Postal Rate Commission
Submitted 9/15/2004 4:11 pm
Filing ID: 41744
Accepted 9/15/2004

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.	)	

REPLY BRIEF OF THE OFFICE OF THE CONSUMER ADVOCATE

September 15, 2004

1333 H St NW, STE 300
Washington, DC 20268-0001
(202) 789-6833, FAX (202) 789-6819
e-mail: costicher@prc.gov

Before the
POSTAL RATE COMMISSION
WASHINGTON, DC 20268

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

REPLY BRIEF OF THE OFFICE OF THE CONSUMER ADVOCATE

September 15, 2004

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 Reply Brief on the Request for Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Inc. ("Discover").

This proceeding is the first to reach the Commission under its new rules of practice for functionally equivalent Negotiated Service Agreements (NSAs). Although marked by some initial acrimony,[2] the case has proceeded expeditiously as a result of cooperation among all participants. All participants agreed that this case was properly brought under the rules for functionally equivalent NSAs.[3] The OCA hopes that its

---

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

2 *See* Initial Brief of Discover Financial Services, Inc., September 8, 2004, at 2, n.1.

3 In its initial brief, Discover points out that an NSA without significant cost savings is not functionally equivalent to the Capital One NSA. *Id.* at 11. Unfortunately, the Discover NSA may very well fit this description. Certainly, there is a significant risk that this NSA will generate minuscule cost savings. As shown in the OCA's initial brief, a forwarding rate of five percent reduces maximum cost savings in Year One to $161,000, approximately 10 percent of the savings predicted by the Postal Service. If, in addition to a five-percent forwarding rate, the ACS capture rate were to be 75 percent instead of 85, or the return rate were to be eight percent instead of 9.3, there would be no cost savings whatsoever. The Discover NSA would then consist of nothing but declining block rates. *See* Initial Brief of the OCA, revised September 9, 2004, at 34-38. Table 4-1 on page 34 shows the $161,000 in cost savings at a five-

request for a hearing has not unduly prolonged the proceedings and expresses its gratitude to the co-proponents for their prompt responses to informal inquiries.

OCA's discovery (both formal and informal) dealt primarily with new financial aspects of the Discover NSA. Because the new First-Class volume to be generated under this NSA is migrating from Standard Mail, the unit contribution to institutional costs is much smaller than under the baseline Capital One NSA (which relied on creation rather than migration). Because discounts will be given to free riders under this NSA, the risk of dissipation of cost savings under alternative assumptions about return rates, capture rates, and forward rates must be analyzed. (Free riders had disappeared from the Capital One NSA by the time the case was submitted to the Commission for a recommended decision.) Obtaining and analyzing information related to these two issues took considerable time.

The co-proponents have expressed concern over the costs of negotiating and litigating functionally equivalent NSAs.[4] They have pointed out that such transactions costs constitute a barrier to entry for small mailers. The OCA is very sensitive to this concern. Throughout discovery and negotiations, the OCA has attempted to devise mechanisms within NSAs that could be applied to any size mailer.

The OCA has learned that every difference with a *financial* impact between a baseline and functionally equivalent NSA creates transactions costs. *Financial* deviations from a baseline NSA require time to negotiate and time for participants and the Commission to analyze. The easiest way to minimize transactions costs for

---

percent forwarding rate. Table 4-2 on page 36 shows the maximum cost savings at capture rates of 85 and 75 percent. The difference in savings is $184,000, totally eliminating the $161,000. Table 4-3 on page 38 shows the maximum cost savings at return rates of 9.3 and eight percent. The difference in savings is $218,000, again totally eliminating the $161,000.

functionally equivalent NSAs is to make them as nearly *financially* equivalent as possible. By this the OCA means that the same *financial* spreadsheets used for the baseline NSA should also be used for a functionally equivalent NSA. Only the actual numbers in the spreadsheets should change. Every new page, column, or row added to the baseline spreadsheets requires time to create and time to analyze.

Valpak devoted significant effort to creating spreadsheets that presented witness Ayub's financial model in a more visually intuitive and comprehensible manner. The Valpak spreadsheets were of significant assistance to the OCA in analyzing the effects of various return rates, forward rates, and capture rates. The OCA commends these spreadsheets to the Postal Service and the Commission for use in future cases derived from the Capital One NSA.

By virtue of the experience gained in litigating three Negotiated Service Agreement (NSA) cases before the Commission (one baseline case and two functionally equivalent cases), OCA has arrived at a greater understanding of the potential benefits and pitfalls of an NSA. Mailers who are not parties to the NSA may benefit from such arrangements when the NSAs are both consistent with the Postal Reorganization Act and when their interests are promoted by maximizing the gains that may be produced by the NSA arrangement, while minimizing the risks of loss. Application of that general proposition to the specific type of NSAs that have been litigated thus far triggers a need to fashion a risk-avoidance mechanism that allows profitable, new-contribution volume to be provided to the Postal Service, but blocks unprofitable, loss-producing volume.

---

[4] Initial Brief of Discover at 1; Initial Brief of USPS, September 8, 2004, at 6.

One of the chief reasons that it has been necessary to devote so much attention to the design of a stop-loss mechanism is that the NSAs presented to the Commission thus far are skewed to favor the NSA mailer and lack symmetrical provisions to protect the Postal Service and other mailers. The NSA partner can continue to enjoy the NSA arrangement without limit if it is profitable for the partner, and may withdraw from the NSA if it becomes unprofitable.[5] The Postal Service, on the other hand, has failed to negotiate a congruent risk-avoidance mechanism for itself. Even if the financial analyses performed under Rule 193(g) and the Data Collection Plan demonstrate to the Postal Service, the Commission, and other mailers that the NSA is loss-producing, the Postal Service has obligated itself under these agreements to continue to provide the negotiated service and discounts without any other limitation than the end of the three-year period of the NSA. Losses can accumulate while mailers outside the NSA arrangement watch with mounting concern.

The Postal Service does not even have the ability to exercise its rate and classification powers under the Postal Reorganization Act (PRA) to rectify such a situation. For example, in non-NSA cases, the Postal Service can make a request of the Commission to implement a new classification under a new rate. In cases where a new classification involves the performance of new activities, it would come as no surprise if the cost estimates included in the initial Request proved to be inaccurate. Were the Postal Service to learn that losses (not the expected gains) were being produced by the new service, it could exercise its power to request a change in rates and request a higher rate to cover the costs of the new service, or it could submit a new

[5] So long as minimum volumes have been provided. Section II.D. of the NSA. *See also*, NSA Section IV.G.2., and PRC Op. MC2002-2, para. 5036.

classification request seeking from the Commission a recommendation to terminate the loss-producing service. By contrast, the NSA agreement underlying the instant request binds the Postal Service for three years with no possibility of withdrawal.

In the Capital One proceeding, the Commission devised a mechanism to protect other mailers where the Postal Service had failed. It took the form of a savings cap. OCA believes, as the Commission does, that some mechanism must be applied to make up for the serious deficiency in the agreement (as described above). Without the imposition of such a protective device, the Commission should reject NSAs such as those that have been filed to date. In its Initial Brief, OCA presented two methods for calculating a protective savings cap of the type devised by the Commission in the Capital One proceeding.[6] OCA has developed still a third possible risk-avoidance device that prevents contribution loss, but permits the continuing entry of profitable new volumes under the NSA, thereby allowing additional contribution to grow.[7] OCA's approach—rejection of any discounts to free riders plus pinpoint reductions in discounts on new volume to maintain net contribution—results in NSAs whose profits are not capped, but whose losses are eliminated. OCA's proposal has the additional advantage of not making any adjustments to an NSA that proves to be profitable under the financial evaluations that are performed annually under Commission rules.

In its Initial Brief, Discover explains: "The negotiation of this contract took almost two years from start to finish . . . ."[8] Since the instant proceeding was filed with the Commission on June 21, 2004, it would appear that negotiations between the Postal Service and Discover likely commenced in the spring of 2002, possibly around the time

---

6 Pages 28 – 30.
7 Id. at 39 – 47.

that the Capital One NSA proceeding[9] was filed, in September 2002. The information cited above caused OCA to re-examine the volume figures provided by witness Giffney.[10]

Witness Giffney included the following First-Class marketing mail volumes in her testimony:

Year	First-Class Marketing Volumes
2000	160 million
2001	210 million
2002	213.2 million
2003	129 million

It may be observed that there was a precipitous drop in the volume of First-Class marketing volumes from 2002 to 2003, i.e., 84.2 million (nearly 40%). During the previous year, 2001, Discover had mailed nearly the same amount of First-Class marketing mail as in 2002, i.e., 210 million pieces. OCA believes there is at least the possibility that the negotiations taking place between Discover and the Postal Service throughout 2002 influenced Discover to deviate (in 2003) from the pattern of the previous two years.

In 2001 and 2002, Discover mailed First-Class marketing pieces at 210 and 213.2 million pieces, respectively. A possible explanation for the 40% drop in the First-Class marketing volume is that Discover might have believed there could be advantage

8 Initial Brief of Discover at 5.
9 Docket No. MC2002-2.

in the resulting NSA from a diminished use of First-Class for marketing purposes in 2003. This would constitute the exogenous volume effect about which the Commission voiced concern in its opinion in the Capital One proceeding.[11]

OCA believes that it is important to consider the financial effect of the Discover NSA not only at the before-rates volume level projected in the NSA filing, but also at Discover's peak levels of 2001 and 2002. In the tables below, OCA presents the net value of the Discover NSA at the lower bound of volumes – those presented in the filing[12] -- and at the upper bound – the 2002 before-rates peak volume figure of 213.2 million plus the estimated amounts of price-induced after-rates volume. In these tables, OCA presents the financial effects of (1) cost assumptions made by the Postal Service in its filing, contrasted with (2) cost assumptions that OCA views as plausible and that were explained in OCA's Initial Brief.[13]

---

[10] DFS-T-1, Appendix I

[11] PRC Op. MC2002-2, paras. 3062 and 5063. The Commission characterized the Capital One before-rates volume estimates as "so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA." Id., para. 8013.

[12] Adding 13 million pieces of after-rates (price-induced) volume to witness Giffney's before-rates volume estimate of 156 million in Year One, and adding 18 million of after-rates (price-induced volume) in Years Two and Three.

[13] A forwarding rate of 8.82% (page 14), and an eACS success rate of 47% (page 10).

TABLE 1
Annual and Three-Year Total Net Value to the Postal Service Based Upon DFS Witness Giffney's After Rates Volume Estimates

	Total Net Value			
	Scenario One	Scenario Two	Scenario Three	Scenario Four
Year 1	$2,026,689	-$2,837,603	$784,417	-$4,079,875
Year 2	$2,670,237	-$2,337,969	$1,340,051	-$3,668,156
Year 3	$3,041,839	-$1,966,367	$1,658,446	-$3,349,761
TOTAL	$7,738,765	-$7,141,940	$3,782,913	-$11,097,792

TABLE 2
Annual and Three-Year Total Net Value to the Postal Service Based Upon Discover's 2002 Volume, Including Contribution from Price-Induced Additional Volume

	Total Net Value			
	Scenario One	Scenario Two	Scenario Three	Scenario Four
Year 1	$784,349	-$5,725,155	-$878,087	-$7,387,591
Year 2	$1,450,491	-$5,202,928	-$316,666	-$6,970,085
Year 3	$1,921,190	-$4,732,228	$83,347	-$6,570,071
TOTAL	$4,156,030	-$15,660,311	-$1,111,406	-$20,927,747

Scenario 1: 9.3% Return Rate, 85% Success Rate, 1.96% Forwarding Rate
Scenario 2: 9.3% Return Rate, 85% Success Rate, 8.82% Forwarding Rate
Scenario 3: 9.3% Return Rate, 47% Success Rate, 1.96% Forwarding Rate
Scenario 4: 9.3% Return Rate, 47% Success Rate, 8.82% Forwarding Rate

It is evident from the net figures presented above that the forwarding rate has a powerful effect on the value of the NSA. Even if one believes that the 169- and 174-million-piece figures that Discover projects are accurate,[14] were forwarding rates to be

[14] First-Class marketing mail, after rates.

as high as the 8.82 % figure presented by OCA in its Initial Brief, the three-year NSA would lose approximately $7 million. The losses are compounded if the eACS success rate is as low as the 47% reported in *Postcom Bulletin* 35-04[15] -- a three-year loss of $11 million.

These losses roughly double if Discover had actually planned to mail First-Class marketing pieces at their 2001/2002 levels (OCA uses the 2002 figure 231.16 million pieces, after-rates). At a forwarding rate of 8.82%, the cumulative three-year loss would be $15.66 million. When combined with a 47% eACS success rate, the three-year loss grows to approximately $21 million.

There is a substantial risk of loss from the proposed NSA that undermines the goals for NSAs identified by Postal Service spokesperson Anita Bizzotto.[16] Witness Bizzotto testified in the baseline NSA case that:[17]

> A natural next step in the evolution of postal pricing is the customization of services and pricing for individual customers in a way that benefits not only the participating customer, but also all other postal customers by *providing a positive net contribution to the institutional costs of the Postal Service*.

and[18]

> Lastly, and most importantly, nonparticipating customers will see a reduction in their institutional cost burden as the total net contribution from Capital One increases.

Witness Bizzotto went on to testify that: "[A]n agreement giving a rate reduction without a net increase in contribution would be inequitable . . . ."[19]

In response to an OCA interrogatory, witness Bizzotto stated:[20]

---

15 Published August 12, 2004, at pages 3 – 4.
16 Ms. Bizzotto is the Chief Marketing Officer and Senior Vice President of the Postal Service.
17 USPS-T-1 at 5, Docket No. MC2002-2 (emphasis added).
18 Id.
19 Id. at 6.

> While increasing First-Class Mail volume is a desirable result, it was not the primary criterion for entering into the agreement with Capital One. The Postal Service was interested in developing an agreement that increased overall contribution to institutional costs from Capital One's mail.

More importantly, the Commission maintains that its focus "is on assuring that the NSA will not make mailers other than Capital One worse off."[21] The Commission formulated a stop-loss cap to "assure[ ] that the Postal Service will not be made worse off by the NSA, so no mailers will be disadvantaged by having to contribute a larger portion of institutional costs than previously found justified."[22]

Like the Commission and witness Bizzotto, OCA believes that it is essential for NSAs to generate net contribution that benefits mailers who are not parties to the agreement. The Postal Service expends substantial resources in negotiating and litigating NSAs.[23] As well, the Postal Rate Commission, including the OCA, also expends valuable staff time litigating NSAs.[24] Since the Postal Service does not submit NSA-specific cost estimates for these institutional activities, they must be recovered from the net contribution generated by the NSA. OCA's analysis reveals that the Discover NSA may not only not make a contribution to institutional costs, but may generate millions of dollars of losses that would be paid for by other mailers (primarily First Class) as part of the prior years' losses included in the Postal Service's request for increased rates in the next or subsequent omnibus rate case. This concern is the impetus for OCA's proposal to use the financial results collected and reported under

---

[20] OCA-T1-1 (Tr. 3/439).

[21] PRC Op. MC2002-2, para. 8006.

[22] Id., para. 8043.

[23] The costs incurred by Postal Service executives and other personnel in planning and negotiating an NSA are not accounted for in the financial analysis. *See* witness Crum's answers to interrogatories NAA/USPS-T3-1, –2, and –5, Docket No. MC2002-2 (Tr. 2/274 – 75, and 278, respectively).

Rule 193(g) and the Data Collection Plan to make adjustments to the discounts paid so that net contribution will be preserved.[25]

Respectfully submitted,

____

Shelley S. Dreifuss
Director, Office of the Consumer Advocate

Emmett Rand Costich
Attorney

1333 H St NW, STE 300
Washington, DC 20268-0001
(202) 789-6830, FAX (202) 789-6819
email: costicher@prc.gov

---

[24] Like the Postal Service's costs for such activities, those of the Commission would be recovered as institutional costs.

[25] Presiding Officer witness Panzar expressed this view in his testimony. "Presiding officer witness Panzar discusses the desirability of having data specific to Capital One as opposed to general information concerning the First-Class mailstream in order to evaluate the proposed NSA. Witness Panzar concludes that information specific to Capital One plays an important role in the NSA because Capital One's mailstream characteristics form the basis for the NSA." PRC Op. MC2002-2, para. 9018. Witness Bizzotto's views echo those of witness Panzar: "To the extent that data are available on the specific cost characteristics of serving an individual customer, that data should be used in evaluating a negotiated service agreement." Witness Bizzotto's answer to interrogatory NAA/USPS-T1-7(a) (Tr. 3/423).