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Before the
POSTAL RATE COMMISSION
WASHINGTON, DC 20268

Rate and Service Changes to Implement	)	
Functionally Equivalent Negotiated Service	)	Docket No. MC2004-4
With Discover Financial Services, Inc.	)	

INITIAL BRIEF OF THE OFFICE OF THE CONSUMER ADVOCATE

September 8, 2004

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Table of Contents

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The Office of the Consumer Advocate ("OCA"), pursuant to Rule 34 of the Rules of Practice and Procedure of the Postal Rate Commission ("Commission"), 39 C.F.R. §3001.34, and pursuant to Ruling No. MC2004-4/3[1], hereby submits its Initial Brief on the Request for Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Inc. ("Discover").

EXECUTIVE SUMMARY

Having reviewed the cost and revenue analysis submitted by the Postal Service, OCA has concluded that the Commission should recommend the submitted NSA to the Governors of the Postal Service—with an amendment to the DMCS language requested. This is a strong caveat—the provisions of the Domestic Mail Classification Schedule (DMCS) should be modified so that a meaningful unit contribution is ensured

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1 "Presiding Officer's Ruling Establishing Procedural Schedule," issued August 25, 2004.

at the margin. OCA has developed and provided DMCS revisions to the initial proposal that would create a stop-loss mechanism tailored to the primary risks attendant to the instant NSA. The proposed stop-loss mechanism makes small, precise reductions in the unit discounts paid until a satisfactory unit contribution for pieces at the margin is achieved. The adjustments result from not only *performing* the annual financial impact assessments required under Rule 193(g) and the proposed Data Collection Plan but also *applying* these assessments in such a way that mailers outside of the NSA agreement are protected from the adverse financial consequences of hypothetical cost estimates that prove to be far off the mark. If the Postal Service has accurately projected the financial impact of the NSA, rates would not change.

OCA also furnishes in its Initial Brief a calculation of a stop-loss cap based on savings generated from the substitution of electronic returns of First-Class solicitation letters for more costly physical returns. OCA has made and presents alternative calculations of the savings cap.

STATEMENT OF THE CASE

Proceeding Under the Rules for Functionally Equivalent NSAs. The Request for a functionally equivalent Negotiated Service Agreement (NSA) for Discover Financial Services, Inc. was filed with the Commission on June 21, 2004. Together with the filing of a similar Request by the Postal Service and Bank One, co-proponents of a functionally equivalent NSA for Bank One, the Discover and Bank One NSAs constitute the first instances for applying new Commission rules concerning NSAs, *i.e.,* Rules 190-194 (39 C.F.R. §§3001.190-.194), and especially Rule 196 (39 C.F.R. §3001.196)) which governs Requests to recommend a Negotiated Service Agreement that is functionally equivalent to a previously recommended Negotiated Service Agreement. OCA agreed to proceed under the rules for functionally equivalent NSAs. Tr. 1/9 (settlement report of the Postal Service). In Ruling No. MC2004-4/1,[2] the Presiding Officer advised the participants he would proceed under Rule 196. On August 17, 2004, OCA informed the Commission it would not require oral cross-examination or the presentation of OCA testimony.[3]

Perspective on the Credit Card Market. With the filing of Docket Nos. MC2004-4 and MC2004-3, the Commission has considered, or is currently considering, NSAs entered into by four out of the largest ten credit card issuers in the United States, namely Capital One, Discover, Bank One, and JP Morgan Chase. Based on 2004 quarterly data, the ten largest issuers are:[4]

[2] "Presiding Officer's Ruling Establishing Procedural Schedule," issued July 20, 2004, at 2.

[3] "Office of the Consumer Advocate Statement Concerning the Need for a Hearing."

[4] http://www.cardweb.com/mod_perl/carddata/secure/top500?sorton=actacct&max_results=10 These data are from the most recent full quarter of 2004.

Rank of Card Issuer (by number of active accounts)	Year to Date Volume	Active Accounts	Cards
1. Citigroup	$142.1 billion	69 million	129.7 million
2. MBNA America	$99.1 billion	33.3 million	72.1 million
3. Capital One	$18.6 billion	24.8 million	48.8 million
4. Bank One	$89.3 billion	21.3 million	60.8 million
5. Discover	$48.6 billion	19.9 million	50 million
6. American Express	$145.8 billion	16.6 million	37.4 million
7. JP Morgan Chase	$46.1 billion	16.4 million	35.4 million
8. Bank of America[5]	$16 billion	12 million	27.7 million
9. Providian	$4 billion	7.3 million	9.9 million
10. Fleet Boston[6]	$5.3 billion	5.3	11.8 million

The total market share for the top ten issuers (by outstandings) is 80 percent.[7] The approximate number of general purpose credit card issuers in the United States is 6000, most of them credit unions.[8] Credit unions comprise the 5000 smallest issuers of credit cards.[9] Given these statistics, it appears likely that future functionally equivalent NSAs will be filed with the Commission, particularly by the remaining banks among the ten largest.

5 Bank of America merged with Fleet Boston in the second quarter of 2004. http://www.cardweb.com/mod_perl/carddata/secure/chart?id=159

6 *Id.*

7 http://www.cardweb.com/cardlearn/faqs/2003/november/7.xcml

8 http://www.cardweb.com/cardlearn/faqs/2002/nov/4.xcml

9 http://www.cardweb.com/cardlearn/faqs/2002/jan/19.amp

Joint Request for Approval by Co-Proponents. The Request for approval of the Discover NSA was supported by the testimony of Postal Service witness Ayub[10] and Discover witness Giffney.[11] The primary elements of the NSA are:

- Provision of electronic address correction service ("eACS") notices for Discover's returned and forwarded First-Class Mail solicitations
- Waiver of ACS fees
- Disposal of Discover's returned mail pieces in lieu of physical return
- Obligation of Discover to explore means of using eACS notices
- Running address lists against NCOA more often than the minimum Move Update requirement
- Declining block rates in excess of specified volume threshold
- A voluntary "competitive cap"

According to witness Giffney, "DFS is a business unit of Morgan Stanley and is responsible for the operation of the Discover® Card brand." DFS is "one of the largest issuers of general purpose credit cards in the U.S." and has 50 million card members.[12] Discover sends two types of mail: operations,[13] which is always sent as First Class, and marketing mail, which is principally sent as Standard Mail.[14]

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[10] USPS-T-1. On September 2, 2004, the Postal Service filed a notice of errata to the testimony of witness Ayub, which contained revisions to Appendix A, including electronic spreadsheets of the appendix. United States Postal Service Notice of Errata to Direct Testimony of Ali Ayub (Errata), September 2, 2004. A second notice of errata was filed on September 3, 2004, which included a pdf copy of page 10 of Appendix A that was inadvertently omitted from the September 2nd filing. United States Postal Service Notice of Second Errata to Direct Testimony of Ali Ayub (Errata), September 3, 2004. However, the pdf copy and the electronic spreadsheets of page 10 contain differing unit cost and contribution figures. Because of these differences and the fact that the filings come late in this proceeding, OCA is using the unrevised figures contained in Appendix A of witness Ayub's direct testimony filed on June 21, 2004.

[11] DFS-T-1.

[12] *Id.* at 2.

[13] This consists primarily of business correspondence and statements.

[14] DFS-T-1 at 5.

Discover anticipates that the NSA will provide the following advantages: greater speed, likelihood of delivery, forwarding, and perceived value. Discover engages in monthly marketing campaigns, which are mailed weekly. Campaigns are planned well in advance and their results are analyzed. Each month, "DFS procures over 40 mailing lists . . . and mail[s] from these lists and not from an internal prospect database."[15] Witness Giffney testifies that the marketing budget is approved in advance with virtually no variance as the year unfolds. Discover focuses on acquiring high quality prospects and does not view address accuracy as an important characteristic.[16]

Each purchased mailing list is analyzed "based on a variety of proprietary factors." This includes purging the list of some potential mail recipients. The final list is run against the NCOA/CASS database within 60 days of mailing. Operations mail has a low return rate of 0.25 percent, but marketing mail has a return rate of 9.3 percent. The method for using return information provided by the Postal Service has not been finalized. Discover has "agreed to work with the Postal Service and [its] list processor to analyze the return data [it] receive[s] from the Postal Service and use it in an efficient manner to improve our mail quality."[17]

Witness Giffney's before-rates marketing volume estimate is 156 million First-Class letters for each of Years 1, 2, and 3 of the NSA; and declining operations volumes of 295, 290, and 285 million for Years 1, 2, and 3, respectively.[18] The after-rates

15 *Id.* at 6.
16 *Id.* at 13.
17 *Id.* at 14.
18 The operations mail volume is projected to decline as a consequence of eliminating low-quality accounts and substituting high quality accounts. Also, some customers are expected to switch from mailed statements to electronic statements. *Id.* at 11.

volume forecast shows modest increases in First-Class marketing mail to 169 million (an increase of 13 million) in Year 1 and 174 million in Years 2 and 3 (increases of 18 million). The after-rates forecast is claimed to be solely the result of NSA incentives, inducing transfer from Standard Mail to First Class. The increases in use of First-Class Mail are characterized as minimums.

The NSA in the instant proceeding provides for discounts of 2.5 to 4.5 cents, increasing by half-cent increments. The threshold at which the lowest discounts are paid is 405 million pieces; with discount tiers increasing by 30-million-piece intervals for the first two discount blocks, and then by 25-milion-piece blocks for the next two blocks. From 515 million pieces upward, the discounts remain at the highest level–4.5 cents. At a volume of more than 532 million pieces the discounts cease altogether. This occurs when the competitive cap is reached.

One of the distinctive features of the Discover Request is the imposition of a 3-year “competitive cap” set at $13 million, an average of $4.3 million per year for the 3-year NSA. While Discover does not support the idea of a competitive cap, it views the voluntary “competitive cap” as a pragmatic adaptation for a functionally equivalent NSA. Discover recognized that the Commission might impose a savings cap for Discover, as it did for Capital One, so it chose to negotiate a cap with the Postal Service. The size of the competitive cap is proportionate to Discover’s volumes as compared to Capital One’s. Since Discover’s First-Class volume estimates are 32 percent of Capital One’s, the cap is set at 32 percent of the stop-loss cap that the Commission calculated for Capital One. It is important to note, however, that a savings cap based on the Commission’s methodology is approximately $1.4 million lower that the $13 million competitive cap, *i.e.*, it is $11.6 million. (The method for calculating the cap is explained *infra.*)

Below the threshold volume (405 million), savings arise from Discover's First-Class marketing mail volumes. The savings are generated from Discover's receipt of electronic notices of returned First-Class marketing pieces in lieu of the physical return of these pieces. Once the threshold is reached, discounts are then paid, first at 2.5 cents, then increasing at half-cent intervals until the maximum discount level of 4.5 cents is reached. From the first piece above the threshold, each additional piece of First-Class marketing is paid discounts that exceed realized savings (1.6 cents per piece). This continues until the accrued savings are exhausted. The point at which savings are exhausted is referred to by the Commission as the "stop-loss cap."[19]

[19] PRC Op. MC2002-2, para. 1008.

ARGUMENT

I. THE DISCOVER NSA COMPARES UNFAVORABLY WITH THE CAPITAL ONE NSA.

Unlike the Capital One NSA, the Discover NSA has free riders, that is, discounts are paid on First-Class Mail solicitation volumes that would have been mailed anyway. In Docket No. MC2002-2, OCA witness Smith testified that:[20]

> Proposing a threshold volume for the payment of incentives at a lower than forecasted volume . . . creates a significant free-rider problem. The free-rider problem is the payment of an incentive where none is necessary, i.e., for pieces which would have been sent absent an incentive.

The Commission observed that:[21]

> Smith's "free-rider" problem can be avoided altogether by following his recommendation to design the two-part tariff in such a way that the threshold [volume] is set above [the volume level that would have been mailed without an incentive]. A tariff designed in this way reverses the sign of the leakage . . . .

Revised volume estimates in the Capital One proceeding eliminated a free rider situation. OCA recommends a correction to the threshold such as that described by the Commission. The free rider issue is discussed at greater length *infra*.

While the functional elements of the Discover and Capital One NSAs are generally the same, the Discover NSA produces a marginal contribution to institutional costs that is a small fraction of that produced by the Capital One NSA. For the most highly discounted pieces under the NSA rate schedule (4.5 cents discount per piece), the unit contribution declines from 2.2 cents in the first year, to 2.0 cents in the second

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[20] OCA-T-1 at 3.

[21] PRC Op. MC2002-2 at para. 5019.

year, and to 1.8 cents in the third year.[22] By contrast, Capital One's most highly discounted pieces made a unit contribution of 10.4 cents per piece.

Mis-estimation of the costs of providing forwarding and return of switched volumes (from Standard Mail to First Class) could actually erode the unit contribution altogether, turning the deal into a money-losing venture for the Postal Service. It would be a perverse outcome if inducing Discover to switch its marketing volume from Standard Mail to First Class actually worsened the Postal Service's financial condition, rather than improve it.

As Standard Mail, Discover's marketing pieces produce a contribution of unit 9.1 cents in Year One.[23] Witness Ayub uses a figure of 15.5 cents for the contribution Discover's mail is expected to make as a First-Class piece in Year One after rates.[24] This contribution figure is highly dependent on two critical, but unproven, assumptions:

- That 85 percent of the returns of First-Class Mail will be handled at a CFS unit, where production of an electronic return is 21 cents less expensive than a physical return.[25]

- That the forwarding rate for Discover is equal to or less than the average forwarding rate for First Class–1.96 percent.

A recent article published in the Postcom Bulletin[26] indicated that, prior to the commencement of the Capital One NSA, much less than 85 percent of ACS mail was being directed to CFS units, *i.e.*, 47 percent. The mail was being erroneously directed to the P&DC for costly return-to-sender processing for a variety of reasons:

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22 Witness Ayub's response to interrogatory OCA/USPS-T1-41.
23 USPS-T-1, Appendix A, page 10, line 12, revised September 2, 2004.
24 *Id.* at line 9.
25 *Id.* at page 1, line 5 minus line 6.
26 *PostComm Bulletin* 35-04, August 12, 2004, at 3-4.

> The [nixie] function no longer is a full-time job, turnover is high, it is not a high priority with management, there is a lack of supervisory involvement, a lack of training, a lack of performance metrics, a lack of data and a lack of accountability in the field.

The Capital One NSA shed light on the incorrect handling of ACS mail—and it is hoped than the problem has been permanently solved. But the Commission cannot absolutely depend on the improvement being permanent. If 53 percent of Discover's First-Class marketing mail receives P&DC return handling, rather than the estimated 15 percent, the unit contribution of 1.8 cents in Year 3 quickly evaporates and turns negative.

The Postal Service states confidently that Discover's forwarding rate is undoubtedly at about the level of Capital One's (2 percent, unaudited) which is slightly higher than the average First-Class forwarding rate of 1.96 percent. It must be borne in mind, however, that Capital One's mailing list and address hygiene practices were cited as among the best in First Class. Discover, on the other hand, has frankly stated that it focuses on high quality credit prospects, not address accuracy. Thus, it is easy to imagine that Discover's forwarding rate will be much higher than Capital One's. At a forwarding rate of **5.92** percent or higher, the unit contribution of 1.8 cents in Year 3 (for the most highly discounted pieces) disappears, and above **5.92** percent, turns negative.

Valpak's discovery efforts have established that the formula that the Postal Service uses for setting fees for return and forwarding service in Standard Mail is based on a 1988 study that showed that the forwarding rate in Standard Mail is 1.472 times that of the return rate.[27] Applying that formula to Discover's marketing mail rate of 9.3 percent produces a possible upper limit on forwarding of 13.6 percent. OCA recognizes

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27 *See* Tr. ^/^^^^ [vp/usps 12]. Data were collected over a period of a month from 2303 representative delivery units.

that running Standard Mail against the NCOA database (a means of the satisfying the Move Update requirement for First Class, but not required for Standard Mail) would reduce the 13.6 percent figure, but it is difficult to estimate by how much.

In the Capital One proceeding, witness Wilson testified that, on average, NCOA will identify 4 percent of the mailing list as having change of address orders on file, allowing this 4 percent to be forwarded. It might be reasonable to reduce the 13.6 percent by this amount, *i.e.*, 13.6 percent – 4.0 percent = 9.6 percent; but this leaves a forwarding rate nearly five times the average First-Class forwarding rate.

There are other reasons to believe that Discover's forwarding rate might be higher than the average First-Class forwarding rate. The 2001 Household Diary Study reports that 42 percent of First Class consists of bills and statements received by households[28] and that bill payments (by households and non-households) comprise 47.1 percent of First Class.[29] These percentage figures sum to 89.1 percent.

The Commission and participants have already learned from the Capital One, Discover, and Bank One filings that companies presenting bills to their customers have extraordinarily accurate address information due to the nature of the relationship.[30] Just as the return rates for Capital One, Discover, and Bank One statement mailings are far below the average First-Class return rate of 1.23 percent, the customer relationship strongly indicates that the forwarding rate should likewise be far below average. Customers are likely to notify their creditors of a change of address; by contrast,

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[28] Table A2-10.
[29] Page 20.
[30] Docket No. MC2002-2, Tr. 2/88.

marketing mail recipients have no means of doing so. Their changed addresses can only be identified via NCOA.

First-Class Mail bill payments present a complementary picture. Most individuals (and businesses) making a bill payment are well aware of the address of the bill recipient; a high percentage of bill payments is mailed in courtesy and business reply envelopes imprinted with accurate addresses. If one isolates bill and statement First-Class Mail, and bill payment First-Class Mail, from the remainder of First-Class Mail, it becomes obvious that the average forwarding rate on the remaining First-Class Mail, marketing mail in particular, is much higher than the very dilute 1.96-percent forwarding rate for all First-Class.

A rough estimate of the likely forwarding rate for First-Class advertising mail may be calculated as follows. The starting point is the return rates for customer mail for the four credit card issuers that have sought NSAs with the Postal Service:

- Capital One 1.2%[31]
- Discover 0.25%[32]
- Bank One 0.3%[33]
- J.P. Morgan Chase 0.5%[34]

The unweighted average return rate for the four credit card issuers is 0.56%. It is reasonable to make the assumption that a figure double that—1.12 percent—can be used as the forwarding rate for bill, statement, and bill payment mail. The 0.56-percent figure includes returns of statement mail for move-related reasons, such as the 12-to-

[31] COS-T-1 at 6.
[32] DFS-T-1 at 13.
[33] BOC-T-1 at 9.
[34] Witness Rappaport's response to interrogatory OCA/USPS-T1-17(f).

18-month period when change of address orders trigger return of a piece, rather than its forwarding. Returns are triggered by other reasons, such as keying errors of bank personnel, recipients who are deceased, mail refused, recipient is temporarily away, and no mail receptacle.[35] If one were to assume that the forwarding rate was double that number, for move-related reasons and where a change of address order was on file, then 1.12 percent could be used as the forwarding rate for the 89.1 percent of First-Class that is bills, statements, and bill payments. The forwarding rate for remaining First Class (including advertising mail) would be calculated as follows: (0.891 x 1.12%) + ((1 – 0.891) x *F*) = 1.96%, or *F* = 8.82%. A figure of 8.82 percent drives the unit contribution estimated by witness Ayub negative.

Implicit in witness Ayub's financial analysis is that the net contribution of 1.8 cents in Year 3 results from the average First-Class forwarding rate. The average First-Class rate that Discover would pay, based upon its presort profile, only includes a unit cost for the much lower 1.96 percent average of First-Class. As was mentioned above, if Discover's forwarding rate is **5.92** percent, the net contribution is erased. A forwarding rate of 8.82 percent produces a *negative* unit contribution of **1.3** cents for the most highly discounted pieces in the third year of the NSA.

[35] Tr. 3/582 (OCA/USPS-T4-17(d)), Docket No. MC2002-2.

II. OCA RECOMMENDS TWO ADDITIONS TO THE DATA COLLECTION PLAN PROPOSED BY THE POSTAL SERVICE.

Without explanation, the Postal Service has omitted a provision in the Discover Data Collection Plan that was included by the Commission in the Capital One Data Collection Plan. In its opinion, the Commission invoked the testimony of Postal Service witness Eakin to support the view that Standard Mail volumes of the co-proponent should be collected and reported as part of the regular reporting program:

> Although witness Plunkett omitted Standard Mail volumes from the data collection plan in his direct testimony, Postal Service rebuttal witness Eakin testifies that securing historical data on Capital One's First-Class and Standard volumes is important. Witness Eakin also lists "measuring changes in Capital One's First-Class and Standard Mail volumes after the NSA is implemented" as an important element of monitoring the NSA.

Thus the Commission added a twelfth item to the Plan—the Volume of Standard Mail solicitations by rate category in Capital One permit accounts. OCA urges the addition of a comparable requirement in the Discover NSA: "Volume of Standard Mail solicitations by rate category in Capital One permit accounts."[36]

OCA also asks the Commission to add still another provision calling for a report by Discover of the practices it will adopt to utilize eACS notices it receives for returned pieces, but also, especially, for forwarded pieces. Capital One made an explicit commitment to revise all of its address lists, whether First Class or Standard Mail, within two days of receipt of eACS information,[37] and specifically to suppress former

[36] PRC Op. MC2002-2, para. 9029. OCA deleted the word "eligible" from the provision presented above because "eligible" applies to First-Class marketing mail whose permit numbers can be identified. Any of Discover's Standard Mail credit card solicitations appear to be candidates for conversion to First Class.

[37] Docket No. MC2002-2, Tr. 2/60.

addresses for which it had been notified that a resident had moved.[38] In the instant proceeding, Discover's methods for using eACS notices have yet to be developed. OCA asked witness Ayub whether it was the intention of the Postal Service to collect and report such information. He answered that it was not and that Discover considered the submission of such information to be proprietary.[39]

Other NSA co-proponents have been willing, not only to provide such information, but to include it explicitly in their direct case. Witness Jean, for example, in the Capital One proceeding, frankly answered a large number of interrogatories and oral cross-examination questions concerning Capital One's then-current and planned practices.[40] Bank One has also stated clearly how it will make use of eACS information furnished under the NSA.[41]

OCA believes that the Commission and interested observers will be precluded from making a thorough, informed evaluation of the financial impact of the Discover NSA if information on Discover's practices in using eACS information is withheld. Commission Rule 193(g) provides that:

> Every formal request shall include a proposal for a data collection plan, which shall include a comparison of the analysis presented in § 3001.193(e)(1)(ii) and § 3001.193(e)(2)(iii) with the actual results ascertained from implementation of the Negotiated Service Agreement. The results shall be reported to the Commission on an annual or more frequent basis.

Whether Discover is able to design procedures that permit it to utilize change of address information in future mailings to the same recipient and return information such

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38 *Id.* at 137.

39 Witness Ayub's response to interrogatory OCA/USPS-T1-40.

40 E.g., witness Jean's response to interrogatory OCA/COS-T1-16 (Tr. 2/96); OCA/COS-T1-25 (Id. at 105); APWU/COS-T1-13 (Id. at 60); and Tr. 2/114 – 152, *inter alia*.

41 Witness Rappaport's response to interrogatory VP/BOC-T1-8, Docket No. MC2004-3.

as forwarding order expired or recipient deceased in future mailings to the same address is the single, most critical reason for entering into an NSA of this type. Making prompt, thorough use of such information so that costly future returns and forwards can be avoided is the primary merit of Capital One's baseline NSA. A Discover NSA that does not produce similar gains for the Postal Service is of dubious value and is surely not the functional equivalent of the baseline agreement. Since Discover and the Postal Service entered into the submitted NSA without knowing how the NSA provisions would be fulfilled, it is essential that the procedures developed be reported throughout the course of the agreement. A meaningful financial assessment under Rule 193(g) cannot be made without this information. OCA thus proposes the following addition to Discover's Data Collection Plan:

> At the end of each year of the agreement, Discover will describe its procedures for receiving and utilizing eACS information on First-Class solicitation pieces that have been forwarded or returned.

a. This description shall include how Discover matches recipient/address information received from eACS to mailing lists from vendors and internal databases.

b. This description shall include how Discover suppresses mailings to recipients/addresses for whom forwarding orders have been filed and for whom Discover has received electronic notice to that effect under the NSA.

c. The description shall include a statement of the length of time elapsed between receipt of eACS forwarding and return information and its incorporation and application by Discover.

III. THE POSTAL SERVICE'S FINANCIAL RISK OF LOSS FROM EXCESSIVE "ANYHOW" VOLUME CAN BE ELIMINATED BY IMPOSING A STOP-LOSS CAP ON TOTAL DISCOUNTS

In this proceeding, the Postal Service proposes a Negotiated Service Agreement (NSA) with Discover Financial Services, Inc., (herein "Discover") that it maintains is "functionally equivalent" to the Capital One NSA—the "baseline" (and first-ever) NSA recommended by the Commission in Docket No. MC2002-2.[42] As a functionally equivalent NSA, the Postal Service argues that one of the "key issues to be addressed . . . . [is] the financial impact of the Discover NSA on the Postal Service over the duration of the agreement."[43]

The Office of Consumer Advocate (OCA) submits that the financial impact of the Discover NSA on the Postal Service is *the* most important issue to be addressed in this proceeding. More specifically, the OCA posits that it is the risk of financial loss—and whether there are sufficient safeguards to minimize the possibility of such loss—that should be the most important consideration in any evaluation of the Discover NSA.

In this regard, the possibility of financial loss was the sole consideration prompting the Commission to make only one change—the imposition of a "stop-loss" cap—on Capital One as part of its recommended decision in Docket No. MC2002-2. Without the stop-loss cap, the Commission found, there is "no reasonable assurance that the Postal Service will not lose money on this NSA." PRC Op. MC2002-2, para. 8013. The Commission concluded

[42] 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. (herein "Request"), at 2.

[43] United States Postal Service Proposal for Limitation of Issues, June 21, 2004, at 2-3.

> Because the evidentiary record contains no plausible estimate of the volume of First-Class Mail that Capital One would send during the term of the NSA if no discounts were made available, a significant risk exists that discounts to Capital One could exceed costs avoided by the Postal Service.[44]

Given the uncertainties associated with Capital One's First-Class Mail volume, the imposition of a stop-loss cap made sense.

In the case of the Discover NSA, the appearance of such "anyhow" volumes—excessive marketing mail that would be sent First Class even if no discounts were made available—is also a possibility. Unforeseen factors could cause Discover's actual First-Class marketing volumes to differ from plausible projections. That said, to the extent excessive "anyhow" volumes appear, the risk of financial loss to the Postal Service from that specific uncertainty can be minimized through the use of a stop-loss cap.

A. The Possibility of Excessive "Anyhow" Volumes Exists, But Such Volumes Are Unlikely to Cause Financial Loss to the Postal Service

Factors other than price can cause actual future mail volumes to differ from volume projections. Such factors always exist and can never be known completely. Nor can the effect of such factors be fully or accurately incorporated into any projection of future volumes.

The Postal Service acknowledges the existence of factors other than postage discounts that could diminish the financial benefits of the Discover NSA. Specifically, non-price factors could increase or decrease the amount of statement or operational mail. According to the Postal Service, increases in statement mail result from increases in the number of customer accounts caused by such non-price factors as changes in

[44] PRC Op. MC2002-2, para. 1008.

response rates that result in a larger customer base; inactive accounts may become active; and greater marketing efforts to cross-sell products. OCA/USPS-T1-5(a). For this reason, the Discover NSA incorporates a "threshold adjustment" mechanism that "is intended to ensure that any increases or decreases in statement or operational mail alone do not provide the volumes necessary for [Discover] to obtain the price incentives."[45]

The Postal Service also agrees that non-price factors could cause marketing volumes to differ from "the best available future volume projections, based upon available data." OCA/USPS-T1-30(a). In general terms, these include "macro and micro economic factors." More specifically, factors that could affect a company's mailing strategies include interest rates, account delinquency rates, response rates, the competitive landscape, a company's growth strategies, and mail production costs. OCA/USPS-T1-30(c).

Unlike the threshold adjustment for statement mail, the Postal Service proposes no specific adjustment mechanisms in the Discover NSA to address the possibility of non-price factors causing changes in marketing mail volumes. More specifically, without such a mechanism, the possibility that non-price factors could cause a substantial *increase* in marketing volumes, and thereby produce a financial loss, becomes most problematic.[46]

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[45] OCA/USPS-T1-5(b). *See also* Request, Attachment F, "Negotiated Service Agreement Between United States Postal Service and Discover Financial Services, Inc.," Article III.F.

[46] Discover has recently mailed as much as 213.2 million pieces of First-Class marketing mail. DFS-T-1, App. I. It should also be noted that the coefficient of variation for Discover's First-Class solicitation mailings is nearly twice that of Capital One, i.e., it is 0.61 for Discover and 0.35 for Capital One. This was confirmed by witness Ayub in his response to interrogatory OCA/USPS-T1-32.

The Postal Service questions whether non-price factors as they relate to marketing mail really pose a risk to the success of the NSA. OCA/USPS-T1-30(d). With respect to marketing mail volumes being higher than projected, the Postal Service suggests it is “probable” that discount leakage will be understated, and electronic Address Change Service (eACS) cost savings will also be understated. Id. The Postal Service further maintains that only at extreme levels of marketing mail would the Postal Service have substantial discount leakage that could result in an overall decrease in value to the Postal Service. OCA/USPS-T1-6(b).

Nevertheless, the existence of non-price factors with respect to marketing mail remains a possibility that could cause the Discover NSA to be a financial loss for the Postal Service. However, like the Postal Service, the OCA believes that the possibility of a financial loss from excessive “anyhow” marketing mail volume rests on several unlikely assumptions. First, it is assumed that **total** volumes in Year 1 increase to 518.2 million pieces—the volume at which the discounts paid to Discover equal the eACS cost savings. In other words, Discover has substantially understated its before rates forecast by 67.2 million pieces. Second, the 67.2 million pieces consist entirely of marketing mail caused by non-price factors. Third, there is no increase in contribution to the Postal Service from marketing mail volume caused by **discounts**.

These assumptions in effect pre-suppose a worst-case scenario for the Postal Service. Based upon these assumptions, Table 3-1 presents the “net value” to the Postal Service considering only eACS cost savings and discounts paid to Discover at selected volume levels. Figure 3-1 visually presents the net value to the Postal Service. The calculation of the cost savings is based on an ACS unit cost savings of $0.0164.[47]

Table 3-1
Net Value to the Postal Service
from eACS Cost Savings
(millions)

Volume	Net Value
295	$0
405	$1.809
435	$1.552
451	$1.335
465	$1.145
490	$0.681
515	$0.092
518	$0

As shown in Table 3-1, where Discover enters the threshold volume of 405 million pieces, no discounts will be paid, and costs are reduced from providing electronic ACS notices on 110 million pieces of additional marketing mail. The net value to the Postal Service is the same as the total eACS cost savings, or $1,808,664.

Beyond the threshold volume, additional marketing mail result in discounts paid exceeding cost savings generated by the electronic ACS notices until the discounts offset all previous eACS cost savings. The analysis of net value at each volume level show in Table 3-1 and Figure 3-1 is discussed below.

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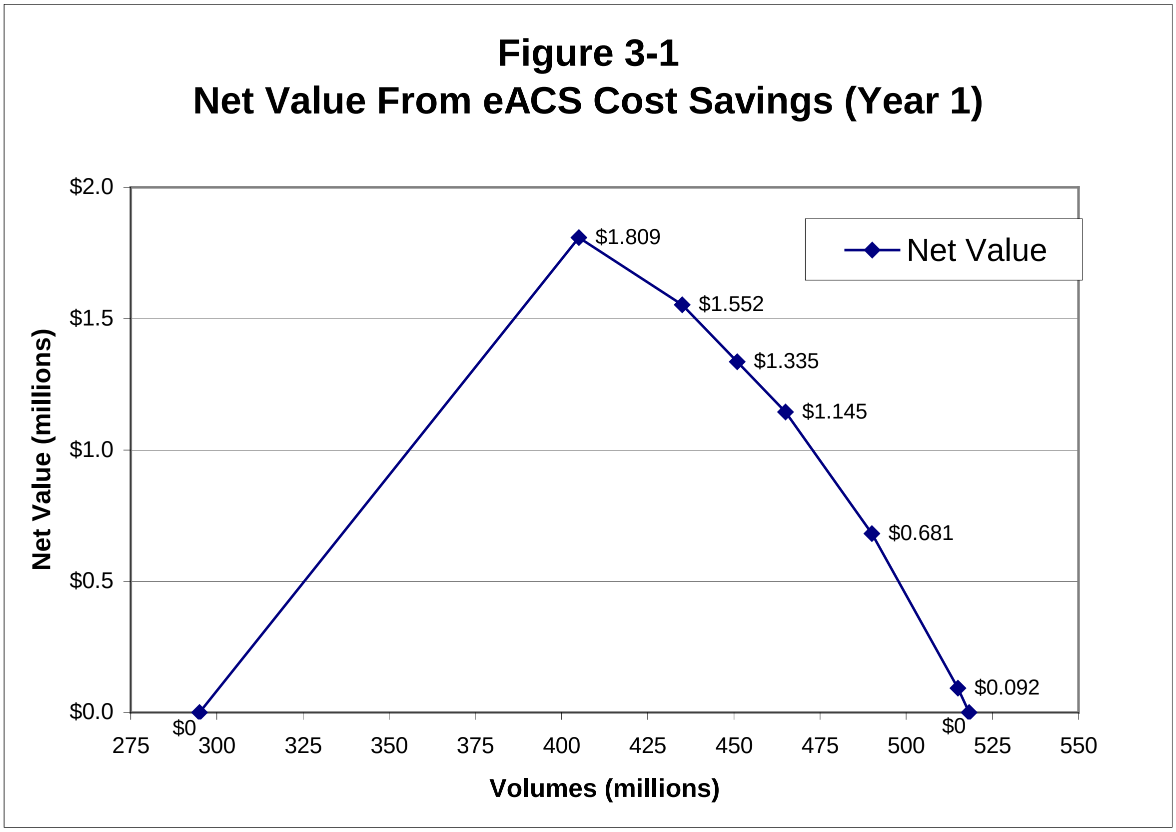
[47] The exact unit cost is $0.01644240. OCA/USPS-T1-37(a).



Where Discover enters its threshold volume plus the first volume block of 30 million pieces of marketing mail, the Postal Service will pay a discount of $0.025 per piece, or $750 thousand. However, the 30 million pieces generate eACS cost savings of $493 thousand (30,000,000 * $0.01644240), for a new net value to the Postal Service of $1.552 million.

Where Discover enters the 435 million plus an additional 16 million pieces—or 451 million, the projected before rates volume—the Postal Service will pay the second-tier discount of $0.030, or $480 thousand. The additional volume will also generate eACS cost savings of $263 thousand for a new a net value of $1.335 million.

Where Discover enters its before rates volume of 451 million plus an additional 14 million pieces, the Postal Service will continue to pay the second-tier discount of

$0.030, or $420 thousand. From this additional volume, eACS cost savings also increase $230 thousand, producing a new net value of $1.145 million.

Where Discover enters the volume of 465 million plus the third volume block of 25 million pieces, the Postal Service will pay a discount of $0.035, or $875 thousand. The eACS costs savings increase $411 thousand. The Postal Service's new net value is $681 thousand.

Where Discover enters the 490 million and the next volume block of 25 million pieces, the Postal Service will pay the fourth-tier discount of $0.040, or $1 million. Again, eACS costs savings increase $411 thousand, resulting in a new net value to the Postal Service of $92 thousand.

At the highest discount of $0.045, where Discover enters 515 million plus an additional volume of 3,233,050 for a total of 518.2 million pieces, the total discounts paid equal $145 thousand. However, the eACS costs savings increase only $53 thousand, for a change in value of $92 thousand. This amount totally offsets the remaining eACS costs savings, leaving the Postal Service with a new net value of $0 (($145,000 - $53,000) - $92,000).

The discussion to this point—under a worst-case set of assumptions—illustrates an important fact: The Postal Service will benefit financially from the NSA so long as Discover's 1) total statement mail is 295 million, and 2) total marketing mail in Year 1 is less than 223.2 million pieces—even if the marketing mail is generated solely by non-price factors. Stated alternatively, the Postal Service's payment of discounts to Discover will not exceed the eACS cost savings, provided marketing mail does not exceed 223.2 million pieces.

To extend the analysis presented in Table 1-1, it is further assumed that any additional marketing volumes above 518.2 million pieces are induced by discounts rather than caused by non-price factors. Moreover, the difference between the unit contribution of Discover's First-Class marketing mail and Standard Mail is $0.067 ($0.158 – $0.091).[48]

Pursuant to this new assumption, the discounts induce Discover to enter one new piece of marketing mail, in addition to the 223.2 million pieces of marketing mail caused by non-price factors. Under the Postal Service's methodology, $0.067 in new contribution would be received, offset by $0.045 in discounts paid, for a net value to the Postal Service of $0.022.[49]

Continuing, the non-price factors that cause 223.2 million pieces of marketing mail prompt an additional piece of marketing mail. And, the discounts induce Discover to enter 1.3 pieces of new marketing mail. The financial result for the Postal Service would be: $0.0164 of eACS cost savings, $0.087 ($0.067 * 1.3) in new contribution, less $0.0104 ((1 + 1.3) * $0.045) in discounts paid, for an increase in net value of $0.00004. Consequently, for every one piece of marketing mail caused by non-price factors, the Postal Service gains financially if the discounts induce only 1.3 pieces of new marketing mail.

Given the worst-case assumptions set forth above, it must be asked: How likely is it that the Postal Service will have a financial loss based upon the volumes projected in the Discover NSA? The OCA concludes that excessive "anyhow" volumes of the

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48 USPS-T-1, Appendix A, page 10

49 Under the Postal Service's methodology, the eACS cost savings are included in the unit cost of a First-Class Marketing Letter, after rates, which is used to calculate the First-Class Marketing Letter average contribution, after rates. *See* USPS-T-1, Appendix A, page 10.

magnitude assumed in this analysis are unlikely, as is a financial loss for the Postal Service from such volumes.

For these reasons, the OCA does not consider excessive “anyhow” volumes to be the most likely cause of financial loss to the Postal Service from the Discover NSA. More significant is the narrow contribution margins, which not only decrease as discounts rise with volumes, but also decrease each year during the three-year period of the NSA. Moreover, should Discover’s unknown forwarding rate exceed the forwarding rate for Capital One, such narrow contribution margins pose the most likely cause of financial loss. These issues are discussed more fully in section IV of this brief.

B. To the Extent Excessive “Anyhow” Volume Poses a Significant Risk of Financial Loss, the Commission Can Eliminate This Risk With a Stop-Loss Cap

In this proceeding, the Postal Service supports a negotiated limit on the total amount of discounts payable to Discover during the NSA as an alternative to a stop-loss cap of the type imposed upon Capital One in Docket No. MC2002-2. In that docket, the Commission recommended a stop-loss cap on discounts paid equal to the net cost savings generated by Capital One’s acceptance of electronic Address Correction Service notifications for its Undeliverable-As-Addressed (UAA) First-Class Mail. PRC Op. MC2002-2, para. 5061.

To the extent that the Commission determines that a limit on the amount of discounts paid to Discover is warranted, that limit should be based on the methodology developed by the Commission with respect to Capital One.

1. Discover's negotiated limit on discounts is an unsatisfactory substitute for the Commission's stop-loss cap

Discover witness Giffney proposes a negotiated limit of $13 million on the total amount of discounts payable to Discover during the three year period of the NSA. DSF-T-1, at 13. This limit is referred to as a "competitive cap" as the amount of the cap is based upon the relative size of Discover's projected First-Class Mail volume to that of Capital One's. Id.

Discover argues that, in principle, there is no need for any cap. Id., at 12. Unlike the uncertainty accompanying Capital One's volume projections, Discover asserts that its volume projections constitute "not just plausible evidence, but [Discover's] actual budget number and its actual current projections." Response of Discover Witness Giffney to POIR No. 1, Question 5, at 1-2. In addition, the Postal Service considers Discover's future volume estimates to be "conservative," and anticipates that the volume response to the discounts will be higher than the estimates. USPS-T-1, at 14. Consequently, the Postal Service "will generate additional profit from the increased volume." DFS-T-1, at 12.

Nevertheless, Discover acknowledges that it is not "completely unreasonable" for the Commission to impose a cap on a functionally equivalent NSA such as Discover's. Id. Moreover, the Postal Service views the competitive cap "as a satisfactorily equivalent substitute for the stop-loss provision in the Capital One NSA." Response of USPS Witness Ayub to POIR No. 1, Question 5, at 1.

The OCA considers the competitive cap unsatisfactory for two reasons. First, the amount of the negotiated competitive cap, by definition, bears no relationship to the cost savings to be generated from Discover's participation in the eACS program for its UAA mail. Second, Discover's competitive cap, if implemented, would be larger in amount than a stop-loss cap based upon the Commission's methodology in the Capital One proceeding.

2. The Commission's methodology for the Capital One stop-loss cap can be used for Discover

To the extent a limit is warranted, a stop-loss cap based on the Commission's methodology developed with respect to Capital One can be applied. A stop-loss cap for Discover calculated in this manner would limit the total amount of discounts paid during the three years period of the Discover NSA to the amount of eACS savings.

The Commission's methodology for calculating the "ACS Related Savings" for Capital One is presented in Table 8-2 of its Opinion and Recommended Decision. PRC Op. MC2002-2, para. 8029. In this proceeding, the OCA has replicated the Commission's methodology presented in Table 8-2. OCA/USPS-T1-35. In addition, the OCA has calculated the ACS related savings for Discover based upon the Commission's methodology. The ACS related savings during the three years period of the Discover NSA equal $9.0 million. OCA/USPS-T1-28, Table 3. Consistent with the Commission's practice with respect to Capital One, the OCA set the stop-loss cap at 95 percent of Discover's three-year ACS related cost savings, or $8.57 million. Id.

In calculating the ACS related savings for Capital One, the Commission's methodology incorporates a critical assumption about Capital One's solicitation mail. The Commission assumed that the percentage of Capital One's solicitation mail to its total volume of First-Class Mail, on a before rates basis, would be the same on an after rates basis. In the case of Capital One, this ratio equaled 55.3 percent. PRC Op. MC2002-2, para. 8029, Table 8-2. The effect of this ratio, as compared to using a higher percentage for after rates solicitation mail, is to reduce estimated amount of ACS related savings, and consequently the total amount of discounts payable to Capital One during the three year period of the NSA.

In calculating the ACS related savings for Discover, a similar assumption is made. The comparable ratio for Discover is 34.6 percent in Year 1, 35 percent in Year 2, and 35.4 in Year 3.[50] The stop-loss cap based on these ratios would permit Discover to mail 3.6 times, 3.1 times, and 3.6 times its projected First-Class marketing mail in Year 1, Year 2 and Year 3, respectively, before the cap would limit the discounts payable to Discover.

3. The stop-loss cap developed for Capital One can be modified to reflect Discover's more reliable future volume projections

As noted previously, both the Postal Service and Discover maintain that the estimates of future marketing mail volumes are "conservative," or are more certain because they are based on Discover's budget. The Postal Service also claims that the conditions that led the Commission to impose a stop-loss cap on Capital One are not applicable in the case of Discover. USPS-T-1 (Ayub), at 16. Specifically, the Commission cited the "questionable volume projection" for Capital One's First-Class Mail volumes as necessitating the stop-loss cap. PRC Op. MC2002-2, para 8026.

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50 OCA/USPS-T1-28, Table 1, in Years 1, 2, and 3. The percentage figures increase from year-to-year because the before rates volume of customer mail declines while the volume of marketing mail remains constant.

There appears ample evidence to suggest that, unlike Capital One, Discover's after rates marketing volume projections are reasonable, and thus are likely to occur. Discover's volume projections are based on a "straightforward calculation of how many pieces could be upgraded from Standard to First Class by reinvesting postage savings realized through the NSA." OCA/DFS-T-1-2(a). Moreover, Discover maintains that the discounted rates available through the NSA will improve the prospect that First-Class Mail will be used in new marketing campaigns. DFS-T-1, at 11.

Given that Discover's after rates volumes are reasonably certain, the OCA has calculated a second stop-loss cap for Discover using the Commission's methodology. OCA/USPS-T1-37. However, the OCA assumed that any "extra" before rates volume was entirely marketing mail. Under such an assumption, the ratio of before rates marketing mail to total mail would equal 100 percent in each year of the NSA. Id. This produces a stop-loss cap of $11.6 million, which equals 95 percent of the estimated ACS related cost savings generated by Discover during the three year period of the NSA. Id., Table 3. Such a stop-loss cap would permit Discover to mail 5.2 times, 4.5 times, and 5.3 times its projected First-Class marketing mail in Year 1, Year 2 and Year 3, respectively, before the cap would limit the discounts payable to Discover.

Should the Commission accept the conclusion that Discover's after rates marketing volumes are reasonably likely to occur, it should modify the methodology applied to Capital One with respect to Discover as proposed above.

IV. THE DISCOVER NSA PRESENTS NEW RISKS THAT NEED TIGHTER MANAGEMENT

The proposed NSA with Discover may be functionally equivalent to the Capital One NSA, but it is hardly identical. The profit margin (unit contribution to institutional costs) on Discover's First-Class marketing pieces is small at the highest discount—approximately two cents.[51] In the Capital One case, that margin was 10.4 cents.[52] There was minuscule risk that unexpected changes in return rates, forward rates, eACS success rates, or attributable costs could drive Capital One's profit margin negative at high discounts. Unfortunately, that is not the case with the Discover NSA. However, the risk that the contribution from high-discount pieces becomes negative can be managed with a modified stop-loss mechanism.

The OCA proposes that discounts be adjusted (if necessary[53]) in Years Two and Three so as to maintain the minimum estimated Year-One unit contribution. This stop-loss mechanism has the advantage of not setting a limit on the volume of mail that Discover could shift from Standard to First Class, so long as the new volume makes a meaningful contribution to institutional costs.

To determine whether an adjustment were necessary, the Commission's version of witness Ayub's model would be rerun at the end of Years One and Two using actual

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51 1.98 cents, to be exact. Tr. ^/^^^^ [oca 41rev] shows a Year-One unit contribution of 2.2 cents. However, that number assumes that 2004 will be Year One. Actually, the NSA cannot be effective until 2005, so the unit contribution for Year Two is the appropriate figure to use.

52 Tr. ^/^^^^ [oca 42].

53 An adjustment might be necessary, for example, if Discover were mailing volumes approaching the 532 million pieces that would trigger the "competitive cap." At this volume, Discover would be receiving the highest level of discounts, and the unit contribution at that discount level might be below the 2.0-cent adjustment trigger.

data from the data collection plan.[54] Inputs such as return rates, billing determinants, subclass attributable costs, etc., would be adjusted to reflect actual experience during the previous year of the NSA.[55] For example, if return rates were lower than expected or declined as Discover's addressing practices improved, then (1) unit cost savings would decline, (2) unit contribution from new volume would increase, and (3) Total USPS Value would decline.[56] However, the reduction in Total USPS Value can be offset by an appropriate reduction in discount(s).[57]

A. Several Inputs to the Model That Estimates the Value of the Discover NSA Are Uncertain

The estimated value to the Postal Service of the Discover NSA depends on several assumptions and forecasts. These assumptions and forecasts are set out in witness Ayub's Appendix A. On page one of Appendix A are values for return rates, inflation rates, unit costs for returned letters, success rates for ACS, and proportion of marketing mail switching from Standard. On page two are volume forecasts. On page three are billing determinants for all discounted First Class. On pages four and five are

[54] Paragraph 10 of the Data Collection Plan recommended by the Commission in Docket No. MC2002-2 requires the Postal Service to "provide an evaluation of the impact [of the NSA] on contribution." This appears to contemplate an analysis similar to witness Ayub's Appendix A. Such an analysis should include a report of contribution at each discount level.

[55] One might expect a contingency provision to provide some cushion for uncertainty. But that is not how witness Ayub's contingency factor (line 9, page 1, Appendix A, USPS-T-1) works. The only effect of the contingency factor in witness Ayub's model is to exaggerate the unit contribution from switched volume. The net effect of witness Ayub's employing a contingency factor is to inflate Total USPS Value, as can be seen by changing the factor from 1.030 to 1.000.

[56] This effect can be seen by reducing the Return Forecasts for Year One at line (2) on page 1 of witness Ayub's Appendix A from 9.3 percent to 9.0 percent and then comparing line (7) on original page 11 with line (7) on page 11 of the adjusted Appendix A. The separate effects of reduced cost savings and increased contribution can be observed at lines (2) and (4) of Page 11, respectively.

[57] For example, the reduction in value obtained in note 56^^, *supra,* can be almost completely reversed by also changing the highest effective discount for Year One, $0.030, appearing in the table at the top of page 6 of Appendix A to $0.028.

First-Class billing determinants for Discover and unit costs by rate category. On page eight are billing determinants for all Standard letters. On page nine are billing determinants for Discover's Standard letters and unit costs by rate category.

Each of these assumptions and forecasts affects the value of the NSA to the Postal Service. Each of these assumptions and forecasts is subject to uncertainty. That is one reason for having a data collection plan—to measure the accuracy of assumptions and estimates. There would be no need for collecting and reporting data on the actual values of estimates if the estimates were believed with certainty to be correct.

Not only is the overall value of the NSA to the Postal Service subject to uncertainty, but there is also a risk that some of the negotiated rates will fail to cover costs or fail to generate a meaningful contribution to institutional costs. Tables 4-1 through 4-3 and Figures 4-1 through 4-3 show how the cost savings from reducing physical returns of marketing mail can be totally consumed by discounts if certain assumptions are off.[58] And the spreadsheets created by Valpak[59] show that the lowest rates in the NSA can easily fall below cost if physical forwarding of marketing pieces occurs at a slightly higher rate than assumed. But it is not necessary to allow these

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58 In these tables and graphs letter costs have been disaggregated. The record in Docket No. MC2002-2 provides the breakdown of First-Class Mail volume by shape: letters/ postcards are 94.6%; flats are 4.9%; and parcels are 0.5%. Tr. 2/278. (The Postal Service's Request states that it will rely on Tr. 2/254-400). For convenience, OCA will assume that the cost of physically returning a parcel is the same as that for flats, i.e., $**1.04**, although a parcel return cost is likely to be higher. ***See*** **witness Plunkett's revised spreadsheet, filed in Docket No. MC2004-3, Appendix A, page 1, line 6.**
The following equation gives an approximation of the manual return costs for First-Class letters:
.946L + .049F + .005F = $0.55; F= $**1.04**
Therefore, 0.946L = $0.55 **-** .054*$**1.04** = $0.55 **-** $0.05724 = $0.49276/0.946= $0.**522**
Thus, for Year 1, the manual return cost for letters is $0.52 **(rounded)**, not $0.55**.**

59 Tr. ^/^^^^ [vp/usps 14].

risks to persist for the life of the NSA. A stop-loss provision in the nature of a mid-course correction can prevent the NSA from losing money.

The tables and graphs below are arranged in order of adverse impact. The high point in each graph represents the cost savings estimated by the Postal Service. Each graph with a high point below the Postal Service estimate shows how maximum possible savings decline as assumptions are modified. The declining portions of each graph show how discounts consume cost savings.

Table 4-1 and Figure 4-1 show how rapidly total cost savings evaporate as forward rates for Discover's marketing mail rise. At a five-percent forwarding rate, cost savings are hardly large enough to discuss. They certainly offer no protection against an underestimate of "anyhow" volume.

Table 4-1
Net Value to the Postal Service from eACS Cost Savings
at Various Forwarding Rates
(millions)

	Net Value at Stated Forwarding Rates			
Volume	**2.0%**	**3.0%**	**4.0%**	**5.0%**
295	$0	$0	$0	$0
405	$1.546	$1.084	$0.623	$0.161
412	$1.471	$0.981	$0.490	$0
435	$1.217	$0.630	$0.043	-$0.545
437	$1.189	$0.595	$0	-$0.595
465	$0.739	$0.026	-$0.688	-$1.401
466	$0.718	$0	-$0.718	-$1.435
490	$0.215	-$0.603	-$1.421	-$2.239
498	$0	-$0.853	-$1.706	-$2.559

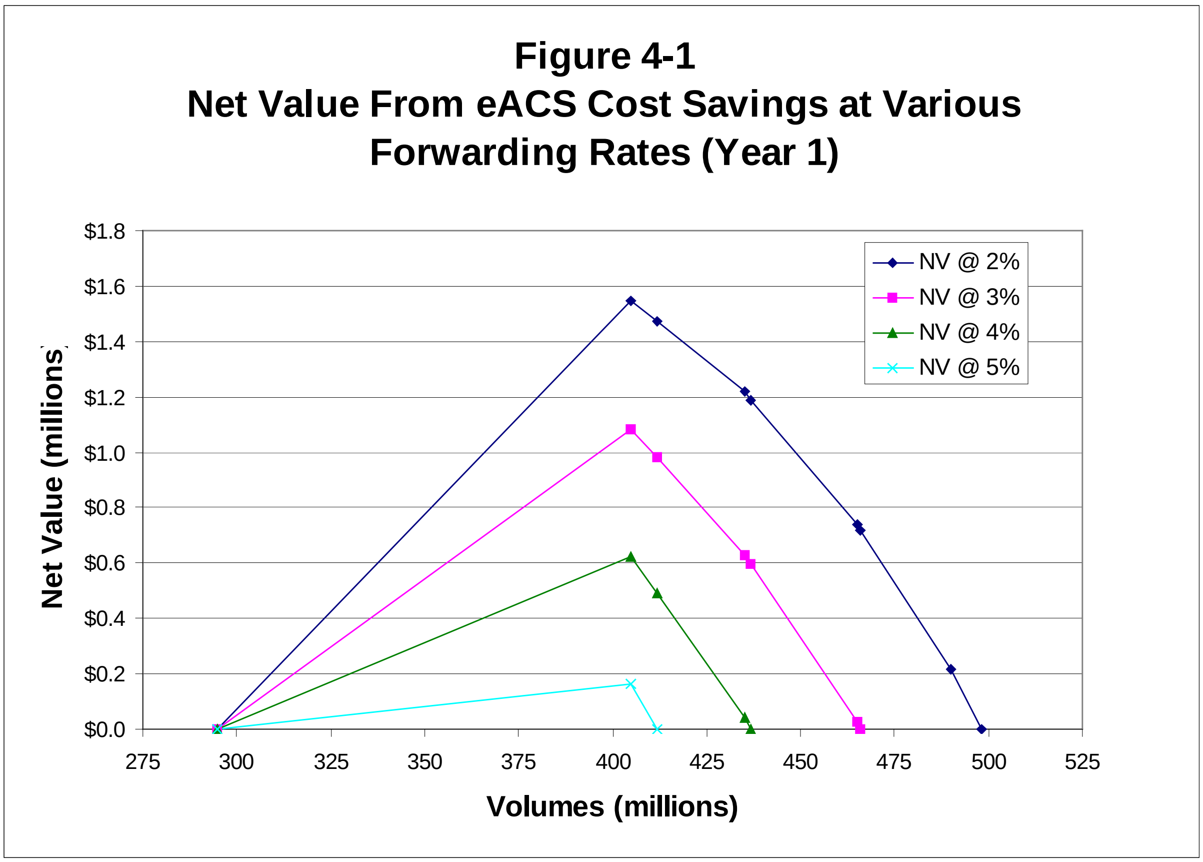


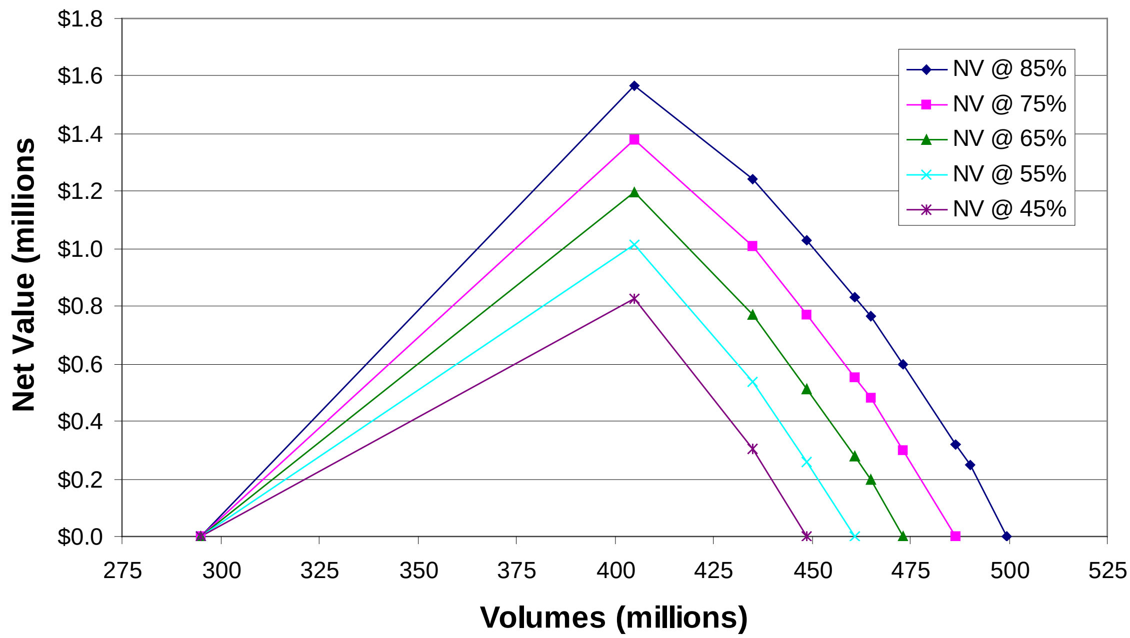
Figure 4-1
Net Value From eACS Cost Savings at Various Forwarding Rates (Year 1)
Net Value (millions)
$1.8
$1.6
$1.4
$1.2
$1.0
$0.8
$0.6
$0.4
$0.2
$0.0
275
300
325
350
375
400
425
450
475
500
525
Volumes (millions)
NV @ 2%
NV @ 3%
NV @ 4%
NV @ 5%

Table 4-2
Net Value to the Postal Sevice from eACS Cost Savings
at Various Success Rates
(millions)

	Net Value at Stated eACS Success Rates				
Volume	**85%**	**75%**	**65%**	**55%**	**45%**
295	$0	$0	$0	$0	$0
405	$1.564	$1.380	$1.196	$1.012	$0.828
435	$1.241	$1.007	$0.772	$0.538	$0.304
449	$1.027	$0.771	$0.514	$0.257	$0
461	$0.833	$0.555	$0.278	$0	-$0.278
465	$0.768	$0.483	$0.199	-$0.086	-$0.370
473	$0.596	$0.298	$0	-$0.298	-$0.596
487	$0.320	$0	-$0.320	-$0.641	-$0.961
490	$0.248	-$0.078	-$0.404	-$0.731	-$1.057
500	$0	-$0.342	-$0.669	-$1.027	-$1.369

Table 4-2 and Figure 4-2 display the sensitivity of cost savings to the success

Figure 4-2
Net Value From eACS Cost Savings at Various ACS Success Rates (Year 1)

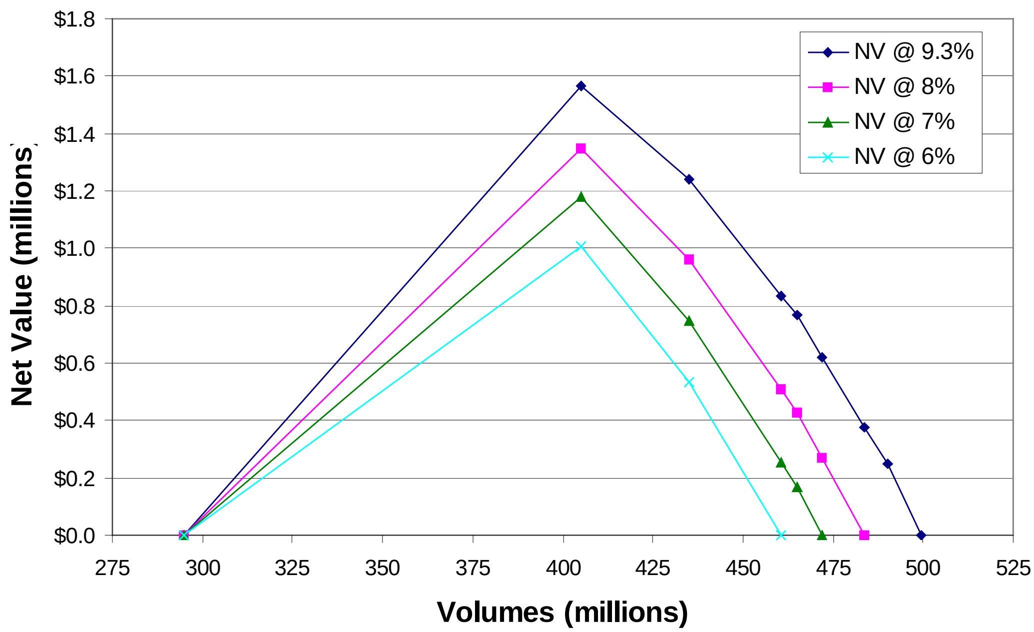


rate for eACS. Witness Ayub has assumed that 85 percent of Discover's First-Class UAA pieces will be directed to a forwarding center where electronic notices of address correction can be created. If Discover's UAA pieces are not processed properly, more of them will be physically returned and cost savings will decline. As discussed *supra,* improper processing of UAA mail was a serious problem prior to the Capital One NSA.

Table 4-3
Net Value to the Postal Service from eACS Cost Savings at Various Return Rates
(millions)

	Net Value at Stated Return Rates			
Volume	**9.3%**	**8.0%**	**7.0%**	**6.0%**
295	$0	$0	$0	$0
405	$1.564	$1.346	$1.177	$1.009
435	$1.241	$0.963	$0.749	$0.534
461	$0.836	$0.507	$0.253	$0
465	$0.768	$0.430	$0.170	-$0.068
472	$0.622	$0.271	$0	-$0.214
484	$0.375	$0	-$0.289	-$0.461
490	$0.248	-$0.140	-$0.438	-$0.588
500	$0	-$0.388	-$0.720	-$0.836

Figure 4-3
Net Value from eACS Cost Savings at Various Return Rates (Year 1)



B. A Margin of Safety Equal to Year-One Expected Contribution at the Highest Discount Should Be Established.

Not only are model inputs uncertain, some factors affecting Total USPS Value have not been modeled at all. The most troublesome unmodeled factor is forwarding costs. An ultimate objective of the NSA is to reduce the frequency of so-called "repeat forwards" and thus reduce forwarding costs. But in order to achieve this objective, two events must occur.

First, the Postal Service will provide Discover free electronic notices of forwarding. These notices will cost the Postal Service approximately 7.4 cents each.[60] Additionally, the Postal Service will begin providing free physical forwarding for Discover's former Standard Mail pieces at a cost of 34.5 cents per piece.[61] All of these costs to the Postal Service can be thought of as an investment in a mechanism—certain features of the NSA—that should reduce future forwarding costs.

Second, Discover and its list processors must make use of the electronic forwarding notices to reduce "repeat forwards." Unfortunately, the record of this proceeding does not provide a precise estimate of how frequently Discover mails solicitations to the same address.[62] It is thus impossible to know how many "repeat forwards" are potentially capable of elimination as a result of Discover's use of electronic forwarding information. Worse, the record provides no information on how Discover and its list processors can or will use electronic forwarding notices to reduce

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60 *E.g.,* Tr. ^/^^^^ [vp/usps 14, att 1, line 31].

61 *Id.*

62 Witness Giffney has testified that "on an annual basis, DFS commonly mails multiple times to a given individual." Tr. ^/^^^^ [vp/dfs 6]. Witness Ayub has testified, "It is very likely given that DFS mails multiple times to a prospective customer that an ACS notice may result in the elimination of a future piece from being forwarded." Tr. ^/^^^^ (vp/usps 14e).

"repeat forwards."[63] Recovery of the Postal Service's investment in free forwarding is highly uncertain.

Witness Ayub has testified that elimination of a single "repeat forward" would cover the cost of 4.5 electronic notices.[64] This statement would have been accurate in the Capital One case, but it is incorrect with respect to the Discover NSA. Because "new" volume under the Discover NSA is really *switched* volume from Satandard, any physical forwarding of such volume in excess of the First-Class average entails a new cost to the Postal Service. There is every reason to expect Discover's forwarding rate to exceed the First-Class average and no reason to expect any reduction in the number of repeat forwards. As witness Giffney testified, it is not known how (or whether) electronic forwarding notices will be used by Discover's list managers to reduce repeat forwards.[65] And Discover's "new" volume will be diverting from Standard, where the forward rate is 1.472 times the return rate. Since Discover's return rate is based in part on two years' worth of data from Standard mailings,[66] its forward rate should also reflect, to some extent, the higher Standard Mail ratio of forwards to returns. Averaging the presumed First-Class forwarding rate of 2 percent with a calculated Standard forwarding rate of 14 percent yields an 8-percent forwarding rate for Discover's First-Class solicitations.[67]

When witness Ayub speaks of covering the cost of 4.5 forwards, he is neglecting the need to recover the cost of the original physical forward. The first avoided "repeat

63 Tr. ^/^^^^ [vp/dfs 6].
64 Tr. ^/^^^^ [vp/usps 14e]
65 Tr. ^/^^^^ [vp/dfs 6].
66 Tr. ^/^^^^ [poir 1, q1]
67 Multiplying 9.3 by 1.472 (tr. ^/^^^^ [vp/usps]) gives 13.6 percent as a Standard Mail forwarding rate.

forward" simply recovers the cost of the prior physical forward. A second avoided "repeat forward" would only have a net value of 3.5 electronic notices, because one notice would have been used with the original physical forward.

Given that nothing is known about how rapidly (or whether) Discover and its list processors would use electronic forwarding notices, it is worth investigating how many "repeat forwards" would need to be avoided in order to offset the costs of two physical forwards and their electronic notices. The number is three, and the third avoided "repeat forward" would have a net value of 2.5 electronic notices. And this assumes that Discover would have mailed at least five solicitation pieces to the same address in the absence of the NSA.[68]

The above exercises demonstrate just how risky it is to ignore the effects of forwarding on the value of the Discover NSA to the Postal Service. As the number of physical forwards grows, the number of avoided "repeat forwards" needed to offset the cost of physical forwards grows. No one knows how rapidly electronic forwarding notices will be utilized by Discover. And the mere *possibility* of the Postal Service's at least breaking even on forwarding depends on Discover's having planned to mail the sum of the physical forwards plus the break-even number of avoided "repeat forwards" to the same addressee in the absence of the NSA. Suppose three notices (and three physical forwards) occurred before Discover's lists were updated. This would represent a loss to the Postal Service unless Discover would have mailed at least seven pieces to the same addressee in the absence of the NSA.

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[68] The cost of two physical forwards must be offset by two avoided "repeat forwards." These last two avoided forwards can only occur if Discover planned to mail them—*i.e.,* it would have mailed four pieces to the same addressee. In order to cover the cost of electronic notices to the first two physical forwards, there would have to be a fifth planned piece whose forwarding could also be avoided.

If 2004 were Year One of the NSA (It won't be; the NSA cannot be implemented before 2005.), the Postal Service is predicted to gain 2.2 cents per piece in contribution at the highest (4.5 cents) discount level. Allowing for another year of cost inflation reduces that unit contribution to 2.0 cents. The OCA views this level of contribution as the absolute minimum necessary to serve as a margin of error. The Commission should recommend a mechanism for adjusting discounts to ensure that a minimum unit contribution of two cents occurs in Years Two and Three.

C. The OCA's Proposed Stop-Loss Mechanism Is Straight-Forward

The DMCS language to implement the OCA's proposed stop-loss mechanism is attached as Appendix A. It consists of one sentence to be added to proposed DMCS section 611.4 and two (virtually identical) footnotes to be added to proposed Rate Schedules 611A and 611B. The language protects the Postal Service from downside risk without restricting potential gains from large volumes' switching from Standard to First Class.

The data needed to update witness Ayub's estimate of the value of the Discover NSA to the Postal Service either are regularly collected data or have been included in his data collection plan. For example, the actual eACS success rate can be determined from items 4 and 6 (physical and electronic returns) of the data collection plan. The actual return rate can be determined from items 1 (First-Class solicitation volume), 4, and 6. The actual forwarding rate can be determined from items 1 and 5 (forwarding notices). The number of repeat forwards *not* avoided can be determined from item 9 (number of uses of the same change of address notice).

As set forth in the proposed footnotes to Rate Schedules 611A and 611B, the Postal Service would have one month to submit the financial analysis required to be submitted at least annually by section 196^^^ of the rules of practice. If the analysis was late or failed to show actual unit contribution at each discount tier, discounts at all tiers would fall to the discount for the first tier: 2.5 cents.

D. The OCA's Proposed Stop-Loss Mechanism Is Consistent With the Postal Reorganization Act

The Commission devised a stop-loss cap in Docket No. MC2002-2 that would prevent contribution erosion stemming from a possible intention of Capital One to mail new First-Class solicitation volume at the levels projected by Capital One's witness Stuart Elliott absent any discount incentives. The Commission recognized that *all* of the contribution that might be produced by pieces receiving a discount would have been realized anyway, and that every penny of discount constituted a reduction in the "anyhow" contribution from Capital One's NSA mailings. The Commission's stop-loss cap ended the payment of discounts at the point that savings from providing electronic returns in lieu of physical returns was exhausted. According to the Commission:[69]

> The function of the stop-loss cap is to prevent a large loss in net revenue if it turns out that the Postal Service has seriously underestimated Capital One's derived demand for First-Class presorted mail. The stop-loss cap is a stop-loss provision because the amount of the cap has been chosen to equal the Postal Service's net cost saving from Capital One's acceptance of electronic notification. . . . . [It] may prevent a hemorrhage in postal net revenue if the Postal Service has seriously underestimated Capital One's volumes and the consequent leakage from the tariff.

[69] PRC Op. MC2002-2, para. 5061 – 5062.

The Commission found the Capital One before-rates volume estimates "so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA."[70] Every Capital One piece receiving a discount on the "anyhow" volume would be a free rider, enjoying the free ride at the expense of other mailers.[71]

The Commission harbored concerns about the lawfulness under the Postal Reorganization Act of an uncapped NSA:[72]

> This additional provision [the stop-loss cap] is necessary to comply with the basic fairness standard for postal rates that finds expression in several provisions of the law. *See, for example,* 39 U.S.C. §§ 101(d), 3622(b)(1), 3623(c)(1). The requirement that rates and classifications be fair and equitable would be violated if the Commission were to recommend a special low rate for one mailer likely to result in higher rates for other mailers. Essentially, this would constitute the sort of unreasonable preferences between mailers that must be avoided. § 403(c).

The Commission implied that, without the stop-loss cap, it might be necessary to reject the Capital One NSA:[73]

> The weakness of the Capital One volume estimates need not, and should not, lead to the rejection of the joint Request in this case. As noted in the Postal Service Reply Brief, the perfect should not be the enemy of the good. The addition of a stop-loss provision allows the otherwise meritorious proposal to become effective without an unreasonably large danger of a financially deleterious preferential rate.

Although the Governors of the Postal Service clearly preferred an uncapped NSA, they acknowledged the prudence of proceeding with the stop-loss cap fashioned by the Commission.[74]

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70 Id. at para. 8013.
71 Id. at para. 8016.
72 Id. at para. 8012.
73 Id. at para. 8021.
74 Governors' Decision, issued June 2, 2002, at 20.

> [W]e do not question that the inclusion of the stop-loss provision may be the result of perfectly reasonable differences of opinion regarding the acceptable level of risk, as we take our first steps down the NSA path. We agree with the Commission that the cap has the intended effect of risk reduction, and we likewise agree that it is a relatively uncomplicated measure that should be fairly simple to administer. Given the distinct possibility that it will have no practical effect on the intended economic benefits of the agreement, we find our continued preference for an NSA without the cap to be no reason not to accept the recommended NSA with the cap.

The Governors unanimously ordered the provisions recommended by the Commission to take effect on September 1, 2003.

Following a careful investigation of the financial effects of the Discover NSA, OCA has reached the conclusion that the risk associated with Discover's functionally equivalent NSA is even more serious than that presented by the Capital One NSA. Unlike the Capital One NSA, which involved a mailer that primarily used First-Class for its solicitation mailings, the Discover NSA is intended to induce Discover to switch *its* solicitation mailings from Standard Mail to First Class. As Standard Mail, Discover's high UAA rate generally imposes a relatively low level of additional costs on the Postal Service because Standard Mail UAA letters are not forwarded (at a cost of 34.5 cents) or returned (at a cost of 55 cents). Rather, they are disposed of at a far lower cost. Inducing Discover to convert Standard Mail to First Class produces large return costs and potentially large forwarding costs that previously did not exist.

While the conversion generates new contribution from these pieces as First-Class Mail, the new contribution is transferred back to Discover in the form of discounts. At the highest discount levels, there is a serious risk that Discover's converted pieces will actually lose money, i.e., the high costs of providing much higher than average return service (even as eACS) and possibly much higher than average forwarding service (since Discover has no customer relationship with the recipients of its solicitation mailpieces) will exceed the discounted rates that Discover is entitled to under the NSA. A circumstance of this type is flatly in violation of 39 U.S.C. §3622(b)(3). Thus, the concerns articulated by the Commission in the baseline NSA opinion, i.e., that the NSA might be unfair and inequitable to other mailers, are exceeded by the risk attendant to the instant NSA. The Courts have held that the §3622(b)(3) provision that "each class of mail or type of mail service bear the direct and indirect postal costs attributable to [it] . . . plus that portion of all other costs of the Postal Service reasonably assignable to such class or type" is a *requirement*.[75] The uncertainty associated with some of the Postal Service's assumptions in the calculation of costs and savings presents a distinct risk that highly discounted Discover solicitation pieces will not cover their costs and, consequently, will violate the §3622(b)(3) requirement.

If losses are produced under the instant NSA, they accumulate. The Commission made this observation in its MC2002-2 opinion:[76] "Although Capital One is free to cancel at any time if it meets a low volume threshold, the Postal Service does not have similar flexibility if volumes skyrocket." Losses from the Discover NSA can mount until the voluntary "competitive" cap is reached.[77]

OCA has devised a possible solution to that problem. OCA's solution is a stop-loss cap that operates at the margin and makes use of the data that the Postal Service (and Discover) and have agreed to collect and report under the Data Collection Plan.

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[75] Nat'l Assoc. of Greeting Card Pubs v. USPS, 462 U.S. 810, 820 (1983).

[76] Page 150, note 78. The withdrawal provisions of the NSA are asymmetric: Under the NSA, the Postal Service must continue to provide service and pay discounts to Discover whether it loses money or not. Discover, however, once it has met an easily reached volume target, may withdraw for any reason without penalty. *See* provisions IV.G. and II.D.

[77] With the stop-loss provision proposed by OCA, it may not be necessary to apply a voluntary "competitive cap."

OCA's proposal takes the Data Collection and Reporting activity one step further to its natural conclusion. Instead of performing the required financial analysis as a mere demonstration of the financial soundness (or unsoundness) of the NSA, OCA would require that the Postal Service make use of the financial analysis to determine whether the NSA contributes the minimal marginal amount contemplated by witness Ayub, i.e., a minimum of approximately two cents per piece on each discounted Discover mailpiece.

This type of financial analysis is already required under the rules for NSAs adopted by the Commission in Docket No. RM2003-5 (39 C.F.R. §3001.193(g)). If the financial analysis shows that highly discounted pieces are producing less than two cents per piece contribution, then OCA proposes small, equivalent reductions in the discounts paid. Discounts paid to Discover would be reduced by fractions of a cent, even mils, until the two cent contribution target is reached. If the results of the financial analysis show that the Postal Service's assumptions have been accurate, then the discounts will not be changed. This introduces a prudent, practical measure for protecting other mailers from having to subsidize some of Discover's solicitation mailings. This type of stop-loss provision would be tailored to the specific risks attendant to Discover's functionally equivalent NSA and should be recommended by the Commission using the same mechanism that it used to apply a stop-loss cap in the baseline NSA decision.

V. FREE RIDERS SHOULD BE ELIMINATED IN YEARS TWO AND THREE TO PROVIDE HIGHER PROBABILITY OF PROFIT TO THE POSTAL SERVICE OVER THE LIFE OF THE NSA.

In Docket No. MC2002-2, OCA witness Smith identified the free-rider problem as the payment of an incentive where none is necessary, *i.e.,* for pieces which would have been mailed absent an incentive. He stated that the incentive should be available to encourage additional mailings beyond the threshold level that would have been achieved absent the incentive, or, alternatively, the incentive should retain mail levels in the event of a projected decline in mail. The Commission has described "free riders" as "mail that would have been sent even absent the NSA . . . ." PRC Op. MC2002-2, para. 8016.

In his testimony in MC2002-2 OCA witness Smith stated that an objective estimate of projected mail volumes is needed in order to avoid a free-rider problem. OCA-T-1 at 3. Witness Giffney has provided a three-year forecast of Before- and After-NSA volumes. DFS-T-1 at 8-9, and Appendix 1.

Operations and Marketing Mail
Total Combined Mailings--Millions

	Before NSA	**After NSA**
2000	463	
2001	521	
2002	545	
2003	435	
Year One	451	464
Year Two	446	465
Year Three	441	461

The proposed NSA provides for a threshold for the first year of 405 million pieces, at which point discounts of 2.5 cents per piece will be paid and continue to be paid up to 435 million pieces. Discounts of 3 cents per piece will then be paid through a volume of 465 million pieces. The Before-NSA volume estimate is 451 million pieces. Thus, the volumes between 405 million pieces and 451 million pieces are free riders, falling within the Commission's description of "volume that would have been sent even absent the NSA."

Accordingly, under the proposed NSA total discounts of $1.2 million will have been paid to free riders in Year 1, prior to the generation of any additional First-Class mail volume. In Years 2 and 3, the projected Before-NSA volumes are 446 million pieces and 441 million pieces, with the free rider discounts being $1.1 million and $0.9 million, respectively.

Associated with the proposed NSA are proposed changes in the processing of Discover's First-Class solicitation mail: the Postal Service will dispose of rather than return First-Class UAA mail, and Discover will accept, and promises to use, electronic address change notices in its future mailings. These changes in operating procedures will become effective upon the initiation of the NSA. Accordingly, one might be tempted to argue that the discounts received by Discover from the free rider mail (those volumes for which Discover receives a discount but which are below the forecasted mail level) are actually the initial compensation for acceptance by Discover of the NSA. Following this line of reasoning, one could argue that there is not a free-rider problem.

However, this is not the case. The changes in procedures in the processing of First-Class Mail are associated with the implementation of the NSA, not with the level of mail entered into the system. Accordingly, in the first year the initial 46 million pieces of mail, representing a payment of $1.2 million, are free riders, as are the corresponding similar volumes of mail in Years 2 and 3.

The OCA opposes the payment of discounts for free rider mail pieces unless there are particularly extenuating circumstances. In the case of Discover, the OCA does not oppose Discover's collecting the $1.2 million for the initial 46 million pieces of mail in the first year of the NSA. However, any additional collection of payments associated with free-rider mail in subsequent years is inappropriate.

In litigating the proposed NSA Discover is clearly incurring legal, administrative, and possibly other costs. These are costs that Discover will need to recover prior to obtaining any benefit from the implementation of the NSA. Companies subject to litigated proceedings in regulated industries—*e.g.,* electric, gas, telephony—typically accrue regulatory costs and subsequently amortize them, possibly with imputed interest, over the expected life of a regulatory decision. It is appropriate that Discover recover its regulatory costs in some way.

In the testimony and interrogatories associated with the proposed NSA, no data have been presented on the regulatory and associated costs being incurred by Discover in pursuit of this NSA. These costs represent the only rationale for Discover's receipt of free-rider payments.[78] In addition to being unknown, these litigation and origination costs may not be representative of the level of costs which may be incurred in future NSA's, given that the proposed NSA is one of the first three to have been proposed. In proposing that Discover be permitted to earn free-rider discounts only in the first year of the NSA, OCA has been forced to rely on generally available public information,

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[78] Witness Ayub testified that "the cost of litigating an NSA for a customer carries a significant transaction cost. The cost of litigating an NSA may be absorbed or exceed the discounts earned on the "free riders." Tr. ^/^^^^ [oca 38a]. This is the only rationale that has been offered for allowing free riders.

bordering on speculation, as to the appropriate level of litigation and other costs incurred by Discover.

Costs appear to consist of three categories: professional costs (the costs to Discover of external legal, economic, or other counsel and assistance), internal costs (costs incurred by Discover personnel, these costs differing from costs delineated as professional costs due to the fact that the personnel are Discover employees), and overhead costs. First, OCA assumes that a professional hour could be estimated to cost $500. Such an hour would be the blended rate for a senior legal professional supported by appropriate office overheads, yielding an annualized cost of $1,000,000 based on full utilization of personnel. Given that the proposed NSA represents approximately one-third of a year of work as measured in expected calendar time, this yields professional charges of $330,000 for professional legal counsel or other supporting personnel based on the assistance of one full time equivalent person (FTE). Obviously, a variety of individuals might charge to such effort. There is no assumption that the FTE is a single specific person.

Second, the OCA assumes that Discover incurs similar costs internally, accounting for another $330,000 in support of the NSA.

Finally, OCA assumes, somewhat arbitrarily, that overhead costs are 50 percent of direct costs, yielding an additional $330,000 of charges. On a combined basis, the charges total $990,000 for the conceptualization, specification, formulation, development, review, filing, litigation, representation, enumeration, finalization, and implementation of the proposed NSA. One might view such a proposed cost level as exceptionally and specifically lavish, but it is also necessary to recognize that the proposed Discover NSA is one of the first three NSA's filed and that the Discover NSA differs significantly from the Capital One NSA and, accordingly, has opened new vistas requiring intensive analysis and, presumably, exceptional professional effort.

Given that this speculative cost analysis has hypothesized a total of $990,000, it appears appropriate that Discover be allowed, as one of the first three proponents of an NSA, to recover free-rider costs as delineated in this brief. OCA, however, does not propose that such cost recovery be recognized as a precedent or expectation. Rather, the main justification for cost recovery under a free-rider situation is the position of Discover as one of the first three NSA proponents.

Accordingly, the OCA believes that the amount to be collected under the free-rider volumes in the first year of the NSA could serve as a substantial offset to the regulatory expenses, associated risks, and management costs associated with the implementation of the NSA. OCA therefore does not oppose the threshold delineated for the first year. However, OCA believes that the threshold upon which discounts are paid should be adjusted to a level appropriate to avoid free-riders in the second and third years of the NSA.

Respectfully submitted,

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611.4 Rates

The rates applicable to this Agreement are set forth in Rate Schedules 611A and 611B. The rates are subject to adjustment at the beginning of Years 2 and 3 so as to maintain an incremental unit contribution of at least 2.0 cents.

Rate Schedule 611A

YEAR ONE

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

YEAR TWO

Volume Block	Incremental Discounts[1]
405,000,000 to 435,000,000	2.5¢
435,000,001 to 465,000,000	3.0¢
465,000,001 to 490,000,000	3.5¢
490,000,001 to 515,000,000	4.0¢
515,000,001 and above	4.5¢

YEAR THREE

Volume Block	Incremental Discounts[2]
405,000,000 to 435,000,000	2.5¢
435,000,001 to 465,000,000	3.0¢
465,000,001 to 490,000,000	3.5¢
490,000,001 to 515,000,000	4.0¢
515,000,001 and above	4.5¢

[1] One year and one month after the effective date of this rates schedule, all incremental discounts will become 2.5 cents, ***unless*** the Postal Service shall have filed a report pursuant to section 19^^^^ of the rules of practice that shows the unit contribution at each discount increment. If such report reveals any unit contribution of less than 2.0 cents, discounts will be reduced in increments of 0.1 cents until the highest incremental discount generates a unit contribution of at least 2.0 cents.

[2] Two years and one month after the effective date of this rates schedule, all incremental discounts will become 2.5 cents, ***unless*** the Postal Service shall have filed a report pursuant to section 19^^^^ of the rules of practice that shows the unit contribution at each discount increment. If such report reveals any unit contribution of less than 2.0 cents, discounts will be reduced in increments of 0.1 cents until the highest incremental discount generates a unit contribution of at least 2.0 cents.