

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

RATE AND SERVICE CHANGES TO IMPLEMENT
FUNCTIONALLY EQUIVALENT NEGOTIATED
SERVICE AGREEMENT WITH DISCOVER
FINANCIAL SERVICES, INC.

Docket No. MC2004-4

NOTICE OF THE UNITED STATES POSTAL SERVICE
OF DECISION OF THE GOVERNORS
(October 27, 2004)

The United States Postal Service hereby provides notice of the attached
Decision of the Governors in Docket No. MC2004-4:

**Decision of the Governors of the United States Postal Service
on the Opinion and Recommended Decision of the Postal Rate
Commission Approving Negotiated Service Agreement with Discover
Financial Services, Inc., Docket No. MC2004-4 (October 27, 2004)**

Respectfully submitted,

UNITED STATES POSTAL SERVICE
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October 27, 2004

CERTIFICATE OF SERVICE

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

Brian M. Reimer

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October 27, 2004

**DECISION OF THE GOVERNORS OF THE UNITED STATES POSTAL SERVICE
ON THE OPINION AND RECOMMENDED DECISION OF THE POSTAL RATE
COMMISSION APPROVING NEGOTIATED SERVICE AGREEMENT WITH DISCOVER
FINANCIAL SERVICES, INC., DOCKET No. MC2004-4**

October 27, 2004

STATEMENT OF EXPLANATION AND JUSTIFICATION

On September 30, 2004, the Postal Rate Commission issued its Opinion and Recommended Decision in Docket No. MC2004-4. The Commission recommended the rates and classification language, with minor modifications, contained in the Postal Service's Request.¹ PRC Op. MC2004-4 at 53. This language will enable the Postal Service to implement a negotiated service agreement ("NSA") that it signed with Discover Financial Services, Inc. ("Discover").

Based upon our review of the record, we find that the Commission's recommended decision is reasonable and supported by substantial record evidence, and we approve the recommendations.

This case, along with Docket No. MC2004-3, the Bank One NSA case, represented the first occasions for the Commission to apply its recently promulgated Rule 196 for NSAs that are functionally equivalent to baseline NSAs, 39 C.F.R. § 3001.196. Specifically, the Commission found that the Discover NSA was functionally equivalent to the Capital One NSA, which we considered in Docket No. MC2002-2. We appreciate the efficient manner in which this docket has been handled. In order for Negotiated Service Agreements to reach their full potential as innovative mechanisms to meet the diverse

¹ 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., Docket No. MC2004-4 (June 21, 2004).

needs of individual mailers, functionally equivalent cases will need to be handled expeditiously, as the cost of litigation is a major upfront expense for any mailer signing an NSA with the Postal Service.

BACKGROUND AND SUMMARY

The Postal Service initiated this proceeding on June 21, 2004, filing its Request in accordance with 39 U.S.C. §§ 3622 and 3623.

The Postal Service supported its Request with the written direct testimony of witness Ali Ayub (USPS-T-1) and other documents. Also on June 21, 2004, Discover, as a co-proponent, filed a notice of appearance, along with the written direct testimony of witness Karin Giffney (DFS-T-1).

The Commission's Office of the Consumer Advocate ("OCA") and twelve intervenors participated in this proceeding. The co-proponents responded to discovery requests from OCA and Valpak Dealers' Association, Inc. and Valpak Direct Marketing Systems, Inc. (collectively "Valpak"), as well as Presiding Officer's Information Requests. The participants also filed briefs and reply briefs in accordance with the Commission's scheduling order.

The Commission determined that this case would proceed under Rule 196 for functionally equivalent NSAs.² It also granted a motion by the Postal Service, filed under that rule, to limit the issues in the proceeding to those related to financial and competitive aspects of the Request.³

² Presiding Officer's Ruling No. MC2004-4/1, Docket No. MC2004-4 (July 20, 2004).

³ Presiding Officer's Ruling No. MC2004-4/2, Docket No. MC2004-4 (August 11, 2004). The Commission also granted a request by Valpak to discuss two other issues -- "consideration of a niche classification" and a "system-wide fix" to the undeliverable-as-addressed (UAA) "pricing problem" -- but stated that such discussions would not form the basis of the Commission's recommended decision on this NSA. *Id.* at 5-6. We agree with the Commission's determination not to base its recommended decision on these issues. Furthermore, we do not believe that this proceeding, which involves a functionally equivalent NSA, is an appropriate forum to discuss those broad issues.

During the course of this proceeding, the participants engaged in settlement conferences, as well as informal discussions.⁴ While these discussions did not result in a settlement agreement, they were fruitful in helping the participants narrow the focus of issues they wished to present to the Commission in this docket. They also facilitated a situation where no participant desired a hearing, and the participants believed that the existing record enabled them to present their issues to the Commission on briefs. We commend the participants for engaging in discussions that resulted in a more efficient resolution of litigation issues.

EVALUATION AND RECORD SUPPORT

Under the terms of the NSA, Discover agrees to acceptance of “electronic returns” of certain undeliverable-as-addressed (“UAA”) First-Class Mail, in lieu of actual physical return of the pieces. This type of provision suits Discover, as it did Capital One in Docket No. MC2002-2, because Discover makes significant use of First-Class Mail to send solicitations that advertise its credit card services. Electronic address correction service will provide Discover with information about each undeliverable piece, rather than returning the advertising piece itself, for which Discover has no further need. This change will result in cost savings for the Postal Service because the costs of providing the information electronically are lower than the costs of physical return of each UAA First-Class Mail solicitation piece.

In addition to the provisions regarding returns, the NSA also provides Discover with the opportunity to pay lower “declining block rates,” if it provides very high volumes of First-Class Mail (over 405 million pieces in the first year). Under this arrangement, Discover receives discounts starting at 2.5 cents off each piece above 405 million, up to 4.5 cents for each piece above 515 million. This provision is comparable to, but not identical with, the provision of declining block rates to Capital One in the baseline docket. The NSA will benefit all mailers because Discover has committed itself to various measures that the Governors and Commission both conclude will reduce costs in a way that exceeds

⁴See Notice of United States Postal Service's Intention to Conduct Settlement Conference, Docket No, MC2004-4 (July 6, 2004); Notice of United States Postal Service's Intention to Conduct Settlement Conference, Docket No, MC2004-4 (July 20, 2004); Reports of Settlement Coordinator (July 22, August 5, August 19, and September 2, 2004).

the cumulative value of the discounts. Also, the NSA will yield contribution from increased First-Class Mail volume.

In the instant docket, the Commission approved of two new customer-specific terms that were not present in the Capital One NSA. The first term is an annual threshold adjustment, which is designed to keep alive, in the second and third years of the agreement, the incentives for Discover to increase its First-Class Mail solicitations.

The second new term is a negotiated "competitive cap," under which the maximum discounts Discover may receive over the life of the NSA will be \$13 million. This is called a competitive cap because Discover calculated it by taking the ratio of its First-Class Mail volume to Capital One's First-Class Mail volume, and applying that ratio to the "stop loss" cap of \$40.637 million from Docket No. MC2002-2. Discover reasoned that a cap proportional to the cap in the Capital One case, while not needed to protect the Postal Service against loss, would maintain Discover's competitive relationship with Capital One. Discover proposed this term, the Postal Service agreed to it, the Commission recommended it, and we accept it as well.

We do not, however, concur with language in the Commission's opinion that could be read to suggest that this competitive cap was acceptable only because it was close (\$13 million versus \$11.8 million) to what a "stop loss" cap would have been, as calculated under the methodology the Commission utilized in Docket No. MC2002-2, with modifications. Nor do we agree with the Commission's association of the cost savings element of the agreement with the discount element. PRC Op. MC2004-4 at 25. See Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission Recommending Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One, Docket No. MC2002-2 (June 2, 2003) at 3 n.3, 17, 18 n.18 and n.19.⁵

The record provides full support for the Commission's conclusion that the Discover NSA is fair and equitable to other users of the mail, including competitors of Discover. PRC

⁵ We do agree, however, that in circumstances where some type of stop-loss cap is warranted, "there might be more than one acceptable form of stop-loss mechanism," such as, in certain cases, a mechanism that focuses on profitability at the margin. PRC Op. MC2004-4 at 36.

Op. MC2004-4 at 43-46. We believe that the best way for issues of competition and undue discrimination to be addressed, in this context, is through notice and opportunity to be heard. As the Commission noted, no competitors of Discover, or any other mailers, argued that this NSA was anti-competitive or unduly discriminatory. *Id.* at 44.

We agree with the Commission that the record supports the recommended changes in rates and classification, and we approve them. We concur with the Commission that its recommended decision is consistent with the policies of sections 3622 and 3623 of the Postal Reorganization Act. See discussion at PRC Op. MC2004-4, at 45-46.

ESTIMATE OF ANTICIPATED REVENUE

The Postal Reorganization Act requires that our Decision include an estimate of anticipated impact on postal revenues (39 U.S.C. § 3625(e)). According to the evidentiary record, the Postal Service will benefit by \$7.16 million over the life of the agreement -- \$8.25 million in ACS Cost Savings, plus \$2.15 million in increased contribution, minus \$3.24 million in discount exposure (referred to in the Capital One proceedings as leakage).

ORDER

In accordance with the foregoing Decision of the Governors, the changes in rates and classifications set forth in the Attachments are hereby approved and ordered into effect. In accordance with Resolution 04-8 of the Board of Governors, dated October 27, 2004, the waiver of fees for ACS notices for First-Class Mail solicitations that comply with the rules and regulations associated with the Change Service Requested ("CSR"), option 2 endorsement, will take effect at 12:01 a.m. on November 1, 2004. All remaining changes will take effect at 12:01 a.m. on January 1, 2005.

By The Governors:

Chairman

**ATTACHMENTS TO THE DECISION OF THE GOVERNORS OF THE
UNITED STATES POSTAL SERVICE ON THE OPINION AND
RECOMMENDED DECISION OF THE POSTAL RATE COMMISSION
APPROVING NEGOTIATED SERVICE AGREEMENT WITH DISCOVER
FINANCIAL SERVICES, INC., DOCKET NO. MC2004-4
(OCTOBER 27, 2004)**

DISCOVER FINANCIAL SERVICES NSA

RATE SCHEDULE 611A

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

DISCOVER FINANCIAL SERVICES NSARATE SCHEDULE 611B
FOR ADJUSTED THRESHOLD (A.T.)

<u>Volume Block</u>	<u>Incremental Discounts</u>
<u>A.T. to A.T+30,000,000</u>	<u>2.5¢</u>
<u>A.T.+30,000,001 to A.T.+60,000,000</u>	<u>3.0¢</u>
<u>A.T.+60,000,001 to A.T.+85,000,000</u>	<u>3.5¢</u>
<u>A.T.+85,000,001 to A.T.+110,000,000</u>	<u>4.0¢</u>
<u>A.T,+110,000,001 and above</u>	<u>4.5¢</u>

NEGOTIATED SERVICE AGREEMENTS
CLASSIFICATION SCHEDULE

611 DISCOVER FINANCIAL SERVICES NEGOTIATED SERVICE AGREEMENT

611.1 Eligible First-Class Mail

Eligible First-Class Mail under this section is defined as: (1) Discover Financial Services' First-Class Mail customer correspondence related to credit and banking products and services account holders; and (2) First-Class Mail solicitations for credit and banking products that bear the endorsement specified by the Postal Service. Eligible First-Class Mail does not include Business Reply Mail, Qualified Business Reply Mail, Cards, or Priority Mail.

611.2 Waiver of Address Correction Fees

The fees for address correction in Fee Schedule 911 are waived for those First-Class Mail solicitations on which Discover Financial Services uses the endorsement specified by the Postal Service, if:

- (a) Discover Financial Services mails more than 350 million pieces of eligible First-Class Mail within the first year after implementation of this section, and
- (b) Discover Financial Services updates any databases it uses for solicitation mail, other than First-Class Mail customer correspondence related to account holders, as specified by the Postal Service.

If, during the first year after implementation, Discover Financial Services mails fewer than 350 million pieces of eligible First-Class Mail, Discover Financial Services agrees to pay the greater of either (1) all address correction service fees under Fee Schedule 911, as specified by the Postal Service, for pieces receiving address correction service, or (2) \$250,000.

611.3 First-Class Mail Discounts

611.31 Discount Threshold

The Discount Threshold is set at 405 million pieces of eligible First-Class Mail for the first year of the agreement.

611.32 Discounts

Discover Financial Services' Eligible First-Class Mail is subject to the otherwise applicable First-Class Mail postage in Rate Schedule 221 less the discounts shown in Rate Schedule 611A, for the first year of the agreement if Discover Financial Services meets the Discount Threshold. The discounts apply only to volume above the Discount Threshold. Each incremental discount applies only to the incremental volume within each volume block.

611.33 Annual Threshold Adjustment

The Postal Service shall annually adjust the Discount Threshold based on the percentage change, from year to year, of Discover Financial Services' domestic gross active accounts, as that figure is reported quarterly in SEC filings. The beginning and ending points for each volume block in Rate Schedule 611A will increase or decrease by the same number as the increase or decrease in the Discount Threshold. Rate Schedule 611B will be applicable in lieu of Rate Schedule 611A if there is such an adjustment.

611.34 Threshold Adjustment for Acquisition or Merger

In the event that Discover Financial Services merges with or acquires an entity with annual First-Class Mail volume in excess of 10 million pieces in the year preceding the acquisition or merger, or in the event that, in any Postal Service fiscal year, Discover Financial Services merges with or acquires multiple entities with combined annual First-Class Mail volume in excess of 25 million pieces, the Discount Threshold will be adjusted upward by the volume of First-Class Mail sent by the other entity (or entities) during the 12 months preceding the merger or acquisition. Rate Schedule 611B will be applicable in lieu of Rate Schedule 611A if there is such an adjustment.

611.35 Discount Limit

The maximum cumulative discount available to Discover Financial Services over the duration of this NSA shall not exceed \$13 million.

611.4 Rates

The rates applicable to this Agreement are set forth in Rate Schedules 611A and 611B.

611.5 Expiration

The provisions of section 611 expire at 12:01 a.m. on January 1, 2008.

611.6 Precedence

To the extent any provision of section 611 is inconsistent with any other provision of the Domestic Mail Classification Schedule, the former shall control.

**RESOLUTION OF THE BOARD OF GOVERNORS
OF THE
UNITED STATES POSTAL SERVICE**

Resolution No. 04-8

Effective Date of Rate and Service Changes To Implement
Negotiated Service Agreement with Discover Financial Services, Inc.

RESOLVED:

Pursuant to section 3625(f) of Title 39, United States Code, the Board of Governors determines that the rate and service changes to implement the Negotiated Service Agreement with Discover Financial Services, Inc., that were ordered to be placed into effect by the Decision of the Governors adopted on October 27, 2004, shall become effective as follows: The waiver of fees for ACS notices for First-Class Mail solicitations that comply with the rules and regulations associated with the Change Service Requested ("CSR"), option 2 endorsement, will take effect at 12:01 a.m. on November 1, 2004. All remaining changes will take effect at 12:01 a.m. on January 1, 2005.

The foregoing Resolution was adopted by the Board of Governors on October 27, 2004.

Secretary