

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001**

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

**REPLY BRIEF OF
J. P. MORGAN CHASE AND CO.
(September 15, 2004)**

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September 15, 2004

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J. P. Morgan Chase and Co. (“JPMC”), a limited participator in this case, respectfully submits its reply brief. JPMC is a competitor of Discover Financial Services, Inc. (“Discover”). Through a predecessor of JPMC, Bank One Corporation (“Bank One”),¹ JPMC has proposed the Negotiated Service Agreement (“NSA”) at issue in Docket No. 2004-3. The Commission has found both the Bank One and Discover NSA proposals to be functionally equivalent to the Capital One NSA approved in Docket No. MC2002-2, and both cases have proceeded on roughly parallel schedules.

I. INTRODUCTION AND SUMMARY

The outcome of the Discover case is of great concern to JPMC. First, the only two participants to challenge either of the proposed NSAs—the Office of Consumer Advocate (“OCA”) and Valpak—have asserted many of the same arguments against

¹ Bank One and J. P. Morgan Chase merged on July 1, 2004, after the filing of the Bank One NSA proposal.

both NSAs. Second, the Commission's decision dealing with these issues in the Discover case appears likely to be issued a few weeks before the Bank One recommended decision. For these reasons, the Commission's recommended decision in the Discover case is likely to be regarded as precedent for the Bank One case. JPMC is concerned that the Commission will reach a decision on the legal issues common to both cases before JPMC can brief those issues in its own NSA case—and without the benefit of the Bank One factual record, which differs significantly from the Discover record. Accordingly, JPMC respectfully urges the Commission to avoid taking action in the Discover case that would inappropriately prejudice the outcome of the issues in the Bank One case.

JPMC's reply brief deals with these concerns in two ways. First, where the NSA constraints proposed by the OCA and Valpak are legally or economically deficient for reasons common to both dockets—*e.g.*, the OCA's proposed adjustment mechanism for maintaining a two-cent margin on each piece—we identify those deficiencies in this brief. Second, where the outcome of an issue may turn on differences between the factual records in the two cases, we identify the relevant differences. These issues include the effect of a stop-loss cap on volume of Standard Mail that migrates to First-Class Mail and the resulting profitability of the NSA for the Postal Service. We respectfully ask the Commission, in resolving these issues, to be sensitive to the differences in the records, limit its rulings on the Discover NSA to Docket No. MC2004-4, and otherwise take care not to give the Discover decision undue precedential effect in deciding the Bank One case.

A. The Factual Record In The Bank One Case Differs In Crucial Ways From The Record In The Discover Case.

The Commission should consider each NSA based on the record developed in that case. Although both the Bank One and Discover NSAs include the requisite components for functional equivalence to the Capital One NSA,² Bank One's record is very different than Discover's. Three of the most important differences are as follows:

First, while the Discover NSA includes an agreed-upon cap on total discounts, Bank One strongly opposes the concept of a cap, and the Bank One NSA omits such a cap. Instead, Bank One submitted substantial evidence into the record demonstrating that the Bank One NSA discounts will cause a large increase in the volume of First-Class Mail solicitations entered by Bank One.³ Most of this volume will migrate from lower-contribution Standard Mail. A cap on total discounts, by limiting the potential incentive to Bank One, would limit the expected increase in First-Class Mail volume, and thus limit the added contribution to institutional costs that the Postal Service would otherwise gain from the NSA. A stop-loss cap on the Bank One NSA thus would be more accurately described as a "stop-gain" cap. In ruling on the OCA's proposal for a cost-savings cap in the Discover NSA case, OCA Br. 18-30, the Commission should make clear that it is not prejudging the cap issue for the Bank One NSA.

² The two main components are an electronic address correction element and a declining block rate element. See DMCS § 610.12

³ Direct Testimony of Lawrence G. Buc on behalf of Bank One Corporation, BOC-T-2, Docket No. MC2004-3, at 2; Direct Testimony of Brad Rappaport on behalf of Bank One Corporation, BOC-T-1, Docket No. MC2004-3, at 12, 13; Direct Testimony of Michael K. Plunkett on behalf of the Postal Service, Docket No. MC2004-3, USPS-T-1 at 2, 3; Response of Witnesses Buc and Plunkett to OCA/USPS-T-1-24, Docket No. MC2004-3; Bank One Corporation Comments on Limitation of Issues, Docket No. MC2004-3 (July 29, 2004; refiled Aug. 5, 2004), at 9.

Second, in the Bank One case, the co-proponents have worked closely with the OCA to allay its specific concerns about contribution of the NSA to the Postal Service's profitability, and have tried to respond to Valpak's concerns as well. In addition to providing in direct testimony a working model of the decisionmaking process for sending solicitations by First-Class Mail or Standard Mail, Bank One and the Postal Service have conducted numerous financial analyses under a wide range of scenarios in response to informal and formal discovery requests from the OCA and Valpak. Most of this evidence appears only in the Bank One case. See, e.g., Response of USPS Witness Plunkett to OCA/USPS-T1-50; Responses of Bank One Witness Buc to OCA/USPS-T1-24 and 46. The Commission should not decide issues such as margins, profitability, and caps, in this proceeding in such a way that precludes a meaningful examination of these questions based on the more complete record in the subsequent Bank One proceeding.

Third, as a result of intensive informal and formal discovery and extensive negotiations, Bank One and the Postal Service have been able to address many of the OCA's concerns (similar to those raised in the Discover case) and have been able to evaluate various suggested solutions and compromises. Bank One and the Postal Service have reached a stipulation and settlement with the OCA in Docket No. MC2004-3, and they expect to obtain the agreement of other participants as well. This settlement alone distinguishes the Bank One NSA proceeding from the Discover proceeding, which has not resulted in any settlement with any of the parties.

Given these key differences between the two pending NSA cases, JPMC urges the Commission expressly to limit its recommended decision in the Discover case to the

facts in Docket MC2004-4, and to avoid prejudging similar issues that should remain open for evaluation under Bank One's very different record in Docket MC2004-3.

B. Certain Of The Constraints And Adjustments Proposed By The OCA And Valpak In The Discover Case Are Inappropriate For Any Functionally Equivalent NSA Case.

In its initial brief, the OCA proposes three constraints on the Discover NSA: (a) a stop-loss cap calculated by a revised methodology from that in the Cap One proceeding (OCA brief at 28 through 30);⁴ (b) an additional stop-loss mechanism at the beginning of Years 2 and 3 to ensure an incremental unit contribution of at least 2.0 cents at the highest discount level, and (3) an adjustment of the discount thresholds in Years 2 and 3 to avoid what the OCA calls "free riders" (discounts offered to mail volume above the minimum discount threshold but below the Before Rates volume forecast). The OCA's purported justification for its proposals rests primarily on the assertion that above-average return or forwarding rates or below-average ACS success rates might possibly result in a decline in total USPS value. In Section II of this brief, JPMC identifies the appropriate standards for evaluating financial risk in the Commission's consideration of NSA proposals. In Section III of this brief, JPMC explains why the OCA and Valpak proposals depart from these standards, and are likely to worsen, not improve, the Postal Service's finances.

⁴ It is not clear whether OCA strongly advocates a stop-loss cap based on cost-savings in the Discover case. OCA simply states that "[t]o the extent excessive 'anyhow' volume poses a significant risk of financial loss, the Commission can eliminate this risk with a stop-loss cap." OCA Brief at 26. On the same page of its brief, OCA also concludes the excessive "anyhow" volumes are unlikely, as is a financial loss for the Postal Service from such volumes. *Id.* Moreover, OCA's Executive Summary characterizes the Brief as "present[ing] alternative calculations of the savings cap" but falls short of urging the Commission to adopt such a cap.

II. IN EVALUATING THE FINANCIAL EFFECT OF A PROPOSED NSA, THE COMMISSION SHOULD ALLOW THE POSTAL SERVICE TO MAKE RATIONAL TRADEOFFS BETWEEN RISK AND REWARD.

A. The Commission Should Focus on the Profitability of the Deal as a Whole, Not on the Profitability of Each Element in Isolation.

An NSA, like any commercial contract that results from arms-length negotiations, is the product of extensive give and take between the parties. The resulting agreement contains a complex combination of provisions, with some benefiting one party and some benefiting the other. Each party, however, must obtain an *overall* benefit from the contract, or the parties would not be able to reach an agreement. The question before the Commission thus is whether the bargained-for NSA, taken as a whole, is likely to make the Postal Service financially better off than the existing rate and classification structure. Unless the NSA imposes a burden on other mailers, the Commission's review of the deal should be satisfied.

The Commission has already rejected the OCA's proposal that "each element [of an NSA] unambiguously benefit the Postal Service." Docket No. RM2003-5, *Negotiated Service Agreements*, Order No. 1391, 69 Fed. Reg. 7574, 7577 (Feb. 18, 2004). In that proceeding, the Postal Service objected to the OCA's proposal "because requiring each element to benefit the Postal Service would bar [NSAs] that are on balance beneficial to the Postal Service just because one element in isolation is not beneficial. Postal Service Reply at 4-6." *Id.* Agreeing with the Postal Service and rejecting the OCA's argument, the Commission explained:

The Commission anticipates that negotiating a multi-element Negotiated Service Agreement will involve some give and take for the parties to reach agreement. Requiring each element to benefit the Postal Service could hinder this give and take process, and eliminate many possible arrangements from consideration. The Commission will review each element of an agreement, and integrate each element into a review of the agreement *as a whole*. *The overall agreement must benefit the Postal*

Service the OCA's policy proposal to require at the outset every element to benefit the Postal Service, without looking at the element's relationship to the *overall* agreement, is too restrictive. It will not be incorporated into the final rule.

Negotiated Services Agreements, 69 Fed. Reg. at 7577-7578 (emphasis added).

Second-guessing the optimality of each individual component of an NSA, as opposed to the reasonableness of the deal as a whole, would transform the Commission from regulator to its micromanager. The Commission, for this reason, has wisely disclaimed any interest in “acting as a bargaining party, or . . . renegotiating the terms and conditions of [an NSA] Nor does the Commission view its role as ensuring that the Postal Service has made the best possible deal.” *Id.* at 7580. The proper role of the Commission is to “apprais[e] whether agreements with rate and classification elements it regards less than optimal nonetheless pass muster under the Reorganization Act's standards.” MC2002-2 Op. & Rec. Deices. at ¶¶3058-59; *accord, id.* ¶ 8006 (the Commission's concern is not with determining “the most appropriate division of costs, revenues or contributions” between the Postal Service and its NSA partners, but with “assuring that the NSA will not make mailers other than [the NSA partner] worse off”). *See also id.* at ¶ 8006 (quoting APWU reply brief with approval (the Commission's role is limited to evaluating the overall effect of a proposal by ascertaining that “postal customers benefit generally” and that “no postal customer is disadvantaged”).

The myopic focus of the OCA and Valpak on the profitability of the deal “at the margin” (*i.e.*, at the deepest discount tier), along with OCA's concern with “free rider” volume, ignore the limits that the Commission has properly placed on its oversight role. If the overall deal is likely to be profitable to the Postal Service, whether marginal pieces in the deepest presort block produce a positive net contribution, and whether Discover

gets discounts for some of its Before Rates volume, are irrelevant. See Sections IV and V, *infra*.

B. The Commission Should Consider The NSA's Benefits As Well As Its Risks, And Avoid Choking Off Significant Potential Gains In A Misplaced Effort To Reduce Risks To Zero.

In evaluating an NSA, the Commission should consider both its risks and potential rewards. Any business decision involves a trade-off between risks and rewards: it is a rare deal that provides only an upside benefit without any corresponding downside risk. Part of the Commission's role is to assess the acceptable level of risk and the magnitude of the potential loss. The Commission intervention could very well be warranted if the probable outcome of the NSA were a net loss, or if the potential magnitude of a loss, even if unlikely, were so large as to endanger the Service's financial survival. The Discover (and Bank One) NSAs, however, pose neither of these risks. The NSAs involve only a very small fraction of the Postal Service's total revenues, and the likely outcome of each deal is a net gain to the Postal Service.

Moreover, the Commission cannot rationally assess only the risk of loss from a deal, without considering the potential gain. Just as an investor balances the risks and potential rewards of an investment, tolerating greater risk for greater rewards, the Commission should weigh the potential rewards of an NSA (such as increased First-Class Mail volumes induced by the NSA) against the possible risks.⁵ Barring the Postal

⁵ See, e.g., Paul Samuelson and Robert Nordhaus, *Economics* 483 (16th ed. 1998) (noting that investors rationally make tradeoffs between risk and expected reward); Investopedia.com, "Financial Concepts: The Risk/Return Tradeoff" (available at <http://www.investopedia.com/university/concepts/concepts1.asp>). As the investor Warren Buffett has noted in explaining why Berkshire Hathaway is willing to underwrite highly risky reinsurance contracts, the possibility that "a single event could cause a major swing in [the reinsurance company's] results in any given quarter or year . . . bothers us not at all: As long as we are paid appropriately, we love taking on short-term volatility that others wish to shed. At Berkshire, we would rather earn a lumpy 15% over

Service from assuming any financial risk—no matter how remote the risk and how great the expected rewards—would violate prudent business practices and make both the Postal Service and the overall mailing community worse off. Any review of an NSA should thus balance both the risks and benefits of the deal.

Sections III, IV, and V analyze the constraints proposed by the OCA and Valpak in light of these two guidelines, examining the profitability of the deal as a whole and considering the anticipated benefits of the deal as well as its risks.

III. THE COMMISSION SHOULD NOT IMPOSE A STOP-LOSS CAP ON DISCOUNTS WITHOUT FIRST CONSIDERING WHETHER THE CAP WILL CUT OFF PROJECTED FIRST-CLASS MAIL VOLUMES WHICH THE NSA WOULD OTHERWISE HAVE INDUCED.

In its Initial Brief, the OCA suggests the imposition of a stop-loss cap based on the Postal Service's cost-savings. The OCA's support for this constraint is equivocal: the OCA acknowledges that "excessive 'anyhow' volumes . . . are unlikely, as is a financial loss for the Postal Service from such volumes." OCA Brief at 25-26. Nonetheless, the OCA proposes that "[f]o *the extent* excessive 'anyhow' volume poses a significant risk of financial loss, the Commission can eliminate this risk with a stop-loss cap." OCA Br. 26 (emphasis added). The OCA identifies two alternative methods of calculating a stop-loss cap: \$8.57 million under the Commission's methodology in the Capital One case and \$11.6 million under the OCA's modified methodology, which assumes that any "extra" Before Rates volume is entirely marketing mail. OCA Br. at 28, 30.⁶ In contrast, the "competitive cap" that Discover and the Postal Service have

time than a smooth 12%." W. Buffett, Letter to Shareholders, *Berkshire Hathaway 2002 Annual Report* (2003) (<http://www.berkshirehathaway.com/2002ar/2002ar.pdf>).

⁶ OCA's assumption that any "extra" Before-Rates volume is marketing mail is appropriate: operational mail is largely nondiscretionary. See Docket No. MC2004-3, Response of Bank One Corporation to August 5 Reply Comments of OCA and Valpak (Aug. 10, 2004) at 4.

themselves proposed in the language of the NSA would be approximately \$13 million.⁷ Direct Testimony of Karin Giffney on Behalf of Discover Financial Services, Inc. DFS-T-1, Docket No. MC2004-4 at 12. The dispute over the appropriate cap in this case is thus relatively narrow (a difference of \$1.4 million over three years). In the Bank One case, by contrast, the range of dispute is large: the cost-savings cap based on the OCA's methodology would be approximately \$11.1 million, Response to OCA/USPS-T1-36, and the competitive cap would be approximately \$16.3 million for Bank One;⁸ but the discounts generated by plausible estimates of the increased First-Class volume generated by the proposed NSA rate schedule in the absence of a cap could be considerably larger.

Perhaps because the amount in dispute here is not great, the Discover record contains less evidence than the Bank One record on the damage that a stop-loss cap could cause. JPMC requests that the Commission specifically reserve judgment on the cap issue as it relates to Bank One until after examining the more complete record in Docket No. MC2004-3. That record includes:

- Unchallenged testimony of a Bank One executive that the Company intends to shift substantial amounts of solicitations from Standard to First-Class Mail as a result of incentives provided by the NSA discounts. BOC-T-1 (Rappaport) at 5-8.

⁷ JPMC believes that the parties to an NSA should have the flexibility to negotiate the terms that fit their particular interests and circumstances. Hence, despite Bank One's general position that caps are inadvisable, Bank One does not oppose the cap proposed by Discover.

⁸ Based upon the J.P. Morgan Chase volumes provided by Bank One witness Rappaport in Docket No. MC2004-3 in response to OCA/USPS-T1-44, combined J.P. Morgan Chase Before-Rates First-Class Mail volume is expected to be approximately one billion pieces. The competitive cap at this volume level would be nearly \$30 million.

- Unchallenged testimony of Bank One’s economic expert that provides a working model demonstrating that discounts on First-Class Mail rates will result in even larger shifts in solicitations from Standard to First-Class Mail. BOC-T-2 (Buc).
- Calculations provided by Bank One’s economic expert showing that a cap on discounts would choke off significant expected increases in First-Class Mail volume, and would act more as a “stop-gain”, rather than a “stop-loss” cap. Response of Bank One Witness Buc to OCA/USPS-T-1-24.

Bank One’s record thus demonstrates a much greater volume response to the NSA discounts than Discover’s. A large First-Class Mail volume response, such as Bank One’s, represents the upside potential for the Postal Service that a cost-savings cap would choke off. In effect, the Postal Service’s prudent decision to accept a minimal level of risk in exchange for huge potential rewards would be trumped by an overly conservative aversion to risk. JPMC thus urges the Commission to refrain from adopting—based on the Discover record alone—a rule that would impose a cost-savings cap on a mailer which has demonstrated a large anticipated volume response.

IV. THE COMMISSION SHOULD ALSO REJECT THE TWO-CENT FLOOR ON PER-PIECE MARGINS PROPOSED BY THE OCA.

The OCA also proposes a stop-loss constraint on the *marginal contribution* from each piece of mail under the NSA. Specifically, the OCA asks the Commission to require the Postal Service to determine, shortly after the end of the first and second years of the NSA, the contribution per piece actually earned by the Postal Service within each discount block of the NSA rate schedule during the previous year. If the net contribution less discount for any discount block is smaller than the margin currently projected by the Postal Service—approximately two cents per piece for the deepest discount block—the Postal Service must increase Discover’s rates for the following year to maintain a minimum contribution margin of the same amount. The OCA apparently would require this margin-based adjustment even when the *aggregate* financial effect of

the NSA to the Postal Service has been positive. OCA Br. 31-32, 42-47; *see also* Valpak Br. 41 (endorsing OCA proposal).

In support of this proposed constraint, the OCA and Valpak contend that Discover's actual return rates could be higher than projected; that Discover's actual forwarding rate is likely to be significantly higher than the national average assumed by the proponents; and the ACS success rates significantly lower than projected. If these variances occur, the Postal Service's margins assertedly would be smaller than projected—and could even be negative, particularly for mail entered within the deepest discount block. OCA Br. 32-42; Valpak Br. 6-10, 15-26, 40-41.

The Commission should reject this proposal. First, the relevant increment of volume for determining the profitability of the NSA is its total expected volume, not the marginal discount block or the marginal piece of mail. Second, the after-the-fact rate adjustment mechanism proposed by OCA would amount to an unlawful delegation of the Commission's ratemaking authority to the Postal Service. Third, the proposed margin adjustment mechanism would reduce the willingness of mailers to enter into NSAs, and reduce the likely contribution to the Postal Service from any NSAs that the Postal Service managed to establish.

A. The Relevant Measure of Profitability Is The NSA As A Whole, Not The Marginal Discount Block Or The Marginal Piece.

The relevant test for the profitability of an NSA is the expected overall profitability of the agreement as a whole, not the marginal or incremental contribution of the deepest discount block, the last piece of mail entered, or any other subcomponent of the deal. *See generally* Section II.A, *supra*; MC2002-2 Op. & Rec. Decis. at ¶¶ 3058, 8006, 8010; *Negotiated Service Agreements*, 69 Fed. Reg. at 7577-78, 7580.

Several factors justify the Commission's focus on the overall contribution of an NSA rather than the marginal contribution of any individual rate cell or other component. First, as noted above, NSAs and other commercial contracts typically contain a complex mixture of provisions, some of which benefit one party while others benefit the second party. To require "each element [of a contract] to unambiguously benefit" one of the parties would be unreasonable. *Id.* at 7574, 7577 (citing OCA comments); *accord, id.* at 7577-78 (rejecting the OCA proposal that "each element [of an NSA] unambiguously benefit the Postal Service").

Second, as the Commission has also recognized, ensuring that the components of the bargain struck by the Postal Service achieve the optimal trade-off of costs and benefits is likely to exceed the ability of even the most omniscient regulatory commission.⁹ Hence, the Commission has properly disclaimed any "intent of acting as a bargaining party, or . . . renegotiating the terms and conditions of [an NSA] Nor does the Commission view its role as ensuring that the Postal Service has made the best possible deal." 69 Fed. Reg. at 7580; *accord*, MC2002-2 Op. & Rec. Decis. ¶¶ 8006, 8010 (the Commission's concern is not with determining "the most appropriate division of costs, revenues or contributions" between the Postal Service and its NSA partners, but with "assuring that the NSA will not make mailers other than [the NSA partner] worse off"). Insisting that each NSA be profitable at the margin, not just in the aggregate, would require the Commission to venture into the thicket of micromanagement that the Commission has properly shunned.

⁹ See, e.g., 2 Alfred E. Kahn, *The Economics of Regulation* 326 (1971) ("Regulation is ill-equipped to treat the more important aspects of performance—efficiency, service innovation, risk taking, and probing the elasticity of demand.").

Third, verifying that the Postal Service has struck the optimal bargain is unnecessary to satisfy the Commission's duties under Title 39. Beyond considering any claims of discrimination raised by competitors of the mailer party to the NSA, the Commission's responsibilities to other mailers are limited to "assuring that the NSA will not make [them] worse off." MC2002-2 Op. & Rec. Decis. ¶¶ 8006, 8010, 8012. In the words of Valpak, the relevant risk is that an NSA will impose a financial burden on third-party mailers: "*if the Postal Service loses money on the NSA*, those losses will become institutional costs that, ultimately, will be paid . . . by other mailers." Valpak Brief at 13-14 (emphasis added). An NSA by definition can burden other mailers in this sense only if the NSA costs the Postal Service money in the aggregate.

Neither the OCA nor Valpak address the Commission's holdings on these points in MC2002-2 and Order No. 1391. Instead, the OCA and Valpak simply assert that a marginal profitability analysis is required by the attributable cost floor of 39 U.S.C. § 3626(b)(3). OCA Br. 46; Valpak Br. 14-15, 40-41. The attributable cost standard of Section 3622(b)(3), however, applies only to a "class of mail or type of mail service" as a whole—not to rate categories, rate cells, individual mailpieces, or other subsets of a class or subclass. See *United Parcel Service, Inc. v. USPS*, 184 F.3d 827, 845 (D.C. Cir. 1999) (holding that Section 3622(b)(3) did not require the Commission to establish a separate rate and classification for non-transported or "local only" First-Class Mail, despite its below-average cost); *Mail Order Ass'n of America v. USPS*, 2 F.3d 408, 437-38 (D.C. Cir. 1993) (same); *id.* at 435 (noting that Section 3622(b)(3) did not require that second-class rates for mail within any individual distance zone cover attributable costs).¹⁰

¹⁰ Although other ratemaking criteria can require consideration of attributable cost coverage for increments of mail volume smaller than the subclass, those criteria do not

The reliance of the OCA and Valpak on the attributable cost floor is misplaced for a second and independent reason: the Commission has specifically held that the attributable costs of a service under Section 3622(b)(3) do not include the potential contribution forgone from other mail classes because of the mail volume cannibalized by the service being costed. R83-1 Op. & Rec. Decis. (Feb. 24, 1984) ¶¶ 6027-6037. While opportunity cost analysis is relevant in deciding whether “new types or classes of service should be launched,” and the amount of institutional costs that should be recovered from each new type or class of service, the relevant cost coverage is for the service or class as a whole, not for an individual rate block or rate cell. *Id.* ¶¶ 6042, 6043-46. This is a crucial distinction, because the OCA and Valpak have computed the narrow margins they attribute to incremental First-Class Mail volume under the NSA by netting out an assumed Standard Mail contribution of more than eight cents for each incremental piece. Direct Testimony of Postal Service Witness Ali Ayub, Appendix A at 10.. Restoring this amount yields a markup over attributable cost in the range of ten cents per piece, not two cents.¹¹ Neither the OCA nor Valpak seriously contends that any plausible variance in return, forwarding and ACS success rates is likely to erode the projected margins by as much as ten cents per piece.

B. The OCA’s Proposed Margin-Adjustment Mechanism Is Unlawful.

The rate adjustment mechanism that the OCA (and Valpak) propose to maintain per-piece contribution margins would unlawfully delegate the Commission’s ratemaking

apply here. The statutory goal of “fairness” (39 U.S.C. § 3622(b)(1)) and the bar against undue discrimination (*id.*, § 403(c)), for example, obviously have no bearing on disparities in cost coverage within a schedule of rates offered to a single mailer—i.e., when the same ratepayer is simultaneously the “preferred” and the “prejudiced” party. The Act does not forbid bathtub discrimination.

¹¹ First-Class Marketing Letter Average Contribution Per Piece From Direct Testimony of Postal Service Witness Ali Ayub, Appendix A at 10.

authority to the Postal Service. The discount adjustment mechanism proposed by the OCA would rely on the Postal Service's determination each year of a welter of inputs whose values are neither transparent nor objectively determinable.

For example, two inputs required to determine the per-piece contribution margins are First-Class Mail cost per piece and Standard Mail cost per piece by presort level. Direct Testimony of USPS Witness Ali Ayub, Appendix A at 4-5, 9. Updating these inputs at the level of detail proposed by the OCA would require the Postal Service to perform a special study of its costs every year. Such studies require numerous assumptions regarding Cost and Revenue Analysis ("CRA") costing methods, mail processing productivities, and mail flows that could not be validated by mailers and other interested parties outside of a Commission proceeding.

Delegating this much rate-setting discretion to the Postal Service would be an abdication of the Commission's ratemaking responsibilities under 39 U.S.C. § 3624. In *United Parcel Service, Inc. v. USPS*, 455 F.Supp. 857 (E.D. Pa. 1978), *aff'd*, 604 F.2d 1370 (3rd Cir. 1979), the District Court and 3rd Circuit held that the USPS could not adopt a "limited and temporary experiment" offering reduced rates for twenty parcel post shippers in exchange for certain operational commitments without submitting the program to the Commission for approval under the rate and classification provisions of 39 U.S.C. §§ 3622 *et seq.* The courts held that the statute forbade the adoption of rate changes without, *inter alia*, a hearing before the Commission on those specific rates and the Commission's recommended decision finding that those particular rates comply with the statutory criteria of the Act. The significance of these decisions was underscored by the dissenting opinion of Judge Higginbotham, which noted that "under the majority's reading of the statute, hearings would be necessary" to "modify some

portion of the experimental design on rates or classifications" "during the process of an experiment" (604 F.2d at 1387).

In Docket No. MC86-1, *Destination-BMC Parcel Post Classification and Rate Changes (Experiment)*, 1985, PRC Op. & Rec. Decis. (June 5, 1986), the Commission faced the very scenario hypothesized by Judge Higginbotham. As part of a package of experimental rate and classification changes proposed for parcel post mail, the USPS requested authority to "change unilaterally both rate levels and rate structure during the life of the experiment." *Id.* at ¶ 531. In support of this request, the USPS stated that "it cannot predict all possible developments during the experiment" -- particularly, the possibility that net contribution might depart from expectations "if the volume mix is very different from that anticipated." *Id.* at ¶ 532. (The volume mix was important because the various kinds of parcel post mail covered by the proposal were expected to have widely varying margins.) The Commission denied this request as unlawful on the ground that the statute did not allow the USPS to make mid-course changes in its rates and classifications without Commission review and approval under 39 U.S.C. §§ 3622 *et seq.* The Commission reasoned, *inter alia*, that:

The Commission is under a statutory obligation to recommend rates that comport with factors found in the statute. The statute provides for rate regulation in order to insure that its objectives are met. The Commission does not take lightly its obligations to determine that the rates paid and the services offered are consistent with the statute. . . . The court in *UPS I* [the case discussed above] pointed out that other entities whose rates are subject to regulation are required -- at a minimum -- to file experimental rate changes and provide an opportunity for comment by parties who might be adversely affected. The court noted the importance of the Postal Rate Commission having an opportunity to consider experimental rate changes and the potential impact on the interests for which the statute has directed protection. 455 F. Supp. 878.

The Postal Service's proposal for flexibility ignores these aspects of the statutory scheme -- that affected parties be given an opportunity to state

their views before rates are changed and, further, that a determination be made on a formal record that the **specific rates** are consistent with the guidelines set out in the statute. . . .

The Postal Service fails to respond to the dissent's conclusion in *UPS I* on appeal, that if the majority's view prevailed -- which it did -- the Postal Service would have to seek permission to change rates during the course of an experiment by means of a separate section 3622-23 hearing procedure.

MC86-1 Op. & Rec. Decis. at ¶ 536-38 (emphasis added). The mid-course correction proposed by the OCA here would entail the same delegation of ratemaking authority to the Postal Service that the Commission found unlawful in MC86-1.¹²

C. The Proposed Margin Adjustment Mechanism Would Reduce The Willingness Of Mailers To Enter Into NSAs, And Reduce The Likely Contribution To The Postal Service From Each NSA Entered.

The proposed mid-life adjustment mechanism is also unsound as a matter of regulatory policy. First, it would radically alter the allocation of risks bargained for by the Postal Service and its mailer. The marginal contribution of a piece of mail is likely to vary for a variety of reasons beyond the control of the mailer. These factors include, *inter alia*, the relationship between First-Class and Standard attributable costs reported by the Postal Service in its CRA reports (which typically vary from year to year); and the relationship between First-Class and Standard rates (which may change in the next omnibus rate case).

Under the terms bargained for by the Postal Service and Bank One, the potential variance from projected margins would be symmetrical: the Postal Service would

¹² The Commission could avoid this legal infirmity by simplifying the adjustment mechanism (to make the needed data more limited, the calculations more transparent, and the Postal Service less able to exercise discretion in performing them), and by making termination of the NSA, rather than an ad hoc adjustment of the discount levels, the consequence of failing the trigger test. The parties have not proposed such an adjustment in this case, however.

generate lower-than-projected margins when the difference between First-Class and Standard costs is large or the difference between First-Class and Standard rates is small, and would generate higher-than-projected margins in the opposite circumstances. The OCA proposal, by contrast, would transform unanticipated changes in margins on the Postal Service into a game of heads-I-win, tails-you-lose: narrower-than-expected margins would prompt a rate increase, but wider-than-expected margins would entitle the mailer to no rate relief at all.

After-the-fact risk reallocation mechanisms of this kind can greatly alter the expected economic value of a contract. Faced with the substantial and one-sided shifting of risk inherent in the proposed margin adjustment mechanism, most mailers are likely to avoid NSAs entirely.

Moreover, the proposed margin adjustment is likely to reduce the net contribution obtained by the Postal Service from the handful of NSAs that it may be able to attract. If a margin that falls below the Postal Service's proposed target of two cents per piece for the deepest discount block must be increased, but a margin that exceeds the two cent target is permitted to remain unchanged, the expected value of the average margin over time will be not two cents, but something substantially higher. Widening the expected margin between rates and costs will reduce, not increase, the likely contribution to the Postal Service from any NSA.

A declining-block rate schedule is, in economic terms, a form of second-degree price discrimination. See F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* 489-90 (3rd ed. 1990). A firm maximizes its net contribution from second-degree price discrimination by capturing the greatest share possible of the potential surplus triangle bounded by the marginal cost curve of the firm, the demand

curve of the buyer, and the vertical axis at the origin. Hence, in a well-designed set of declining block rates the final discount tier will have an expected margin relatively close to zero.¹³

Widening the expected value of the margin between rate and costs, by contrast, would limit the ability of the Postal Service to capture the full share of contribution from the area of the triangle under the mailer's demand curve. Increasing the wedge between the Postal Service's marginal costs and the minimum price offered to the mailer would reduce the potential surplus available for sharing between the Postal Service and the mailer,¹⁴ and thus would make the Postal Service and other mailers worse off. As with the proposed cost-savings cap, a mechanism intended as a stop-loss mechanism is more likely to stop the Postal Service's gains. See Stephen J. Brown and David S. Sibley, *The Theory of Public Utility Pricing* 82 (1986) (demonstrating that modifying a multipart tariff by adding another rate tier closer to the supplier's marginal costs increases "the level of total surplus").

V. THE COMMISSION SHOULD DECLINE TO MAKE A "FREE RIDER" ADJUSTMENT.

The Commission should also reject the OCA's proposal to "cure" the asserted problem of "free riders" by raising the minimum volume threshold for discounts in the

¹³ See Scherer & Ross, *supra*, at 490 (Fig. 13.1). Indeed, in the hypothetical limit case of a market without transaction costs and other market imperfections, the firm will offer an infinite number of rate blocks—and the deepest discount will produce a marginal price that is *exactly equal to* marginal cost. Stated otherwise the expected margin of the most deeply discounted rate will equal zero. See Robert D. Willig, "Pareto-superior nonlinear outlay schedules," *Bell J. of Economics*, vol. 9, no. 1 (Spring 1978) at 56.

¹⁴ In illustrations of declining block and other multi-part rate designs, the area of potential surplus is represented by the triangle between the mailer's demand curve and the Postal Service's marginal cost curve. See, e.g., MC2002-2 Op. & Rec. Decis. ¶ 5025 (Figure 5-2). Increasing the minimum allowed expected value of "P" reduces the area of the triangle bounded by P, the demand curve, and vertical axis.

second and third years of the NSA. OCA Br. 48-53. This proposal is another illustration of the errors that can result from a misplaced focus on the profitability of individual components of a contract in isolation, rather than on the profitability of the deal as a whole. See Sections II.A and IV.A, *supra* (discussing MC2002-2 Op. & Rec. Decis. and Order No. 1391).

The OCA concedes that discounts for “free rider” volume are appropriate to compensate a mailer for the negotiation and litigation costs that it must incur at the outset of an NSA. For this reason, the OCA proposes that Discover be allowed to recover “free rider” discounts for the first year of the NSA, a concession that the OCA estimates is roughly equivalent to the Discover’s negotiation and litigation costs. OCA Br. 50-52. The OCA ignores the possibility, however, that “free rider” discounts may provide consideration for other aspects of Discover’s performance. Moreover, the OCA overlooks the fact that the expected payoff to a mailer from its sunk initial investment in obtaining NSA must be discounted to reflect the possibility that the NSA may be disapproved by the Commission—or may be approved only under conditions that substantially alters the expected value of the agreement. Just as the payoffs received by oil companies, pharmaceutical companies and plaintiff’s tort lawyers from oil drilling, pharmaceutical research and contingent fee litigation must be large enough, on average, to compensate for the unsuccessful ventures (“dry holes”) as well as the successes, so must the “free rider” discounts obtained by a mailer include a multiplier large enough to compensate for the uncertainty of success in each individual case.

CONCLUSION

For the foregoing reasons, the Commission should approve the NSA proposed by the Postal Service and Discover. Because J. P. Morgan Chase believes that parties

to an NSA should have flexibility to negotiate the terms of their own bargain, J. P. Morgan Chase does not oppose adoption of the conditions that those parties have proposed in the instant case. We respectfully request, however, that the Commission take care to limit its decision to the record before it, lest the Commission inadvertently prejudge the outcome justified by the significantly different record made by the Postal Service and Bank One in Docket No. MC2004-3.

Respectfully submitted,

/s/

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September 15, 2004

CERTIFICATE OF SERVICE

I hereby certify that I have today served this document in accordance with
Section 12 of the Commission's Rules of Practice

/s/

Joy M. Leong

September 15, 2004