Association ("ABA"), American Postal Workers Union, AFL-CIO ("APWU"), J.P. Morgan Chase and Co. ("J.P. Morgan Chase"), Magazine Publishers of America ("MPA"), National Association of Postmasters of the United States ("NAPUS"), National Newspaper Association ("NNA"), Newspaper Association of America ("NAA"), Parcel Shippers Association ("PSA") , David B. Popkin ("Popkin"), and Valpak Dealers' Association, Inc. ("VPDA") and Valpak Direct Marketing Systems, Inc. ("VPDMS") (collectively "Valpak").

On July 20, 2004, the Commission issued Presiding Officer's Ruling No. MC2004-4/1, determining that this case would proceed under Rule 196 for functionally equivalent NSAs. On August 11, 2004, the Commission issued Presiding Officer's Ruling No. MC2004/2, addressing the proposal for limitation of issues. The Commission concluded that it would consider issues that were identified by OCA[2] and

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[2] Specifically, the Commission listed, as potential issues identified by OCA, the fact that the Discover NSA grants discounts to volume that would have been mailed even in the absence of discounts; differences concerning Capital One's and DFS's ownership of mailing lists and ability to update such lists; the fact that Discover's mail currently is not incurring physical return costs; and the issue of whether new costs incurred by moving DFS's mail from Standard Mail to First-Class Mail, such as new forwarding costs, outweigh the estimated additional contribution. Presiding Officer's Ruling No. MC2004/2 (August 11, 2004) at 3. OCA has stated that it will perform a financial analysis of the Discover NSA and, in its initial brief, "state its position on the Discover NSA." Office of the Consumer Advocate Statement Concerning the Need for a Hearing (August 17, 2004) at 1-2. Moreover, the identified issues have been discussed in informal meetings involving counsel for the Postal Service, Discover and OCA.

Valpak[3] concerning the impact of similarities and differences between Capital One and its mail, and Discover and its mail, insofar as those differences relate to the financial aspects of the underlying Request in this docket, as well as issues concerning the calculation of a cap on discounts available under the NSA. Id. at 5.

The Commission also concluded that that it would allow Valpak to discuss two other issues which it has requested to address on brief -- "consideration of a niche classification" and a "system-wide fix to the UAA pricing problem" -- but stated that such discussions would not form the basis of the Commission's recommended decision on this NSA. Presiding Officer's Ruling No. MC2004/2 (August 11, 2004) at 5-6.[4]

Accordingly, the Postal Service intends to wait until OCA has had the opportunity to perform its analysis and state its position before addressing these specific issues.

[3] As possible issues identified by Valpak, the Commission listed the calculations of costs of electronic Undeliverable as Addressed (UAA) mail for new First-Class Mail volumes; the treatment of the cost of free forwarding and free ACS; the possibility of a reduction in contribution due to migration of mail from Standard Mail to First-Class Mail; the value of obtaining UAA electronic information for DFS because DFS uses rented lists whereas Capital One maintains its own lists; the fact that the Capital One NSA was expected to result in new First-Class Mail volume, while the Discover NSA is expected to involve migration of Standard Mail to First-Class Mail, resulting in concerns relating to before and after rates of contribution; and whether the negotiated competitive cap satisfies the principals in Docket No. MC2002-2. Presiding Officer's Ruling No. MC2004/2 (August 11, 2004) at 3-4. As is the case with OCA's potential issues, these issues have been informally discussed by counsel for the Postal Service, Discover and Valpak, and the Postal Service intends to await Valpak's brief before addressing these specific issues in depth, with the exception of the cap issue.

[4] The Postal Service sees no need to discuss these issues in this docket, which concerns a functionally equivalent NSA, and agrees with the Commission's conclusion that such discussions will not form the basis for a recommended decision. The Postal Service will not discuss these issues in this brief, and is disinclined to address them in its reply brief. Nonetheless, the Postal Service will make a decision about whether to discuss these issues in is reply brief, after it has had the opportunity to read Valpak's brief.

During the course of this proceeding, the participants have engaged in settlement conferences, as well as informal discussions. *See* Notice of United States Postal Service's Intention to Conduct Settlement Conference (July 6, 2004); Notice of United States Postal Service's Intention to Conduct Settlement Conference (July 20, 2004); Reports of Settlement Coordinator (July 22, 2004) (August 5, 2004) (August 19, 2004) (September 2, 2004).

While these discussions have not resulted in a settlement agreement, they have been fruitful in helping the participants narrow the focus of issues they wish to present to the Commission in this docket. They have also facilitated a situation where no participant desires a hearing, and the participants believe that the existing record will enable them to present their issues to the Commission on briefs. *See* Office of the Consumer Advocate Statement Concerning the Need for a Hearing (August 17, 2004); Valpak Direct Marketing Systems, Inc and Valpak Dealers' Association, Inc. Withdrawal of Protective Request for Hearing (August 20, 2004).

OCA and Valpak conducted discovery on both co-proponents. In addition, both co-proponents responded to Presiding Officer's Information Requests. As required by Presiding Officer's Ruling No. MC2004-4/3 (August 25, 2004), participants have designated direct testimonies and written cross-examination, which have been supported by appropriate declarations for inclusion in the evidentiary record.[5] This Order also set today as the deadline for filing briefs.

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[5] Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Designation of Written Cross-Examination (August 31, 2004); Office of the Consumer Advocate Designation of Interrogatory Responses (September 1, 2004); American Postal Workers' Union, AFL-CIO, Designation of Written Cross-Examination of USPS Witness Ali Ayub (USPS-T-1) (September 1, 2004); American Postal Workers Union,

The Postal Service appreciates the efficient manner in which this docket has been handled. In order for Negotiated Service Agreements to reach their full potential as innovative mechanisms for postal ratemaking to meet the needs of individual diverse mailers, functionally equivalent cases will need to be handled expeditiously. The cost of litigation is a major upfront expense for any mailer signing an NSA with the Postal Service, especially a smaller mailer. The precedents set in this docket will have a strong effect on mailers who seek to negotiate NSAs with the Postal Service in the future.

II. The Commission Should Recommend the DMCS and Rate Schedule Language Implementing The NSA Between the Postal Service and DFS.

A. The Discover NSA Is Functionally Equivalent to the Capital One NSA.

The Discover NSA is functionally equivalent to the current Capital One NSA. The Commission pointed out in Docket No. RM2003-5, Order 1391 at 50, that the analysis that determines whether an NSA is functionally equivalent to a baseline NSA involves a comparison of the literal terms and conditions of the NSAs, and a comparison of the effect that each NSA has on the Postal Service.

AFL-CIO, Designation of Written Cross-Examination of Discover Financial Services Witness Karin Giffney (September 1, 2004); Office of the Consumer Advocate Supplemental Designation of Interrogatory Responses of Ali Ayub (September 3, 2004); Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Supplemental Designation of Written Cross-Examination (September 7, 2004); United States Postal Service Motion for Inclusion of Direct Testimony, Designated Written Cross-Examination, and Responses to POIRs Into the Record (September 1, 2004); Motion of Discover Financial Services, Inc. (DFS) to Enter Testimony, Designated Written Cross-Examination, and POIR Responses and Answers Into the Record (September 3, 2004); Notice of the United States Postal Service Regarding Filing of Original Declarations of Authenticity of Witness Ali Ayub (September 3, 2004).

The comparison of literal terms and conditions focuses on whether each agreement rests on the same substantive functional elements. Docket No. RM2003-5, Order 1391 at 50. As explained in the testimony of Postal Service witness Ayub (USPS-T-1) at 6-7, the Discover NSA is based on the same two key substantive functional elements that are central to the Capital One NSA and recommended changes -- an address correction element and a declining block element.

As to the first element, if the DMCS is amended as proposed, the Postal Service would provide to Discover, at certain levels of volume, electronic address corrections without fee for solicitations sent by First-Class Mail that are undeliverable-as-addressed and cannot be forwarded under existing regulations. *See* Request, Attachment F (Discover NSA) at ¶¶ I.B and II.B-E. In return, Discover would agree to forgo requiring the Postal Service to return such undeliverable mail, under the existing service features of First-Class Mail. Id. at ¶ II.A. The Postal Service estimates that this feature of the NSA will result in $8.2 million in savings, over the life of the NSA, because of the address correction feature. Ayub Testimony (USPS-T-1) at 12.

As to the second element, if the foregoing conditions are met, to encourage increased First-Class Mail volume, Discover would be eligible for per-piece discounts on those portions of its First-Class Mail solicitation volume that exceed specified volume thresholds. Attachment F at ¶¶ III.A and C. The discounts, set forth below, are applied only to incremental volume above the negotiated threshold. In other words, no discount would be applied to the first 405 million pieces; a discount of 2.5 cents would be applied to the next 30 million pieces, etc.:

Volume Block	Incremental Discounts
405,000,001 – 435,000,000	2.5¢
435,000,001 – 465,000,000	3.0¢
465,000,001 – 490,000,000	3.5¢
490,000,001 – 515,000,000	4.0¢
515,000,001 – above	4.5¢

Considering these discounts, and the testimony of witness Giffney (DFS-T-1) regarding the volume response of Discover to the proposed discount structure, the Postal Service expects Discover's use of First-Class Mail to increase, resulting in additional net contribution to the Postal Service. The Postal Service estimates it will receive $2.1 million in increased contribution, over the life of the NSA, due to increased First-Class Mail volume, as well as a net exposure (leakage) of minus $3.2 million due to the discount feature of the agreement. Ayub Testimony (USPS-T-1) at 12. In all, the NSA is expected to result in 52 million new pieces of First-Class Mail, at a time when Discover's volume of First-Class Mail is declining. Giffney Testimony (DFS-T-1) at 8-9.

The Discover NSA also has a comparable effect on the Postal Service, including the provision of real ACS savings. Ayub Testimony (USPS-T-1) at 7. Specifically, the NSA would benefit it $7.1 million over the life of the agreement, based on the estimates described in the previous paragraphs. The ACS cost savings that will result from the Discover NSA are significant, since over nine percent of its marketing First-Class Mail volume is currently physically returned. *See* Giffney Testimony (DFS-T-1) at 9. Also, as in Capital One, the Discover NSA will generate contribution from new First-Class Mail volume. Ayub Testimony (USPS-T-1) at 7, Appendix A at 1, 10, 11.

The Discover NSA incorporates other terms and conditions found in the Capital One NSA. The agreement waives the seal against postal inspection of mail; requires Discover to prepare mail under applicable standards and to enhance its address management practices; includes a transaction penalty; and contains a provision for Discover to make necessary records and data available to the Postal Service to facilitate and monitor compliance. It also enables the Postal Service to cancel for failure by the mailer to provide accurate data, to present properly prepared and paid mailings, to comply with a material term of the NSA, or to use the NSA. *See* Request, Attachment F.

The Request's Compliance Statement (Attachment E) contains a part-by-part analysis of differences between the functionally equivalent Discover NSA and the baseline Capital One NSA. These differences do not, in any way, detract from the functional equivalency of the two NSAs. To the contrary, the Commission and the Postal Service anticipated that there would be differences between baseline and functionally equivalent agreements, even if they shared the same terms and conditions. Functionally equivalent agreements would likely include provisions that recognize the unique mailing characteristics of each company, because of the differences in how individual companies conduct business, solicit customers, and make business decisions. *See* PRC Op., MC2002-2, at 31-40, 136-42. *See also* DMCS § 610.12; DMM G911.

To be comparable to the Capital One NSA, an agreement need not contain identical terms, such as the level of First-Class Mail volume. PRC Op., MC2002-2, at 141. A review of the Attachment E to the request reveals that while there are differences in wording between the Discover NSA and the Capital One NSA, the differences fall well within the parameters of DMM G911.

Two customer-specific terms and conditions, not found in the Capital One NSA, merit special mention: an annual adjustment mechanism to the threshold and a negotiated cap. As explained below, neither term alters the functionally equivalent status of the Discover NSA.

The first new customer-specific term is the annual threshold adjustment. In general, NSAs patterned after Capital One are intended to increase First-Class Mail marketing volumes, among other objectives. However, statement volume growth could have the unintended consequence of diminishing the incentives for new marketing mail volume. The annual threshold adjustment protects against this contingency, and also mitigates against greater discount exposure (leakage), by adjusting the thresholds in the years following the first year of the agreement (the out-years) by the percentage change in the number of credit card accounts. For example, under the Discover mechanism, if the number of accounts were currently at an annual volume level of 10 million pieces, and were to increase to 12 million pieces, there would be a 20 percent adjustment to the volume threshold. In other words, the logical correlation between accounts and statement volume will allow the Postal Service to use the threshold adjustment to mitigate the risk that exogenous factors will result in threshold levels that do not provide the appropriate incentive for marketing mail. Ayub Testimony (USPS-T-1) at 9.

The second new customer-specific term is a negotiated cap. The Discover NSA stipulates a discount cap of $13 million over the life of the NSA. This cap is the maximum amount of discounts that the Postal Service will give over the three year agreement. Assuming the discount is spread evenly over the life of the agreement, Discover would have to mail over 532 million pieces per year to reach the $4.33 million cap per year (*i.e.,* $13 million divided by 3), which would represent an 18 percent increase in First-Class Mail volume from its Year 1 Before Rates (Y1BR) forecast of 451 million pieces. In fact, DFS's Before Rates First-Class Mail marketing volume, the only type of First-Class Mail over which DFS appears to have significant discretion, would have to increase by over 75% before the resulting "leakage" from the NSA's rate discounts outweigh the cost savings. *See* Response to OCA/USPS-T1-22.

Discover Witness Giffney describes the DFS rationale for proposing the cap, and how it was developed based upon the respective First-Class Mail volumes of Capital One and Discover. Giffney Testimony (DFS-T-1) at 12-13. This cap will give Discover the ability to enjoy a proportional benefit to the one enjoyed by Capital One. Id. at 13. The Postal Service evaluated the cap proposed by Discover, and found it acceptable. Ayub Testimony (USPS-T-1) at 9. A competitive cap, rather than a stop-loss cap, gives Discover access to discounts on the same relative basis as its competitor, Capital One. It fosters competition, whereas a stop-loss cap could be viewed as restricting competition.

It is worth noting that Discover is a direct competitor of Capital One, and, in pertinent respects, is similarly situated. *See* Giffney Testimony (DFS-T-1) at 2, 12-13;

See also Order 1391 at 52.[6] Accordingly, it is appropriate that Discover should have an opportunity to participate in a functionally equivalent NSA.

B. The Discover NSA Will Have a Positive Economic Effect on the Postal Service.

The overall cost, volume, and revenue effects of the proposed Discover NSA are relatively modest, both in the first year of the agreement, as well as later years. The changes would apply to only one, discretely-positioned mailer. The duration of the rates, fees and classifications would be limited to three years by the terms of the NSA. The changes would apply to the rates, fees and classifications for Address Correction Service and First-Class Mail. No other mail classes or special services would be affected.

The impacts of this proposal are described fully in the testimony of Postal Service witness Ali Ayub (USPS-T-1) at 10-14, Appendices A and B. The Postal Service estimates it will benefit by $7.1 million over the life of the NSA -- $8.2 million in ACS Cost Savings plus $2.1 million in increased contribution, minus $3.2 million in discount exposure (referred to in the Capital One proceedings as leakage).[7] Discover has conservatively estimated that 100 percent of incremental volume would be converted from Standard Mail. Giffney Testimony (DFS-T-1) at 9. Both the Postal Service and DFS believe that the incremental volumes will exceed the forecast. Id.; Ayub Testimony (USPS-T-1) at 11.

Witness Ayub also estimated that the Discover NSA will have minimal impact on Discover's competitors, the Postal Service's competitors, and on mail users. Ayub

[6] The Postal Service reviewed the testimony of Discover witness Karin Giffney and, in accordance with Rule 192 (b), 38 C.F.R. § 3001.192(b), stated that such testimony may be relied upon in presentation of the Postal Service’s direct case. See Direct Testimony Of Ali Ayub On Behalf Of United States Postal Service (USPS-T-1) at 1-2.

[7] Witness Ayub referred to this amount as "discount exposure" in his testimony. Ayub Testimony (USPS-T-1) at 9, 10.

Testimony (USPS-T-1) at 14-15. In providing his analysis of the competitive impact, witness Ayub relied upon the extensive evidence in the Capital One case.[8]

In its Opinion and Recommended Decision in the Capital One case, Docket No. MC2002-2, the Commission determined that the Capital One NSA's effect on competition was a minor concern, particularly since no participant alleged that the Capital One NSA would cause competitive harm. PRC Op., MC2002-2, at 79, 159. The Postal Service considers that the competitive impact of extending the same terms and conditions to Discover, a competitor of Capital One, should garner a similar level of concern. The converse is not true, however. Failure to permit Discover, a similarly situated competitor, access to the functionally equivalent NSA could give rise to allegations of unreasonable discrimination contrary to the Postal Reorganization Act. *See* PRC Order 1391, Docket No. RM2003-5, at 52.

The NSA between the Postal Service and DFS provides a foundation for the changes to the DMCS and Rate Schedule, and those changes should be read in concert with the terms of the NSA. Among other provisions, the Discover NSA specifies: (1) the key conditions making the NSA possible; (2) obligations undertaken by Discover to ensure reduction of postal costs associated with handling of returned and forwarded mail; (3) volume thresholds pertaining to mail qualifying under the NSA for additional discounts; (4) information concerning other issues, such as monitoring, compliance, regulatory review, implementation, withdrawal, and cancellation; and (5) conditions affecting public communications, amendments, and notices.

[8] Particularly, Docket No. MC2002-2, Tr. 8/1571-1789 and Tr. 10/2060 to 2141.

The proposed data collection plan (USPS-T-1, Appendix C) will provide the same types of data as the data collection plan approved in the Capital One case, Docket No. MC2002-2.

The proposed classifications will further the general policies of efficient postal operations and reasonable rates and fees enunciated in the Postal Reorganization Act. *See* 39 U.S.C. §§ 101(a), 403(a), and 403(b). The requested changes also conform to the criteria of 39 U.S.C. §§ 3622(b) and 3623(c).

C. The Commission Should Not Impose So-Called "Stop-loss" Caps on Negotiated Service Agreements.

In Docket No. MC2002-2, the Commission instituted, on its own initiative, a so-called "stop-loss" cap because of the variability in the volume history of Capital One. Specifically, it found that Capital One's estimates of Before Rates volume were "so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA." PRC Op. MC2002, ¶ 8013. It cited Capital One's history of rapidly increasing First-Class Mail volume. Id. at ¶ 8014. It also found that "[a]bsolutely no evidence suggests that the volume projected for the current year will be representative of experience in each of the following three years when the NSA would be in effect." Id. at ¶ 8015. The concern over "discount leakage" exceeding cost savings influenced the decision to limit the total value of discounts Capital One could earn. *See* PRC Op., MC2002-2, ¶¶ 8013, 8019, 8024-26.

In their decision the Governors, however, determined that this cap was unnecessary, and pointed out that it represented a potentially significant restructuring of the economics of the agreement between the parties. Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal

Rate Commission Recommending Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One, Docket No. MC2002–2 (June 2, 2003) ("Governors' Decision") at 3 n.3, 17, 18. Finding that the impact of the cap, as applied to the Capital One Agreement, was likely to be minimal, however, the Governors decided to accept the recommendation, with the cap, despite their preference for an NSA without a cap. Governor's Decision at 3 n.3, 20.

As witness Ayub explains in this docket, USPS-T-1 at 14-15, a cap based on either cost savings or exposure (leakage) unnecessarily hinders the ultimate objective of utilizing NSAs as a tool to increase net contribution. Basing a "stop-loss provision" on cost savings tends to limit participation in the NSA process to only large volume mailers who can offer significant cost savings opportunities. This would place customers who do not impose added costs on the Postal Service at a disadvantage.

Specifically, a stop-loss provision based on the Capital One model and passing through 95 percent of the cost savings (PRC Op., MC2002-2 at 156) would foreclose the potential contribution from increased volume. A smaller First-Class mailer, such as DFS, often has potential cost savings that are not nearly as large as the potential cost savings for a larger First-Class mailer, like Capital One.

Moreover, a stop-loss cap merely operates to have the Postal Service share cost savings with a mailer. It fails to acknowledge any contribution from new volume induced by a price reduction, and thus inhibits the potential for such contribution. If NSAs are to have a future as a means to "improve [the Postal Service's] profitability by developing innovative rate designs to meet the needs of diverse individual customers," (PRC Op.

MC2002-2 at 1), then they cannot be limited to agreements that merely have the Postal Service sharing cost savings with a mailer.

Of course, there may be risks to pricing to induce volumes, the main risk stemming from the forecasts upon which the assumptions are based. While cost savings can mitigate any risks that may stem from the variability of a forecast, it is false security to allow cost savings to define the parameters of the risk. The risk that increased contribution will be stifled is very real.

Accordingly, a stop-loss could cause much harm because it would limit the upside potential not only of this NSA, but of future NSAs. It could risk the loss of important opportunities, in the event that contribution which otherwise would have accrued to the Postal Service from the creation of additional First-Class Mail volume does not materialize because of the cap. *See* Governors' Decision at 18, n. 19. In this regard, it is noteworthy that the Commission has affirmed that NSAs ought to result in a net increase in contribution, such that they benefit all users of the Postal Service. Imposition of a stop-loss cap in this instance would work against this aim by arbitrarily limiting such benefits. Thus, caps of this type may merely reduce potential opportunities to gain additional revenues. Ayub Testimony (USPS-T-1) at 10.

D. There Is No Basis In The Instant Record For a Stop-loss Cap.

In their decision in Docket No. MC2002-2, the Governors, in addressing the Commission's rationale for recommending a stop-loss cap on the Capital One NSA, pointed out that "[b]y the same token, however, we expect that if similar NSA proposals were negotiated in the future with mailers presenting less volatile historical mailing patterns, the Commission might view the corresponding need for a cap to be very much less compelling." Governors' Decision at 18, n. 18.

This is such a case. The concerns underlying the cap in Docket No. MC2002-2 are completely absent here. The Postal Service and Discover have provided more data than were provided in Docket No. MC2002-2, in compliance with Rule 193(e)(2). In witness Giffney's testimony, Discover has provided both Before Rates and After Rates mail volume forecasts in Years 1, 2 and 3 of the agreement. Giffney Testimony (DFS-T-1) at 8. Thus, the co-proponents have presented a fully representative estimate of the cost and volume effects of the NSA in all three years of the agreement. *See* Ayub Testimony (USPS-T-1) at Appendix, pp. 2-3. As compared to the Capital One case, there is no evidence to suggest that the Before Rates forecasts are not representative of the three years during which the NSA would be in effect.

Discover's volume history and projections do not justify the imposition of a cap under the reasoning employed by the Commission in Docket No. MC2002-2.[9] Preliminarily, Discover's volume projections are uncontested in the record. *See* Giffney Testimony (DFS-T-1) at 8-9. Moreover, the record demonstrates that Discover has a stable volume history, and that its forecasts are in line with that history. Giffney Testimony (DFS-T-1) at 8-9, Appendix I. Indeed, Discover has a history of declining First-Class Mail volume, and the NSA is expected to help to reverse this trend. Ayub Testimony (USPS-T-1) at 5. Any fears that DFS would have significantly increased mail volumes, absent the NSA, should be mitigated in the current environment of declining

[9] Moreover, the Commission's methodology for calculating the stop-loss cap in Docket No. MC2002-2 was flawed. As witness Ayub explains, it unreasonably assumed that the percentage of solicitation mail versus total mail could remain constant at higher volume levels. *See* Response to OCA/USPS-T1-35(a). Furthermore, the stop-loss cap was set without regard for contribution from new volume.

First-Class Mail volumes, and business conditions related specifically to credit card issuers. Giffney Testimony (DFS-T-1) at 6.

To be conservative, Discover has estimated that 100 percent of incremental volume would be converted from Standard Mail. (DFS-T-1 at 9). Both the Postal Service and DFS believe that the incremental volumes will exceed the forecast. Id. Ayub Testimony (USPS-T-1) at 11. In addition, the threshold adjustment mechanism will ensure that discounts are tied to marketing mail, as opposed to operations mail.

Thus, the evidence of record indicates that the Discover's estimates of Before Rates Volumes are reasonable, and there is no record support for a conclusion that, absent the NSA, actual volumes would exceed these forecasts. It is highly unlikely that the Postal Service's exposure from misestimation could exceed the expected ACS savings from the Discover NSA. Therefore, imposition of a stop-loss cap, in the context of the Discover NSA, would do nothing to mitigate this specific form of risk. Ayub Testimony (USPS-T-1) at 10.

Because the concerns that led the Commission to recommend a "stop-loss" cap in the Capital One case are completely inapplicable here, there is no basis for imposing one.

E. The Commission Should Recommend the Competitive Cap Negotiated By the Parties.

The parties have negotiated a "competitive cap" limiting the discounts Discover receives to $13 million. This figure is based on the fact that DFS's forecasted First-Class Mail volume (451 million) is equal to 32% of Capital One's initial forecast (1.41

billion), and therefore the negotiated cap is a similar percentage of the $40.637 million cap in Docket No. MC2002-2. Giffney Testimony (DFS-T-1) at 13.[10]

The Postal Service will come out ahead if Discover receives all of these discounts. To reach the cap of $13 million, and assuming it is equally distributed over 3 years (i.e., a yearly cap of $4.3 million), DFS would have to mail 532,962,956 pieces per year. This would be 82 million pieces more than their Before Rates Forecast and 69 millions above their After Rates forecast (*see* Response to OCA/USPS-T1-35). The variance required to reach the cap is higher than any previous change in any of Discover's marketing or operational mail volumes. Moreover, if the figure of 532,962,956 pieces were plugged into the model in Appendix A of witness Ayub's testimony (USPS-T-1), based on DFS's Before Rates forecast of 451,000,000, the value of the NSA to the Postal Service would grow from $2.5 million to $3.7 million in year one.

Accordingly, when asked in a POIR, the Postal Service stated that it viewed the negotiated "competitive cap" as a "satisfactorily equivalent substitute" for the "stop-loss" provision in Cap One. (Answer to POIR 1, Q5). In contrast, a stop-loss cap could be viewed as putting Discover at a competitive disadvantage to Capital One, and unnecessarily so because, as noted above, the Postal Service estimates that the value of the NSA will grow if Discover reaches the negotiated cap. While the Postal Service accepts the logic of this competitive cap as promoting the goals of NSAs, it continues to believe that caps for any purpose will not necessarily benefit either the customer or the Postal Service.

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[10] This is yet another conservative assumption in this case. Had Discover used Capital One's revised forecast of 1.21 billion, the competitive cap would have been a higher figure.

The Commission should approve of the competitive cap. It is the result of arms-length negotiations between the co-proponents in this docket. It will allow Discover to benefit from discounts in a manner proportional to the discounts that Capital One can receive under the baseline NSA. Given the stability in Discover's volume history, there is no reason to believe that this NSA can result in a loss to the Postal Service or harm to any other mailers.

III. Conclusion

WHEREFORE, the Postal Service requests that the Commission submit a recommended decision in accordance with its Request.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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September 8, 2004

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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