Postal Rate Commission
Submitted 5/15/2003 12:54 pm
Filing ID: 38142
Accepted 5/15/2003

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION

Before:

Chairman Omas,
Vice Chairman Covington, and
Commissioners Goldway and Hammond

Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One

Docket No. MC2002-2

OPINION

AND

RECOMMENDED DECISION

Washington, DC 20268-0001
May 15, 2003

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I. SUMMARY

[1001] The Postal Rate Commission recommends that the United States Postal Service enter into a three-year Negotiated Service Agreement (NSA) with Capital One Services, Inc., the nation's largest user of First-Class Mail. Under this agreement, for the next three years Capital One will receive discounts of 3 - 6 cents per piece for annual First-Class bulk volumes exceeding 1.225 billion pieces. As part of the NSA, the Postal Service will avoid the costly return of undeliverable Capital One First-Class solicitations.

[1002] This arrangement will mark several important firsts for the Postal Service. It will be the first time a separate rate discount has been offered to a single mailer that agrees to act to reduce Postal Service costs. Additionally, this will be the first time a declining block rate volume discount has been offered.

[1003] NSAs are a way to add flexibility to postal ratemaking. They provide the Postal Service with the ability to take advantage of special situations to improve its profitability by developing innovative rate designs to meet the needs of diverse, individual customers. The Commission finds that it is appropriate for the Postal Service to explore opportunities for improving efficiency and expanding its markets through economically beneficial rate programs.

[1004] The legality and efficacy of NSAs involving the Postal Service have been controversial issues for more than a decade. The topic was discussed at the joint Postal Service/Postal Rate Commission ratemaking summit last summer. At the direction of Congress, both the Commission and the Postal Service submitted written views opining that NSAs are permissible under current law.

[1005] This case is serving as a vehicle for exploring practical problems associated with negotiating, reviewing and administering an NSA. The Commission's role in this process is to provide the open public review required by 39 U.S.C. § 3624. Having conducted a thorough examination of both the legal and technical ramifications of the proposed NSA, as detailed in the following pages, the Commission finds that it can be recommended almost without change.

[1006] As might be expected, this initial request for an NSA contained flaws. The Opinion discusses many areas where future improvements will facilitate faster and more precise Commission analysis. Also, the Commission will promptly initiate several rulemakings to develop procedures and filing rules to guide future NSA requests. The lessons learned in this case, and developed in those rulemakings, should allow quick yet thorough review of future proposals, and the extension of NSAs to a broad cross-section of mailers. Improved knowledge of what is necessary to support an NSA should also expedite the process of initial negotiation between the Postal Service and potential NSA partners.

[1007] This decision was greatly assisted by the initiative of the Postal Service, Capital One, and Commission's Consumer Advocate to develop and submit a stipulation and agreement that was eventually joined in by 13 participants. The stipulation includes specific procedures the Postal Service will use to fulfill its commitment to extend the NSA to other similarly situated mailers. The stipulation also specifies data that the Postal Service and Capital One will collect and provide to the Commission for evaluating this NSA.

[1008] A primary Commission role in reviewing NSAs is to assure adherence to the statutory prohibitions against unduly discriminatory or inequitable rates, and that the general mailing public is not harmed. 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. Under that circumstance, other mailers' rates would have to increase to make up the difference. To prevent that inequitable result, a single additional clause has been added to the proposal presented in the stipulation and agreement. The addition is a simple stop-loss provision that sets a maximum of $40.6 million that can be given in discounts over the three-year life of the NSA. This amount is the point at which discounts exceed savings to the Postal Service under the NSA.

II. INTRODUCTION AND PROCEDURAL HISTORY

A. The Postal Service Proposal

[2001] On September 19, 2002, the United States Postal Service filed a request with the Postal Rate Commission, pursuant to chapter 36 of the Postal Reorganization Act, 39 U.S.C. §§ 3601 et seq., for a recommended decision on a proposed three-year experimental classification change, and related discounts and fee waivers, for qualifying First-Class mailings entered by Capital One Services, Inc. (Capital One). Request of the United States Postal Service for a Recommended Decision on Experimental Changes to Implement Capital One NSA, September 19, 2002 (Request).

[2002] The Request proposes experimental rate and classification changes that allow the Postal Service and the Commission to test the feasibility of the Negotiated Service Agreement (NSA) approach, as a means of providing pricing flexibility under the existing statutory ratemaking scheme. Request at 2-3. NSAs are negotiated contracts founded on the distinct operational and service relationships between the Postal Service and its individual customers. This Request is the first instance of the Postal Service seeking a recommended decision on a proposal based on an NSA. It also is the first time that the Commission reviews a proposal specifically limited in applicability to one Postal Service customer — Capital One.

[2003] The Request describes proposals in regard to two significant mail service features that form the basis of the NSA: an address correction service feature, and a declining block rate volume discount feature. Both features are reviewed in this Opinion.

[2004] The address correction service feature provides Capital One, at certain levels of volume, electronic address corrections without fee for First-Class Mail solicitations that are undeliverable as addressed (UAA). In return for receipt of electronic address correction, Capital One will no longer receive physical return of its UAA mail that can not be forwarded under the existing service features of First-Class Mail. Capital One will also be required to maintain and improve the address quality for its First-Class Mail.

Use of the address correction service feature is a prerequisite to use the second feature of the NSA.

[2005] The second feature of this proposal is a declining block rate volume discount. This feature provides Capital One with a per-piece discount for bulk First-Class Mail volume above an annual threshold volume. The per-piece discount varies from 3 to 6 cents under a "declining-block" rate structure. Should first-year mail volume decline under a predetermined quantity, a reduced threshold and lower initial discounts take effect.

[2006] The Commission previously expressed an opinion, and has provided broad principles, under which it may consider NSAs legally permissible.[1] The institution of this proceeding before the Commission adheres to the first principle, which is that the proposal must be reviewed in a public proceeding as required by the Act. The recommendations and opinions contained in this Opinion demonstrate the probability that the proposal adheres to the second principle, which is that the agreed-upon rate and service changes will work to the mutual benefit of mail users and the postal system as a whole. The third and final principle, that the rate and service package must be made available on the same terms to other potential users willing to meet the same conditions of service, remains an important open issue that is a subject of the "experiment" contained within the proposal. It eventually must be demonstrated as a measure of the success or failure of the NSA concept.

[2007] Implementing the proposals of this request require the Commission and the Postal Service to develop procedures to negotiate, review, and administer NSAs. The Commission's prime responsibility is the review process. The Commission already has discovered areas where its existing procedural rules are not well suited for NSAs, and plans to address these issues immediately in rulemakings. Procedural rules also will be

[1] *See* Report to Congress: Authority of the United States Postal Service to Introduce New Products and Services and to Enter Into Rate and Service Agreements With Individual Customers or Groups of Customers, February 11, 2002.

developed that are applicable to the renewal of existing NSAs, and that allow extension of existing NSA benefits to other qualifying customers.

[2008] The Postal Service's responsibilities are much greater. It must negotiate, present for review, and administer NSAs. This includes developing procedures to administer the instant NSA, and developing procedures to administer the potential for many concurrent NSAs, which might be in the negotiation, review, or implementation stages. During the life of this NSA, the Postal Service will be called upon to demonstrate that it can do so on a fair and equitable basis.

B. Unique Presentation of Supporting Evidence

[2009] Section 3623(b) specifies that "the Postal Service may from time to time request that the Commission submit, or the Commission may submit to the Governors on its own initiative, a recommended decision on changes in the mail classification schedule." Typically, this provision results in the Postal Service initiating classification changes by filing a request with the Commission. Attached to such requests is the Postal Service's direct case in support of its classification change proposal. After notice of the case and establishment of a docket by the Commission, interested persons are allowed to intervene, and file testimony in support of, or in opposition to the Postal Service's proposal. Participants also may submit relevant new proposals of their own. After completion of this second stage of litigation, participants are provided with a final opportunity to file testimony in rebuttal.

[2010] The three-step litigation process described above might or might not be appropriate for classification proposals based on NSAs. NSAs are contractual agreements negotiated between the Postal Service and one or more parties. The parties included in the agreement potentially possess relevant information that is necessary for the presentation of the Postal Service's direct case in support of the proposal.

[2011] In this docket, the Postal Service filed a motion requesting that the Commission treat the proposal filed in the Request as jointly sponsored by both the Postal Service and Capital One.[2] It further sought leave to rely on Capital One's testimony outside of the typical schedule for presentation of evidence by intervenors. Capital One filed a motion to join the Postal Service's motion for joint sponsorship and requested intervention prior to public notice of the proceeding.[3] The Commission granted the motions, which effectively made the Postal Service and Capital One

[2] Motion of United States Postal Service for Joint Sponsorship of Proposals and for Leave to Rely on Capital One's Case-In-Chief, September 19, 2002. This motion was filed together with the Service's Request.

[3] Petition of Capital One Services, Inc. for Leave to Intervene in the Above-Captioned Proceeding, and to Join United States Postal Service Motion for Joint Sponsorship of Proposals, September 19, 2002.

co-proponents of the proposals contained in the Request. PRC Order No. 1346 (September 24, 2002).

[2012] Postal Service witnesses Bizzotto, Plunkett, Crum and Wilson, and Capital One witnesses Jean and Elliott present the Capital One/Postal Service case-in-chief. Postal Service witness Bizzotto presents the important policy considerations for the Postal Service's decision to enter into NSAs, and discusses how this NSA is consistent with the general policies of the Act. Postal Service witness Plunkett expands upon the concepts in witness Bizzotto's testimony, and describes the specific terms and conditions of the Capital One NSA. He also discusses the applicability of the experimental rules, and proposes a data collection plan.

[2013] Capital One witness Jean presents the estimate of Capital One's before rates First-Class Mail volume. He also describes Capital One's mailing practices, including mail hygiene, and how adoption of this NSA will reduce physical returns. His estimate of before rates volume relies on analysis presented in Capital One witness Elliott's testimony. Postal Service witness Crum relies on the Capital One volume projection to estimate the financial impact of the NSA on the Postal Service. Witness Crum also relies on Postal Service witness Wilson's background testimony relating to the address quality features of the NSA.

C. Request to Apply Experimental Rules

[2014] The Postal Service stated that it believed it would be appropriate for the Commission to review and recommend the operative rate and classification elements of the Request as an experimental classification under the experimental rule procedures specified in Rules 67-67d (39 C.F.R. 3001.67-67d). Request at 3. This is the twelfth occurrence of the Postal Service requesting to proceed under the experimental rules.

[2015] The request to proceed under the experimental rules was unopposed, however the participants raised many material issues that potentially would require more in depth hearings than could be provided under the 150 day experimental rule timeline. Newspaper Association of America (NAA) raised issues of the legality of NSAs, whether limiting the benefits of this NSA to one mailer is reasonable, and whether the proposed NSA is fair and equitable to other mailers.[4] NAA also questioned the economic projections of this proposal. The Office of the Consumer Advocate (OCA) asserted that the concept of NSAs remained controversial, and questioned the need for an NSA instead of developing experiments to separately test the major features of the proposal. It also stated that there was uncertainty over the estimates of cost savings.[5] APWU raised issues questioning the development of the test year mail volume, the estimated cost savings, the effects of Postal Automated Redirect System (PARS), and the costs of administering an NSA tailored to Capital One.[6] The Commission was mindful that this was the first instance of the Postal Service seeking a recommendation based on an NSA, and the first instance of a request that contained a volume based declining block rate discount.

[2016] The Presiding Officer considered the Postal Service's request to proceed under the experimental rules and determined:

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[4] Comments of the Newspaper Association of America on Order No. 1346, October 17, 2002.

[5] Office of the Consumer Advocate Comments in Response to Order No. 1346, October 17, 2002.

[6] Comments of American Postal Workers Union, AFL-CIO Concerning Need for Hearings, October 17, 2002.

> The extreme novelty of the NSA-based proposal militates against limiting or foreshortening exploration of the issues that it may entail. The magnitude of the proposed changes is narrow in scope, but somewhat uncertain in financial impact. Generating and gathering data during the proposed experiment appears feasible, but may involve difficulties in disaggregating Capital One's volumes of First-Class Mail. Finally, the proposed duration of the changes are at the outer limit of recently-approved experiments, and its length would tend to amplify uncertainty regard[ing] the potential impact of the proposed discounts.

After weighing the relevant factors specified in Rule 67, the Presiding Officer concluded that the Postal Service's NSA proposal was too complex to allow the streamlined and expedited consideration provided under the experimental rules.[7]

[2017] Four witnesses provide testimony in response to the Capital One/Postal Service direct case: National Newspaper Association (NNA) witness David, NAA witness Kent, and OCA witnesses Smith and Callow. NNA witness David testifies from the unique perspective of small and locally based businesses, and discusses how such businesses can be disadvantaged by volume-based discounts. NAA witness Kent expresses concern that the Postal Service has not accurately calculated the cost savings, and asserts that the Postal Service is entering into a three-year agreement without fully considering the financial implications during the second and third years. OCA witness Smith questions the adequacy of Capital One's volume forecasts, and explains the necessity to accurately predict volumes for volume based discounts. OCA witness Callow proposes two alternative experimental mail classifications based on the major features of the Postal Service's proposal.

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[7] P.O. Ruling MC2002-2/3 at 5.

D. Need for a Presiding Officer Witness

[2018] The Commission has not previously reviewed a proposal containing a pure volume discount, as distinct from cost based discount rates. The Commission recognizes that declining block rate discounts raise important economic issues, and that the record would benefit if those issues were thoroughly reviewed. The proponents of the NSA did not initially offer testimony on the economic implications of volume discounts, and the Commission could not be certain that other participants would address these issues in the future.

[2019] The Presiding Officer engaged a respected expert economist knowledgeable in the area of concern as a Presiding Officer's witness. This was intended to assure that the pertinent economic issues would be discussed on the record, hopefully in a thorough and unbiased manner, and that this might inspire other participants to address these issues.

[2020] On December 20, 2002, the Presiding Officer issued notice that the Commission had contracted with Professor John C. Panzar to serve as a Presiding Officer's witness.[8] Professor Panzar was tasked with identifying and analyzing the economic issues pertinent to this docket, and providing a report to the Commission on his findings. His statement of work provided him with wide latitude to discuss whatever issues he considered relevant. The report would be made publicly available, and would be used to supplement the record on economic issues related to this NSA. Panzar submitted a report to the Commission in the form of written testimony.[9]

[2021] Panzar's testimony addresses issues related to declining block rate volume discounts. It highlights the potential for benefits to the Postal Service and it discusses possible areas of concern where discrimination might occur, or where the Postal Service

[8] Presiding Officer's Notice of Anticipated Sponsorship of Testimony on Economic Issues, December 20, 2002. The contract description of the tasks assigned to Panzar is included with the Notice as an attachment.

[9] Testimony of John C. Panzar, JCP-T-1, January 16, 2003.

might suffer financial harm. It also successfully sparked debate on declining block volume discounts. Postal Service rebuttal witness Eakin addresses and develops many issues raised in Panzar's testimony.

E. Rebuttal

[2022] Five witnesses provide testimony in rebuttal: Capital One witnesses Shippee and Elliott, PostCom, et al. witness Posch, and Postal Service witnesses Plunkett and Eakin. The re-evaluation by Capital One of its before-rates test-year volume, and the economic analysis of volume-based declining block discounts provided by the Postal Service significantly further the development of the record.

[2023] Capital One rebuttal witness Shippee re-evaluates the Capital One before-rates test-year volume forecast and concludes that the original forecast was optimistically high. He bases this opinion on a new volume analysis provided by Capital One rebuttal witness Elliott. Elliott uses previously unavailable data from recent months, and projects a Capital One First-Class Mail before-rates test-year volume of 1.21 billion pieces. The new volume projection is substantially below the previous forecast of 1.41 billion pieces, and it is below the volume threshold of 1.225 billion pieces where discounts initially become available.

[2024] Postal Service rebuttal witness Eakin's testimony complements Presiding Officer witness Panzar's testimony by expanding on the relevant economic theory related to volume-based declining block discounts. He relates the general theory espoused by Panzar to the specifics of the Capital One NSA. Further, he discusses the pricing structure of this NSA in relation to experiences from other regulated industries. The combination of the Eakin and Panzar testimonies forms the basis of the economic analysis of volume-based declining block discounts discussed within this Opinion.

[2025] Postal Service rebuttal witness Plunkett's testimony answers criticisms of the Postal Service's proposal, and demonstrates that even with a high UAA Rate, Capital One's solicitation mail is more beneficial to the Postal Service as First-Class Mail, than if it were to migrate to Standard Mail. He also discusses obstacles that could hinder implementation of the experimental classifications proposed by OCA.

[2026]   PostCom, et al. rebuttal witness Posch's testimony further supports the NSA concept, and discusses the types of information that the Commission should reasonably expect to receive from companies entering into NSAs.[10]

[10] PostCom et al. represents the interests of PostCom, DMA, and PSA.

F. Late-Filed Settlement

[2027] Late in this proceeding, the Postal Service, Capital One, and OCA filed a joint motion requesting a two week delay in the procedural schedule to allow for settlement discussions.[11] The settlement discussions culminated in the filing of a Stipulation and Agreement, dated March 31, 2003, after the close of the evidentiary record. The Stipulation and Agreement addresses issues with the Postal Service's original data collection plan, and proposes new language to be included in the Domestic Mail Manual (DMM) and the Domestic Mail Classification Schedule (DMCS) that express the intent to make the terms and conditions of this NSA available to other qualifying mailers. Thirteen participants signed the Stipulation and Agreement.[12] The Postal Service, Capital One, and OCA filed a joint motion requesting that the Commission base its recommendation on the Stipulation and Agreement. NAA was the only participant that filed a pleading in opposition to this motion.[13] Per the terms of the Stipulation and Agreement, OCA filed a notice withdrawing its classification proposals from consideration and filed a separate motion requesting removal of its proposed classification language from the record.

[2028] Although the Stipulation and Agreement does not address all of the concerns of the Commission, such that the Commission can base this Opinion solely on the Stipulation and Agreement, it does address several important areas of fairness and equity. This represents a commendable effort by the participants involved. The

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[11] Joint Motion of the United States Postal Service, Capital One Services, Inc., and the Office of the Consumer Advocate for Extension in Brief Schedule, March 13, 2003. Motion granted in P.O. Ruling MC2002-2/22, March 13, 2003.

[12] American Bankers Association (ABA); Advo, Inc.; AOL Time Warner Inc.; Capital One Services, Inc.; Douglas F. Carlson; Direct Marketing Association, Inc. (DMA); Dow Jones & Company, Inc.; Magazine Publishers of America, Inc. (MPA); Office of the Consumer Advocate; Parcel Shippers Association (PSA); Pitney Bowes, Inc. (Pitney Bowes); Association for Postal Commerce (PostCom); and United States Postal Service.

[13] Opposition of Newspaper Association of America to Joint Motion for Consideration of Stipulation and Agreement, April 7, 2003.

Commission incorporates many of the salient features of the Stipulation and Agreement into this Opinion.

III. THE LEGAL STATUS OF NEGOTIATED SERVICE AGREEMENTS

A. Novelty of Negotiated Service Agreements

[3001] Since passage of the Postal Reorganization Act of 1970, the Postal Service has proposed, and the Postal Rate Commission has recommended, mail classifications and their associated rates in the form of uniform tariffs, which make postal services available to all potential users on equal terms. Introduction of Negotiated Service Agreements (or “NSAs”) as the bases of distinct mail classifications would represent a departure from this established practice, in that they would make special rate and service provisions available only to specified users. The proposal in this proceeding to adopt rate and service provisions for which only one user — Capital One Services, Inc. — would be eligible poses questions regarding the legal status of such bilateral arrangements, and the standards under which they should be evaluated.

B. Origins of the NSA Concept

[3002] For a number of years, some stakeholders in the postal system have pursued the idea of establishing customized postal rates and/or terms of service through negotiation with the Postal Service. Depending on their respective objectives and features, contractual arrangements of this kind have been labeled “contract rates,” “negotiated service agreements,” or more recently, “niche classifications.”

[3003] The Commission's institutional involvement with these related concepts began with a rulemaking proceeding conducted in the late 1980s. The rulemaking, Docket No. RM89-5, was begun at the request of a mail user. The proposal included two variants:

1. The Commission might, after considering cost and other relevant evidence, establish a range of permissible rates for particular subclasses, with the Postal Service and individual mailers free thereafter to negotiate rates within this range; or

2. The Postal Service and one or more mailers would negotiate a rate and service package which would then (i) be submitted to the Commission for a review, and (ii) thereafter be available on the same terms to all potential users.

The Commission solicited two rounds of comments on the proposal from interested parties. The proponent and one other mailer took the position that the Postal Service is authorized to enter into such contracts, provided the procedural requirement of review under chapter 36 is observed. Other commenters — including the Commission's Office of the Consumer Advocate — expressed doubts regarding the legal soundness of one or both of the proposed variants of such agreements. The Postal Service commented that, in its view, legal constraints would not preclude a contract mechanism in principle, but that no such arrangement would be permissible without the Commission's participation in accordance with 39 U.S.C. §§ 3622 through 3625.

[3004] Upon consideration of the initial comments it received, the Commission declined to pursue the contract rate proposal, but solicited further comments on several broad issues concerning possible changes in the mail classification system. The Commission explained that its reluctance to pursue the concept of contract rates was based on substantial uncertainty regarding the legal sufficiency of examining agreed-upon rates after the fact, rather than in a prior review. It also raised the potential problems of unreasonable discrimination that such contracts might cause, in contravention of 39 U.S.C. § 403(c), and the preservation of fair contributions to the Postal Service's institutional costs by mail volumes.[14] Such problems might well arise if the Service were to negotiate "discounted" rates — unaccompanied by a change in service conditions that provided cost or revenue justification.

[3005] In the early 1990s, a Joint Task Force consisting of representatives of the Postal Service's Board of Governors and the Commission revisited some aspects of the NSA concept. In its final report,[15] the Joint Task Force stated:

> The Task Force believes that the rate and classification process should have a means to accommodate service agreements with postal customers, varying from the general rate and classification schedules in ways which add value both for the customer and for the postal system as a whole. In specific situations involving one customer or a limited group of customers, negotiated agreements tailored to the particular circumstances might be more effective than the broad schedules in meeting what the particular facts require, so that the benefits can be shared between the participating customer and the postal system.[16]

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[14] Docket No. RM89-5, Further Invitation for Comments, 54 Fed. Reg. 47223 (1989).

[15] *Postal Ratemaking in a Time of Change: A Report by the Joint Task Force on Postal Ratemaking* (June 1, 1992).

[16] *Id.* at 54.

[3006] Based on the above considerations, the Task Force recommended that the Postal Service and the Postal Rate Commission make a start toward addressing this need by establishing procedural rules for reviewing such agreements.[17]

[3007] The Task Force also addressed one potential substantive form of NSA: declining-block rates for large-volume users of competitive services. Noting that competitors of the Postal Service provide discounts for high-volume users, the report opines that it would likewise be advantageous for the Service to offer discounted rates for large-volume shippers. However, it anticipated an accompanying requirement that the rates would generate a reasonable contribution to institutional costs, and thereby gain additional business for the Service while earning an incremental contribution to its fixed overhead. It also noted that, "[w]here rate differentials as between customers are not based on cost differences, they must have some other adequate justification."[18]

[3008] As a solution, the Task Force suggested consideration of introducing declining block rates for competitive services, to improve their price competitiveness for high-volume shippers who frequently have more alternatives available to them than lower-volume shippers. The report recommended rate structures that would reward high-volume users specifically for their higher level of usage, without discriminating against low-volume users.[19] However, the report did not explicitly address whether the availability of such rates could or should be restricted by contract.

[3009] Following publication of the report of the joint Postal Service-Postal Rate Commission task force on ratemaking, the Postal Service petitioned the Commission to adopt rules to implement some of the report's recommendations. One recommendation included in the Service's petition was adoption of Commission rules for reviewing "service agreements with postal customers, varying from the general rate and

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[17] *Ibid.*

[18] *Id.* at 43.

[19] *Id.* at 44.

classifications schedules in ways which add value both for the customer and for the postal system as a whole”[20] on an expedited basis.

[3010] The proposal in the Postal Service's petition would have established negotiated service agreements as a new form of mail classification, with individual agreements to be reviewed by the Commission within 60 days. In the Commission's Notice of Proposed Rulemaking, it deferred consideration of the NSA proposal, citing legal uncertainty regarding the consistency of negotiated rates with the Act's ratemaking provisions. However, the Commission also expressed a general willingness to address the concept in a subsequent rulemaking.

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[20] *Postal Ratemaking in a Time of Change*, *supra*, at 54.

C. Recent Congressional Submissions

[3011] In joint deliberations on appropriations for the United States Postal Service and certain other agencies and departments for Fiscal Year 2002, the committee of conference directed both the Postal Service and the Postal Rate Commission to prepare reports on particular areas of the Postal Service's authority under existing law.[21] Specifically, the conferees directed:

> …both the United States Postal Service and the Postal Rate Commission to independently report, 90 days after enactment of this Act, on the scope of existing authority of the US Postal Service, under title 39, United States Code, and title 39, Code of Federal Regulations, to introduce and provide new products and services (including the introduction and provision of new products and service on an experimental or market test basis) and to enter into negotiated service agreements with individual customers or groups of customers. Such reports shall include background on the use of such authority within the past 24 months and shall be provided to the Committees on Appropriations, the Senate Committee on Governmental Affairs, and the House Committee on Government Reform.

H. R. Conf. Rep. No. 107-253, 107th Cong., 1st Sess. 59 (2001). As directed, the Commission and the Postal Service submitted their reports to the Senate and House of Representatives Committees on Appropriations, the Senate Committee on Governmental Affairs, and the House Committee on Government Reform in February, 2002.

[3012] In its report,[22] the Commission recounted much of the history of the negotiated service agreement concept presented above. It also observed that no provision in existing law explicitly authorizes or prohibits the Postal Service from entering

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[21] The amended bill produced by the conference committee was enacted as Pub. L. No. 107-67, 115 Stat. 514 (2001).

[22] Report to the Congress: Authority of the United States Postal Service to Introduce New Products and Services and to Enter into Rate and Service Agreements with Individual Customers or Groups of Customers, February 11, 2002.

into rate or service agreements with mail users, but that there could be both procedural and substantive impediments to introducing changes in rates or mail classifications by agreement alone. The Commission particularly noted the fairness and equity considerations in 39 U.S.C. §§ 3622 and 3623 as potential obstacles, as well as the prohibition of undue and unreasonable discrimination and preferences in § 403(c).[23]

[3013] However, assuming the procedural requirements of chapter 36 are met, the Commission opined that changes negotiated by the Postal Service and a mail user for their mutual benefit may merit recommendation under the applicable statutory standards.[24] In summary, the Commission concluded that rate and service adjustments arranged by the Postal Service and mailers are legally authorized if three conditions are satisfied. First, the agreement must be subject to review in a public proceeding, as the Reorganization Act requires. Second, the changes agreed upon must work demonstrably to the mutual benefit of mail users and the postal system as a whole consistent with established postal policy and statutory criteria. Finally, the negotiated rate-and-service package must be available on the same terms to other potential users willing to meet the same conditions of service.[25]

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[23] *Id.* at 10-11.

[24] *Id.* at 11-12.

[25] *Id.* at 14-15.

D. Current Challenges to Legality of Recommending NSAs

1. Alleged Incompatibility with the Statutory Scheme of the Postal Reorganization Act

[3014] In opposing the Negotiated Service Agreement advanced by the Postal Service and Capital One in this proceeding, intervenor Newspaper Association of America (NAA) asserts, among other arguments, that the NSA should be rejected as contrary to governing law. Initially, NAA argues that this is the case because single-customer agreements are not permissible bases for mail classifications under the policies and structural contours of the Postal Reorganization Act.[26] Because this argument is the most comprehensive and categorical challenge to the legality of the NSA under consideration in this docket, the Commission will address it first.

[3015] According to NAA, negotiated service agreements cannot serve as bases for appropriate rates and classifications under the Act, in part because doing so would violate the Act's expectation that the Commission exercise its primacy in ratemaking by actively reviewing and recommending rates. NAA Brief at 6-7. NAA also argues that the structure of the Act — which refers to "classifications" of mail and recommending rates for classes of mail or types of mail service — leads to the conclusion "that there is simply no room under the Act for single-mailer negotiated contract rates." *Id.* at 8 (footnote omitted). Recommending rates on the basis of the outcome of negotiations would also, according to NAA, contravene one of the policy goals of enacting the Reorganization Act, to "get politics out of the Post Office." *Id.* at 11, *quoting National Association of Greeting Card Publishers v. United States Postal Service*, 607 F.2d 392, 400 (D.C. Cir. 1979).

[3016] Several participants dispute NAA's claim of inconsistency with the Reorganization Act's terms and policies. The Postal Service argues that the Commission's review of the proposed NSA in this case is no more passive than it would be in any other rate or mail classification change proceeding. Postal Service Reply Brief

[26] NAA Brief at 5-9, 11-13; NAA Reply Brief at 2-4.

at 2-7. It also claims that NSAs are fully compatible with the structure of the Act, which "provides no minimum acceptable number of potential users of a mail classification[,]" *Id.* at 10, and that they are consistent with a natural evolution of ratemaking under the Act. *Id.* at 7-10. Co-proponent Capital One similarly argues that the Commission's review of proposed NSAs involves the same analyses and options employed in other mail classifications proceedings, and that the fact that requested changes were arrived at in negotiations does not in any way distinguish the process of considering NSAs from those proceedings. Capital One Reply Brief at 1-4. Finally, OCA disputes NAA's claims of inconsistency with the Reorganization Act's terms in a pleading responsive to the arguments of NAA and other participants.[27]

[3017] NAA correctly observes that the development of mail classification under the Reorganization Act has proceeded by identifying and refining classes, subclasses, and rate categories within the framework of an overarching Domestic Mail Classification Schedule. The introduction of negotiated, special rate and service arrangements for specified individual mailers would differ qualitatively from preceding changes in mail classification since establishment of the DMCS. However, the Commission does not believe that this form of innovation would exceed the mail classification authority entrusted to the Postal Service and the Commission by the Reorganization Act.

[3018] The ratemaking and mail classification authority jointly exercised by the Postal Service and the Commission under the Reorganization Act derives from the plenary authority of Congress to "establish Post Offices and post Roads[.]"[28] Prior to enactment of the Reorganization Act, Congress exercised its authority to classify mail matter by establishing the forerunners of the current major mail classifications, such as First-Class Mail.[29] In determining eligibility for the various mail classifications it

[27] Office of the Consumer Advocate Reply Comments Concerning the Legality of the Capital One NSA, April 14, 2003.

[28] U. S. Const. art. I, § 8 cl. 7.

[29] *See* former 39 U.S.C. §§ 4251-4254.

established, Congress typically legislated empirical criteria to be satisfied, many of which survive in the current DMCS — content restrictions, size and weight limits, and the like.

[3019] However, Congress also classified mail by establishing certain mail categories and associated rates that were restricted to specified classes of mail users, such as educational institutions,[30] state agencies and institutions,[31] and qualified nonprofit organizations.[32] This form of mail classification was grounded in considerations of public policy.

[3020] In enacting the Postal Reorganization Act, Congress delegated its mail classification and ratemaking authority to the Postal Service and the Commission under the collaborative provisions of chapter 36 of Title 39. This act of delegation was complete; as the court found in the *National Retired Teachers Association* decision,[33] "notwithstanding the observations of the House Committee some four years later, and subject to congressional power to amend or repeal the statute, Congress unmistakably delegated its ratemaking and classification prerogatives to the PRC."[34] This being the case, the mail classification authority exercised by the Service and the Commission under chapter 36 is co-extensive with the powers exercised by Congress prior to enactment of the Reorganization Act. In the context of this proceeding, recognition of the extent of this authority supports a conclusion that the Postal Service is authorized to request, and the Commission to recommend, mail classifications that are available exclusively to specified users.

[3021] As the Postal Service has argued (Postal Service Reply Brief at 9), structural elements of the Act tend to confirm this conclusion. Section 3623 directs the Commission to consider "the desirability and justification for special classifications and

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[30] *See* former 39 U.S.C. § 4355(a)(1).

[31] *See* former 39 U.S.C. §§ 4355(a)(2)-(5), 4356.

[32] *See* former 39 U.S.C. § 4452(d).

[33] *National Retired Teachers Assn. v. United States Postal Service*, 430 F. Supp. 141 (D. D.C., 1977), *aff'd*, 593 F.2d 1360.

[34] 430 F.Supp. at 146. (Footnotes omitted.)

services of mail", 39 U.S.C. § 3623(c)(2), and "the desirability of special classifications from the point of view of both the user and of the Postal Service", 39 U.S.C. § 3623(c)(5). Congress explicitly provided for consideration of "special" classifications, in addition to the more general components of the DMCS, and restricted-user categories of mail would appear to be a potential example of such classifications.

[3022] In place of the public policy deliberations on which Congress based the restricted-user mail classifications it enacted, the Reorganization Act directs the Commission to conduct formal proceedings in accordance with § 3624, and to make recommendations based on consideration of the policies of Title 39 and the enumerated factors of § 3623(c). Contrary to NAA's suggestion, no intrinsic feature of a negotiated service agreement necessarily subverts this process. While the terms of the NSA obviously are the product of negotiations between the Postal Service and a prospective user, the Commission's review need not be entirely passive, or limited to rendering a "thumbs up" or "thumbs down." It may, for example, recommend additional conditions in connection with implementing the agreement, as the Commission does in this instance. *See* Chapter VIII of this opinion, *infra*.

2. Alleged Inconsistency with § 403(c) Prohibition of Undue Preferences

[3023] Several participants in this proceeding, including opponent NAA, have stated concerns that the Postal Service's proposed NSA with Capital One — and mail classifications based on negotiated service agreements in general — may violate one of the Reorganization Act's cardinal policies governing mail classification, ratemaking, and the provision of postal services:

> In providing services and in establishing classifications, rates, and fees under this title, the Postal Service shall not, except as specifically authorized in this title, make any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue or unreasonable preferences to any such user.

39 U.S.C. § 403(c).

[3024] NAA, citing the Commission's findings in the Report to Congress of February 11, 2002 described above, argues that the proposed NSA violates the Commission's own interpretation of § 403(c). According to NAA, this is the case because the Postal Service has failed in these proceedings to prove that it will benefit from the NSA with Capital One. NAA Brief at 16. NAA presents detailed arguments citing deficiencies in record evidence to demonstrate that there is inadequate support for a conclusion that the Service would derive a net benefit from its NSA with Capital One. *Id.* at 16-29. NAA also argues that the NSA would violate § 403(c) because limiting eligibility for its non-cost based benefits to Capital One for three years "violates well-established principles of non-discrimination in regulatory law, and Section 403(c) of the Act specifically." *Id.* at 29.[35]

[3025] The Commission confirms its view, stated in last year's Report to Congress, that "[n]egotiated rate or service changes also may run afoul of the substantive standards prescribed for rates and mail classifications in the Reorganization Act[,]"[36] including § 403(c). However, we disagree with NAA's suggestion that the exclusive benefits conveyed to Capital One by the agreement renders the NSA a violation of § 403(c) *per se*.

[3026] That provision forbids granting only those preferences to mail users that are "undue or unreasonable." It does not preclude conveying a benefit to a mail user for which there is a rational, ascertainable basis.

[3027] As the OCA has noted in reply comments, determining whether any given preferential benefit is "undue or unreasonable" requires a factual inquiry.[37] Further, in

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[35] Intervenor Valpak similarly cautions that the potential for discriminatory exclusion in adopting NSAs renders it highly appropriate for the Commission to consider alternative mail classification approaches. Valpak Brief at 27-34. The Commission agrees with this concern, and discusses the feasibility of alternative approaches in the following subsection of this opinion.

[36] Report to the Congress, *supra*, at 11.

[37] Office of the Consumer Advocate Reply Comments Concerning the Legality of the Capital One NSA, April 14, 2003, at 2.

examining record evidence to determine whether a particular preference is undue or unreasonable, that determination depends on whether there is a rational basis for treating a single mailer differently from others.

[3028] OCA takes the position that the record demonstrates sufficient cost and demand differences in Capital One's mailing practices to justify separate classification treatment of its First-Class solicitation mail.[38] The Commission agrees, and finds these differences sufficient to allay concerns that the proposed separate classification treatment is unduly or unreasonably preferential to Capital One.

[3029] As the Commission finds in Chapter VI of this opinion, *infra*, Capital One's mailings to solicit new customers have distinctive characteristics. Capital One makes extensive use of First-Class Mail for this purpose, although Standard mail service is a readily-available substitute. Capital One's First-Class Mail solicitations generate an unusually large proportion of unforwardable undeliverable as addressed pieces, which must be returned — to the benefit of neither Capital One nor the Postal Service — incurring substantial costs.

[3030] The described conditions may, or may not, make Capital One's First-Class solicitation mailings unique in the postal system. However, the Commission does not understand § 403(c) to preclude preferences for mailers whose circumstances are other than "unique." Rather, it requires that any identified user preference have a reasonable justification.[39] In view of the significant cost-saving opportunities that the terms of the Postal Service-Capital One NSA make available to the Postal Service, the Commission finds no violation of the prohibitions in § 403(c).

[3031] We find no inconsistency between this conclusion and prior Commission decisions in omnibus rate proceedings, cited by NAA, that rejected earlier proposals of volume-based discounts. NAA Brief at 9-10. In Docket No. R87-1, the Commission

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[38] *Id.* at 3-4.

[39] *See,* e.g.*, National Easter Seal Society v. United States Postal Service*, 656 F.2d 754, 762: "But *absent some reasonable ground for differential treatment*, section 403(c) forbids discriminatory phasing of discounts to only one class of mailers." (Emphasis added.)

declined to recommend volume discounts proposed by the Postal Service for Express Mail; in Docket No. R90-1, the Commission rejected a similar proposed discount for the same service.[40] In both instances, rejection was based on the Commission's assessment that the proposed discounts were unsupported by any measurable cost difference between low-volume and high-volume mailings or other empirical justification.[41] Here, by contrast, the agreed-upon declining block rates are justified by Capital One's agreement to take measures that will avoid the potential costs of physical return.

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[40] PRC Op. R87-1, March 4, 1988, para. 6020; PRC Op. R90-1, January 4, 1991, para. 6535.

[41] PRC Op. R87-1, *supra*, para. 6020: "The Postal Service, however, did not address the issues that must be considered before accepting rate differentials within a subclass that have no origin in—at a minimum—a perception of some difference in costs."

E. Potential Violations of Regulatory Axioms Advanced For Application to NSAs

[3032] Intervenors Greeting Card Association (GCA) and Valpak devote large portions of their briefs to articulating prescriptive principles that they believe the Commission should apply in evaluating negotiated service agreements for possible recommendation in this and future proceedings.[42] In the Commission's view, this initial review of one potential type of NSA is not an appropriate vehicle for comprehensive consideration of the guiding principles that should be selected for application to NSAs generically. However, to the extent the Postal Service-Capital One agreement arguably would violate the principles advanced by the commenting parties, the Commission will consider them for the purposes of this decision.

[3033] Three of the suggested principles are addressed in the following subsections. Others are treated in later sections of this opinion, primarily Chapter VIII.

1. Preferability of an “Open” Niche Classification

[3034] Among the standards GCA advocates is the principle that: “NSAs should not be used when a classification open to additional mailers could provide benefits to the Postal Service, and to more than one mailer.” GCA Brief at 8. (Emphasis in original.) GCA argues that using the NSA mechanism in place of a workable niche classification could produce a variety of detrimental results, including expenditure of additional

[42] The Greeting Card Association advances two principles for NSAs: that (1) “NSAs are appropriate only for unique situations where a niche classification open to all is infeasible”; and (2) “An NSA should not combine independently usable, unrelated elements.” GCA Brief at 8, 14. Valpak presents seven principles: (1) “NSAs cannot substitute for fixing systemwide pricing problems”; (2) “NSAs must demonstrate that they do not result in net financial loss to the Postal Service”; (3) “NSAs must be evaluated using mailer-specific costs”; (4) “NSAs must not result in undue or unreasonable preferences to certain mailers or discrimination against similarly-situated mailers”; (5) “NSAs must not provide discounts based solely on high volume”; (6) “NSAs must not provide unfair rewards for high-cost mailers discontinuing high-cost behavior”; and (7) “NSAs must attempt to anticipate and avoid unintended consequences.” Valpak Brief at 5.

resources to create corresponding NSAs for others, the risk of unfairness and competitive harm to excluded mail users, and the introduction of perverse incentives to the mailing activities of the latter. *Id.* at 8-11. Given the Postal Service's public service mission and its legal monopoly over letter mail, GCA asserts, the Service should not pick and choose among competitors, which using an NSA rather than an open classification necessarily entails. In addition to the transaction costs incurred in negotiating NSAs, GCA claims that their unnecessary use would create process inefficiencies in comparison with serviceable niche classifications, which would not need to rely on projections based on one firm's anticipated actions, and thus might actually take less time to review and put into effect. *Id.* at 12-13. For these reasons, GCA asks that the Commission "put all concerned on notice that a necessary element in the presentation of an NSA proposal will be a reasonable showing that the expected benefits could not be achieved by such a niche classification." *Ibid.* (Footnote omitted.)

[3035] The Postal Service challenges this proposed requirement. It disputes GCA's premise that broader classifications are to be preferred over NSAs under the Reorganization Act, arguing that Congress created a flexible mechanism to allow rates and classifications to be established principally by reliance on the judgment and discretion of the Commission and the Postal Service. Postal Service Reply Brief at 19-20. The Service also states that its interest in NSAs is focused on potential benefits to both the NSA's parties and all other mailers, and that there should be no artificial impediment to exploiting such opportunities, especially where an NSA could provide the means for making similar arrangements available to other mailers, as in this case. Finally, the Service concedes that the costs and administrative burdens of such agreements "could militate against a wide network of NSAs[,]" *Id.* at 21, but asserts that uncertainty regarding costs is not a sufficient reason for declining to embark upon the pricing experiment it proposes in this case.

[3036] Capital One argues that GCA's position betrays a misunderstanding of the different and legitimate uses of NSAs and niche classifications. GCA does not dispute that a niche classification would have been an appropriate proposal "[i]f there had been

20 Capital Ones who made extensive use of First-Class Mail for solicitations, and were sufficiently large to comfortably absorb the transaction costs of the negotiation[.]" Capital One Reply Brief at 17-18. However, given the benefits its NSA with the Postal Service would confer on the Postal Service and other stakeholders in the postal system, Capital One asserts that it would be perverse to reject it for failure to find 19 other mailers to qualify for a niche classification.

[3037] The Commission agrees with GCA's basic premise that, all other things being equal, more inclusive mail classifications are preferable to more restrictive alternatives. This predisposition is grounded in the Reorganization Act's command to be guided by considerations of fairness and equity in establishing and maintaining "a classification system for all mail", 39 U.S.C. § 3623(c)(1), as well as a corresponding schedule of rates for all mail, 39 U.S.C. § 3622(b)(1). It also serves as a preventive safeguard against potential claims of undue or unreasonable discrimination among mail users, which § 403(c) prohibits as a matter of postal policy.

[3038] For these reasons, the Commission has maintained a consistent policy of entertaining and acting upon claims that new mail classifications should be available on more inclusive terms than were originally proposed. According to one reviewing court, "[o]n its face, this is the kind of determination the Commission is allowed, and indeed required, to make."[43] In keeping with this obligation, in this case the Commission determined to allow the Office of the Consumer Advocate to submit a more inclusive alternative to the NSA originally filed, over the objection of its private sector proponent.[44]

[3039] However, the Commission's predisposition to prefer more inclusive mail classifications is not a sufficient basis for canonizing GCA's proposed requirement that NSAs be supported by a showing that its expected benefits could not be achieved through a niche classification. The Postal Service and any co-proponent bear the burden of demonstrating that the proposed NSA is compatible with statutory policies, as

[43] *Mail Order Association of America v. USPS*, 2 F.3d 408, 423 (D.C. Cir. 1993).

[44] Order No. 1359, Order Accepting Certification of Questions and Disposing of Motion for Declaratory Ruling, February 3, 2003.

well as the applicable ratemaking and mail classification factors. The Commission is not inclined to complicate this process by adding a requirement that would further burden the proponents by tasking them with what would, in effect, be proving a negative.

[3040] Nevertheless, the Commission will continue to allow participants to inquire into the feasibility of more inclusive classification provisions, and to propose more expansive alternatives, as it has done in this proceeding.[45]

2. Appropriateness of Incentives to High-cost Mailers to Discontinue High-cost Behavior

[3041] Valpak advocates a substantive limitation on the terms of negotiated service agreements: that they “must not provide unfair rewards for high-cost mailers discontinuing high-cost behavior.” Valpak Brief at 36. Valpak concedes that substituting a low-cost method of mail use for a high-cost method reduces costs and increases efficiency. However, it argues that rewarding high-cost mailers who benefit from rate averaging for foregoing some of their high-cost practices, while excluding low-cost and all other mailers not deemed to be “similarly situated,” raises a basic issue of fairness. Valpak Brief at 36. *Ibid.*

[3042] Valpak asserts that the § 3622(b)(1) and § 3623(c)(1) fairness criteria require the Commission to guard against giving high-cost mailers rate advantages over low-cost mailers who lack costly practices to forego in exchange for a price incentive. Moreover, Valpak argues, awarding a formerly high-cost mailer a rate lower than any available to low-cost mailers could be considered an undue or unreasonable preference, in contravention of the Reorganization Act's prohibition. On these grounds, Valpak asserts that the Commission should reject the NSA at issue in this case. *Id.* at 36-37.

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[45] The record of this proceeding indicates that the Postal Service does not have the operational capability to implement the terms of its NSA with Capital One on a systemwide basis as a niche classification at this time. *See* Rebuttal Testimony of Michael K. Plunkett on Behalf of United States Postal Service, USPS-RT-1, Tr. 9/1866-69.

[3043] The Postal Service denies that the practice Valpak claims to be objectionable is present in its NSA with Capital One. Because the relevant "behavior" of Capital One is using First-Class Mail for solicitations, in place of Standard Mail, the Service claims it is highly beneficial to the Postal Service. According to the Service, the NSA will serve only to increase the value of this practice, because Capital One is voluntarily declining a service to which it would otherwise be entitled, and will be rewarded only if it increases the First-Class volume it sends. This arrangement, the Service claims, unequivocally benefits itself and all mailers by providing contribution to institutional costs that it would not have received without the discounts. Postal Service Reply Brief at 17.

[3044] Capital One also disputes applicability of Valpak's principle to its NSA with the Postal Service, on the ground that the reward it will receive will be less than the cost saved by eliminating the service it will be forgoing. Capital One Reply Brief at 5. The Commission is well aware that subclasses with rate elements based on averaged costs present opportunities for rate de-averaging that might work to the disadvantage of lower-cost users of the subclass. Any proposal to re-align rates internally in such a subclass to exploit cost differences requires scrutiny of the potential consequences to all users.

[3045] To illustrate the question of fairness it raises, Valpak poses two hypothetical questions regarding the appropriateness of adopting a discount or rebate to reward postal patrons for curtailing permissible higher-cost activities. Without addressing the merits of the specific scenarios described by Valpak, several observations are in order.

[3046] First, the Commission has long recognized the potential benefits of encouraging mailers to reduce the costs they impose on the postal system by creating rate incentives for activities that will accomplish that end. Generically, these have become known as "worksharing" discounts. They are not, and should not be, rewards for the fact that a mailer could impose relatively higher costs on the postal system, but does not.

[3047] Second, the rate incentives adopted for worksharing activities should not exceed the cost savings that result from their performance. Excessive discounts do not benefit the postal system as a whole, and ultimately result in harm to other mail users. Indeed, it is often appropriate to return something less than 100 percent of estimated cost savings, to accommodate the likelihood of some imprecision in the estimate.

[3048] Finally, in considering the adoption of discounts, the Commission will always consider the potential impact on other users of the pertinent category of mail. This will include the potential "push up" effect of new discounts on the underlying rate schedule, the ability of other users to convert their mail to the discounted category, and other alternatives available to such users.

[3049] In the case of First-Class Mail, the free forwarding and return features create opportunities to identify cost savings that could result from avoidance of those activities for users able and willing to forego either of the services. Availability of these cost-saving opportunities would appear to support introduction of rate incentives, provided they are designed and offered on fair and equitable terms. The availability of less costly electronic alternatives to the traditional form of these services strengthens this inference.

[3050] However, while physical forwarding and return are available to First-Class users at no additional charge, at this time the electronic substitute requires a fee. The Postal Service-Capital One NSA addresses this apparent pricing anomaly by waiving the electronic address correction service (eACS) fee and compensating Capital One for activities to support electronic address correction through a schedule of additional discounts that increase with incremental volume.

[3051] NAA and Valpak argue that, instead of submitting the Capital One NSA, the Postal Service should have formulated and proposed a more comprehensive solution to the current pricing anomaly.[46] In view of the rebuttal testimony of Postal Service witness Plunkett that the Postal Service is aware of this issue and is currently reviewing possible

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[46] NAA Brief at 34-35; Valpak Brief at 13-18.

pricing approaches to physical return of mail and electronic alternatives,[47] the Commission strongly encourages the Service in its efforts to develop a more general solution. However, the record indicates that it would not be feasible to implement a systemwide program at this time.[48]

[3052] In the interim, the Commission finds that the NSA, as recommended, would not violate the standard of equity advanced by Valpak, as it will not increase the burden of contribution that must be borne by other First-Class Mail users. As Capital One asserts, the rate benefits it receives will be exceeded by the amount of physical return costs driven out of First-Class Mail, to the benefit of all its users. Further, as the Postal Service observes, to the extent the declining block rates stimulate volumes Capital One would not otherwise have entered as First-Class solicitation mail, the additional contribution to institutional costs would also benefit all other mailers. Thus, if the Service's agreement with Capital One is implemented according to this schematic, no user of First-Class Mail is likely to suffer negative impact rate as a consequence.

3. Appropriateness of Combining "Independently Usable, Unrelated Elements"

[3053] The Greeting Card Association also suggests a substantive restriction on the constituent elements of NSAs: that they should not combine independently usable and unrelated elements to benefit a single mailer where (i) they could be pursued separately in niche classifications to afford greater fairness to mailers who might benefit from use of at least one of the elements; and (ii) such separate use would produce the measurable results needed to evaluate the value and future usefulness of the beneficial element. In this case, the purportedly independently usable and unrelated elements are

[47] "This case has brought to light important issues relating to the pricing of address correction services, and the associated operational impacts. These issues warrant careful consideration, in light of the total rate and fee structure, but they are not amenable to comprehensive resolution in this case." Tr. 9/1868. *See also* Tr. 9/1876.

[48] *See* n. 31, supra.

a provision of free eACS in lieu of the physical return of undeliverable mail, and an optional tariff in the form of declining block rates. GCA Brief at 14.

[3054] GCA argues that the record supports a conclusion that the free eACS and the block rate volume discounts have no evident functional relationship, and could work independently. *Id.* at 15-17. According to GCA, combining these elements in a single package is objectionable because it presents serious risks of exclusionary unfairness to other potential users. *Id.* at 17-18. It would also, GCA claims, blur the data that could be generated by independent operation of the two separate elements of the agreement, thereby impairing the utility of the information generated during performance under the agreement. *Id.* at 18.

[3055] The Postal Service denies GCA's claim that the elements of its NSA with Capital One are unrelated, asserting that their combination is needed to induce Capital One to move solicitation mail into the eACS program in order to realize maximum potential benefit. Postal Service Reply Brief at 30. The Service also defends the combination as “an effective short-term way to deal with a situation that is not easily susceptible to traditional price signals[,]” *Ibid*., and contends that joining the two elements will minimize the risk of unintended consequences that could occur if they were available as separate classification options. *Id.* at 31.

[3056] Capital One argues that GCA's position proceeds from an erroneous assumption: that parties would be willing to negotiate separate deals for the individual elements. Capital One cites witness Plunkett's testimony that Capital One declined to accept an agreement that did not include volume discounts. Capital One Reply Brief at 24-25, citing Tr. 4/848. It also asserts that there is neither a basis in the record for concluding that the Postal Service would be willing to take the risk of offering volume discounts to mailers where there is no quid pro quo in the form of mailer undertakings that would produce substantial cost savings, nor evidence that the Service is inclined to provide free eACS to First-Class mailers who have lower proportions of physically returned mail than Capital One. *Id.* at 25-26.

[3057] The Commission agrees with GCA that the combination of unrelated and independently operative elements in a single negotiated service agreement has the potential for generating issues of fair access. Indeed, as we note below, the NSA now before us for consideration poses a critically important question of whether implementation of the agreement will operate to the net benefit of other mail users and the postal system as a whole. However, adoption of the restriction GCA suggests would not, in our view, represent a pragmatic approach to the Commission's consideration of individual NSAs in the future.

[3058] Intervenor American Postal Workers Union (APWU) provides valuable insight into the practical limits of expectations regarding NSAs likely to be formulated and presented to the Commission for review. In its reply brief, APWU states:

> If NSAs are accepted, the Commission's considerations will have to accept that an NSA may not be structured to anyone's liking. A single party-absent the problems inherent in negotiations-could design rate and service changes less troublesome for the Commission to judge, but less responsive to the very specific goals of the parties. . . .The Commission can expect to see such “imperfect” NSAs again. The Commission should not judge NSAs on whether they are well crafted-the negotiation process will sometimes prevent that-but on whether the NSA benefits the Postal Service such that postal customers benefit generally and no postal customer is disadvantaged.

APWU Reply Brief at 5.

[3059] If the Commission crafted the terms of agreements between the Postal Service and putative users of negotiated service agreements, it might well observe the guideline GCA advances here, as well as other mail classification and ratemaking principles. However, because of the bilateral negotiation preceding any Commission involvement in the process, this opportunity will not be available. Therefore, as APWU sagely suggests, the Commission's role is more likely to be that of appraiser of whether agreements with rate and classification elements it regards as less than optimal nonetheless pass muster under the Reorganization Act's standards.

[3060] In the process of reviewing proposed NSAs, either participants or the Commission itself can inquire into the kinds of issues GCA's proposed standard seeks to minimize. If there are issues of fair and equitable access to an element of the NSA by other mailers who might benefit, they can be investigated and addressed. If the presence of independently usable, arguably unrelated elements raises issues of their effects in actual operation, these matters can also be explored in the proceeding.

[3061] In this case, participants have probed the potential effects of the two independent elements of the Postal Service-Capital One NSA: substitution of free electronic address correction service for physical return of undeliverable First-Class pieces, and a compensatory schedule of declining block rates. One participant — the Office of the Consumer Advocate — presented an alternative proposal that sought to accommodate concerns regarding more equitable access to the NSA's beneficial terms and limitation of the proposed block rate discounts' application to cost savings resulting from the eACS element.

[3062] Notwithstanding the signatory parties' laudable attempt to remove potential roadblocks from approval of this first NSA in the form of a Stipulation and Agreement, the Commission remains extremely concerned about the potential effects of the independent elements of this NSA on other mailers. Primarily because of uncertainties about the baseline volume of First-Class Mail Capital One would send in the test year, there is a distinct possibility that in actual operation the NSA would return greater rate discounts than the amount saved by the eACS component of the agreement.

[3063] This outcome would not benefit the Postal Service, and would ultimately burden other mail users. For this reason, the Commission recommends an additional, financially protective element, as described in Chapter VIII of this opinion. In the Commission's view, adopting a solution tailored to the specific needs of this case is superior to adoption of a general rule that would preclude or disfavor negotiated service agreements with terms that combine independently usable, unrelated elements.

IV. EXPERIMENTS

A. Introduction

[4001] An experiment is a test done in order to learn something or to discover whether something works or is true.[49] It can be used to verify a prediction or to support a hypothesis. In the context of the Postal Service, an experiment can be used to test the feasibility, and to quantify the potential benefits, of a new postal service. It can be used to discover and resolve unanticipated problems with a new service before a request for permanent classification is proposed, and it can be used as a conduit for generating data to support a proposal for a permanent classification.

[4002] Well-designed experiments have the common attribute of following a "scientific method." A scientific method, for the purpose of discussion, shall be defined as a four-step process. First, a thesis or observation of some aspect of a postal service is made. Second, a description or hypothesis is formed that is consistent with the observation, which may include predictions based on the hypothesis. Third, a test or "experiment" is performed to test the hypothesis and/or the associated predictions, and to gather data. Fourth, the data gathered during the experiment are analyzed, summarized, and used to draw conclusions. A proposal for an experiment that describes this process implicitly or explicitly, and demonstrates a reasonable expectation that the process will yield the desired results, shall be considered experimental in character.

[4003] The significance of determining whether a proposal is experimental in character, or whether it describes something else, is evident by the different standard of review the Commission applies when considering a Postal Service proposal. For a proposal that is experimental, initial data requirements are often relaxed because the required data do not exist. Additional focus is applied to reviewing the experimental aspects of testing or learning something, collecting data, and reaching a conclusion.

[49] Cambridge Dictionary of American English.

Less weight may be given to any potential negative impact on the Postal Service, its customers, and competitors because the effects of an experiment typically are limited in scope and duration. The risk of discrimination is also reduced because to be manageable limits are placed on the scope of the experiment, the number of participants, and perhaps the geographic area where the product or service is available. The review of the goals of the purported experiment and what may be learned, including the cost, the risk, the impact on the marketplace, the design of the test or experiment, and whether the duration of the experiment is appropriate, become important to the review process. Because of these considerations, it is important to thoroughly examine whether or not a Postal Service proposal designated as experimental is in fact experimental in character.

[4004] An NSA may describe an experiment, but there is not a requirement for an NSA to be experimental in character. Based on the potential differences in characteristics of a proposal that is experimental in character versus a proposal that contains an NSA, the standard for reviewing each form of proposal may be different. The purpose of an experiment is generally to test, discover, and learn. The purpose of an NSA is to benefit the Postal Service consistent with the policies of the Act. An experiment places considerable emphasis on the development of a suitable data collection plan and the collection of data in order to learn about a postal service. Data collection during the life of an NSA will not necessarily result in learning something about a new postal service. An experiment will have a predetermined expiration date, with the expectation that some further action will result based on the experiment. An NSA typically will be a contract, and similar to an experiment have a predetermined expiration date. However, there is no expectation that an NSA will be expanded to other customers or geographic regions after its termination date. Experiments may limit participation, typically on a first-come first-serviced basis, or through limiting the geographic extent of the experiment. Participation in an NSA is limited to the signatories of the contract, given that similar terms and conditions will be made available to other similarly situated mailers in the future. The data requirements for an experiment include the possibility that data are not initially available. This might not be an appropriate consideration for an NSA.

B. Existing Rules for Experiments

[4005] United Parcel Service v. United States Postal Service, 604 F.2d 1370 (3d Cir. 1979), held: "any proposal which would effect a change in mail classification or a rate, including a test or experiment embodying those features, must be submitted to the Rate Commission, no matter how experimental, temporary, or limited in scope the change." Subsequent to this decision, the Commission adopted rules of procedure suitable for considering Postal Service proposals for experiments, which provide the Postal Service with maximum flexibility, and ensure appropriate regulatory review as required by the Act and as set forth in United Parcel Service. PRC Order No. 363, December 12, 1980.

[4006] The Commission's experimental rules may be applied in cases where the Postal Service requests a recommended decision pursuant to § 3623 and denominates the new service or change in existing service as experimental in character. The Commission reserves the right to require use of the normal procedures prescribed for non-experimental cases where the experimental rules are determined to be inappropriate. In determining whether the procedures for experimental cases should be used, the Commission will consider: (1) the novelty of the proposed change; (2) the magnitude of the proposed change; (3) the ease or difficulty of generating or gathering data with respect to the proposed change; and (4) the desired duration for the experiment as indicated by the Postal Service. Rule 67. In exercising its discretion to apply the experimental rules, the Commission will consider representations by parties to the case that experimental rules should not be applied to the particular Postal Service proposal.

[4007] If applied, the Commission's experimental rules simplify and expedite the review process. They allow the Postal Service to provide a data collection plan to collect data required by Rule 64 that are unavailable at the time of filing, or to state with particularity the reasons it believes that such data are unnecessary. The rules also require the Postal Service to provide a data collection plan for data that it intends to collect to evaluate the results of the experiment. Rule 67c. These provisions address the heart of any experiment, the necessity to collect data. Without the collection of appropriate data, analysis can not be performed and conclusions can not be drawn. If the data gathering, analysis, and conclusion steps are not performed, little will be learned from the experimental process. Requiring a data collection plan also directs attention to the design of the experiment to ensure that it is likely to produce the appropriate data. A proposal that does not perform a test and collect data is of little value as an experiment.

[4008] The experimental rules allow for the limitation of issues on which a trial-type hearing is required. Rule 67a. This provision encourages participants to come to agreement on the non-controversial issues of a case. It allows participants to concentrate on issues that are relevant in the context of a limited service. This expedites the proceeding.

[4009] The experimental rules provide for consideration of an experimental proposal with maximum expedition consistent with procedural fairness, allowing for decisions within a 150-day timetable. Rule 67d. This provides a decision-making process appropriate to the nature and scope of an experiment, while preserving procedural due process for all interested participants involved.

[4010] Over the years, the Postal Service has requested that eleven proposals be considered under the experimental rules. Review of these eleven cases provides insight into what has been considered experimental in character in the past. A brief review of the attributes of each of these dockets is provided as Appendix C to this opinion and recommended decision.

[4011] There are similarities among the experiments reviewed in Appendix C, either as proposed, or as modified by the Commission. Each experiment had a goal to learn something about a potential postal service through the experimental process. Each experiment included a data collection plan, which was frequently made more robust as a result of the review process, and which directly related to the experiment being performed.

[4012] Each proposal for an experiment included a credible assertion by the Postal Service that upon successful completion of the experiment, the Postal Service anticipated seeking a permanent classification or change based on the experiment. Implicit with this assertion was the indication that the permanent classification would be available to a generally defined type of mail.

[4013] Previous experiments sometimes limited participation to a workable number of participants, or otherwise limited the scope of the experiment. The test group has always been open to more than one customer.

[4014] All experiments, with the exception of Mailing Online, have been recommended for a duration of two years or less. The recommended durations were appropriate in relation to the goals, risks, and benefits involved with each experiment. The three-year Mailing Online experiment, MC2000-2, was the longest duration experiment recommended by the Commission under the experimental rules. Although the duration was relatively lengthy, it was appropriate given the character of the experiment, i.e., its complexity, the economic projections provided by the Postal Service in the proposal, and its compatibility with the data that the experimental process could provide.

[4015] Previously recommended experiments were either cost based, or otherwise provided enough detail in their proposals such that the economics of the proposed experiment could be analyzed over the life of the experiment. The economic impact of even the longest duration experiment recommended to date, Mailing Online, MC2000-2, was analyzed over the full life of the experiment.

C. (Limited) Experimental Nature of Request

[4016] The NSA includes two classification features, each of which by themselves could be considered experiments, and thus these features also warrant individual review. First, the Postal Service proposes to provide electronic address corrections without fee for solicitation mail sent by First-Class Mail that is undeliverable as addressed while forgoing the current practice of returning such undeliverable mail to the mailer when it cannot be forwarded address correction service (address correction service or ACS feature).[50] Request at 2. Second, the Postal Service proposes to provide per-piece discounts for First-Class Mail for volumes in excess of an overall annual volume threshold that vary under a declining block rate structure (declining block rate feature). Request at 2.

[4017] Analyzing the experimental characteristics of the proposal begins with the Postal Service's description of the experiment: "Adoption of the experimental rate and classification changes associated with the NSA will also allow the Postal Service and the Commission to test the effectiveness of the NSA approach, as a means of providing pricing flexibility under the existing statutory ratemaking scheme." Request at 2-3. This statement not only indicates that a test of the NSA approach is to attain certain financial and operational goals, it indicates that this is a test of the ability of the Postal Service and the Commission to manage NSAs within the requirements of the Act.

[4018] The administrative tasks of the Postal Service are different from those of the Commission. To comprehensively test the NSA approach, the Postal Service has to develop and test a system to administer NSAs in general for the future. It is important to distinguish what needs to be tested because testing the specific application of one NSA might not provide insight into the problems involved with administering the broader issues related to NSAs in general.

[50] Additional address hygiene requirements on the part of the mailer are included with this proposal.

[4019] In this experiment, the Postal Service intends to explore the acceptability of NSAs under the current statutory ratemaking scheme. The Postal Service should evaluate its ability to negotiate multiple requests for NSAs, and take these requests efficiently through the review process. It should strive for a "user friendly" process to allow multiple customers to have an equal opportunity to negotiate with the Postal Service. It must provide the opportunity for similarly situated customers to participate in NSAs comparable to those already approved. Finally, it should address problems of the management and oversight of a multitude of recommended NSAs simultaneously in progress. These issues are in addition to the requirement to develop tracking and review procedures tailored to this particular NSA.

[4020] Given the limited nature of the Postal Service's proposal to experiment with one NSA, the Postal Service's experiment does not address the broader issues that should be answered to test handling NSAs in general. These issues must be considered if the Postal Service intends to make the application of NSAs widespread.

[4021] Further, the experiment described in the proposal will provide only limited insight into answering the questions posed in the Postal Service's overview statement. When examined from the perspective of an experiment that follows the scientific method, the Postal Service's overview statement includes two observations and infers a general hypothesis. The two observations are: (1) the Postal Service does not have the pricing flexibility that it wants, and (2) the Postal Service is constrained by an existing statutory ratemaking scheme. It follows that the Postal Service hypothesizes by negotiating service agreements with its customers, it both could gain pricing flexibility and comply with the existing statutory ratemaking scheme. The Postal Service thus has made an observation, and has formed a hypothesis.

[4022] The problem lies in designing an experiment to test the hypothesis, which possibly could result in learning about the NSA approach. The first part of the hypothesis is somewhat rhetorical. Assuming that the statutory requirements are met, if the Postal Service negotiates service agreements containing rates with individual customers it obviously will gain some level of pricing flexibility. Designing an experiment to test this part of the hypothesis is trivial and will not lead to meaningful results.

[4023] Testing the second part of the hypothesis, that NSAs can comply with the statutory ratemaking scheme, is more complex. Given the experiment proposed, the terms and conditions of the specific NSA will provide insight into how the general NSA concept will mesh with the criteria of the existing statutory ratemaking scheme. However, only the terms and conditions of the specific NSA can be examined for compliance with the existing statutory ratemaking scheme.[51] The experiment does not follow a traditional scientific method because the design of the experiment can provide only a limited test of the general hypothesis. It only tests the hypothesis with the limited subset of one possible NSA proposal. Therefore, at the overview level, the Postal Service's proposal is not representative of a proposal that is experimental in character because the proposed experiment does not adequately test the hypothesis as stated. The ramification of this problem is that any decision made concerning this specific NSA will only have limited value as precedent for the acceptability of future NSAs.

[4024] NSAs by definition are individualized proposals. Because the specific elements of NSAs will vary from one to the next, each NSA must be independently reviewed for statutory compliance. NSAs must be shown to benefit the Postal Service, and must be consistent with applicable statutory policies. There is not an individual right for approval of an NSA. Testing one version of an NSA does not guarantee the acceptability of NSAs in general.

[4025] The Postal Service is not explicit as to the Commission's role in testing the NSA approach. The Commission intends to analyze data generated from the implementation of the NSA as part of its normal procedure, but does not have an active role in administering the NSA after the initial recommendation. The primary role of the Commission is the review process. The assumption is that the Commission is to test its procedural and legal ability to review and make recommendations on NSAs. The

[51] This fact must be taken into consideration when considering any future rulemaking contemplated to streamline the NSA recommendation process.

Commission is also aware that for the future, it will have to consider procedures to facilitate the review process and to ease the administrative burden on customers who wish to consider NSAs. It also will consider streamlining procedures for handling renewals of existing NSAs, and for assuring that comparable NSAs are readily available to similarly situated mailers.

[4026] The Commission has stated that it has the procedural and legal ability to review and make a recommendations on NSAs. In the February 11, 2002, Report to Congress, the Commission stated at 1:

> Negotiated Service Agreements (NSAs) or "niche classifications" are rate and service adjustments arranged by the Postal Service and potential users that are legally permissible, provided that:
>
> 1. The proposal is reviewed in a public proceeding, as the Reorganization Act requires;
>
> 2. The agreed-upon rate and service changes will work to the mutual benefit of mail users and the postal system as a whole; and
>
> 3. The negotiated rate-and-service package is made available on the same terms to other potential users willing to meet the same conditions of service.

The Report to Congress asserts that NSAs are legally permissible, implies that the Commission will review NSA proposals, and provides general parameters in the broadest sense for the Commission to recommend an NSA. The Commission will further examine procedures to facilitate the review of NSAs in a series of rulemakings to develop specific procedures for reviewing future NSAs.

[4027] The instant NSA is composed of two classification features, an address correction service feature and a declining block rate feature, either of which is potentially experimental in character. The Postal Service proposes to provide electronic address corrections without fee for solicitation mail sent by First-Class Mail that is undeliverable as addressed while forgoing the current practice of returning such undeliverable mail to the mailer when it cannot be forwarded.[52] Request at 2. The Postal Service asserts that this will "induce mailer behavior that would save substantial costs associated with return and forwarding of undeliverable mail." Request at 3. This infers a Postal Service observation that the Postal Service is incurring a high cost due to undeliverable mail. It follows that the Postal Service hypothesizes the return mail feature of the NSA will reduce Postal Service costs associated with undeliverable mail.

[4028] The address correction service feature forms a basis for a potentially useful experiment that tests a valid hypothesis. The characteristic that makes the ACS feature an acceptable candidate for an experiment is the potential for being able to measure the results of the experiment, and to learn something about ACS, forwarding, and return mail. There also is the potential for making an accurate prediction before the commencement of the experiment as to its results. This ability to predict both lowers the risk of experimentation to the Postal Service, and provides a benchmark for judging success or failure. More important though is the ability to learn by reaching a conclusion as to success or failure at the end of the experiment through measured results. This makes the ACS feature somewhat experimental in character.

[4029] However, the design of the ACS proposal does not reflect an intention to thoroughly explore the efficacy of the ACS feature. The ACS feature is expected to reduce Postal Service costs. For optimum review of such a proposal, the Postal Service should provide the Commission with readily ascertainable cost and volume information, and provide estimates of relevant cost and volume data that is not available at the time the proposal is submitted. This may require that the Postal Service gather data and make projections before filing for a recommendation.

[4030] To support this NSA, the Postal Service could have considered undertaking additional research to improve economic predictions estimating the ACS forwarding (and repeat forwarding) costs, the effects of PARS, and the current specific

[52] Additional address hygiene requirements on the part of the mailer are included with this proposal.

cost characteristics of Capital One's mail.[53] This would have provided a better baseline on which to judge the success or failure of the experiment. Additionally, the Postal Service has not stated its willingness to collect and analyze costs during the NSA. The Postal Service should consider studying actual ACS forwarding (and repeat forwarding) costs, the effects of PARS, and other unique cost characteristics of Capital One's returned mail, as part of assessing the overall success or failure of this experiment.

[4031] Finally, the length of the experiment generally should reflect its complexity, the economic projections made, and the ability to collect meaningful data. If designed as an individual experiment, answering whether there is a systemwide benefit to the ACS feature might be feasible in substantially less than the proposed three-year NSA. Consideration should be given to utilizing the experience of this NSA as part of an experiment to test its potential benefit to a wide group of mailers.

[4032] The second rate feature of this NSA is the Postal Service's proposal to provide per-piece discounts for First-Class Mail volumes in excess of an overall annual volume threshold under a declining block rate structure (declining block rate feature). Request at 2. The Postal Service asserts that this is "designed to stimulate volume." Request at 3-4. The effect would also be to increase overall contribution from Capital One. Request at 4.

[4033] When examined from the perspective of an experiment that follows the scientific method, the observations inferred are that the Postal Service is interested in stimulating an increase in First-Class Mail volume, and interested in increasing contribution, in this case from Capital One. The hypothesis that follows is that by providing declining block rates Capital One will be enticed to increase First-Class Mail volume, which will result in increased contribution from Capital One.[54] The Postal Service thus has made an observation, and has formed a hypothesis. The problem

[53] These issues are discussed in Chapter VI of this opinion.

[54] The declining block rate feature is also an inducement to enter the overall NSA. This is not considered as part of the discussion to determine whether this feature is experimental in character.

again lies in the design of the experiment. As designed, the experiment will not provide substantial support for the hypothesis.

[4034] Theoretically, the reaction of Capital One to the availability of declining block rates can be tested so long as other important input variables are quantifiable.[55] However, this approach is difficult to apply in the real world. External factors such as the U.S. economy, the 9/11 events, Capital One's business plans, and Capital One's competitors have had and will continue to influence Capital One's mailing plans. In many instances, these factors may be far more important than the availability of a slightly reduced marginal postal cost. The multi-variable input factors that are present make it difficult to accurately discern the effects of implementing block discounts from the effects of the other variables.

[4035] An experimental approach can include making a prediction, and then performing an experiment to confirm that prediction. The Postal Service has provided economic projections for the NSA for a single test year, but proposes an experiment that will last for three years. If the goal of the experiment were to test a prediction, three years of economic projections would be required. The projections provided by the Postal Service could at most support a one-year experiment. Even for the single test year, the volume predictions on the record are suspect, which also makes this experimental approach problematic.

[4036] The declining block rate feature requires an estimate of the baseline before rates mailing volume for comparison to the after rates mailing volume to determine whether the declining block rate feature has enticed new volume. The before rates volume has been referred to as the "anyhow volume" or the volume that Capital One would mail absent the NSA. Learning something about the declining block rate effect on volume further requires an assumption that other outside factors can be accounted for, or are not otherwise influencing volume.

[55] The greater the number of input variables, the less certain the experimental results are the direct effect of any one variable.

[4037] Capital One witness Jean originally projected a before rates volume of 1.408 billion pieces. Tr. 2/40-41. This projection came with the caveat that Capital One does not typically forecast solicitation mail volumes more than six months in advance. OCA witness Smith attempted to provide an independent volume projection, and to cast doubt on the Capital One volume projection. Tr. 7/1235, et. seq. Smith did not display confidence in his own volume projections. The effect of Smith's testimony is to exemplify the difficulty involved in making a volume projection based on the limited data provided on the record. Capital One rebuttal witness Shippee reevaluated the projected before rates volume and concluded that previous predictions may have been optimistic. Tr. 9/1800-1801. Capital One witness Elliott projects a new before rates volume of 1.21 billion pieces by including actual data from recent months into the analysis. Tr. 9/1843-1844. Uncertainty of the volume that Capital One will actually mail is further evident by the terms and conditions of the NSA. If Capital One does not exceed an eligible volume of 1.025 billion pieces in a year, the threshold volume where discounts begin is lowered for subsequent years.

[4038] To judge the success or failure of the declining block rate feature, before rates volumes have to be reasonably projectable over the life of the NSA. The baseline volume data required for evaluating this feature is not well supported on the record. Without reliable before rates volumes, it may not be possible to determine the success or failure of this feature of the NSA.

[4039] The Postal Service has indicated that it intends to collect data that may be of use to measure the effects of the declining block rate feature. *See* USPS-T-2 at 12; Stipulation and Agreement, Attachment C. The Postal Service is encouraged to collect data in regard to this feature in an effort to learn more about the effects of declining block rate, and to develop an improved testing methodology for use in the future.

D. Development of Procedural Guidelines

[4040] The OCA and the Postal Service have put forth a commendable effort to design rules for the Postal Service that specify a procedure to make the features of this NSA available to other customers. *See* Stipulation and Agreement, Attachment D. This is a significant step in the experimental process to demonstrate the acceptability of this NSA on a non-discriminatory basis. Still, the Commission will look to the results of successfully implementing these rules to determine the success or failure of this part of the experiment.

[4041] The Commission intends to consider new procedural rules to facilitate consideration of future NSAs after the conclusion of this docket. Rulemaking dockets will be established to consider efficient procedures to review the unique characteristics of NSAs. Separate procedural rules might be appropriate for considering: (1) the initial request for an NSA encompassing a new concept; (2) the expansion of a previously recommended NSA concept to new similarly situated customers; and (3) the renewal or extension of the duration of a previously recommended NSA.

[4042] This docket has highlighted several areas where proceeding under the experimental rules is less than optimal, and has brought to the Commission's attention several areas where new rules might be necessary. The following forms a non-exhaustive list of items that could be addressed in a rulemaking to develop specific rules for NSAs:

- Suggestions to streamline the standard procedural rules, while ensuring an appropriate level of regulatory review.
- Discussion of the appropriate framework for joint initial filings and the delineation of the procedural responsibilities of each party.
- Examination of the data requirements necessary for filing an NSA.
- Discussion of whether a test-year approach, or whether a projection of the total financial impact over the life of the NSA, is appropriate.
- Discussion of the necessity for, and content of, periodic reporting to the Commission on the progress of an NSA during its lifetime.

- Discussion of the requirement for the proposed NSA to be made available to all similarly situated mailers in the future.
- Discussion of how the terms and conditions of the NSA should be considered in the event of an omnibus rate case filed during the life of the NSA.
- Discussion of any time limits to be imposed on the life of an NSA.

V. DECLINING BLOCK TARIFFS

A. Introduction

[5001] The tariff proposed in the Negotiated Service Agreement (NSA) between the Postal Service and Capital One is a type of non-linear tariff known to economists as a declining block rate tariff. USPS-T-2 at 4-6 and Tr. 10/2067, 2087. The name is derived from the principal structural feature of the tariff, which is a series of declining rates applied to a corresponding sequence of blocks of mailings of predetermined sizes over a fixed period of time such as a year. The tariff is also "optional" or "self-selecting" (Tr. 8/1578) because the customer makes the determination of the actual volume level under the terms of the tariff. The NSA also includes an important provision that is tied to the tariff. To receive the tariff, Capital One has agreed to accept electronic notification of Undeliverable as Addressed (UAA) solicitation mail in lieu of the usual physical return of the UAA letters.

[5002] Declining block rate tariffs are a common pricing structure in regulated industries such as electricity, water, and local phone service according to Postal Service witness Eakin. Tr. 10/2056. Witness Plunkett also testifies that "customer-specific pricing arrangements" are familiar to the Postal Service from their use in other industries, by foreign posts, and by the Postal Service with its international customers. USPS-T-2 at 1 and Tr. 5/932. However, neither past nor present U.S. postal rate systems have ever included a tariff for any domestic customer or category of mail or service resembling the declining block rate tariff proposed for Capital One in this NSA. USPS-T-2 at 1.

[5003] Nevertheless, the initial testimony from witnesses sponsored both by the Postal Service and by Capital One fails to provide any formal economic analysis of the effects of such a tariff. Instead, Postal Service witness Plunkett cited Service "policy and business considerations" to support the proposed NSA. USPS-T-2. To correct the deficiency the Commission invited testimony from Professor John C. Panzar, Tr. 8/1574-1606, a distinguished scholar at Northwestern University whose published work includes commentaries on the effects of non-linear tariffs. The Postal Service replied with testimony from B. Kelly Eakin, Tr. 10/2063-2106, a respected economist with Christensen Associates. The Commission's understanding of the issues raised by application of this proposed tariff to a monopoly postal product is derived mainly from the written and oral testimony of these two witnesses.

B. How the Tariff Works

[5004] The workings of the actual tariff are explained in detail by Postal Service witness Plunkett. USPS-T-2 at 4-6 and 14. Formally, an initial rate, let us say P_0, applies to an initial volume block of size Q_1*. Mailings during the year up to Q_1* are charged at the initial prevailing rate P_0. When total mailings reach Q_1* the rate declines to P_1 for the next block extending to the volume Q_2*. The volume level Q_1* is called the tariff's "threshold" because it is the volume level at which the first discount from the prevailing subclass rate begins. As mailings increase from Q_1* to Q_2* they are charged at the rate P_1 at which point the rate may decline further to P_2 for a volume block that ends at Q_3*, and so on. The last block in the sequence is open ended.

[5005] The block ranges and discounts from the prevailing piece rate can be found in many places in the record for this proceeding, for example, in witness Plunkett's testimony. *Id.* at 4 and witness Crum's testimony USPS-T-3, Attachment B at 3. It is set out in Table 5-1.

Table 5-1
Declining Block Discount

First-Class Mail Presort Volume Range				Discount
0	to	1,225,000,000	$	-
1,225,000,001	to	1,275,000,000	$	0.030
1,275,000,001	to	1,325,000,000	$	0.035
1,325,000,001	to	1,375,000,000	$	0.040
1,375,000,001	to	1,450,000,000	$	0.045
1,450,000,001	to	1,525,000,000	$	0.050
1,525,000,001	to	1,600,000,000	$	0.055
1,600,000,001	to	above	$	0.060

[5006] As originally proposed, the actual multi-block tariff offered to Capital One would have had a variable number of blocks. The size of the first block and the number of blocks thereafter were linked by a formula to 90 percent of Capital One's average annual mail volume from FY 2000 to FY 2002. USPS-T-2 at 14. At this time FY 2002 has come and gone, and Capital One's volumes were larger than expected, Tr. 5/935-38, but not enough to alter the terms of the tariff. Consequently, the formula is no longer relevant and the tariff's threshold will remain at 1,225 million pieces per year at least for the first year of the NSA.

[5007] The NSA also specifies a series of lower blocks down to 1,025 million pieces that would be activated "in the event Capital One's First-Class volume in any year of the agreement is below 1.025 billion pieces." USPS-T-2 at 14. The tariff would remain in force for three years. It is an optional tariff so Capital One chooses the volume of First-Class presort mail subject to the tariff in each year.

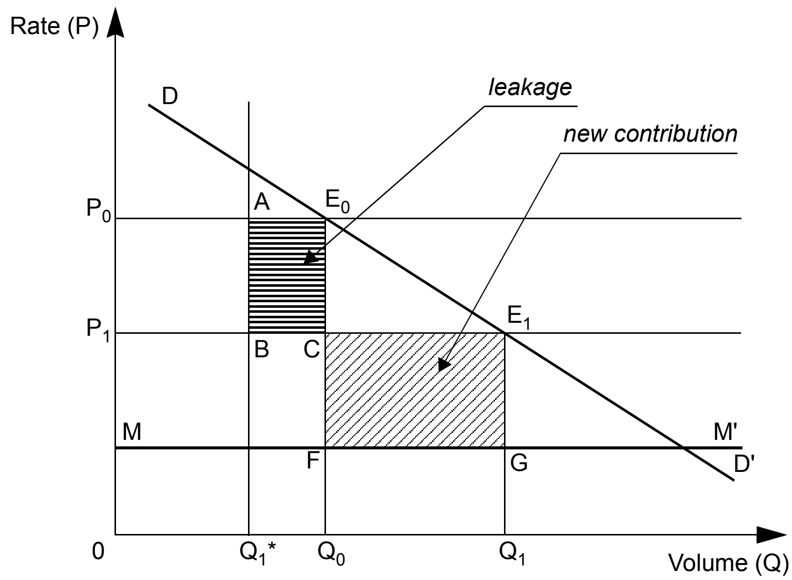
C. How a Declining Two-Block Tariff Can Create an Efficiency Gain

[5008] The basic rationale for any economic agreement is that all parties that have freely consented to the agreement expect to gain, or, at the least, not lose economic benefit under the agreement. Certainly, this is the belief of the Postal Service regarding the proposed NSA with Capital One. Postal Service Vice President Bizzotto testifies that "customization of services and pricing" can benefit both Postal Service and its customers, USPS-T-1, and that the Capital One NSA is "mutually beneficial" to both parties. Tr. 3/447.

[5009] The testimony of witnesses Panzar Tr. 8/1583-89 and Eakin, Tr. 10/2074-76, 2098, contain essentially identical partial equilibrium analyses of the effects of a declining block rate tariff with just two blocks. A partial equilibrium analysis makes the assumption that other postal customers' demands for postal services are independent of the rate offered to Capital One. According to Panzar "This is a standard assumption in microeconomics in the analysis of markets." Tr. 8/1581-82.

[5010] It is apparent from the testimony of both Panzar, *Id.* at1579, 1585, and Eakin, Tr. 10/2066, 2068, 2085, that a declining block rate tariff may improve the efficiency of postal rates even if the tariff is limited to only a single customer as is the case with the Capital One NSA. Figure 5-1a shows how a declining two-block tariff could increase both the net revenue received by the Postal Service and the consumers' surplus left to the customer receiving the tariff. Under the breakeven constraint currently applicable to postal rates, the added net revenue from the customer receiving the tariff would have to be matched (all other things equal) by a reduction in the net revenue collected from other postal customers. Eventually, this reduction in the net revenue collected from them lowers the average rate paid by all other mailers. Tr. 8/1581-82.

Figure 5-1a
Declining Two-Block Tariff



[5011] In Figure 5-1a Capital One's demand curve is represented by the negatively sloped line labeled DD'; the Service's marginal cost curve is shown as the horizontal line MM'; the rate for the first block is P_0 and the rate for the second block is P_1. The declining two-block tariff works by applying the first block rate P_0 to a given volume of mail denoted Q_1*. Volume in excess of Q_1* is charged at the lower second block rate of P_1. The boundary between the first and second block, Q_1*, is the threshold. As the figure is drawn, Capital One would demand the volume Q_0 at the initial rate P_0 but would increase its demand to Q_1 as the rate dropped to P_1. Each of these equilibriums is represented by a point, E_0 and E_1, lying along Capital One's demand curve DD'. Since the tariff is optional Capital One would choose the equilibrium that gave the firm the greatest profit. This turns out to be the rate and volume represented by the equilibrium point E_1.

[5012] The impact of the tariff on postal net revenue has two parts. There is, first, the net revenue added by the increase in volume from Q_0 to Q_1. This is the "increased contribution from new mail volume" in the testimony of Postal Service witnesses Crum and Eakin. Tr. 10/2084. This increase is shown in Figure 5-1a as the area of the rectangle CE_1GF labeled "new contribution". It is equal to the product of the volume increase and the margin on the second block rate. The margin is the difference between the price P_1 and marginal cost.

[5013] The second part of the impact is a decrease in net revenue dubbed the discount "leakage" in the testimony of several witnesses including Postal Service witnesses Crum, USPS-T-3 at 2 and 6, and Eakin. USPS-T-2 at 9. A leakage occurs when Q_1* is set below Q_0, that is, when the boundary between the first and second blocks of the tariff, the tariff's threshold, is set below the volume that Capital One would have demanded at the rate P_0. The leakage in Figure 5-1a is represented by the area of the rectangle AE_0CB. The difference between Q_0 and Q_1* constitutes volume that Capital One would have mailed at the rate P_0, but will only be charged the lower rate of P_1 under the declining block rate tariff. The area of AE_0CB equals the product of Q_0 minus Q_1* and the second block discount, P_0 minus P_1. The new contribution produced by Capital One's response to the lower second block rate P_1 in Figure 5-1a exceeds the leakage caused by setting Q_1* below Q_0. Therefore, the Postal Service's net revenue will increase (all other things equal) as Figure 5-1a has been drawn.

[5014] The impact of the tariff on Capital One can be inferred from the change in consumers' surplus left to Capital One by the tariff. Capital One is a producer of credit card services but it is a consumer of postal services. Capital One uses First-Class presorted mail as a production input both to service its existing customers (customer mail) and to solicit new customers (solicitation mail). Neither Panzar nor Eakin specifically point out Capital One's increased surplus in the figures that accompany their testimony, however, consumers' surplus is a familiar economic concept. Several witnesses refer to Capital One's "surplus,” Tr. 8/1578 and Tr. 4/723-24, and the change in surplus can be identified as an area in Figure 5-1a.

[5015] In general, consumers' surplus is the area under the demand curve that remains after deducting the consumer's expenditures for a good or service. Consumers' surplus has an intuitively appealing interpretation for a producer who takes the input price as given, such as Capital One. Each point on the demand curve DD' corresponds to the marginal revenue product of the input - it is the addition to its own revenue that Capital One generates from an additional mailing. If the cost of the mailing is deducted from the marginal revenue product, the remainder is the additional profit (or loss) that is generated by an additional mailing. Thus consumers' surplus is equal to the change in Capital One's profit that results from moving from one point to another along the demand curve DD'.

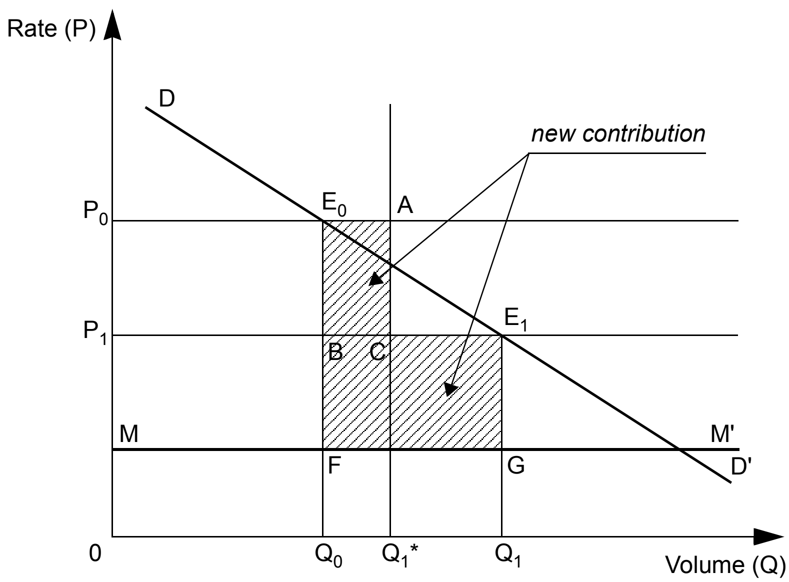
[5016] Figure 5-1a discloses that the declining two-block tariff will increase Capital One's surplus in two ways. First, Capital One gains an increase in surplus from its increased volume at the lower second block rate of P_1. This increase is represented by the triangle E_0E_1C. Second, the Postal Service's leakage AE_0CB is a reduction in cost to Capital One, so it also is part of Capital One's added surplus. The sum of these two areas in Figure 5-1a comprises the increase in profit that Capital One can expect from the new tariff.

[5017] Both the Postal Service's other customers and Capital One stand to gain from the two-block tariff depicted in Figure 5-1a. The Service's other customers gain on average because the increase in net revenue from Capital One must be matched by a corresponding decrease in the net revenue the Postal Service collects from all of its other customers. Capital One gains because its profits improve. It is the potential for these kinds of gains that makes non-linear tariffs a possibly useful addition to the rate maker's toolbox. If the tariff leaves no identifiable losers among the Postal Service's other customers or Capital One's competitors, then the two-block tariff is said to be Pareto dominant with respect to the original rate P_0. A Pareto dominant tariff is more efficient than the tariff it replaces.

[5018] OCA witness Smith claims that the leakage that occurs when Q_1^* is set below Q_0 creates a "free-rider" problem. Witness Smith uses the term "free-rider" to refer to the "payment of an incentive where none is necessary, i.e., for pieces which would have been sent absent an incentive." Tr. 7/1241 and 1285.[56] However, Smith's "free-rider" problem does not necessarily prevent the two-block tariff from making a positive overall contribution to postal net revenue.

[5019] 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 Q_1* is set above Q_0. A tariff designed in this way reverses the sign of the leakage as shown in Figure 5-1b.

Figure 5-1b
Added Contribution



[5020] The area BE_1GF is still the new contribution, however, the area of the rectangle E_0ACB now represents a payment from Capital One to the Postal Service that Capital One would not have made "absent the incentive". The leakage shown in Figure 5-1a is reversed in Figure 5-1b and becomes part of the new contribution. Setting the threshold Q_1* above Q_0 increases postal net revenue and decreases Capital One's surplus but does not change the overall result of the analysis as Figure 5-1b has been drawn. Both parties still gain from the tariff.

[56] Although the term “free rider” has other meanings in economic literature, it was urged in this way throughout this proceeding by all witnesses.

D. Equivalence to a Two-Part Tariff

[5021] Any likely non-linear tariff can be shown, after the fact, to be equivalent to a two-part tariff consisting of a marginal rate and a fixed charge (or rebate). *See* Eakin at Tr. 10/2068-69. The marginal rate is the rate the customer is charged for the last unit purchased. The fixed charge is set so that the marginal rate and the fixed charge together recover the same revenue as the non-linear tariff. As Figure 5-1a is drawn, the marginal rate is the second block rate P_1 since this is the rate at which Capital One mails its last letter. The fixed charge is the rectangle enclosed by the points P_0ABP_1. The revenue from the marginal rate is the rectangle $P_1E_1Q_10$. When the revenue from the marginal rate is added to the fixed charge the result equals the revenue received from the two-block tariff. The revenue from the first block of the two-block tariff is represented in Figure 5-1a by the area $P_0AQ_1{}^*0$ and the revenue from the second block is $BE_1Q_1Q_1{}^*$.

[5022] The reduction of a non-linear tariff to a simple two-part tariff is a useful standardization for several reasons. First, the equilibrium volume under the non-linear tariff is determined entirely by the customer's demand at the marginal rate. Tr. 2/223-24. Therefore, the marginal rate isolates the aspect of the tariff that determines its economic efficiency. This is why Eakin can say "the opportunity for efficiency with declining block rates comes from the ability to move marginal prices in the direction of marginal costs." Tr. 10/2068. All of the other elements of the non-linear tariff serve only to establish the amount of revenue that is ultimately recovered from the customer. They do not affect the efficiency of the tariff unless they lead either the Postal Service or Capital One to reject the tariff altogether. Therefore, the fixed charge and the revenue recovered at the marginal rate together determine the distributional effect of the tariff. No other information about the tariff is needed for most economic analyses. Since virtually any non-linear tariff that the Postal Service is likely to propose can be reduced to an equivalent two-part tariff, the two-part equivalents can provide the basis for "apples-to-apples" comparisons of non-linear tariffs even though their specific terms may be quite dissimilar.

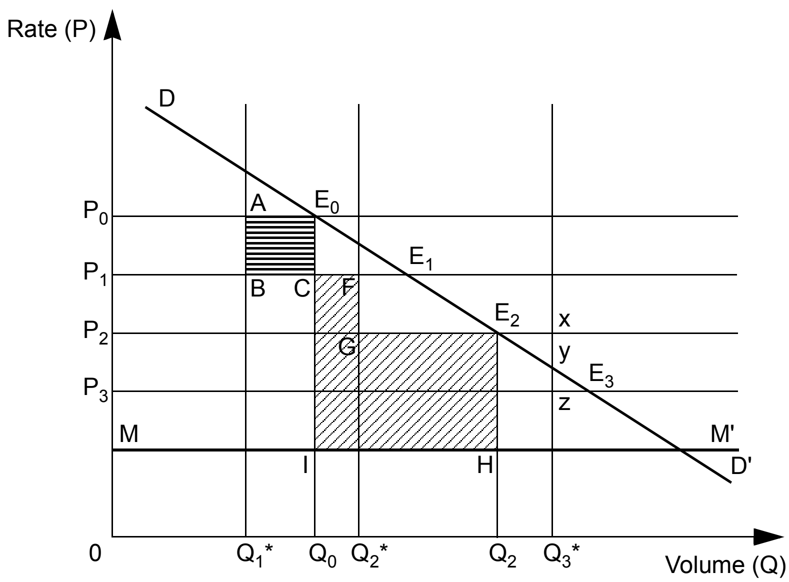
[5023] The equivalence to two-part tariffs may also be used to show why non-linear tariffs generally provide an opportunity to improve postal rate making. Conventional postal rates are one-part tariffs - they omit the fixed charge. A one-part tariff is just a restricted form of a two-part tariff - it is a two-part tariff with the fixed charge preset to zero. Any societal objective that is pursued by setting rates within a pricing system composed exclusively of one-part tariffs can be pursued at least as effectively, and, possibly, much more effectively by marginal rates and fixed charges within a pricing system that includes some two-part tariffs. This is true because the two-part tariff system offers the rate setting agency all of the same rate possibilities as the one-part tariff system and many more besides.

[5024] This argument can be made formal by considering postal rate setting to be a process in which postal rates are selected to maximize some measure of social welfare defined over a set of possible outcomes. Since the two-part tariffs include one-part tariffs as a special case, the two-part tariffs may enlarge the set of possible outcomes but cannot shrink it. If the social welfare maximum occurs among the added outcomes there is a potential benefit to be derived from adding the two-part tariffs to the rate system. This argument is quite general and does not depend upon an assumption that demands are independent or a demonstration that any of the added outcomes are Pareto dominant.

E. Declining Multi-Block Tariffs

[5025] A declining multi-block tariff, of the kind found in the Postal Service's NSA with Capital One, is more complicated to analyze than a simple two-block tariff, but the analysis leads to the same general finding. A declining multi-block is equally capable of improving the efficiency of postal rates in such a way that the Postal Service gains net revenue and Capital One increases its surplus. Such a declining block rate tariff with four blocks is shown in Figure 5-2.

Figure 5-2
Declining Multi-Block Tariff



[5026] The initial rate P_0 applies to mailings up to the threshold Q_1*. Thereafter, P_1 applies to mailings up to Q_2*, then P_2 applies up to Q_3*, then P_3 for mailings above Q_3*. The last block is open-ended.

[5027] To analyze this declining four-block tariff it is first necessary to find the marginal rate among the four candidates. Each of the block rates P_0, P_1, P_2 and P_3 correspond to a possible equilibrium on Capital One's demand curve DD'. These equilibriums are shown in Figure 5-2 as the points E_0, E_1, E_2 and E_3. Capital One can be expected to select the equilibrium that provides the greatest profit. This will be the equilibrium point in Figure 5-2 that leaves the largest consumers' surplus. The point that maximizes the surplus is E_2. Therefore, P_2 is the marginal rate and Q_2 is the volume that Capital One will choose to mail under the tariff.

[5028] Why does Capital One not choose E_3? E_2 is chosen over E_3 because Capital One will lose consumers' surplus as it increases its mailings from Q_2 up to the block limit Q_3* at the rate P_2. The amount of the loss is represented by the area of the triangle E_2XY. At Q_3* the rate drops to P_3 and Capital One again earns a positive surplus on its mailings until it has moved down the demand curve to E_3. The surplus that is regained at the rate P_3 is represented by the area of the triangle YE_3Z. This surplus gain is smaller than the earlier surplus loss so Capital One will choose E_2.

[5029] As in Figure 5-1a, the Postal Service's net revenue changes by an amount that consists of the net revenue from Capital One's additional mailings minus a leakage of revenue that the Service would have received on the first block at the preexisting rate. The net revenue from Capital One's additional mailings is the area of the irregular figure $CFGE_2HI$. The leakage is the rectangle AE_0CB. As Figure 5-2 has been drawn, the added net revenue clearly exceeds the leakage so the Postal Service gains net revenue from the tariff.

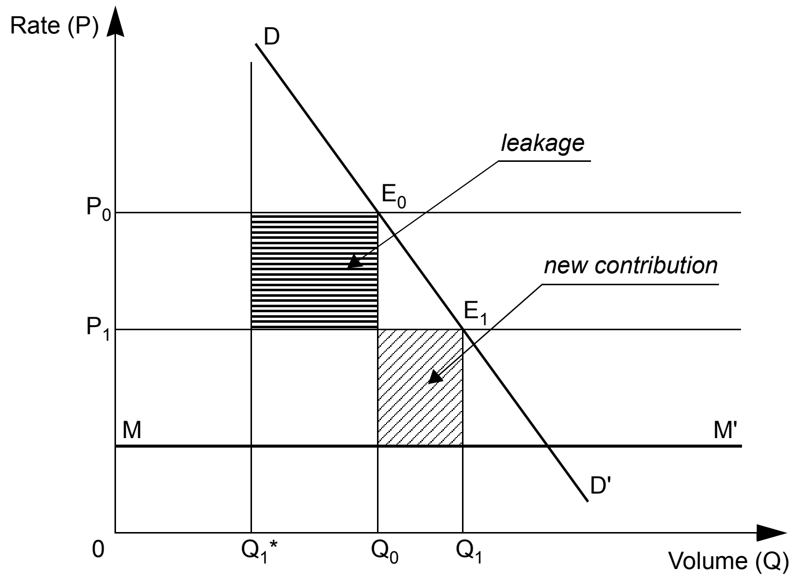
[5030] Capital One also gains consumers' surplus from the tariff. This gain is represented by the area of the irregular figure E_0E_2GFC.

[5031] In his response to an OCA interrogatory Capital One witness Elliott describes his method for finding the equilibrium as solving "a problem of two equations with two unknowns." Tr. 2/235. The two equations are the demand curve DD' and a step function derived from the terms of the NSA. The levels in the steps of the step function are the possible marginal rates P_0, P_1, P_2 and P_3. The steps occur at the block boundaries Q_1*, Q_2* and Q_3*. Figure 5-2 shows why Elliott's method will only work some of the time. The demand curve and the step function for a declining multi-block tariff can intersect more than once. In Figure 5-2 the demand function and the step function intersect at the steps for the rates P2 and P3. When there are multiple intersections the surplus must be evaluated and compared at each of the possible equilibriums represented by an intersection.

F. Design Issues

[5032] Although it is usually possible to design a declining block rate tariff to increase both net revenue and consumers' surplus when the tariff replaces a fixed rate, it is not true that all rate designs will improve efficiency as shown in Figures 5-1a, 5-1b, and 5-2. A two-block tariff design that sacrifices postal net revenue is shown in Figure 5-3a; a design that fails to increase Capital One's surplus is shown in Figure 5-3b.

Figure 5-3a
Leakage Exceeds New Contribution

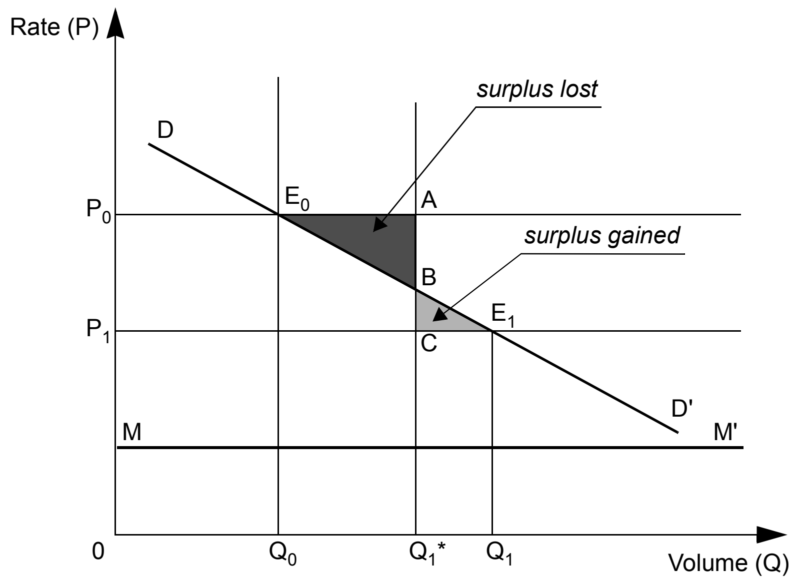


[5033] The Postal Service's net revenue decreases in Figure 5-3a because the revenue leakage on the volume from Q_1* to Q_0 exceeds the new contribution due to Capital One's volume increase from Q_0 to Q_1. The defect in the design of the tariff is that the threshold Q_1* has been set too low. The result is a large leakage from net revenue and a corresponding windfall for Capital One.

[5034] Capital One's surplus decreases in Figure 5-3b for exactly the opposite reason. As its volume increases from Q_0 to Q_1, Capital One's surplus first decreases by the area E_0AB then increases by the smaller area BE_1C. The design defect in Figure

5-3b is that the upper limit Q_1^* on the first block has been set so high that the leakage vanishes and is replaced by a loss in surplus that is larger than the amount regained when the rate eventually drops to P_1.

Figure 5-3b
Surplus Change



[5035] Neither of these design defects would ever occur if 1) the Postal Service always seeks to maximize its net revenue as it negotiates NSAs with mailers such as Capital One, 2) the Postal Service knows its marginal cost curve MM', 3) both parties to the negotiations know the demand curve of the mailer DD', and, 4) there are no exchanges of value in the other terms of the NSA. Under these conditions the Postal Service could be relied upon to avoid tariffs that would sacrifice net revenue and Capital One would never negotiate a tariff that reduced its profits. As it is, none of these conditions, except, approximately, the second one are met. Therefore, it is necessary to consider the outcomes when the declining block rate tariff has either of the design defects shown in Figures 5-3a and 5-3b.

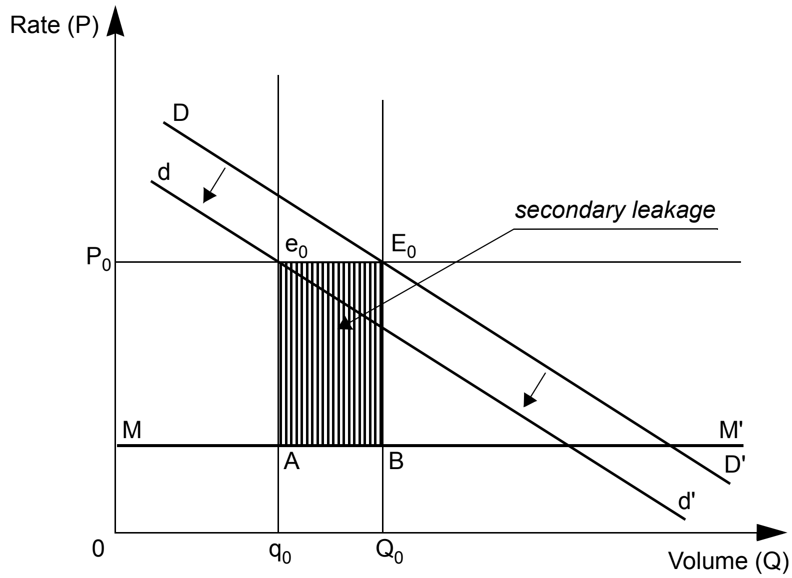
[5036] These outcomes are asymmetric. It is the optional feature of the tariff offered to Capital One that is responsible for this asymmetry. Tr. 8/1578-79. If, over time, the Postal Service should discover that it is sacrificing net revenue as in Figure 5-3a, it must, under the terms of the NSA as proposed by Postal Service and Capital One, continue to offer the defective tariff to Capital One for the three-year term of the agreement. On the other hand, Capital One does not have to endure a reduction in its surplus as in Figure 5-3b for any longer than the time it takes to discover the loss. Under the NSA, Capital One's use of the lower block rates, such as P_1, is optional. Capital One has provided an enforceable guarantee that its volumes will exceed 750 million pieces annually during the term of the NSA. This volume is well below any possible threshold of the actual tariff. Consequently, Capital One is free to reduce its volumes to Q_0 and forgo mailing at the lower rate P_1 as soon as it discovers that it cannot benefit from the declining block rate tariff (so long as Q_0 exceeds 750 million pieces). This action not only negates the reduction in Capital One's surplus, it would also eliminate any additional net revenue contribution that the Postal Service may have anticipated from the declining block rate tariff.

G. Competition Issues

[5037] Capital One is far from alone in its own industry. Capital One's position in the credit card services industry is briefly described by the company's Senior Vice President, Donald Jean. Tr. 2/37. There are many other banks and financial service firms, large and small, that solicit and service credit card accounts, although the use of the mail by few of these competitors compares in scale to Capital One's. In fact, Capital One was the single largest originator of First-Class mail in FY 2000, FY 2001 and FY 2002, *Id.* at 207, although it is only the nation's sixth largest issuer of credit cards. The impact of the proposed tariff on Capital One's competitors was largely ignored in the testimony that accompanied the Postal Service's initial filing. An assumption that Capital One's competitors are unaffected might be justified if Capital One was an average-sized member of a large and competitive industry. However, the large size of Capital One relative to most of its competitors and the similarity of the services offered throughout the credit card industry seemed to the Commission to make it unlikely that competitors would be wholly unaffected by Capital One's mailing activities. The Commission invited the testimony of Professor Panzar to analyze the impact of the proposed tariff under the imperfectly competitive conditions that are observable at the present time in the industry. The request to Professor Panzar, Tr. 8/1577, asked him to take into account "that competition may exist among users of the affected service or services".

[5038] Panzar's analysis, *Id.* at 1582 and 1589-92, follows conventional neoclassical economic logic to reach the conclusion that if mail is a normal input to both Capital One and its competitors, then a declining block rate tariff offered to Capital One, but not to its competitors, will 1) reduce the market price of the output of credit card solicitations and services, 2) increase Capital One's output, and 3) reduce the output, input purchases, and profits of Capital One's competitors. Since Capital One's competitors also use First-Class presorted mail to service customer accounts and, to a lesser extent, solicit new accounts, their use of this input will decrease. How this might reduce the Service's net revenue is shown in Figure 5-3c.

Figure 5-3c
Positive Cross Elasticity with Other Categories and with Competitors



[5039]   The demand curve DD' is the demand curve of a Capital One competitor if Capital One pays the preexisting rate. This demand curve shifts downwards to dd' after Capital One receives the declining block rate tariff. This shift along the entire length of the demand curve occurs because the competitor's mailings will be reduced at every rate. At the rate P_0 the downward shift results in a reduction in mailings from Q_0 to q_0 and a consequent loss in net revenue to the Postal Service represented by the area of the rectangle e_0E_0BA. Such net revenue losses are a form of secondary leakage. The sum of the secondary leakages for all of Capital One's affected competitors may be large, and must, in any case, be considered and evaluated by the Commission. Note that Eakin sometimes uses the term "secondary leakage" to refer to the loss in volume not, as here, the loss in revenue.

[5040]   According to Panzar, *Id.* at 1590, First-Class Mail is a normal input to the production of credit card solicitations and services, meaning that as the output of credit card solicitations and services increases so does the amount of First-Class mailings. When the marginal rate drops Capital One would respond to the decreased input price by increasing its mail volumes as already shown in Figure 5-1a. However, Capital One's competitors also use First-Class Mail as a production input but do not receive the lower marginal rate. This gives Capital One a production advantage that will translate into a lower total cost and, most likely, a lower marginal cost than its competitors for the production of credit card solicitations and services. Capital One can be expected to use this advantage to increase its business at the expense of its competitors. The mechanism that produces this rearrangement begins when Capital One uses its new production advantage to lower the price of its own product offerings. The expected reaction of Capital One's competitors is to reduce both their own prices and outputs. Capital One would then react by readjusting its own price and output. Ultimately the chain of action and reaction ends at a new equilibrium with the characteristics Panzar describes. Implicit to this analysis is the assumption that Capital One and its competitors are all profit seekers.

[5041] Witness Panzar shows that it is possible, with an additional assumption, to derive a useful upper bound to the aggregate loss in Capital One’s competitors’ mail volumes resulting from the NSA. Tr. 8/1701-09. The bound is useful as it makes possible the derivation of an upper limit to Panzar’s secondary leakage. Tr. 10/2079-80 (Eakin).

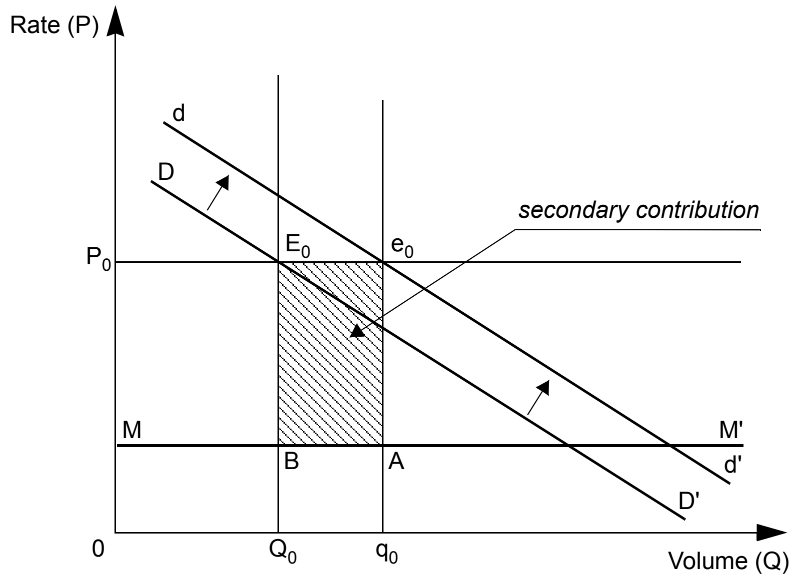
[5042] The additional assumption that Panzar needs is that both Capital One and its competitors use First-Class presorted mail as an input in fixed proportion to their output of credit card services; and, that Capital One’s proportion is at least as large as any of its competitor’s. Under this assumption, which is not inconsistent with any record evidence, the decrease in the competitors’ mail volume predicted by neoclassical economics must be less than the increase predicted in Capital One’s volume.

[5043] The line of reasoning that leads to this result emerges from Panzar’s responses to the hypothetical situations posited during cross-examination by Capital One counsel. Tr. 8/1701-1709. The lower marginal rate to Capital One under the NSA ultimately lowers the price of credit card services in the downstream market and causes a simultaneous increase in the total quantity of these services supplied by both Capital One and its competitors. The decrease in the quantity of these services supplied by

Capital One's competitors cannot exceed Capital One's increase. Under the proportionality assumption, this relationship must also apply to Capital One's and its competitors' mailings. Therefore, Panzar's testimony confirms that the NSA would result in a net increase in the use of postal services by the credit card industry.

[5044] In his rebuttal testimony Eakin confirms that secondary leakage is one possible outcome of offering a lower marginal rate only to Capital One but he goes on to assert that there will be an offsetting effect that he calls a "secondary contribution." Tr. 10/2076-79. Figure 5-3d, which is virtually the mirror image of Figure 5-3c, shows how an offsetting upward shift in a competitor's demand curve would reverse the secondary leakage. In Figure 5-3d the rectangle E_0e_0AB represents the offsetting gain in postal net revenue. [Eakin sometimes uses the term "secondary contribution" differently from its use here. Eakin's "secondary contribution" sometimes appears to refer to the volume increase, not the revenue increase.]

Figure 5-3d
Negative Cross Elasticity with Other Categories and with Competitors



[5045] Eakin's explanation for the offset is based upon "industrial economics" theory rather than neoclassical economics. Eakin begins by confirming that an increase in Capital One's customer mail would be accompanied by the kind of secondary leakage described by Panzar. *Id.* at 2078-79. However, Eakin believes that Capital One's competitors would react differently to Capital One's increased use of the mail to make solicitations. They may react by increasing their own mailings as a way to preserve their own position in the output market for credit card solicitations and services. Eakin's hypothesis makes the most sense if Capital One's competitors are not pure profit seekers but, instead, have adopted some other proximate objective such as preserving sales revenues or market shares. Otherwise it is difficult to see why they would not have increased their solicitation mailings even without the stimulus from Capital One. However, a competitor who was intent on maintaining sales or market share might react by increasing mailings exactly as Eakin describes even at the cost of some unnecessary reduction in profits. It is important to note that Eakin's analysis confirms that Capital One's competitors lose part of their surplus even if, as he contends, the secondary leakage and the secondary contribution to postal net revenue are largely offsetting.

[5046] Panzar supports much of Eakin's secondary contribution hypothesis. During cross-examination, Tr. 8/1751-55, Panzar acknowledges that the likely response of a firm to an advertising campaign by a rival firm would be to launch its own advertising campaign. If mailings are part of the campaigns, then mail volumes increase and there is a secondary contribution. Tr. 8/1788-89. As with secondary leakage, Eakin produces a bound for the contribution based upon the principle that the additional advertising mail from Capital One's competitors would not exceed Capital One's own increase in solicitation mail. Tr. 10/2080-84.

[5047] Panzar's testimony illustrates generally why competitive responses must be an important part of the evidence that the Commission considers when it evaluates an NSA. Tr. 8/1591-92. When there are "downstream" competitors to a "favored" customer such as Capital One, the losses in surplus suffered by these downstream competitors may negate the benefits of the NSA even if it can be shown that postal net revenue and the favored customer's surplus will each increase. In this regard Eakin's rebuttal testimony does not really address Panzar's critique. Like all of the Postal Service witnesses in this proceeding, he limits his testimony to an evaluation of the impact of the proposed NSA on postal net revenue. In the final analysis, Panzar's unanswered point means that competitive responses make it impossible for the Commission to rely upon the normal outcome of negotiations between the Postal Service and customers such as Capital One to yield NSAs that are automatically Pareto dominant, even if the Service can demonstrate that it gains net revenue from these agreements. *Id.* at 1594-95.

[5048] Capital One's competitors did not object to the NSA during the proceeding. In fact, the party most likely to represent direct competitors, the American Bankers Association, signed the Stipulation and Agreement recommending the Commission adopt the NSA. Therefore, Panzar's point does not apply with much force given the evidence adduced from Capital One's competitors in this particular case.

H. Substitution and Complementarity Issues

[5049] Other parties have noticed that Capital One also uses Standard Regular Mail to send solicitations. Tr. 2/222. The volume of these Standard mailings is not small. *Id.* at 207. Moreover, Capital One has acknowledged that the solicitations it sends as Standard mail are virtually identical to those it sends as First-Class presorted mail. *Id.* at 40. Capital One's own descriptions of its use of First-Class and Standard mail for solicitations strongly suggests that the two are viewed by Capital One as substitutes. *Id.* at 40. However, Capital One has maintained throughout this proceeding, primarily in its responses to interrogatories, that the increased volume shown in Figure 5-1a would be entirely "new" mail. That is, its additional First-Class mailings under the declining block rate tariff would not be accompanied by any offsetting reduction in its Standard mailings. According to witness Jean "we don't believe the proposed discounts will cause Capital One to significantly switch our Standard Mail solicitations to First-Class Mail." *Id.* at 39 and 66 Postal Service appears to have accepted this claim. Tr. 4/704 and Tr. 2/280.

[5050] It is difficult for the Commission to reconcile the claim with the models used by the Postal Service to forecast mail volumes in recent omnibus rate proceedings. In the most recently completed proceeding (Docket No. R2001-1) Postal Service witness Thress submitted an aggregate demand function for workshared First-Class letters with several non-zero cross price and discount elasticities with other subclasses of mail. Docket No. R2001-1, USPS-T-8 at 30. These included a cross-price elasticity of .008 for Standard Regular Mail. A small positive cross-elasticity like this suggests that First-Class presorted letters and Standard Regular Mail are weak substitutes. Several years ago the volume models offered by Postal Service witness Tolley for First-Class letters included a small positive cross-volume elasticity indicating a weak complementary relationship between the same categories of mail. Docket No. 94-1, USPS-T-2, Technical Appendix I at I-91.

[5051] Aggregate demand elasticity estimates, which are essentially averages for all mailers, may greatly understate the cross-price elasticities for Capital One. Capital

One is a mailer with large volumes of both First-Class presort and Standard Regular Mail. It is not known to the Commission if it is typical of many worksharing mailers to simultaneously use both of these two worksharing categories as Capital One does. Possibly, most worksharing mailers use just one or the other and have zero individual cross-price elasticities between the two categories. If this is the pattern, then the small estimated cross-price elasticity for many mailers may be an average of high cross elasticities for a few mailers like Capital One, and zero cross elasticities for the more numerous remainder. The same logic can be applied to the cross-price elasticity for complementary mail such as First-Class single-piece letters.

[5052]   Panzar and Eakin have little to say about the effects of interdependence among Capital One's demands for different kinds of postal service although Eakin mentions the possibility and believes that interdependent demands are "relevant in evaluating the Capital One NSA". Tr. 10/2073.

[5053]   In general, it is not hard to see that First-Class presorted mail could be both a substitute and a complement to other subclasses for Capital One. It would be a substitute for Standard Regular if Capital One views the two categories as alternative ways to mail the same solicitation. It would be a complement for, say, First-Class single-piece letters if the successful solicitations are returned through the First-Class single-piece mail stream. Capital One witness Jean alludes to this kind of complementarity when he says "incremental First-Class Mail marketing volume has a multiplier effect by creating Business Reply Mail". Tr. 2/43. A complementary relationship may also exist for Capital One's conventional correspondence. Much of this correspondence may require a response that is characteristically returned as a First-Class single-piece letter. *Id.* at 68.

[5054]   Lowering Capital One's marginal rate for First-Class presorted letters has effects on substitute and complementary subclass volumes that are identical to the mechanisms portrayed for Capital One's competitors in Figures 5-3c and 5-3d. Let DD' be Capital One's own demand curve for a substitute such as, possibly, Standard Regular Mail. When the declining block rate tariff reduces Capital One's marginal rate, the effect on a substitute subclass is to shift the substitute's demand curve down to dd' as shown in Figure 5-3c. When this happens the net revenue contribution from Standard Regular drops by the area of e_0E_0BA. This becomes another source of secondary leakage from the tariff.

[5055] Figure 5-3d shows what may happen to a complementary subclass such as, possibly, First-Class single-piece letters when the marginal rate drops. Capital One's increased volume of solicitations and correspondence induce an increase in the complementary return flow of First-Class single-piece letters. This shifts up the demand curve for First-Class single-piece letters from DD' to dd' as shown in Figure 5-3d. The area E_0e_0AB is the gain in net revenue for the Postal Service.

I. Cost Issues

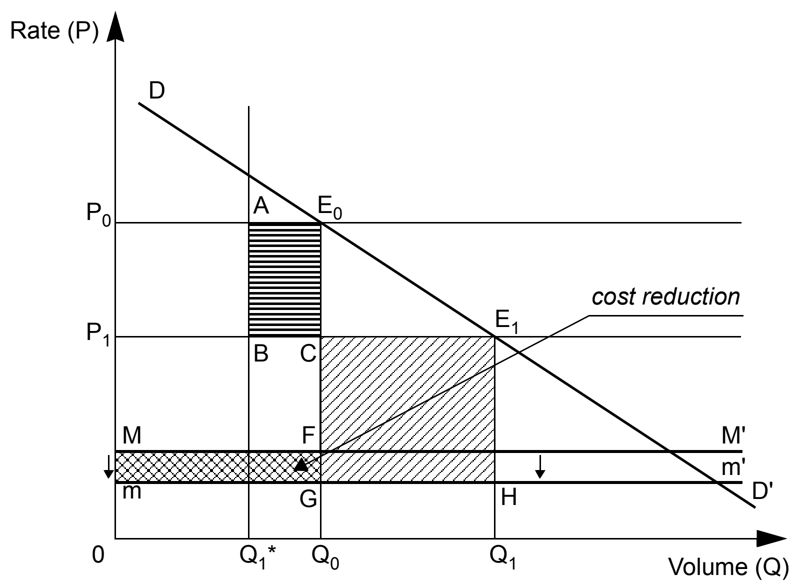
[5056] The Capital One NSA bundles the declining block rate tariff with a concurrent agreement by Capital One to accept electronic notification of Undeliverable as Addressed (UAA) solicitation mail in lieu of the usual physical return of the UAA letters. Capital One would also be obligated to promptly use electronic address corrections to correct its address lists. Tr. 4/743-44. The principal effect of this part of the NSA is to reduce the marginal cost to the Postal Service of handling Capital One's First-Class presorted mail. The reduction is significant because 1) physical return of a letter is far more costly per piece than electronic notification, and 2) an extraordinary proportion of Capital One's solicitation mail is UAA despite Capital One's compliance with Postal Service address hygiene requirements. In fact, Capital One's address hygiene program is exemplary. Tr. 2/41-43. Nevertheless, Capital One experiences return rates of 6 to 12 percent on solicitations sent by First-Class mail, *Id.* at 42 and 334, but only around 1 percent on its customer mail. According to Postal Service witness Crum the cost per piece of returning Capital One's First-Class letters is 53.47 cents but the cost of electronic notification is only 33.21 cents per piece USPS-T-3 at 5. *See also* USPS-T-2 at 3 and 7.

[5057] According to the testimony of its witnesses Capital One just disposes of returned First-Class letters and derives no benefit from their return. The NSA imposes an additional obligation on Capital One to use the electronic notifications to reduce the frequency of UAA mail that it sends. This should also help to reduce the marginal cost of Capital One's mailings. For its part Capital One regards electronic notification as more useful for its address hygiene program, Tr. 2/42, but otherwise seems to be almost indifferent to the change in service. According to Eakin the bundled attribute (physical return of pieces that are undeliverable as addressed) "apparently provides Capital One little or no value." Tr. 10/2068. In any case, Eakin and others analyze the effect as simply a shift downward in the marginal cost curve.

[5058] According to Eakin, "The NSA also represents an efficiency-improving application of a non-linear pricing structure." Tr. 10/2068. However, this efficiency improvement has little to do with the nonlinear nature of the tariff. The efficiency improvement occurs because Capital One receives a service that it values equally but that it costs the Service less to supply.

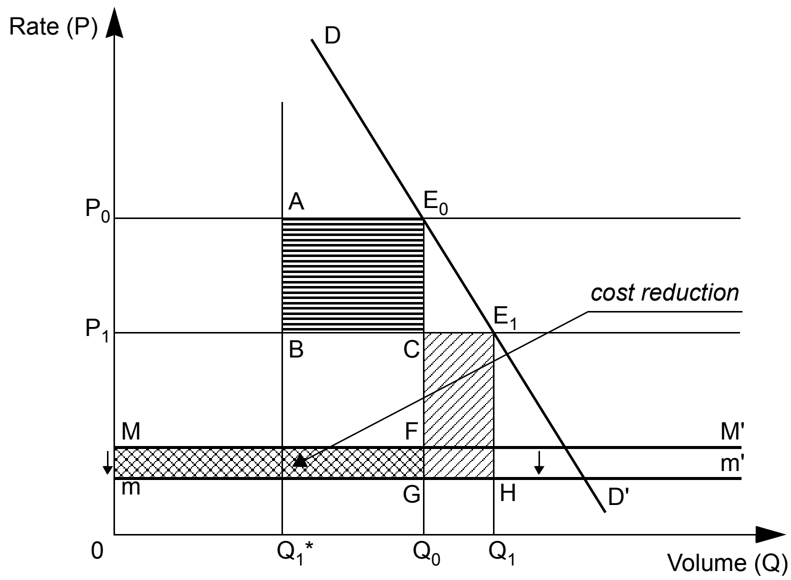
[5059] Figure 5-4a shows how a simple downward shift from MM' to mm' increases postal net revenue by an amount equal to the area of the rectangle MFGm. There is no other effect either on the Service's net revenue or on Capital One's surplus so long as Capital One is indifferent to the switch from physical to electronic returns. Figure 5-4a has been drawn to conform to the practice of Postal Service witness Crum who applies the drop in marginal cost only to the volume Q_0.

Figure 5-4a
Marginal Cost Reduction



[5060] Both the Postal Service and Capital One consider electronic notification to be an essential part of the NSA. Capital One witness Jean explains how electronic notification is expected to improve the effectiveness and lower the cost to Capital One of its solicitations. Tr. 2/42. Nevertheless, it is difficult to understand why Capital One considers electronic notification essential, since the optional declining block rate tariff alone would leave Capital One with a larger surplus. However, it is easy to see how the added contribution electronic notification makes to net revenue could be essential for the Postal Service. This situation is depicted in Figure 5-4b. In this figure the leakage AE_0CB exceeds the net revenue added from Capital One's additional volume CE_1HG. It is only the addition of the net revenue from the marginal cost decrease MFGm that makes the NSA an improvement for the Postal Service.

Figure 5-4b
Marginal Cost Reduction is Essential



J. Stop-Loss Cap Issues

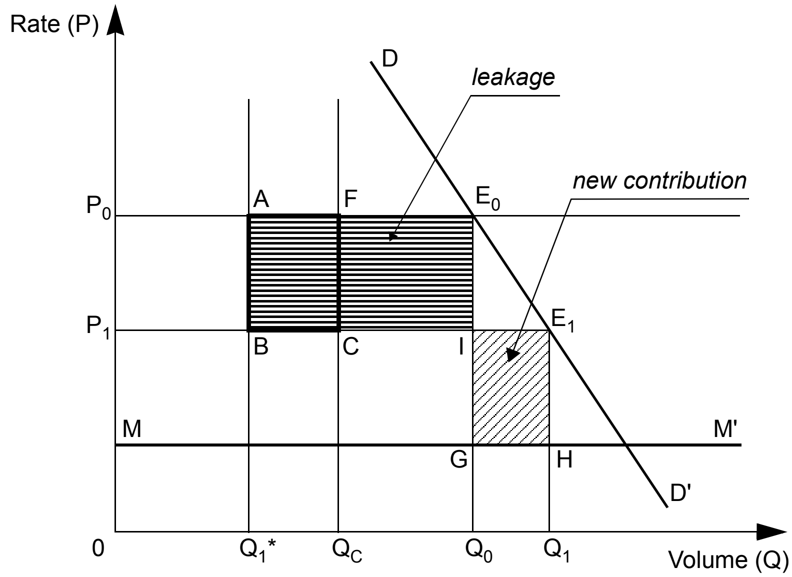
[5061] The Commission's decision in this proceeding includes the provision that a stop-loss cap be placed on the total value of the discounts that Capital One could receive under the NSA. The function of the stop-loss cap is to prevent a large loss in net revenue if it turns out that the Postal Service 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.

[5062] The stop-loss cap is cumulative over the three-year term of the NSA. If the cap is not reached in the first year then the remainder of the cap after the deduction of the first year's discounts becomes the cap for the second year. The discounts in the second year would then be deducted to determine the stop-loss cap in the third year. If the accumulated discounts reach the cap in any year of the NSA the declining block rate tariff is terminated. Capital One would then be required to pay the undiscounted rate on the remainder of its mailings.

[5063] Basically, in any single year the cap becomes a form of non-price rationing if Capital One's discounts would exceed the amount of the cap. Otherwise, the cap has no effect on either the Postal Service or Capital One. If the cap takes effect, it forces Capital One to reduce its volume below the level that Capital One would otherwise choose at the marginal rate produced by the declining block rate tariff. A cap that actually takes effect produces a loss in surplus to Capital One but 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.

[5064] Figures 5-5a and 5-5b depict the two ways that a stop-loss cap that takes effect could alter the terms of a two-block tariff. Figure 5-5a shows the outcome when the leakage of net revenue (from the Postal Service to Capital One) would exceed the stop-loss cap. Figure 5-5b shows the way the stop-loss cap works if the leakage is smaller in amount than the stop-loss cap. Figure 5-5c shows the outcome when the stop-loss cap is too high to take effect.

Figure 5-5a
Leakage Exceeds Stop-Loss Cap



[5065] In Figure 5-5a the amount of the discount cap is equivalent to the area of the rectangle AFCB. This is smaller than the leakage, which is represented by AE_0IB. Since the top, bottom, left-hand side and area of the rectangle AFCB are all predetermined; the right-hand side of the rectangle establishes an upper limit, Q_c, on Capital One's volume under the NSA. For the cap to take effect, the volume Q_c must be less than the volume Q_1 that Capital One would have chosen at the marginal rate, P_1.

[5066] As Figure 5-5a has been drawn the leakage AE_0IB is larger than the direct contribution of the tariff to net revenue shown as the area IE_1HG, so this is not a tariff that contributes to net revenue. Presumably the Postal Service would not knowingly negotiate such a tariff unless there was some other provision providing a large cost offset. The obvious design error in the tariff is that the threshold volume Q_1* has been set much too low.

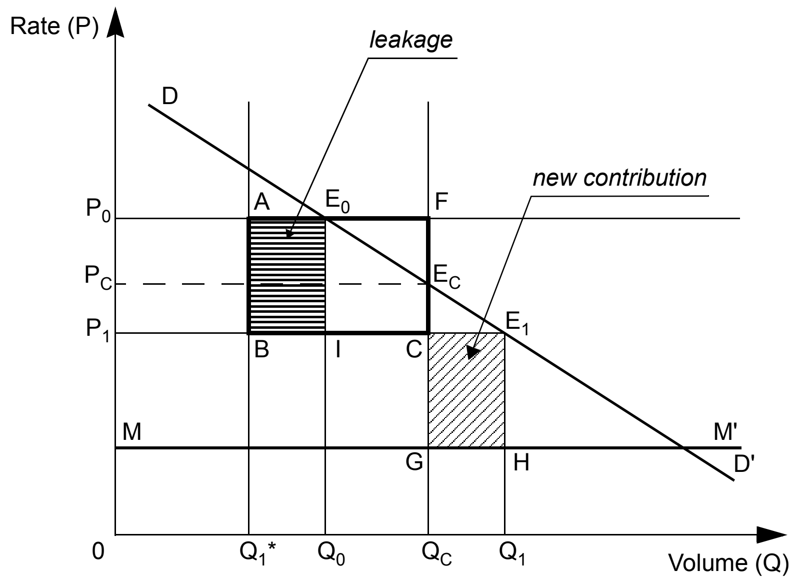
[5067] The effect of the stop-loss cap is to terminate the two-part tariff after the discounts reach the amount AFCB. In this case the cap takes effect at a volume Q_c that is less than the volume Q_0 that Capital One would send at the undiscounted rate P_0. Therefore, Capital One's marginal rate is P_0 and its volume is Q_0, exactly the same volume it would have chosen without the declining two-block tariff.

[5068] The termination of the discount leaves Capital One with an addition to its surplus equal to the amount of the cap but cancels all of the other surplus it stood to gain on volumes above Q_c. In Figure 5-5a the stop-loss cap AFCB is smaller than the leakage represented by the area of AE_0IB. Therefore, the rectangle FE_0IC represents a portion of the leakage that is prevented by the stop-loss cap. This area constitutes both a net revenue gain for the Postal Service and a loss in consumers' surplus for Capital One. Capital One also loses the surplus represented by the triangular area under the demand curve whose corners are E_0E_1I. This would have been Capital One's added surplus on the additional volume produced by the lower marginal rate of the tariff.

[5069] The Postal Service avoids the part of the leakage FE_0IC but must also give up the new contribution to net revenue from Capital One's added volume under the two-block tariff. This contribution is the area IE_1HG. Since the avoided leakage FE_0IC is greater than the lost contribution IE_1HG, the cap limits the loss of postal net revenue to the discount on Capital One's mailings before the cancellation of the tariff. This loss in net revenue is the same as the cap and is represented by the area AFCB. This is also Capital One's only gain in surplus. Ultimately, the only result of the tariff is a transfer represented by the rectangle AFCB from the Postal Service to Capital One.

[5070] In Figure 5-5b the stop-loss cap AFCB is greater than the leakage AE_0IB so the cap does not completely suppress the decrease in the marginal rate that results when Capital One's volume passes the threshold Q_1*.

Figure 5-5b
Leakage less than Cap



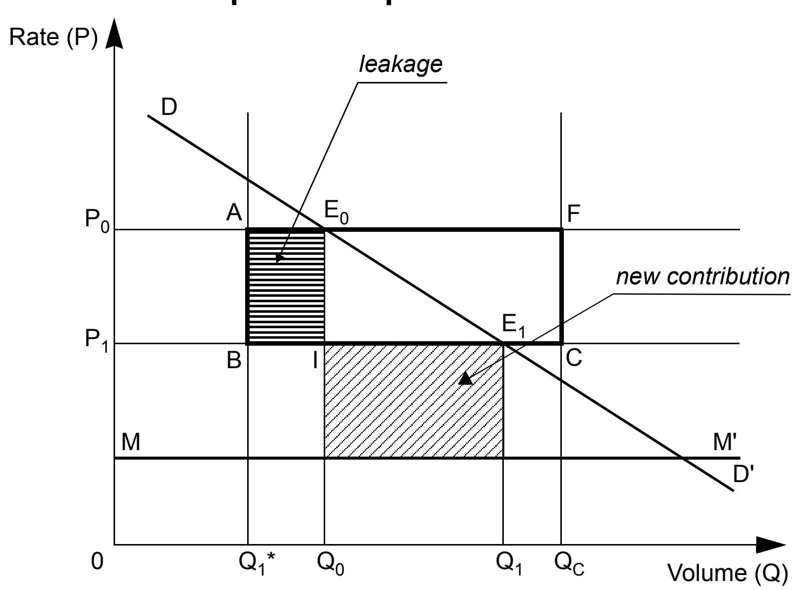
[5071] As before, the cap establishes a maximum volume Q_c; however, in this case the volume Q_c is greater than the volume Q_0 that would have been mailed without the tariff. Capital One responds to the stop-loss cap exactly as it would to an increase in the marginal rate — by moving back along its demand curve DD' starting at E_1 until it reaches the point E_c where its demand has been reduced from Q_1 to Q_c. This point corresponds to a price P_c that is higher than the marginal rate P_1. The reduction in demand amounts to non-price rationing because there is no actual increase in the marginal rate from P_1 to P_c.

[5072] Both the Postal Service and Capital One's losses from the operation of the cap can be identified as areas in Figure 5-5b. The Postal Service loses the new contribution that would have been contributed by the additional volume, Q_1 minus Q_c. This area, represented by the rectangle CE_1HG, is equal to the product of the additional volume and the per unit contribution to net revenue at the marginal rate. Unlike a price increase, there is no offsetting increase in revenue derived from a higher rate on the remaining volume Q_c. Capital One's loss takes the form of a loss in consumers' surplus.

As Capital One moves back along DD', the area representing the surplus shrinks by an amount equal to the area of the triangle E_cE_1C.

[5073] A stop-loss cap that actually takes effect can prevent a large loss in net revenue when the threshold is set too low, as in Figure 5-5a. But it does so at the risk of reducing the efficiency gains from the tariff when the threshold is set high enough to assure that new contribution exceeds leakage, as shown in Figure 5-5b. In the situation depicted in Figure 5-5b the Postal Service gain in net revenue is limited when stop-loss cap intervenes to hold Capital One's volume to Q_c. This situation is avoided when the cap is set so that the bounding volume Q_c exceeds the volume Q_1 corresponding to the marginal rate P_1. In this case the stop-loss cap has no effect as shown in Figure 5-5c. Postal Service witnesses Crum and Eakin both rely on volume estimates for Capital One at the marginal rate that are sunstantially less than the bounding volume under the Commuission's stop-loss cap.

Figure 5-5c
Stop-Loss Cap Has No Effect



[5074] In this figure the two-block tariff works exactly as it would without the stop-loss cap. When Capital One chooses the volume Q_1 corresponding to the marginal rate P_1, the total of the discounts Capital One receives is less than the area of the cap AFCB. Consequently, the upper bound on volume imposed by the cap Q_c is less than the volume that Capital One chooses under the two-block tariff.

K. Miscellaneous Economic Issues

[5075] Beyond the specifics of the Capital One NSA, the expert testimony in this proceeding raises but does not resolve a number of economic issues regarding the offering of non-linear tariffs to selected postal customers. Satisfactory resolutions to these issues should be found if the Postal Service intends to continue following the pattern established by the Capital One NSA. That the effort is worth making seems apparent from the testimony. Virtually all of the expert witnesses in this proceeding would appear to agree with the basic finding that non-linear tariffs, such as the declining block rate tariff offered to Capital One, have the potential to improve the efficiency of the postal rate system as it is presently designed.

[5076] *Rate Discrimination (1)*: Economic price discrimination occurs when postal customers are supplied the same service but are charged different marginal rates. Rate discrimination is undesirable because it encourages an inefficient use of the mail by postal customers. Rate discrimination also underlies the competition issues illustrated in Figures 5-3c and 5-3d. Non-linear tariffs do not automatically produce rate discrimination but they do seem to invite it. Panzar's testimony contains an example that shows how offering the same declining block rate tariff to different postal customers fails to avoid the issue. Tr. 8/1581 and 1584-87. In his example a small and a large customer are offered the same two-block tariff. The large customer benefits from the tariff but the small one does not, thus leaving the two customers with unequal marginal rates. The Postal Service also acknowledges that "a similar, but not identical, NSA would likely better suit other customers." Tr. 3/416. The Postal Service has expressed a willingness to negotiate similar NSAs with other mailers but has apparently not yet done so. Tr. at 897-98.

[5077] *Rate Discrimination (2)*: Under the proposed NSA electronic notification of UAA mail is provided free-of-charge to Capital One. Electronic notification is a service that other mailers must pay for, but that Capital One has declined in the past to purchase. Therefore, the provisions of the NSA replacing physical return with electronic notification introduce another element of price discrimination into the postal rate system. This form of rate discrimination has not gone unnoticed in this proceeding by other parties. Tr. 3/415. The Postal Service is now "actively engaged in re-evaluating address correction fees," including the option to eliminate the charge for electronic address correction altogether. Tr. 5/941.

[5078] *Reselling*: A non-linear tariff that leaves postal customers with dissimilar marginal rates must include enforceable provisions for preventing the customers with the lower marginal rates from reselling postal services to the others. Tr. 8/1579. Reselling, if it is permitted, results in an uncontrolled increase in the leakage of net revenue from the Postal Service to the customer receiving an NSA. The terms of the Capital One NSA prohibit Capital One from directly reselling postal services and also include provisions intended to shut the door to indirect forms of reselling. For example, under the NSA the mailings of any merger partner or subsidiary acquired by Capital One while the NSA is in force would qualify for the discounts but would also raise the block boundaries Q_1*, Q_2* etc., Tr. 4/691. This limits the indirect leakage from unanticipated (by the Postal Service) mergers and acquisitions by Capital One during the course of the NSA. Any NSA that is likely to create discriminatory rates needs to have provisions of this kind to forestall an increase in the leakage of net revenue. These provisions must reliably prevent reselling in any form to avoid the situation shown in Figure 5-3a.

[5079] *Profit Maximizing*: If the Postal Service were a profit-seeking monopolist there would be little reason for the Commission to review the Service's judgment that an NSA would increase its net revenue. Tr. 8/1580-81. The Service would be expected not to negotiate NSAs that sacrificed profits. However, as Panzar points out, the Postal Service operates under a net revenue constraint that prevents it from maximizing net revenue over the long run. Under the net revenue constraint any increase in net revenue produced by an NSA must ultimately be given up by rate decreases to other postal customers. This leaves the Service without much of an institutional incentive to generate additional net revenues from the NSAs it negotiates. *Id.* at 1595. The Postal Service response to an OCA interrogatory asserts that the Service would consider the effect of an NSA on "the cost burdens of all mailers" as only one of several criteria including "increased volume, lower costs and increased contribution". Tr. 5/993-94.

[5080] *Pareto Dominance*: Pareto dominance defines a relationship between two sets of postal rates. A new set of rates is Pareto dominant over an existing set if no postal customers are worse off and at least one postal customer is made better off by the new rates. Pareto dominance is a sufficient test for demonstrating the superiority of a new set of rates. However, neither Panzar, Tr. 8/1736 and 1595, nor Eakin, Tr. 10/2071, believe that Pareto dominance would be particularly helpful as a criterion for judging the acceptability of most NSAs. The problem with the test is that it is too strict. Even the Capital One NSA would probably ultimately fail the test because some of Capital One's competitors are likely to suffer some reduction in profit, even under Eakin's industrial economics analysis, when Capital One gets a lower marginal rate. As a practical matter, demonstrating that a declining block rate tariff is Pareto dominant means showing that the tariff is an improvement for all of the parties that are most likely to be affected. It may not be sufficient simply to estimate the increase in postal net revenue from the NSA as has been done by the Postal Service witnesses supplying quantitative estimates in this case. Normally, one would trust a profit-seeking firm such as Capital One to negotiate an NSA that increased its surplus. In any event the optional nature of the tariff virtually guarantees that Capital One cannot lose under the terms of the NSA. However, Capital One's competitors are another matter. None has objected to the Capital One NSA so it may be reasonable to suppose that they will not be seriously harmed in this instance. But this may not be characteristic of the NSAs the Service might negotiate in the future with other customers.

[5081] *Bundling*: The Capital One NSA bundles electronic notification service with First-Class presorted mail for Capital One's mail. The Postal Service's reasons for doing this are explained at length in its response to an OCA interrogatory. Tr. 5/935-38. In essence the Postal Service gains net revenue by inducing Capital One to forego physical returns. The bundling induces Capital One to accept the switch from physical returns to electronic notification on all of its First-Class solicitation mail. In this case bundling services may produce an efficiency gain, but, more commonly, bundling does just the opposite because it prevents mailers from combining the bundled services most efficiently for their own use.

L. Who Has "Economic Standing"?

[5082] At the conclusion of his direct testimony Professor Panzar makes three observations that are actually recommendations to the Commission regarding the evaluation of optional tariffs such as the one found in the Capital One NSA. Tr. 8/1595. The second of these recommendations proposes that "competitors of the firm receiving the NSA should have 'economic standing' in evaluating its provisions." The Postal Service has responded by observing that none of Capital One's competitors has come forth to object to the Capital One NSA during this proceeding, even though there has been amply opportunity to do so. Nevertheless, Panzar's testimony raises the issue of what economic effects should be considered by the Commission to reach an informed finding that an NSA is (or is not) in the public interest.

[5083] The Postal Service's position on this issue can be judged from the economic effects that are considered in the economic analyses of its corporate witnesses in this proceeding. These analyses are limited to evaluations of the impact of the NSA on postal net revenue and assertions (many of them untestable) that the NSA advances the purposes of the Postal Reorganization Act (1970). USPS-T-2 at 6-10. Professor Panzar's testimony shows that such a restricted evaluation of the economic effects of an NSA would not be good public policy and, more importantly, would not conform very well to the Commission's wider responsibility to establish a fair and equitable rate schedule under the Act.

[5084] Its two major limitations are easily identifiable from Panzar's testimony. First, the Postal Service cannot be relied upon to negotiate NSAs that maximize the public benefits (represented by the added contribution to postal net revenue) to be derived from them. And, second, the two-party negotiations that produce the NSAs cannot be relied upon to recognize the economic interests of a major affected class of postal customers, namely, the direct competitors of the firm receiving the optional tariff, who would typically be excluded from the negotiations.

[5085]   The Commission accepts the general finding that NSAs offer an opportunity to improve the efficiency of the existing system of postal rates. NSAs can usually (but not always) be relied upon to accomplish this by increasing the aggregate surplus left to postal customers. It is then possible, at least in principle, to distribute the added surplus so that no postal customer is harmed. But to conclude that a specific NSA is in the public interest, it is also necessary to know approximately how the added surplus would be distributed. This is particularly true if the proposed tariff can lead to a redistribution that leaves an identifiable group of postal customers, such as Capital One's direct competitors, with a smaller surplus. Therefore, the Commission's position with respect to Capital One's competitors mirrors Professor Panzar's second recommendation. "The NSA may be in the public interest even if they are damaged, but their concerns are an important part of the evaluation process." Tr. 8/1595.

M. Estimates of Volumes and Net Benefits

[5086] In order to assess the Capital One proposal relative to the theoretical issues discussed above, it is necessary to examine the testimonial record to develop estimates for each of the factors. In particular, it is necessary to examine the estimates that have been presented regarding volumes with and without the NSA. Once volume estimates are selected, net benefits of the proposal can be developed.

1. Capital One's Estimates of Volumes

[5087] Capital One witness Jean provides the initial test year (FY 2003) forecast for its First-Class presorted mail volume in the absence of the agreement (1.408 billion pieces of mail). Capital One developed this initial Test Year Before Rates (TYBR) forecast by asking business managers to provide estimates of their use of First-Class Mail Tr. 2/41. Capital One witness Elliott then reviewed this estimate and placed it in context of the company's mail volume history, the impact of the anthrax attacks, and its change in marketing strategy announced in the summer of 2002. *Id.* at 202-204.

[5088] The mail volume history presented by witness Elliott provides actual volumes from October 1999 through July 2002. Elliott finds Jean's estimate reasonable. He also derives Test Year After Rates (TYAR) volume projections under two separate methods, one using the elasticity of First-Class workshared letters, and the second using the Standard Regular Mail elasticity. The details of Elliott's calculations of the TYAR volumes are found attached to his testimony as Exhibits 6 and 7. *Id.* at 212. Postal Service witness Crum uses the most conservative forecast, under the former method, to estimate the amount of new volume that would result from the discounts.

[5089] In his rebuttal testimony, witness Elliott revises the TYBR forecast of Capital One's First-Class Mail volumes to 1.210 billion pieces. Tr. 9/1838-46. This revised TYBR forecast is based upon actual volumes from October 1999 to December 2002. *Id.* at 1883-84; COS-LR-4, Exhibit 1. It does not rely upon the statements of business managers, as did the first forecast. The details of Elliott's revisions to his earlier estimates and to Crum's net revenue estimates are displayed in Exhihit 3 from a worksheet accompanying his rebuttal testimony. Tr. 9/1836. Capital One witness Shippee endorses the revised TYBR volume forecast as more accurate due to changing marketing, customer and economic circumstances. *Id.* at 1809. According to the Postal Service, either the original or the revised TYBR forecast of Capital One's First-Class Mail volume yields an acceptable basis for forecasting Capital One's volumes and can be used to evaluate the merits of the NSA in the test year. Postal Service Brief at 26-27.

[5090] Elliott's forecasting method makes use of a characteristic of constant-elasticity demand curves that is summarized by the following formula:

> Percent Change in Demand = Own-Price Elasticity of Demand x Percent Change in Price

[5091] Utilizing this formula, the volume on Capital One's demand curve corresponding to any marginal rate can be estimated from just two pieces of information. The necessary pieces of information are: 1) the volume Q and rate P for any predetermined point on Capital One's demand curve (DD' in Figure 1), and 2) Capital One's own-price elasticity of demand. In his response to an OCA interrogatory Elliott describes his method as solving "a problem of two equations with two unknowns". Tr. 2/235. The two equations are the formula above and a step function derived from the terms of the NSA which relates the marginal rate to volume. Elliott's method will not work for all declining block rate tariffs, but it does work to correctly identify the equilibrium that maximizes Capital One's surplus for the tariff proposed in the NSA.

[5092] In his testimony Elliott applies the formula three ways to obtain three different estimates of Capital One's TYAR volume. The three estimates are produced as follows:

1. Jean’s TYBR Volume and Thress’ First-Class Presort Elasticities: An estimate of Capital One's total TYBR First-Class solicitation and customer mail volume (1,408 million pieces) is combined with an estimate of the own-price elasticity of workshared First-Class letters (-0.071) taken from the testimony of Postal Service witness Thress given during the last omnibus rate proceeding Docket No. R2001-1, USPS-T-7 at 51. The option that Capital One would select under the declining block rate tariff is within the block ranging from 1,375 to 1,450 million pieces. The average rate discount for this block is 4.5 cents per piece. Capital One's estimated TYAR volume is 1,423 million pieces, and includes increases of 7.027 million pieces in customer mail and 8.432 million pieces in solicitation mail. This estimate is presented in Elliott's direct testimony and is the estimate relied upon by Postal Service witnesses Crum and Eakin to develop their estimates of postal net revenue.

2. Jean’s TYBR Volume and Thress’ Standard Regular Elasticities: An estimate of Capital One's TYBR First-Class solicitation volume (768 million pieces) is combined with an estimate of the own-price elasticity of Standard Regular Mail (-0.388) taken from Postal Service witness Thress' R2001-1 testimony. Docket No. R2001-1, USPS-T-7 at 99. The option that Capital One would select under the declining block rate tariff is within the block ranging from 1,450 to 1,525 million pieces. The average rate discount for this block is 5.0 cents per piece. Capital One's estimated TYAR solicitation volume is 819 million pieces. Capital One's customer mail is then treated as a derived demand that is proportionate to the number of customer accounts. Each customer account is expected to entail 12.5 First-Class workshared mailings per year. To determine the increase in the number of Capital One's accounts, Elliott

uses the industry-average solicitation response rate (0.6 percent) and the average length of time that new accounts are active (only 6 months). These parameters allow him to compute the number of new accounts that Capital One generates from the increase in solicitation mail, (307,200) and the average number of new accounts over the year, (153,600). The additional annual First-Class Mail from these new accounts is 1.920 million pieces. Capital One's customer mailings increase by 1.920 million pieces and its solicitation mail increases by 51.200 million pieces. Altogether, Capital One's TYAR First-Class volume is forcast as 1,461 million pieces,

3. Elliott's Revised TYBR Volume and Thress' First-Class Presort Elasticities: A lower estimate of Capital One's TYBR First-Class solicitation and customer mail volume (1,210 million pieces) is combined with the own-price elasticity of presorted First-Class letters (-0.071) as in 1. However, Capital One's selected block turns out to be the range corresponding to the initial undiscounted rate. Consequently, Capital One's estimated TYAR volume is the same as the TYBR volume of 1,210 million pieces. Neither customer mail nor solicitation mail changes. If this estimate is correct the NSA has no benefit for Capital One save for a possible cost reduction from improvements in its solicitation mail hygiene due to replacement of physical return by electronic notification.

[5093] In general, Elliott's method of estimation relies upon having a point on the demand curve and an own-price elasticity that are themselves accurately known. Unfortunately, neither the TYBR volume nor the own-price demand elasticity Elliott uses are estimated with much accuracy for Capital One's presorted First-Class letters.

[5094] Elliott takes the TYBR volumes used to make the first two estimates from the testimony of Capital One witness Jean. The estimates were produced by "asking business managers to provide estimates of their anticipated volumes". Tr. 2/41. It is clear from Jean's testimony that Capital One does not normally forecast its mail volumes beyond six months, and probably has little idea how accurate the TYBR forecasts are. However, a more serious problem with judgmental estimates of this kind is “moral hazard.” The estimates have been produced by a party with an interest in the outcome of the proceeding. The business managers supplying the responses may have conceived an interest in reporting anticipated volumes that are optimistic or pessimistic. When this happens the derived estimates of net revenue are biased. Smith cites this problem with Capital One's TYBR forecast as one of the reasons for preferring an objective means for making such a forecast. "A major drawback of a poll of operating personnel is that the poll may be inaccurate or subject to gaming." Tr. 7/1258.

[5095] The TYBR volume used to make the third estimate was presented by Elliott in his rebuttal testimony. It makes use of Capital One's FY 2003 quarter one volumes that were unavailable at the time he prepared his direct testimony. Elliott's forecast of 1,210 million pieces is obtained by seasonally adjusting the monthly average of 105.7 million pieces recorded during Q1 FY 2003 quarter one, and then converting the adjusted average to an annual rate. This simple extrapolation ought to produce a better forecast of the TYBR volume, not because it is a technically superior procedure, but because it utilizes as data about 25 percent of the annual volume it forecasts.

[5096] Elliott uses elasticity estimates from the R2001-1 testimony of Postal Service witness Thress as proxies for Capital One's own-price elasticity for which he had no direct estimate. But his use of Thress' elasticities is problematic. Thress' elasticity for workshared First-Class letters of -0.071 (used to derive estimates 1 and 3) has an associated t-value of only -0.149. This corresponds to a large sample 95 percent confidence interval of -1.004 to 0.862. Thress' elasticity for Standard Regular Mail of -0.388 (used to derive estimate 2) is a much better estimate. Its t-value is -9.418 and corresponds to a confidence interval of -0.308 to -0.468. Nonetheless, it is the insignificant estimate of the workshared First-Class letters elasticity that underlies the estimates of net revenue made by Service witnesses Crum and Eakin, and that are principally relied upon in the testimony of other Postal Service witnesses.

[5097] Crum and Eakin use the first of Elliott's estimates because it results in a more conservative estimate of postal net revenue than the second. But the confidence interval for Thress’ First-Class presort letters elasticity is so large that it overlaps the confidence interval for his Standard Regular elasticity and extends well above zero in the opposite direction. In fact the appropriate statistical lower bound to net revenue would correspond to the (positive) upper boundary of the confidence interval for the First-Class presort elasticity rather than the point estimate used in Elliott's first estimate of TYAR volume.

[5098] Elliott does not make use of a worksharing discount elasticity that is an integral part of Thress' fitted demand function for workshared First-Class letters. Thress' estimates include an estimated elasticity of 0.027 (with a t-value of 2.271) for workshared First-Class letters with respect to the worksharing discount. The worksharing discount is defined as the difference between the average per piece rate on single-piece First-Class letters and the workshared rate. The discount to Capital One obviously increases when the marginal rate for workshared First-Class letters declines under the proposed tariff. Elliott has not explained why he did not apply Thress’ discount elasticity to estimate Capital One’s demand behavior.

[5099] Elliott has generally ignored all of the cross-price elasticities found in Thress' fitted demand functions even though the calculations of postal net revenue and consumers' surpluses technically should incorporate the cross effects that they represent. Fortunately, most of the neglected cross-price elasticities are quite small. The cross-price elasticities found in Thress' workshared First-Class letters equation are for workshared First-Class cards (0.006), for Standard Regular Mail (0.008), and, through the discount elasticity, for single-piece First-Class letters. Thress' equation for Standard Regular Mail also has a cross-price elasticity for First-Class letters (0.012).

[5100] The elasticities Elliott borrowed have been estimated econometrically by Thress in a way that makes them measurements of the central tendencies for all of the mailers in a subclass or worksharing category. In OCA witness Smith's words: “The elasticity for workshared First-Class letters applies to mail from all types of customers; it is not specific to Capital One.” Tr. 7/1240. There is nothing in economic demand theory or in Thress' econometrics that requires the demand elasticity of any individual mailer to agree with the average of the aggregate. During cross examination by Commissioner Goldway, witness Elliott acknowledged that economic theory does not support the assumption that an individual user of the subclass (such as Capital One) will necessarily have the same demand elasticity as the entire subclass. Tr. 2/248.

[5101] Nor is there much in the testimony in this proceeding to support a hypothesis that Capital One is typical or average in its demand behavior. In fact, Capital One's use of presorted First-Class mail is close to being unique. According to the testimony of witnesses Jean and Plunkett, Capital One is the Postal Service's largest single First-Class customer but is only the sixth largest firm in the credit card industry. Smith describes the “drivers” for Capital One's solicitation mail and concludes that " [t]he drivers for other types of workshared mail may be quite different from those of Capital One's solicitation mail." Tr. 7/1241.

[5102] Finally, neither of the borrowed elasticities matches the correct definition of the own-price elasticity of Capital One's demand for presorted First-Class Mail. To see the problem, examine the economist's definition of the own-price elasticity. It is $\varepsilon = \frac{\partial Q}{\partial P} \cdot \frac{P}{Q}$ Embedded in this definition is a partial derivative, $\frac{\partial Q}{\partial P}$, that is defined as the rate of change in volume, Q, in response to a unit change in price, *P*, with the values of all other variables in the demand function held constant. A subtle change in this definition is made when an aggregate demand elasticity is borrowed and used, as Elliott does, in the demand function for an individual mailer. In the aggregate setting the partial derivative refers to the rate of change in demand when all of the participants in the market react together to a unit change in the rate for workshared First-Class letters. In this setting the variables held constant are the rates for all other subclasses and categories of mail and non-rate variables such as income and advertising. But Elliott uses the elasticity as though the partial derivative refers to the rate of change in Capital One's demand when Capital One reacts to a unit change in its own marginal rate. In Elliott's setting the variables that are held constant include everything except Capital One's marginal rate. Specifically included among the variables held constant are the marginal rates paid by all other mailers, including Capital One's competitors, for workshared First-Class letters. These rates are not among the variables held constant in the aggregate setting.

2. OCA's Estimates of Volumes

[5103] Most of the problems Elliott's estimates encounter would be avoided if his forecasting method could be applied using an elasticity extracted from an econometric fit of Capital One's own demand function. A "company-specific demand study" is first proposed by OCA witness Smith. *Id.* at 1248-49. According to OCA, a company-specific demand study would involve: (a) the identification of the exogenous factors that affect Capital One's demand for mail services; (b) the selection of an econometric or statistical model that relates the exogenous factors and declining block rates to Capital One's demand; and (c) the analysis of trends in the exogenous factors for their future impact. Estimation of the econometric demand model could produce elasticities — one for each exogenous factor and the declining block rates. These elasticities along with the trends of exogenous factors could be used to produce Capital One's volume projections for the test year. The study should be based on publicly available data and be verifiable and reproducible. OCA Brief at 12-13.

[5104] OCA witness Smith makes two attempts to produce volume projections derived from monthly time series data for Capital One's First-Class customer and solicitations mailings. The first, and most ambitious, attempt is to find and fit an econometric model of Capital One's demand for First-Class Mail. The attempt fails for lack of information on the factors that affect Capital One's demand and a limited amount of historical volume data. Smith also attempts a simple extrapolation of the previous year's experience by computing average growth rates over 2001 - 2002 and applying them to 12-month volumes ending in Sept. 2002. This attempt Smith describes as "the least bad alternative" because "it does not rely on private undisclosed information and involves minimal analyst judgment." Tr. 7/1258. But it, too, fails to produce reliable estimates of Capital One's TYBR or TYAR volumes primarily because Capital One's solicitation mailings have been quite variable over time.

[5105] The Commission notes that even had Smith's regressions and simple extrapolations been successful they only lead to forecasts of the TYBR volumes. To derive the TYAR volumes it is also necessary to estimate Capital One's own-price elasticity. However, none of Smith's models even includes the postal rate as a variable.

3. Postal Service Estimates of Volumes

[5106] Postal Service witnesses during this proceeding have been content to use the TYBR and TYAR estimates for Capital One's volumes derived from the testimony of Capital One witnesses Jean and Elliott. The initial testimony of Postal Service and Capital One witnesses left begging at least two major questions indicated by our earlier review of the issues: (1) Would Capital One also respond to the lower marginal rate under the NSA by substituting workshared First-Class mail for the solicitations it would otherwise send as Standard Regular Mail; and, (2) would Capital One's competitors respond to the NSA by reducing their own use of the mail, both First-Class and Standard? The answers that are implicit in the initial testimony are that the volume changes to be expected from these cross effects are zero.

[5107] With respect to the first question, the Postal Service initially accepted uncritically the assertions of Capital One's corporate witnesses that Capital One's Standard mailings would be completely unaffected as the company responded to the lower marginal rates for First-Class made available under the declining block rate tariff.

Tr. 2/270-271. However, its rebuttal witness Eakin warned that "interdependent demands also exist among different postal services (e.g., First-Class Mail and Standard Mail)" and that "[t]hese interdependent demands have received less discussion in this proceeding, but I believe they are more relevant in evaluating the Capital One NSA". Tr. 10/2073. Despite Eakin's warning no independent attempt to verify Capital One's claim can be found in the hearing record for this case.

[5108] The Commission finds it difficult to credit Capital One's claim that its Standard mailings would be unaffected by the NSA. It appears from witness Jean's descriptions of Capital One's use of the mail for solicitations, Tr. 2/38-40, that Capital One regards First-Class presort and Standard Regular mailings as imperfectly substitutable inputs to a production process the output of which is credit card solicitations. Economic theory suggests that Capital One's Standard mailings normally would decrease if the rate for Standard mailings remained constant while the marginal rate for First-Class presort declined under the NSA.

[5109] With respect to the question of the response of Capital One’s competitors, Eakin says that "[c]alculating point estimates for these secondary impacts is problematic, but plausible bounds can be estimated." Tr. 10/2076. In general he is skeptical of the possibility of obtaining data to calculate secondary impacts because much of the relevant data is proprietary. He then proposes ways to bound the "secondary leakage" and the "secondary contribution" that together constitute the cross effects of the tariff on Capital One's competitors. Note that here the terms "secondary leakage" and "secondary contribution" refer to changes in net revenue, whereas Eakin occasionally applies the terms to changes in volumes.

[5110] Eakin's upper bound for the secondary leakage is based upon two observations regarding the aggregate change in competitors' volumes. First, he expects that the losses in volumes indicated by witness Panzar's discussion of neoclassical production theory are limited to customer mailings, and, second, under "competitive assumptions" the total of these losses would not exceed the increase in Capital One's customer mail volume. These observations establish the "worst case" but "in actuality, the offset is likely to be less than the increase in Capital One's First-Class customer mail". *Id.* at 2078. To estimate the volume loss for the worst case Eakin uses the first of witness Elliott's three methods for estimating Capital One's TYAR volume. *Id.* at 2079-80. Elliott's estimated gain in Capital One's customer mail of 7.027 million pieces becomes Eakin's estimate of the upper bound for the aggregate volume lost by competitors. Eakin's "best case scenario" is that the aggregate loss in volume is zero. Thus his lower bound is zero. Eakin expects any actual losses to be much closer to the lower bound than the upper bound. He points out that the upper bound corresponds to a response rate of 12.8 percent on Capital One's solicitation mail while the industry average is only 0.6 percent.

[5111] Eakin's derivation of bounds for his "secondary contribution" mirrors his derivation for the secondary leakage but is based upon his own industrial economics theory rather than neoclassical production theory. Again, two observations underlie his arithmetic. First, he expects that the gains in volume that result from competitors' reactions are limited to solicitation mailings, and, second, that it would be unlikely for Capital One's competitors to more-than-match an increase in Capital One's solicitation mail. These observations determine the choices he makes for values of the variables in the formula he applies to compute a "best case" for the increase in Capital One's competitors' solicitation mail. *Id.* at 2081-83. To estimate the volume gain for the best case Eakin uses the second of witness Elliott's three methods for estimating Capital One's TYAR volume. *Id.* at 2082. Elliott's estimated increase of 51.200 million pieces in Capital One's solicitation mail becomes Eakin's best case increase in the presorted First-Class solicitations mailings of Capital One's competitors. Eakin's "worst case" for the added mail of competitors is zero and corresponds to the circumstance wherein competitors completely fail to react to Capital One's mailings under Eakin's industrial economics hypothesis. Therefore, Eakin's upper and lower bounds for the aggregate increase in competitors' volume are 51.200 million pieces and zero, respectively.

[5112] Eakin's bounds cannot be more reliable than the Capital One TYBR and TYAR volume predictions from which they are derived, even if Eakin's added observations and assumptions are all correct. As stated previously, these volume projections seem badly flawed. Therefore, the Commission finds that it cannot rely upon Eakin's bounds to establish limits upon the volumes that the Postal Service will gain or lose from Capital One's competitors.

4. Estimates of Net Revenue

[5113] The components that must be estimated to obtain a complete estimate of the effect of the NSA on postal net revenue can be inferred from the Commission's review of the issues. These components are:

1. Contribution: the contribution from the increase, if any, in Capital One's mailings of presorted First-Class letters; that is, from the difference between the TYBR and TYAR volumes for the combined total of Capital One's customer and solicitation mail.

2. Leakage: the discount leakage from the loss of net revenue that results from setting the second block threshold below the TYBR volume; or, the added contribution in the form of the gain in revenue that results from setting the second block threshold above the TYBR volume.

3. Cost saving: the cost saving to the Postal Service from the marginal cost reduction attributable to the conversion from physical return to

electronic notification for Capital One's UAA mail. This reduction in marginal cost is applied to Capital One's TYBR volume.

4. Competition leakage: the net revenue gained or lost on induced changes in the mailings made by Capital One's competitors in response to a drop in the marginal rate offered to Capital One. This change may have two parts, a gain from increases in competitors' solicitation mail and a loss from decreases in customer mail.

5. Substitution leakage: the net revenue gained or lost on accompanying changes in mailings in other subclasses or worksharing categories. This change may also be thought of as having two parts: the increase in mailings in complementary subclasses such as First-Class single-piece mail, and the decrease in mailings in substitute subclasses such as Standard Regular Mail.

6. Discount Cap: the effect on net revenue of the Commission's stop-loss factor, should it take effect.

[5114] The starting point for estimation of the net benefit from each of these components is the TYBR and TYAR volume forecasts. While problems have been identified with each of witness Elliott's TYBR and TYAR volume forecasts, the least problematic is the third, primarily because it was made five months later than the first two and after Capital One's Q1 FY 2003 volumes were known. Witness Elliott's revised TYBR volume estimate is 1.210 billion pieces. When this estimate is combined with Thress' own-price elasticity for First-Class presorted mail (-0.071) Capital One's TYAR volume under the tariff remains unchanged at 1.210 billion pieces. This is due to the fact that there are no price changes. Capital One’s volume is expected to be insufficient to qualify for declining block tariffs. The Commission has adopted the 1.210 billion piece estimate for the calculation of estimation of the net revenue impact.

[5115] The calculation of the net revenue impact of the Capital One NSA with Elliott's third set of estimates is relatively simple. Of the six components, all but one are zero. The nonzero component is the cost saving to the Postal Service resulting from the conversion from physical return to electronic notification for Capital One's UAA mail. This value is calculated by the Commission in Chapter VI Table 6-2 to be $11.067 million.

[5116] The stop-loss cap adopted by the Commission is $40.637 million. If, as witness Elliott's presentation suggests, TYAR volumes are only 1.210 billion pieces per year, this stop-loss cap will not take effect and will not limit the estimated net benefits.[57]

[57] Using witness Elliott's initial estimate of TYAR volume using Method 1 and Capital One's original estimate of TYBR volume, the total test year discount is $7.431 million. This is also well below the Commission recommended stop-loss cap.

VI. THE PROPOSED ADDRESS CORRECTION SERVICE PROVISIONS

A. The Agreement

[6001] The portion of the proposal that relates to the treatment of Capital One's undeliverable as addressed (UAA) First-Class solicitation mail has several aspects. The essence of the agreement is that, over the 3-year term of the contract, Capital One will have the option of using electronic Change Service Requested (CSR) option 2 at no charge for its First-Class solicitations.[58] [59] Capital One has also agreed to meet address hygiene requirements, including continuing its practice of checking its mailing lists against the National Change-of-Address (NCOA) database more frequently[60] than what is typically required, and incorporating information from address correction service (ACS) notifications into its database within two days of receipt. To facilitate monitoring of the terms of compliance, Capital One has agreed to waive the usual prohibition against opening its First-Class Mail for inspection.

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[58] CSR option 2 is a new variation of Address Correction Service whereby the mailer receives an electronic notification for each UAA piece that it sends. UAA pieces for which there is a forwarding address are then forwarded, while those that cannot be forwarded are disposed of by the Postal Service. USPS-T-4 at 4.

[59] If Capital One fails to send 750 million pieces of First-Class mail, it will pay the Postal Service $1 million or the fee (20 cents per correction) for any ACS notices it receives, whichever is greater. Request, Attachment A (Proposed DMCS Section 610.2).

[60] Every 30 days for customer mail, and 60 days prior to mailing solicitations. Tr. 2/41.

B. Benefits of ACS Arrangement

[6002] The ACS arrangement will benefit both Capital One and other mailers (through lower Postal Service costs) in several ways. Capital One will benefit by receiving information about its returned mail sooner and in a form that is less costly for it to process. In addition, Capital One will obtain information about its forwarded solicitations that it would not otherwise receive. Tr. 1/57-58. This richer and more timely information should enable Capital One to refine and improve its mailing lists and thus use the mail more efficiently. *Id.* at 65. In addition, under the terms of the agreement Capital One's use of CSR option 2 is a necessary condition to qualify for the declining block rates included in the proposal. Request at 2.

[6003] There also may be additional savings that are impossible to accurately forecast with the information available on the record. Improved timeliness of information about returns might reduce the return rate of Capital One's solicitations. By making corrections to its mailing lists more quickly, Capital One could reduce the occurrence of multiple solicitations to the same (UAA, non-forwardable) address. Tr. 2/92. Perhaps to an even greater extent, by receiving (for the first time) forwarding addresses for UAA mail that can be forwarded, Capital One may be able to reduce the occurrence of multiple solicitations to the same (UAA, forwardable) address, or "repeat forwards." *Id.* at 284, 318-22.

[6004] Other mailers will benefit from a reduction in Postal Service costs. Because it is less costly for the Postal Service to provide electronic notification than physical return of UAA mail that cannot be forwarded, there will be a direct and immediate reduction in Postal Service costs as a result of the ACS arrangement. The estimate of these savings is presented in the following section, followed by a review of the criticisms raised by various parties.

[6005] In addition to the immediate benefits of the specific arrangement with Capital One, there is reason to believe that as the Postal Service evaluates the execution of the arrangement, a broader classification change might evolve that could be made available to other First-Class mailers. Indeed, the record in this case reflects an increased awareness on the part of the Postal Service and other parties that the current design of rates and fees in First-Class Mail sends an inefficient signal to mailers about the relative (Postal Service) costs of processing UAA mail. Tr. 9/1868. Specifically, a more costly means of handling returns (physical) is available to mailers for free, while a less costly means (electronic ACS) carries a fee of 20 cents per return. Valpak Brief at 38. If the implementation of the arrangement with Capital One helps the Postal Service to develop a proposal for an improved pricing structure with respect to returns for all bulk First-Class mailers, then further benefits will accrue to all mailers.

C. Postal Service Estimate of Cost Savings

[6006] The Postal Service estimates the ACS portion of the NSA will reduce its costs significantly. The savings are possible primarily because Capital One's business plan utilizes First-Class Mail to send solicitations that are returned-to-sender at the rate of nearly one in ten. Tr. 2/38-39, 42. This exceptionally high return rate,[61] applied to a large volume of First-Class solicitations, causes the Postal Service to incur significant costs in the course of physically returning UAA mail to Capital One. The Postal Service estimates that by providing Capital One with electronic notification of pieces that would otherwise be physically returned, it will save approximately $13.1 million in the test year.

[6007] Witness Crum calculates the Postal Service's estimated savings of $13.1 million by taking the difference between the average TYBR unit cost of Capital One's First-Class Mail ($0.1359) and the average TYAR unit cost of Capital One's First-Class Mail ($0.1266). This difference (roughly 0.9 cents) is then multiplied by the original estimate of Capital One's TYBR volume (1.408 billion).[62]

[6008] The source of the difference between the TYBR and TYAR unit cost of Capital One's First-Class Mail is the treatment of mail that is undeliverable as addressed and cannot be forwarded. The total savings can be calculated analytically, so as to reveal the individual factors affecting the estimate. Based on the difference in unit costs for physically returned (53.5 cents)[63] and “electronically returned” (33.2 cents) mail, each piece for which the Postal Service substitutes an electronic notification for a physical return reduces its costs by roughly 20.3 cents.[64] By factoring in estimates of Capital One's TYBR First-Class solicitation mail volume (1.408 billion), the return rate for these

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[61] It is worth noting that the return rate of Capital One's First-Class solicitations (9.6%) is roughly four times the UAA rate of Standard Mail (2.4%). USPS-LR-J-69, Table 4.2. This implies that the high return rate is not exclusively a function of the solicitous nature of the mail.

[62] Witness Crum presents this calculation in USPS-T-3, Attachment B, page 2. The TYBR and TYAR unit costs are calculated in USPS-T-3, Attachment A, page 2.

[63] The physical return unit cost excludes the costs associated with pieces that are accountable or postage due. USPS-T-3, page 5 and Tr. 1/271.

solicitations (9.6%), the ACS success rate (85%), and a 3% contingency factor, Crum arrives at the total reduction in the cost of Capital One's First-Class Mail. These calculations are shown in Table 6-1.

Table 6-1
Analysis of ACS Cost Savings Estimate

	Average Unit Cost		
(1)	**FC Physical Return**	$ 0.5347	
(2)	**"Electronic Return"**	$ 0.3321	
(3) = (1)-(2)	**Difference**	**$ 0.2026**	

		TYBR Volume Estimate	
		Original	Revised
(4)	**Capital One TYBR First-Class Solicitation Volume** (thousand)	**768,000**	**669,538**
(5)	**Capital One First-Class Solicitation Return Rate**	9.6%	9.6%
(6) = (4)*(5)	**Capital One TYBR First-Class Solicitation Return Volume** (thousand)	73,728	64,276
(7)	**ACS Success Rate**	85%	85%
(8) = (6)*(7)	**Volume of Capital One Physical Returns converting to ACS** (thousand)	62,669	54,634
(9) = (3)*(8)	**Total Test Year Savings** (thousand)	$ 12,695	$ 11,067
(10)	**Contingency Factor**	1.03	1.03
(11) = (9)*(10)	**Total Test Year Savings with Contingency** (thousand)	**$ 13,076** *	**$ 11,399**

* This figure differs slightly from the $13,094 in USPS-T-3, Attachment B, page 2 because witness Crum rounds off his TYBR and TYAR unit costs (from Attachment A, page 2) before multiplying the difference by the TYBR volume estimate.

Sources: (1) & (2) - USPS-LR-1
(4) - Original: COS-T-2, Exhibit 1; Revised: COS-LR-4, Exhibit 3
(5), (7) & (10) - USPS-T-3, Attachment A, page 2

[64] The physical and "electronic" return costs are presented in USPS-LR-1, with supporting calculations in USPS-LR-J-69. An "electronic return" is an electronic ACS notification in lieu of physical return of the piece.

[6009] In rebuttal testimony, Capital One presents a revised estimate of 1.210 billion as its expected First-Class volume for the test year. Witness Elliot calculates the revised estimate based on the actual volume for the first quarter of FY 2003 (317.1 million). He uses this to estimate volume for the full Fiscal Year by assuming that the percentage of annual volume mailed in the first quarter is the same as it was for the years FY 1999 to FY 2001 (26.2%). Tr. 9/1843-45. Witness Shippee confirms that Capital One endorses the 1.21 billion-piece estimate over the initial 1.41 billion-piece estimate. *Id.* at 1809. Table 6-1 includes a parallel set of calculations using witness Elliot's revised forecast of Capital One's TYBR volume.

D. Areas of Dispute

[6010] Several Intervening parties express concerns about the accuracy of the cost savings estimated by the Postal Service. The criticisms fall into three general categories: the appropriateness of using average costs instead of mailer-specific costs, whether the test year estimates are sufficiently representative of the full term of the contract, and concerns about how the arrangement will affect the costs associated with Capital One's forwarded solicitations. As Table 6-1 above shows, the estimate of Capital One's TYBR First-Class solicitation volume also has a significant effect on estimated savings. Therefore, parties' concerns regarding the reliability of volume estimates is a relevant consideration in evaluating the ACS provisions of the contract.

1. Use of Average Costs

[6011] The Postal Service's estimate of savings from the ACS portion of the agreement relies heavily on test year unit costs for physical and electronic returns that are taken from a Library Reference submitted in Docket No. R2001-1, USPS-LR-J-69. Various parties have raised questions about whether these costs — which reflect the average cost of physical returns for First-Class Mail and the average cost of electronic ACS notifications — are sufficiently representative of the actual costs of handling Capital One's physical returns and ACS notifications.

a. Physical return costs

[6012] To estimate the unit cost of physically returning Capital One's First-Class solicitations, witness Crum starts with the average cost of a returned First-Class mail piece. He removes the costs associated with handling accountable and postage due returns, and uses the remaining cost as a proxy for the unit cost of handling Capital One's physical returns. Tr. 2/340-41, 361-62, 389. Because Capital One's returns are neither accountable nor postage due, the appropriateness of the adjustment is not disputed by any party.

[6013] However NAA, GCA and Valpak caution that other differences between Capital One's returns and the average First-Class return have not been taken into account and, as a consequence, the estimate of savings is not reliable. *See* generally Tr. 6/1010-13, GCA Brief at 21 and Valpak Brief at 22-27. Even parties who support the use of average cost figures do not dispute that customer-specific costs would yield a more accurate savings estimate. Rather, they argue that — given the difficulty and expense of measuring customer-specific costs and the limited and experimental nature of the agreement — the use of average costs is acceptable and reasonable. *See* Tr. 10/1976-77; ANM, DMA, MPA and PSA Brief at 13-15; Pitney Bowes Brief at 5-7; Capital One Brief at 14-15; and Postal Service Brief at 30.

[6014] NAA witness Kent argues there is no evidence on the record to demonstrate that the average First-Class return mail costs match the costs for Capital One's returned mail:

> The USPS has presented no evidence that the shape mix of COS mail reflects that of the First Class Mail (FCM) average mix. Presorted/bar-coded letters, the type of letter that COS normally mails, comprise only a part of total FCM volume. The First Class mailstream also includes flats and parcels, as well as hand-addressed letters, that cost more to return than COS's mail. [Footnote omitted] Witness Crum's adjustment to remove the postage due costs, while correct, does not address the additional costs of other shapes and workshare levels. Thus, the average FCM return cost is unlikely to accurately reflect the cost of returning COS's pieces, because COS's pieces are generally uniform letters.

Tr. 6/1011.

[6015] Witness Kent also asserts that the high volume of the Capital One return mail enables the Postal Service to gather it into trays or sacks that will avoid processing throughout the return process unlike other First-Class Mail. *Id.* at 12. It would follow, he contends, that this more expedited return implies a below average return cost and consequently the Postal Service has overestimated the potential savings from electronic returns.

[6016] NAA and GCA also contend that the average costs used are from FY 1998 and FY 2000 and therefore do not accurately reflect changes in the physical processes of returning and forwarding mail that will be present in the test year for the NSA. Tr. 6/1012-13 and GCA Brief at 21. *See also* Tr. 3/605-610.

[6017] The Postal Service maintains that because the cost-driving characteristics (e.g. shape mix, national scope) of Capital One's First-Class solicitations are similar to the national average, the adjusted average return cost can appropriately serve as a reasonable proxy. *See* Tr. 2/325, 328, 331.

b. Commission Analysis

[6018] Clearly, the most probative costs to be considered are the actual costs of Capital One's physical returns.[65] When questioned by Valpak about the use of average costs to estimate the financial effects of customer-specific deals, Presiding Officer witness Panzar indicated that customer-specific costs would "be preferable because the costs associated with the large customer directly affect the monopolist's profits. However, if such data are unavailable, the use of average costs may have to suffice." Tr. 8/1633. Unfortunately, the record in this proceeding leaves the Commission in just such a position. (No party presents a specific alternative estimate of the cost of Capital One's returned pieces.)

[6019] Therefore, we must attempt to determine if the average cost of First-Class physical returns, as adjusted by witness Crum,[66] is an acceptable proxy for the cost of physically returning Capital One's First-Class solicitations. The Commission agrees that

[65] The potential overstatement of savings is a factor causing the Commission to pass through less than 100 percent of projected savings when developing the stop-loss provision recommended in this decision.

[66] The Commission accepts the uncontested exclusion of accountable and postage due costs.

there are reasons to suspect that the proxy is somewhat too high. Especially compelling is witness Kent's assertion that the relative propensity of Capital One to send machinable letters (as opposed to flats, parcels, handwritten or nonmachinable letters) is likely to result in below average return costs. Unfortunately, the available return cost data do not provide the level of detail necessary to adjust for differences in the characteristics of the mail. Despite these concerns there is little cause to believe that the proxy is so inaccurate as to be unusable. *See National Association of Greeting Card Publishers v. USPS*, 569 F.2d 570, 591 (D.C. Cir. 1976); and Chapter 8, Section B. Therefore the Commission will use the unit cost of physical returns as presented by the Postal Service, while bearing in mind the possibility that it is somewhat higher than the true cost of Capital One's physical returns. The Commission strongly encourages the Postal Service to include a specific analysis of the costs of the mailer in question in any future proposals that rely on customer-specific costs (including an extension of the Capital One NSA). *See* Tr. 8/1781-82.

c. Electronic return costs

[6020] The proxy witness Crum develops for the cost of providing Capital One with an electronic notification (in place of physically returning a UAA First-Class solicitation) is based on the average cost of an electronic ACS (eACS) transaction from USPS-LR-J-69. To this he adds carrier preparation and clerk handling costs (also from USPS-LR-J-69).[67]

[6021] NAA witness Kent notes that the $0.1450 per piece cost estimate for eACS notifications is the weighted average of two cost components: ACS change of address notification ($0.0997 per piece) and ACS nixie processing ($0.2074 per piece). He asserts that the higher ACS nixie processing costs are solely associated with returns, while the ACS change of address notification cost is for forwards. He claims that including the lower cost for forwards in the average understates the cost of electronic

[67] The carrier preparation and clerk handling costs are identical to those included in the cost of physical returns. Therefore these costs effectively cancel out when the savings are estimated.

returns, and therefore the Postal Service's estimate of cost savings arising from substituting eACS for physical returns is too high. Kent suggests that the nixie processing cost should be used instead of the weighted average the Postal Service uses. Tr. 10/1967F-G.

[6022] On rebuttal, Postal Service witness Plunkett challenges Kent's recommendation. While he acknowledges that the nixie processing costs are solely associated with returns, Tr. 9/1896, he argues that that the ACS change of address notification costs are not exclusively incurred by forwards but also by returns such as those resulting from an expired forwarding order (for which a change of address notification is provided).[68] To further support use of the weighted average cost, he states his understanding that because a forwarding address is not provided, returns require fewer keystrokes than do forwards. *Id.* at 1872.

[6023] Witness Plunkett offers another justification to support the use of the weighted average cost. He states that lower-cost ACS change of address processing is done primarily on mechanized terminals and the higher-cost nixie processing is mostly non-mechanized. He concludes that, because Capital One's solicitations are letters, they will be primarily processed on mechanized terminals and therefore using the weighted average of $0.145 is conservative. *Id.* at 1958-60. Capital One agrees with witness Plunkett's reasoning. COS Brief at 11.

[6024] NAA expresses doubts about this last assertion. It is skeptical of witness Plunkett's explanation of the operations underlying the costs. It argues that his claims about the (mechanized/non-mechanized) nature of these operations conflicts with the labels assigned to them in USPS-LR-J-69. It states that witness Plunkett's claim implies that 58 percent of ACS mail currently is processed on mechanized terminals and 42 percent is processed on non-mechanized terminals. NAA expresses doubt that so much ACS mail is processed on non-mechanized terminals, and stands by its contention that the $0.1450 cost for eACS is below what the true cost will be. NAA Brief at 23-24.

[68] Witness Plunkett does not know the proportion of ACS change of address notifications that are for returns. *Ibid.*

d. Commission Analysis

[6025] As with the issue of the cost of physical returns, the Commission would, of course, prefer to have customer-specific costs available to measure the potential savings of the ACS arrangement. However, no actual cost of “electronic returns” currently exists for Capital One's First-Class solicitations. Indeed, measuring the actual cost of providing “electronic returns” should be one of the goals of the proposal.

[6026] Because the higher-cost nixie processing is incurred exclusively by returns, while the lower-cost ACS change of address notifications are incurred by both returns and forwards (in unknown proportions), NAA's argument that the proxy is too low appears to have merit. Likewise, the Postal Service's counter-argument that Capital One's eACS returns (being primarily machinable letters) will cost less than the average eACS return is also logical. The Commission does not find that either of these factors is significant enough to make the proxy unusable, and their impact is moderated because to some extent they offset. Therefore, the estimated cost of providing “electronic returns” as calculated by the Postal Service will be used.

2. Representativeness of the Test Year

[6027] For purposes of evaluating the impact of the proposal, the Postal Service presents financial estimates for FY 2003 (the test year). Witness Plunkett cites two main reasons for the Postal Service's assertion that a single fiscal year is the appropriate test period:

> First, FY 2003 was the test year in the most recent omnibus rate proceeding, Docket No. R2001-1. Consequently, a compete panoply of both general and specific volume, cost, and revenue information, in the form used in Commission proceedings, already existed for that year. . . . Second, relying on a FY 2003 test year appropriately reflects the nature of the proposed NSA. . . . The mechanics of this NSA are such that the responses of the parties to its implementation will be virtually immediate,

> and there will be no predictable trend of financial effects from one year to the next. Accordingly, the first year of the agreement is likely to constitute just as representative a test period as would one consisting of the entire duration of the experiment. Tr. 4/769-70.

[6028] Several parties dispute the Postal Service's assertion that the FY 2003 test year is representative of the remaining years of the agreement. With respect to the ACS portion of the NSA, the primary disagreement is over the effect that the implementation of the Postal Automation Redirection System (PARS) will have on the cost of handling UAA mail, especially in the later years of the experiment. Also, annual variations in the volume of First-Class Mail that Capital One would send in the absence of the NSA (“anyhow” volume) over the duration of the contract affect the potential savings in each year.[69]

[6029] PARS is a new system designed to reduce the cost of redirecting UAA mail by intercepting this mail earlier in the processing stream. The Postal Service expects PARS to significantly reduce handlings for UAA First-Class letter mail. Phase I deployment is planned to occur between July 2003 and May 2004 and the system is expected to become fully operational during FY 2005. PARS is designed to identify UAA letter mail at the first machine handling and redirect it automatically to the correct destination. Tr. 5/889-92. The Postal Service specifies the degree of automation it expects to achieve from the full implementation of PARS:

> In FY 2005, once Phase I is fully implemented, PARS is expected to process about one-third of all UAA machinable letter mail volume. About one quarter of that mail will be intercepted at the plant before it reaches the DDUs. The remaining three-quarters will be identified as UAA mail by the carrier and sent back to the plant for processing on PARS.

Id. at 891-92.

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[69] Variations in "anyhow" volumes have an even more significant impact on the revenue "leakage" than on the cost savings. This effect is discussed in Chapter V of this Opinion.

[6030] The volume of First-Class solicitations that Capital One would have sent in the absence of the agreement is an important factor in determining the potential savings from the ACS arrangements within the contract. This volume determines the number of pieces that receive eACS treatment instead of being physically returned. The more pieces for which eACS can be substituted for physical returns, the more the Postal Service will save. For example, Table 6-1 shows that the original TYBR volume estimate implies roughly $13.1 million in potential savings, while the (lower) revised TYBR volume estimate implies about $11.1 million in potential savings. If the volume of First-Class solicitations that Capital One would have sent in the absence of the agreement differs in the later years of the agreement from the test year estimate, then the savings in the later years also would be different.

a. Parties' Positions

[6031] NAA witness Kent testifies that the Postal Service's estimate of cost savings from electronic provision of ACS notices in lieu of manual returns may be overstated. He points out that the Postal Service uses FY 2000 data, which does not reflect the introduction of PARS. In support of his claim that savings are likely to be overstated, he cites the potential for the system to reduce UAA costs. Tr. 6/1010-12. NAA also criticizes the lack of any estimate of solicitation volume beyond the first year of the NSA. NAA Brief at 22.

[6032] APWU expresses concern that Postal Service's estimates do not examine the financial picture over the full term of the NSA. APWU Brief at 8. It argues that by 2005, PARS should have reduced the cost of processing UAA mail significantly. Consequently, it is difficult to know what the amount of cost savings will be in the later years of the agreement. *Id.* at 6.

[6033] GCA presents a similar argument, stating that the costs of providing the fee waiver over a three-year period are largely unknown. It criticizes the Postal Service for not presenting cost savings that reflect the anticipated PARS implementation. GCA also cites the lack of volume forecasts beyond the first year as one reason behind its skepticism of the estimated financial impact of the agreement. GCA Brief at 19-24.

[6034] The Postal Service has consistently downplayed the potential impact of PARS on the cost savings associated with the NSA. It states that the impact of PARS on the agreement is expected to be minimal for several reasons. First, the test year will include only a few months of PARS implementation. Second, PARS will not be fully implemented until FY 2005 when it will process only about one-third of UAA letter mail. Tr. 5/891. In addition, PARS is expected to increase the 85 percent ACS success rate assumed by witness Crum in his calculation of the per-piece cost savings. This in turn would increase the cost savings. Finally, PARS is expected to reduce the cost of providing electronic correcion notices. These potential reductions were not factored into witness Crum's estimates. For these reasons the impact of PARS is expected to be small in the test year.[70]

[6035] The Postal Service presents a sensitivity analysis to ensure that the agreement would result in a positive net contribution over the entire three-year period. The sensitivity analysis provides a range around witness Crum's original savings estimate of $13.1 million. The results vary between $10.6 million (if both volumes and return cost difference decrease by 10 percent) and $15.8 million (if both volumes and return cost difference increase by 10 percent) in year three of the NSA. Based on these results, the Postal Service concludes that the test year of the agreement is representative of the subsequent two years. In addition, the Postal Service argues that even with significant changes in the costs and volumes for years two and three, the net contribution remains positive. Tr. 5/869-78, Postal Service Brief at 29.

[6036] The Postal Service also defends its use of a single test year by asserting that it is consistent with the Commission's rules and past practice of evaluating omnibus rate proposals on the basis of a single test year. Postal Service Brief at 27-8.

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[70] Second Revised Response of United States Postal Service to Interrogatory of the American Postal Workers Union, AFL-CIO (Errata) (hereinafter APWU/USPS-7 revised). *See* Tr. 5/882 and P.O. Ruling at Tr. 7/1229-30.

[6037] Capital One agrees with the Postal Service's rationale for the use of a single fiscal year as the basis for evaluating the impact of the experiment. It cites the same reasoning of witness Plunkett that is summarized above. COS Brief at 33. On rebuttal, witness Posch claims that the 3-year nature of the agreement does not require the Commission to deviate from its standard practice (in omnibus rate cases) of relying on a single test year. Tr. 10/1977-78.

[6038] Pitney Bowes defends the use of a single test year on the grounds that requiring projections beyond the first year of an agreement would prove unduly burdensome, and would unnecessarily increase the cost of litigating NSAs. It argues that this might exclude small or medium firms from the NSA approval process. Pitney Bowes Brief at 5-7.

b. Commission Analysis

[6039] The Commission shares the participants' concerns about the implementation of PARS. However, it appears that the impact of this new system will be small. The Postal Service demonstrates some offsetting aspects of the possible effects of the cost and revenue projections in years two and three of the agreement. While PARS may somewhat reduce the costs of forwarding and returning UAA letter mail, it will also impact the ACS success rate.

[6040] Despite the validity of the argument that the implementation of PARS will likely have some impact on the potential savings from the NSA, the state of the record does not provide a sufficient basis for quantifying these effects. Nor does any party propose a specific adjustment to the estimated savings to account for the effects of PARS. The first phase of PARS implementation will barely be underway in the late stages of the test year, so the Commission accepts the Postal Service's contention that any test year impact will be insignificant. Therefore no adjustment to the method of estimating the savings from the ACS arrangement is made for the impact of PARS.

However, the Commission is aware that the implementation of PARS may slightly reduce the savings in the later years of the contract.

[6041] Given the wide variations in Capital One's historical mail volumes, it is not realistic to assume that the First-Class volume Capital One would have mailed without the agreement will remain constant over the three years of the agreement. However, there is insufficient record basis to forecast these volumes and the Commission is accepting the use of a single test year for estimating the financial effects of the agreement. The revised volume estimate for the test year[71] is used to estimate the financial effects of the ACS provisions of the NSA.

3. Forwarded Mail

a. Parties' Positions

[6042] In his initial estimation of the NSA costs and savings witness Crum does not consider forwarded mail. Tr. 2/268. This omission is largely due to the fact that neither Capital One nor the Postal Service knows the volume of Capital One mail that is forwarded. Tr. 2/89 and 3/575.

[6043] Taking notice of this omission, several parties query the Postal Service about the cost of providing Capital One with eACS notices for First-Class solicitations that are forwarded. In response, witness Crum calculates an estimated additional unit cost for providing an electronic address change notice of 6.6 cents. Crum goes on to assert that providing Capital One with address change notices for forwarded mail will reduce the number of forwarded pieces and thereby reduce Postal Service costs. Tr. 2/284.

[6044] In response to Presiding Officer's Information Request No. 2, Question 7, witness Crum attempts to quantify the total impact of the NSA on the Postal Service's

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[71] As presented by COS-RT-2 in COS-LR-4, Exhibit 3. *See* Chapter V of the Opinion for a discussion of the volume estimates.

cost of handling Capital One's forwarded solicitations. Depending on the number of notices provided for a given address before Capital One corrects it, he identifies a range of possible net Postal Service cost reductions of between roughly $8,000 and $3.1 million. These figures all rely on several simplifying assumptions to estimate the number of repeat forwards currently sent by Capital One including: Capital One's solicitations are distributed evenly to every domestic delivery point (i.e., every address receives exactly 5.6 pieces per year), the same delivery points have forwarding orders in effect for the entire year, and Capital One solicitations are forwarded at the average rate for all First-Class Mail. Tr. 2/318-22.

[6045] The Postal Service's assumption that the Capital One rate of forwarded mail is equal to the average forward rate of all First-Class mail drew particular criticism from NAA witness Kent:

> It is difficult to believe that while COS has incorrect addresses for 9.6% of its solicitation targets (resulting in a returned piece), it somehow has sufficiently good addresses as to have only the FCM “average” rate of forwards. My rationale for linking the forwarding rate to the return rate is that both are related to poor address quality and if Capital One has a return rate 8 times higher than the FCM average, then one would expect the forwarding rate for the mail sent using those same address lists to be higher than the FCM forwarding rate.

Tr. 10/1967D.

[6046] Witness Crum justifies this assumption on the grounds that the cause of forwards is not the same as the cause of returns, “[w]hat drives the forwarding volume for an address list is how many addressees have recently moved, not the quality of the addresses themselves.” Tr. 5/860. He goes on to note that a higher forwarding rate would imply greater potential savings from the reduction of repeat forwards. *Id.* at 862.

[6047] However, under cross-examination, Crum declined to endorse his estimate of savings:

> As I tried to explain earlier we responded to POIR-2 Question 7 because we were asked to do it. That does not mean we are making a cost estimate of the avoided costs due to forwarding. There are too many assumptions in there to have a solid analysis but we were asked to do that. Therefore I provided a range of likely things.

Tr. 2/383.

[6048] Capital One agrees with the Postal Service's assertion that the savings from reducing repeat forwards will more than offset the cost of providing electronic address change information for forwarded mail. Capital One Brief at 12-14.

[6049] While acknowledging the likelihood that the Postal Service will realize cost savings from the reduction in repeat forwards, NAA argues that Crum has underestimated the unit cost of providing eACS for forwarded mail. It emphasizes that much is unknown about the effect of the NSA on the Postal Service's cost of handling Capital One's forwarded mail. NAA Brief at 26-28.

b. Commission Analysis

[6050] The Commission finds that the lack of information about the current and expected forwarding rates of Capital One's First-Class solicitations is not a serious problem. In response to questioning by parties and the Commission, the proponents fail to provide any reliable quantitative estimate of the effects of the NSA on the Postal Service's costs of handling Capital One's forwarded mail. However, the reasoning of witness Crum, as well as the calculations in his example, do serve to help bound the direction and magnitude of the effects.

[6051] The Commission finds no record basis on which to quantify the effects of the NSA on forwarding costs. However, we do believe that it is likely to result in a net reduction of the Postal Service's cost of handling Capital One's forwarded mail. Because the cost of physically forwarding a piece is so high, even a slight reduction in the number of forwarded pieces (which seems likely) should produce enough savings to offset the (relatively low) costs of providing Capital One with free eACS for its forwarded pieces.

Therefore, the Commission will not adjust the savings estimate for the costs related to forwarded mail. Unlike the areas of contention discussed above, the Commission believes it is likely that the Postal Service's treatment of the costs of forwarded mail results in a slight underestimation of the potential savings.

E. Commission Estimate of Savings from ACS Provisions of NSA

[6052] The Commission views the substitution of electronic address correction for returns of UAA mail as a variation of worksharing, where Capital One is agreeing to modify the preparation of its mail (e.g., using the CSR Option 2 endorsement) thereby making it less costly for the Postal Service to handle. In return, Capital One receives some consideration (e.g., free eACS service, potential access to declining block rates). The estimate of the costs avoided by using eACS is akin to the estimates of cost avoidance used in setting worksharing discounts. However, in this case, contrary to established practice for estimating cost avoidances, witness Crum applies a contingency factor of three percent to the TYBR and TYAR unit costs. He does so without explanation, and the effect is to inflate the amount of savings by three percent.[72] Consistent with past practice, the Commission estimates cost avoidance exclusive of any contingency amount.

[6053] Table 6-2 presents the Commission's estimation of savings from the ACS provisions in the test year.[73] The Commission recognizes that this estimate relies on the use of average costs and other proxies as well as a test year volume estimate that is suspect. However, none of these imperfections is sufficient to render the estimate unusable, and the Commission anticipates that future proposals of a similar nature will incorporate improvements as the Postal Service gains experience in mailer-specific agreements.

[6054] As Table 6-2 shows, the ACS provisions should result in a significant increase in contribution to the Postal Service, which in turn will reduce the burden that

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[72] Discount rates should be set at no more than 100 percent of costs avoided by the Postal Service to be consistent with the principles of efficient component pricing. If discounts exceed actual avoided costs, other mailers are made worse off.

[73] Because the revised TYBR volume estimate is below the threshold for the declining block rates, no discounts are awarded (and thus there is neither leakage nor new volume). Therefore, the savings in Table 6-2 represents the total estimated financial effect on the Postal Service of the NSA in the test year. *See* Tr. 9/1845.

must be borne by other mailers. The Commission also finds that there are likely to be other benefits from this arrangement (described in Section B of this Chapter). Therefore, the Commission recommends approval of the provisions of the NSA relating to the treatment of Capital One's First-Class UAA solicitations as detailed in the Request.

Table 6-2
PRC Estimate of Test Year Savings from ACS Provisions

(1)	**FC Physical Return Unit Cost**	$	0.5347
(2)	**"Electronic Return" Unit Cost**	$	0.3321
(3) = (1)-(2)	**Difference**	$	0.2026
(4)	**Capital One TYBR First-Class Solicitation Volume** (thousand)		669,538
(5)	**Capital One First-Class Solicitation Return Rate**		9.6%
(6) = (4)*(5)	**Capital One TYBR First-Class Solicitation Return Volume** (thousand)		64,276
(7)	**ACS Success Rate**		85%
(8) = (6)*(7)	**Volume of Capital One Physical Returns converting to ACS** (thousand)		54,634
(9) = (3)*(8)	**Total Test Year Savings** (thousand)	**$**	**11,067**

Sources: (1) & (2) - USPS-LR-1
(4) - COS-LR-4, Exhibit 3
(5) & (7) - USPS-T-3, Attachment A, page 2

VII. THE ADMINISTRATION OF THE NSA

[7001] Postal Service witness Plunkett testifies that the process which produced the NSA in this case began when the Service became involved in negotiations with Capital One sometime prior to January 2002. Tr. 4/772. He also states that negotiations between the Service and Capital One took place over a number of months, and that many of the contract's terms and conditions — including the use of declining block rates and the volume thresholds at which they become available — were changed during the course of negotiations. *Id.* at 781, 823-24.

[7002] The contract between the Postal Service and Capital One, included as Attachment G to the Request filed with the Commission, was executed on September 9, 2002. Prior to its presentation to the Board of Governors as the basis for the Request in this docket, the contract was reviewed by the Postal Service's executive committee. *Id.* at 798. The presentation to the Governors included an internal financial analysis of the NSA that became the basis for the testimony of Postal Service witness Crum, USPS-T-3. *Id.* at 797. This is the first NSA negotiated by the Postal Service, and the Commission does not consider the length of this process unreasonable. As the process becomes more normal, contracting should be less time consuming.

A. Extension to Similarly Situated Mailers

[7003] Section 403(c) of the Postal Reorganization Act includes among the Postal Service's general duties:

> In providing services and in establishing classifications, rates, and fees under this title, the Postal Service shall not, except as specifically authorized in this title, make any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue preferences to any such user.

[7004] Prior to the filing of the Postal Service's Request, with this statutory requirement in mind, the Commission had expressed its view that in order to gain approval of a negotiated service agreement, the Postal Service should ensure that "[t]he negotiated rate-and-service package is made available on the same terms to other potential users willing to meet the same conditions of service."[74]

[7005] The Postal Service recognizes that a negotiated service agreement must meet this condition in order to satisfy section 403(c). The Postal Service commits itself to this principle in its agreement with Capital One. The preamble to their agreement recites that it "will be transferable to other mailers willing to meet the same conditions and terms . . . ." Footnote 3 at page 4 of the Postal Service's Request states "[t]he Postal Service acknowledges that application of the proposed changes to similarly situated customers might be considered as a condition of a permanent classification change." It is the understanding of Postal Service witness Plunkett that "one of the conditions under which NSAs are considered to be legal is their availability to all similarly situated customers." Tr. 4/705.

[7006] The OCA persuaded the Postal Service and Capital One to include as part of the Stipulation and Agreement, proposed DMM language that includes specific procedures that other mailers could follow in applying for a negotiated service agreement that is comparable to that entered into by the Postal Service and Capital One. It includes a list of core elements for such an agreement, specific features thought necessary to implement them, and mailer characteristics that would make a candidate eligible for such an agreement. With this "roadmap" by which candidates could arrive at a comparable agreement, Capital One asserts that much of the legitimate concern about the fairness of the Capital One agreement to similarly situated mailers has been put to rest. Capital One Brief at 27-28.

[74] Report to Congress: Authority of the United States Postal Service to Introduce New Products and Services and to Enter Into Rate and Service Agreements with Individual Customers or Groups of Customers, February 11, 2002 at 15.

[7007] Capital One is optimistic that the Postal Service will reach other agreements modeled upon this agreement. It cites the testimony of Postal Service witness Plunkett, who states that the Postal Service has had discussions with eight-to-ten financial service companies about negotiating an agreement, all of whom would be given serious consideration if they were to apply. Capital One Brief at 31, citing Tr. 9/1889-90, and 1932-33. Capital One notes that witness Plunkett said that the Postal Service is actively discussing agreements with companies whose volume is less than one quarter of Capital One's. Capital One states that the prospect of negotiating more agreements will "heavily depend upon," among other things, "Commission guidance on what constitutes a similarly situated mailer." Brief at 32, citing Tr. 9/1886, 1888.

[7008] The Greeting Card Association (GCA), the Newspaper Association of America (NAA), and Valpak warn that the Postal Service's assurance that the Capital One agreement will be available to similarly situated mailers is a theoretical safeguard without practical value. They are deeply skeptical that any mailer negotiating an individual agreement will be considered by the Postal Service to be "similarly situated" to Capital One. They argue that if there were a realistic prospect of demonstrating that other mailers were similarly situated, that fairness could only be secured through a "niche classification" that would offer a consistent set of benefits and burdens to all such mailers. GCA Brief at 8, 17, 19; NAA Brief at 30; Valpak Brief at 5, 10.

[7009] The Postal Service's statements are ambiguous on this point. NAA notes the assurance in the preamble to the Capital One agreement that it "will be transferrable to other mailers willing to meet the same conditions and terms" and asks the Postal Service to reconcile that assurance with the language in its Request, which states "[a]s proposed, the changes would apply only to one, discretely-positioned mailer." Request at 4 (footnote omitted). It asks the Postal Service to clarify whether the Capital One agreement was available to other mailers, or just to one mailer. The Postal Service responds that both are true. Tr. 5/897.

[7010] The Postal Service acknowledges that the Capital One agreement and the changes to the DMCS that implement it, by their terms, apply only to Capital One. It explains that the assertion in the Capital One agreement that it is transferable to other mailers willing to meet its terms and conditions is not a term or condition of the Capital One agreement, but a statement of:

> the Postal Service's willingness to enter into **the same** NSA with another mailer capable of accepting and willing to accept the same terms and conditions. To the best of the Postal Service's knowledge, no other mailer is situated **exactly like** Capital One with respect to the terms and conditions embodied in the Capital One NSA. Nevertheless, the Postal Service would be willing to enter into an agreement consisting of **the same terms and conditions** with another mailer willing to accept them. The mailer would have to demonstrate to the Postal Service that it is **similarly situated**, and that the Postal Service would derive from the agreement with the new mailer the **same or substantially the same** benefits resulting from the Capital One NSA. ... As a result of inherent differences among mailers, the Postal Service would expect that any NSA it was considering with other mailers would have **terms and conditions different from** the Capital One NSA, and would reflect the **distinct characteristics of the mailer and its relationship with the Postal Service**. The Postal Service is willing to consider new NSAs on those **different terms**, as negotiated between the mailer and the Postal Service. As with an NSA **duplicating** the Capital One agreement, furthermore, DMCS changes implementing any new NSA would be submitted to the Commission for review. (Emphasis added.)

Tr. 5/897-98.

[7011] All agree that there is a legal requirement that “similarly situated” mailers be offered NSAs on “similar terms.” But the Postal Service characterizes the Capital One agreement simultaneously as “the same” as and “different from” anticipated future agreements. Its semantic imprecision makes it difficult to determine to what degree this requirement might actually protect other NSA applicants from undue discrimination.

[7012] Some guidance as to how the right of the “similarly situated” mailer to the "same" rate-and-service package offered to Capital One can be gleaned from the substantial body of precedent available interpreting this requirement.

[7013] The obligation of the regulated entity to offer the same rate-and-service package to all similarly situated applicants has become an axiom of regulatory law in the public utility/common carrier area. It originated at the Interstate Commerce Commission with sec. 208(a) of the Staggers Act, 49 U.S.C. sec. 10713(d)(2)(B)(i), *see Sea-Land Service v. I.C.C*, 738 F2d. 1311 at 1319 (D.C. Cir. 1984). This principle is applied at the Federal Communication Commission, *see MCI v. FCC*, 917 F2d. 30 at 34 (D.C. Cir. 1990) (Communications Act of 1934); Federal Energy Regulatory Commission, *see Associated Gas Distributors v. FERC*, 824 F2d. 981 at 1009-11 (D.C. Cir. 1987) (Natural Gas Act); the Federal Maritime Commission, *see North Atlantic Mediterranean Freight Conference-Rates on Household Goods*, 11 F.M.C. 202, 213 (1967) (Shipping Act); and, arguably, the Postal Rate Commission, *see UPS Worldwide Forwarding v. USPS*, 66 F.3d 621, 635 (3d Cir. 1995) (Postal Reorganization Act). The same principle is applied at the state level. *See Cass Co. Electric Coop v. Northern States Power*, 518 N.W. 2d 216, 221 (N.D. 1994).

[7014] The relevant cases recognize that identifying the circumstances and conditions that would make an applicant "similarly situated" so as to qualify for a rate-and-service package offered to another will, in all likelihood, have to be determined on a case-by-case basis. In *Sea-Land*, the court quoted the Interstate Commerce Commission's observation that "[a]s with other aspects of contract ratemaking, the existence of these circumstances and conditions can best be determined on a case-by-case basis." 738 F2d. at 1317, n. 10. The court commented:

> Although one normally regards contract relationships as highly individualized, contract rates can still be accommodated to the principle of nondiscrimination by requiring a carrier offering such rates to make them available to any shipper willing and able to meet the contract's terms. If those terms result in lower costs or respond to unique competitive conditions, then shippers who agree to enter into the contract are not similarly situated with other shippers who are unwilling or unable to do so. *Id.* at 1317, quoted in *Competitive Telecommunications Ass'n. v. FCC,* 998 F2d. 1058 at 1063-64 (D.C. Cir. 1993).

[7015] It is inherently difficult to define by rule what circumstances should qualify an applicant as "similarly situated." Recognizing this, courts have focused on whether a utility used consistent criteria to determine that an applicant was qualified for an agreement and to determine that other applicants were not qualified because they were not "similarly situated." *See Associated Gas*, 824 F2d. at 1010-11. Courts also hold that services do not have to be identical in order for them to be "like" services when examining them for undue discrimination. *See Ad Hoc Telecommunications Users Committee v. FCC*, 680 F2d. 790 at 795 (D.C. Cir. 1982). This logic is refined in a line of telecommunications cases. Those precedents determine whether service packages offered different applicants are "like" packages by asking whether the differences are incidental or material. They first ask whether the packages offered are functionally equivalent, primarily from the customer's viewpoint. If they find functional equivalence in this sense, they then examine whether price differences (or whether different sets of service features offered for the same price) are reasonable. *Ad Hoc Committee*, at 795,797; *Competitive Telecommunications Ass'n, v. FCC*, 998 F2d. 1058 at 1061 (D.C. Cir. 1993).

[7016] Two things, therefore, that the Postal Service should look at in evaluating any future applicants for the rate-and-service package that has been offered to Capital One are whether the service offered other applicants is functionally equivalent to the one offered to Capital One, particularly from the applicants' point of view, and whether the criteria used to evaluate capabilities of successful candidates are the same as those used to evaluate unsuccessful candidates.

[7017] As noted, the Postal Service is obligated to offer the same rate-and-service package to other applicants that are similarly situated to Capital One. The Commission is optimistic that this will provide protection from undue discrimination to those who might seek an equivalent package. In addition to legal precedents that direct the Postal Service to focus on material, rather than minor dissimilarities in terms and conditions, the Commission finds grounds for optimism in some aspects of the roadmap that was provided for those seeking an agreement like that offered to Capital One. This roadmap has been provided as proposed language for Section G of the language that is appended to the Stipulation and Agreement.

[7018] Section G101, paragraph 1.0, of the proposed DMM language, is labeled "Basic Information." It sets out the core elements of a comparable agreement. These are a promise by the applicant to forego physical return of its UAA mail and to enhance its address and mail preparation quality. The Postal Service promises to provide free electronic notification through the ACS program of the applicant's UAA mail, and declining block rates for volumes above stated thresholds.

[7019] Paragraph 2.0, labeled "Requirements," spells out specific characteristics and duties of the mailer that the Postal Service considers necessary to implement the core elements in Paragraph 1.0. The applicant would be required to be using First-Class for mail that qualifies for Standard rates. It would also be required to exceed move update standards for its automation rate First-Class Mail. Notably, Paragraph 2.0 does not require volumes of any specific level. Paragraph 2.2, labelled "Candidate Factors," proposes criteria that a candidate would have to meet in order to qualify for an agreement like Capital One's. The applicant is required to provide accurate historical volumes and projected volumes, automated mail preparation, and maintain a prepaid postage account. It is also required that the arrangement yield an overall positive financial result for the Postal Service. Paragraph 3.3 makes an internal administrative appeal available to a rejected candidate.

[7020] Although these requirements seem beyond the reach of many First-Class mailers, they appear to leave some large-volume users of First-Class Mail in the running, even though other users of First-Class mail may not have the total volume, or the proportion of First-Class volume that could be mailed by Standard Mail, that Capital One has. The proposed DMM language appears to reflect an understanding on the part of the Postal Service that neither comparable overall First-Class volumes, nor a comparable percentage of First-Class volume that could be mailed by Standard Mail, should be required for an applicant to obtain a rate-and-service package similar to the Capital One package.

[7021] This, read together with Postal Service witness Plunkett's assurances that other mailers with much smaller volumes than Capital One would have a realistic chance to qualify for an agreement like Capital One's, if they so desire, causes the Commission to find that the Postal Service intends to make the essential features of the Capital One agreement available to other similarly situated mailers. The Commission's recommendation that the Capital One NSA be approved rests, in part, on this finding.

[7022] The Commission's recommendation that the Capital One agreement be approved also rests on the knowledge that the terms of any comparable NSAs will be made public, and reviewed by this Commission. In approving the Capital One NSA, the Commission has also relied on the knowledge that the complaint procedures of chapter 36 are available to applicants for NSAs comparable to the Capital One agreement who feel that they have been unfairly rejected.

[7023] The Commission considers it important for the Postal Service to understand, however, that it remains ready to consider NSAs that are not designed to conform specifically to the Capital One mold — for example, NSAs that include free ACS notification and/or block volume discounts offered in conjunction with cost avoidance features that ensure a positive net financial impact on the Postal Service, but do not involve foregoing the physical return of UAA mail.

B. Guidence on the Potential Scope of Future NSAs

[7024] In addition to advocating adoption of the Capital One NSA, certain participants have encouraged the Commission to provide guidance regarding the conditions under which NSAs will be considered in the future. In a footnote to its Request, the Postal Service states:

> The Postal Service anticipates that in the future it may be worthwhile for the Commission to consider creating specialized procedures, and perhaps a classification framework, for consideration of proposals based on NSAs. Such procedures might involve more expeditious review than currently contemplated under the experimental rules, standardization of evidence and of analytical approach in evaluating proposals, and mechanisms that will effectively protect sensitive proprietary information, while maintaining the integrity of the review process.

Request at 5, n. 5. The Office of the Consumer Advocate has submitted extensive comments[75] suggesting guiding principles for prospective application to subsequent NSA proposals. Additionally, intervenor Pitney Bowes argues on brief that the Commission should not adopt unduly burdensome volume or cost projection requirements in connection with approval of NSAs.[76]

[7025] These proceedings to consider the first proposed negotiated service agreement have impressed upon the Commission the potential range and diversity of single-customer contracts with the Postal Service. In our opinion, it would be premature at this early stage to adopt substantive prescriptions or proscriptions for NSAs generically, except to emphasize that they must honor the Reorganization Act's policies and criteria. In dealing with proposed NSAs in subsequent proceedings, the Commission anticipates it will proceed on a case-by-case basis for the immediate future.

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[75] Office of the Consumer Advocate Comments Concerning Procedures for Future NSAs, April 3, 2003.

[76] Pitney Bowes Brief at 5-7.

[7026] Nevertheless, assuming the Postal Service finds it worthwhile to propose additional NSAs, the Commission will move to regularize procedural aspects of considering NSAs in one or more rulemaking proceedings. One initiative will explore adoption of a specialized set of procedural rules for proceedings in which the Postal Service (and the contracting mail user) propose changes to implement an NSA. A related initiative will concern appropriate standards for the information to be filed in support of NSAs, including such matters as appropriate test periods and user-specific volume and cost information. Finally, the Commission will also consider rules providing for the extension of expiring NSAs for additional periods.

VIII. STANDARDS FOR EVALUATION OF NEGOTIATED SERVICE AGREEMENTS

A. Review of the Current Request

[8001] This is the first case in which the Postal Service has sought authority to enter into a rate agreement with a single customer. The Commission has given considerable thought to how it should exercise its statutory functions in this case. Neither the Postal Service nor Capital One contends that the Commission must either approve the Request in its entirety or reject it completely. Postal Service Reply Brief at 6-7, Capital One Reply Brief at 2. Obviously, both parties to the agreement would prefer that the Commission recommend the NSA as detailed in the Stipulation and Agreement they support, but both are prepared to consider whether their agreement remains viable in light of whatever the Commission recommends and the Governors approve. *See* Stipulation and Agreement Section II, para. 7.

[8002] Analysis of the record in this case reveals a mixture of policy and factual issues that make this docket unlike any other previously before this Commission. The Postal Service has acknowledged from the outset that its Request was put forward for policy reasons as much as to achieve specific financial or operational objectives. This forthright attitude has allowed the Commission and the participants to focus on the important, long-term rate policy implications of this Request together with the more limited implications of a three-year arrangement with a single customer.

[8003] Several participants express concern that the integral role this Commission plays in the statutory ratemaking scheme may be compromised by the unique nature of NSA requests where the Postal Service and one of its customers agree on the proposed rates and conditions of service. That concern seems unwarranted. The Commission has long encouraged participants to attempt to negotiate settlements of contested issues. This case can be seen as an instance where two key parties have already “settled” on terms they believe the Commission should accept.

[8004] The Commission has a fairly active adjudicatory role in normal omnibus rate cases when the Postal Service seeks additional revenues and mailers often object. In normal omnibus rate cases the Commission's role, beyond being the trier of fact, is to balance among mailer categories the allocation of the burden of providing the Postal Service with needed additional revenues. Even when the Service suggests a new worksharing discount or classification, there are frequently mailers contending that the discount should be greater, or the terms of service more lenient. In such cases, the Commission again must balance conflicting contentions.

[8005] The Commission has determined that it should approach its duties in this case a little differently than it would in an omnibus rate case. The comments in the APWU Reply Brief at 5, are particularly helpful in this regard. In most cases, the Commission must exercise its discretion on behalf of users and potential users of postal services. In this case, all potential users are represented, and support the proposal on its terms.

[8006] Therefore, the Commission is not so concerned with determining the most appropriate divisions of costs, revenues or contributions. The two participants in the NSA have already done that to their satisfaction. Furthermore, it can be assumed that both Capital One and the Postal Service consider the agreement beneficial to themselves as institutions. Instead, the Commission's focus in this case is on assuring that the NSA will not make mailers other than Capital One worse off.

[8007] This focus is consistent with the Efficient Component Pricing standards that the Commission applies in setting rate discount levels. There too, the goal is to assure that third parties are not made worse off by rates that benefit the Postal Service and a category of mailers. *See also,* discussion of Pareto Improvement, Tr. 8/1580-81, 1727-37, 1763-64 (Panzar).

[8008] The Commission expects its role in reviewing requests for NSAs will evolve over time, but it is clear that when cases raise new and important issues, as in this case, the Commission has a significant role notwithstanding the fact that the request initiating the docket is for an NSA. As discussed in Chapter III, participants in this case have presented a variety of arguments challenging the legality of the Postal Service entering into negotiated service agreements. These issues were fully briefed, and the Commission has concluded that such arrangements are not prohibited so long as their terms are not inconsistent with the policies enumerated in Title 39.

[8009] The Commission still has an absolute obligation to assure that any rates and classifications it recommends are consistent with the policies of the Act. It fulfills that obligation in this Opinion and Recommended Decision. The Postal Reorganization Act of 1970, as amended, specifically enumerates nine ratemaking criteria and six classification criteria for Commission evaluation. These will be addressed separately later in this section. The Act also establishes a number of broad policy aims that are particularly applicable in this case.

[8010] The Commission has long recognized that there can be more than one set of rates that satisfies the policies of the Act. PRC Op. R87-1 para. 4001. This fact seems particularly salient in the context of a recommended decision on a proposed negotiated service agreement. The Commission has carefully reviewed the various aspects of the proposed NSA to assure that individually, and in totality, they do not conflict with operative laws. However, in its recommendation, the Commission has chosen to defer to the signatories of the Stipulation and Agreement as to some of the constituent parts of the NSA. For example, OCA witness Callow suggests an ingenious rate design for maximizing the appeal of declining block volume discount rates while limiting potential leakage. Tr. 7/1373-7. The fact that the Commission recommends the volume discount rate design contained in the Stipulation and Agreement should not be taken as an indication of preference for that particular design. Rather, it reflects a determination that the design preferred by the signatories is not inconsistent with any applicable legal policy constraint.

[8011] Despite the exercise of restraint, the Commission has determined that in order for this NSA to comply with the statutory standards applicable to postal rates, one additional provision must be grafted on to the NSA proposed by the Postal Service and Capital One. This addition has been drawn as narrowly as possible, to preserve the maximum possible deference to the terms of the proposal. The addition is a stop-loss provision — a cap on the dollar amount of discounts that Capital One may receive over the life of the agreement.

[8012] This additional provision 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).

[8013] The Commission finds that the estimates of "before rates" volumes for Capital One are so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA. If that were the result, other mailers would be harmed by the unreasonable preference being given to Capital One. Additionally, such a result would conflict with the Commission's long-term practice of assuring that classification changes recommended in the interim between omnibus rate cases are, at worst, revenue neutral. *See* § 3621 (the break even requirement).

[8014] The facts supporting this conclusion are as follows. Capital One has a history of rapidly increasing First Class Mail volume. Tr. 2/202-3 It does not project its volumes more than six months in advance. Tr. 2/41. In the last complete year, it sent record levels of First Class Mail. Tr. 2/207. It indicates this high volume was the result of anomalous circumstances, Tr. 2/203-4, but it can not rule out the reoccurrence of a set of events that might prompt a similar mailing pattern.

[8015] Simple projections of historical volumes excluding the most recent year's experience indicate a substantial volume of mail above the discount threshold even if no discount becomes available. Projections of historical volumes including the most recent year's experience indicate a volume of mail above the discount threshold even if no discount becomes available. Capital One's estimate of its First-Class volume in the current year has fluctuated markedly while this case has been in progress. Capital One witness Jean originally projected an FY 2003 First-Class Mail volume of 1.4 billion pieces. Tr. 2/40. Capital One witness Elliott subsequently revised this estimate downward to 1.2 billion pieces. Tr. 9/1843. Absolutely no evidence suggests that the volume projected for the current year will be representative of experience in each of the following three years when the NSA would be in effect.

[8016] The decisional issue before the Commission is whether it can reasonably conclude that volume discounts paid to “free riders” (mail that would have been sent even absent the NSA) over the course of the NSA will not exceed the savings generated by the electronic address correction features of the agreement. Under the circumstances set out above, the Commission can not reasonably make that conclusion unless a stop-loss provision is added. To the contrary, the Commission finds that absent such a provision there is a serious risk that discounts given to “free riders” will exceed savings to the Postal Service, and that other mailers will be worse off because of the NSA.

[8017] Signatories to the Stipulation and Agreement support a slightly modified version of the original proposal in this case that assumes volumes estimated for the test year will be representative of the three year experience of the NSA. The Commission can not accept that unsupported assumption. Nothing in the record indicates that Capital One volumes will not resume their previous pattern of growth during the next three years. If absent the NSA volumes would grow during the next three years, there is a significant risk that discounts to “free riders” will be greater than savings from other aspects of the NSA.[77]

[8018] The Commission uses estimates for a test year to project volumes, revenues and expenses in most rate and classification cases. However, that fact alone is not dispositive. Experience has shown that such projections from systemwide

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[77] Witness Callow computed a $28.5 million annual discount for Capital One if its volume was 1.8 billion. Tr. 7/1376. Witness Smith notes that a straight line projection would put Capital One test year volumes at 2.2 billion. Tr. 7/1247.

experience are reliable — for most subclasses and the postal system as a whole. Here, the projection of volumes is based on limited, volatile recent experience of one mailer. A history of stable trends does not exist. Furthermore, rates and classifications generally are subject to change if the Postal Service finds that its projections were inaccurate and it is losing money as a result. The current Request relates to a contract that, once ratified, will be legally binding on the Postal Service for three years.[78]

[8019] The central point, however, is that test year estimates are only usable if they are found to be reliable indicators. If a test year estimate, even one developed using a standard methodology, is not representative, then it should not be relied on. In this case the Commission can reasonably conclude that the test year relative processing costs for physically and electronically returned mail are representative of the costs that will be incurred in those operations during the three years of the NSA.[79] In contrast, there is no basis for concluding that total Capital One First-Class Mail volume in the test year is representative of volumes for the following three years.

[8020] 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.[80] It will allow the Postal Service and the Commission to explore the feasibility of NSAs, and it will enable the Postal Service and Capital One to initiate an electronic returns program that should be beneficial to both principals and third parties.

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[78] 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. Request, Attachment G, section IV, para. G.

[79] As discussed in Chapter VI, Section D, the gradual adoption of PARS should have some impact, but it is expected to be minor.

[80] The Commission recognizes that each of its findings of estimated costs and revenues are subject to error, and that combinations of errors might cause its other projections to be inaccurate. However, only in the area of projections of before rate Capital One volumes is the record so inadequate that any finding would be arbitrary or capricious.

[8021] The stop-loss provision theoretically limits the benefits Capital One may enjoy as a result of this NSA. However, Capital One's best estimate of its volumes during the test year, and presumptively continuing through the three-year NSA, would result in no discounts being earned from the declining block rates agreed to.[81] The recommended stop-loss still allows Capital One to receive $40.6 million if its previous volume trends resume.

[8022] The stop-loss provision will allow Capital One to receive $40.6 million in discounts over the life of the NSA while assuring that other mailers are not harmed. Because the before rates volume estimates are so speculative, it may not be possible to reliably measure the impact of the availability of the block discounts on Capital One's mailing practices. Certainly one will not be able to simply conclude that annual volumes in excess of 1.2 billion, or 1.4 billion, or any other number are solely the result of the availability of the new discounts. *See* Tr. 4/767-8. The Postal Service has undertaken to analyze the effects of the NSA on its volumes, and will consult with Capital One to develop information that may be usable in future cases. Proceeding with the NSA, even with a stop-loss provision, will enable the Service to expand its knowledge of the impact of price changes on individual mailers.

[8023] In future NSAs similar problems should be far less likely to occur. The experience of litigating this case, together with the discussions in this opinion, will inform subsequent Postal Service proposals. Additionally, the Commission will initiate rulemaking dockets to develop procedures specifically suited to the review of proposed NSAs. One of the issues to be faced will be the need for projections that are representative of the expected life of proposals. Many if not all private sector businesses try to assure themselves that they will not lose substantial amounts of money over the course of a contract they are negotiating. The Postal Service should be able to develop NSAs that meet that minimal test.

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[81] Neither the Postal Service nor Capital One project that the new reduced rates will generate more new volumes than the historical systemwide price elasticity for similar mail. However, if Capital One volumes during the NSA again exhibit their previous growth pattern, the stop-loss provision may moderate the generation of new Capital One volume and thereby reduce new contributions to the Postal Service.

B. The Stop-Loss Provision

[8024] The actual limitation recommended by the Commission is intended to be as simple to apply as possible. It is a single clause providing that over the life of the NSA, discounts allowed as a result of Capital One volumes may not exceed a specific dollar amount.

[8025] The NSA is a single contract applicable to three years of mailings. During that three-year period the Postal Service expects substantial savings to be generated by the electronic returns provisions of the agreement. In return, it has agreed to provide Capital One with declining block volume discounts. Third party mailers will be unharmed by the NSA so long as the dollar amount of the volume discounts the Postal Service makes available to Capital One is not greater that the costs it avoids as a result of the return mail feature of the agreement.

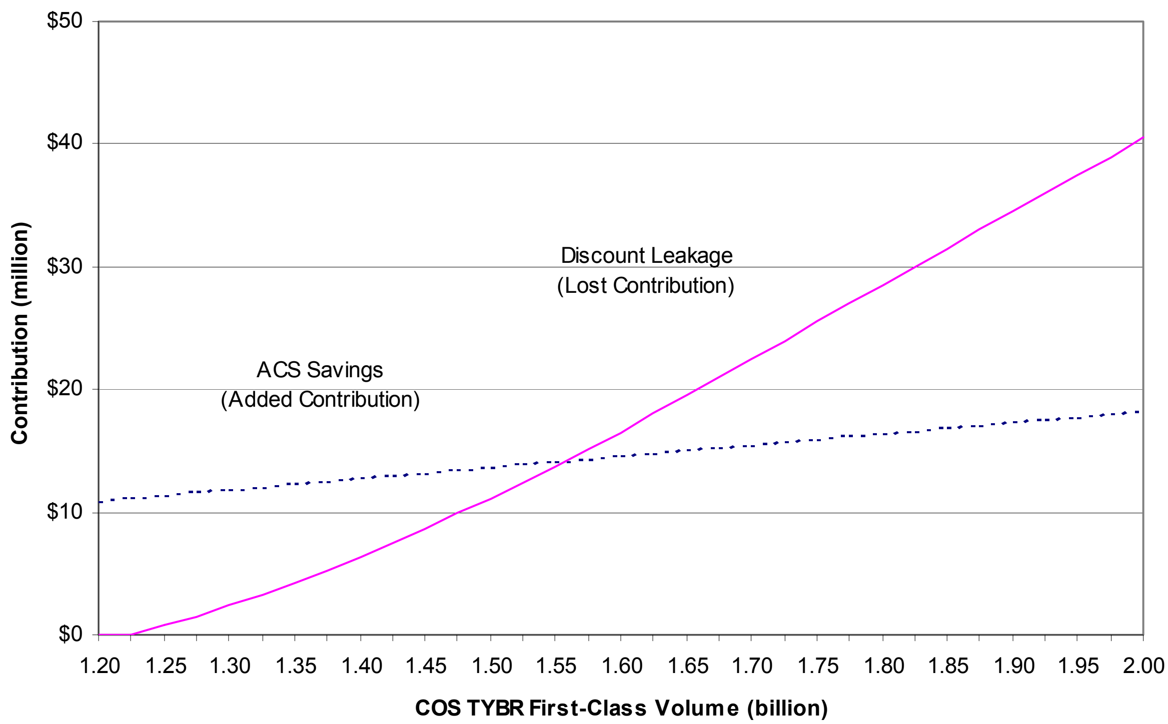
[8026] Costs will be avoided by substituting electronic address correction for actual return of First-Class solicitation mail sent by Capital One. The same questionable volume projection used to estimate total Capital One First-Class Mail volumes for the life of the NSA forms the basis for the Postal Service’s savings projections. However, in this context the unreliability of the volume projection poses no problem.

[8027] If Capital One’s forecast of its First-Class solicitation mail volumes is too high, the amount of savings from the return mail feature will be reduced, but volumes will be insufficient to receive the volume discounts provided for in the NSA. If Capital One’s volume forecast is too low, there will be more avoided returns, and consequently greater savings than those estimated by witness Crum. The Commission took this possibility into account in developing the stop-loss provision.

[8028] Developing a stop-loss provision that achieves the desired goal (restricting the total dollar amount of discounts awarded to Capital One to no more than the total dollar amount of savings realized by the Postal Service) requires an analysis of the implicit relationship between before rates volumes of First-Class Mail, savings from the ACS provisions, and discount leakage from the declining rates. As Capital One's

First-Class before rates volume increases, the savings from the ACS provisions increases, but not as quickly as the discount leakage increases. This cost/benefit relationship is demonstrated in Figure 8-1, which plots the savings from the ACS arrangement[82] and the discount leakage over a range of possible volumes of Capital One TYBR First-Class Mail.

Figure 8-1.
Effect of TYBR Volume on USPS Contribution



82 Calculated using the method presented by Postal Service witness Crum, as adjusted by the Commission. Chapter VI of the Opinion discusses the Commission's evaluation of Crum's method, and the adjustment.

[8029] The point at which these two lines intersect is the point where the benefits of the agreement (to the Postal Service) are equal to the costs (to the Postal Service), and net contribution as a result of the NSA is zero.[83] Any discounts above this amount would exceed the value of the additional savings. The lines cross at a TYBR volume of 1.559 billion, but more importantly, the value at this point is $14.3 million. Table 8-1 shows the development of the discount leakage at the applicable TYBR volume, and Table 8-2 traces the calculation of the value of ACS related savings at that volume.

Table 8-1
Discount Leakage

First-Class Volume Block			Incremental Volume	Discounts (Cents)	Discount Leakage
1,225,000	to	1,275,000	50,000	3.0	1,500
1,275,000	to	1,325,000	50,000	3.5	1,750
1,325,000	to	1,375,000	50,000	4.0	2,000
1,375,000	to	1,450,000	75,000	4.5	3,375
1,450,000	to	1,525,000	75,000	5.0	3,750
1,525,000	to	**1,559,248**	34,248	5.5	1,884
Total					**$14,259**

[83] This excludes any potential increased contribution as a result of Capital One responding to the declining block rate structure by increasing its volume of First-Class Mail. The Commission is excluding this potential contribution because the record does not provide an adequate basis for evaluating the response of Capital One (and its competitors) to the declining block rates. *See* Chapter V, Section M, for the analysis leading to this conclusion.

Table 8-2

ACS Related Savings

(1)	**FC Physical Return Unit Cost**	$	0.5347
(2)	**"Electronic Return" Unit Cost**	$	0.3321
(3) = (1)-(2)	**Difference**	$	0.2026
(4)	**Solicitation Percentage of Revised Captial One TYBR First-Class Volume**		55.3%
(5)	**Capital One TYBR First-Class Volume** (thousand)		**1,559,248**
(6) = (4)*(5)	**Capital One TYBR First-Class Solicitation Volume** (thousand)		862,612
(7)	**Capital One First-Class Solicitation Return Rate**		9.6%
(8) = (6)*(7)	**Capital One TYBR First-Class Solicitation Return Volume** (thousand)		82,811
(9)	**ACS Success Rate**		85%
(10) = (8)*(9)	**Volume of Capital One Physical Returns converting to ACS** (thousand)		70,389
(11) = (3)*(10)	**Total Test Year Savings** (thousand)	**$**	**14,259**

Sources: (1) & (2) - USPS-LR-1
(4) - COS-LR-4, Exhibit 3
(7) & (9) - USPS-T-3, Attachment A, page 2

[8030] When designing a discounted rate for the first time, the Commission normally has recommended that the discount be set at some level less than the full estimate of avoided cost. After the rate has been in place for some time, and better estimates of avoided cost become avaiable, a higher passthrough is then applied. *See,* e.g., PRC Op. R90-1, para. 5946 and PRC Op. R97-1, para. 5131. One of the justifications for this practice is the uncertainty inherent in estimating the costs associated with a service that does not yet exist. To make such an estimate, proxies must often be used and assumptions made about the mail that will qualify for the new rate.

[8031] In this case, the estimate of savings from substituting electronic notices for the physical return of Capital One's First-Class solicitations relies on several assumptions. As described in Chapter VI of this Opinion, these include the use of average costs as proxies for unknown mailer-specific costs and assumptions about the potential effects of changes in UAA processing as a result of PARS implementation. Therefore, the resulting estimate is less certain than those used to set established discounts and rates (but not necessarily less certain than estimates typical of newly proposed rates). Consistent with past practice, the Commission is passing through less than the full estimate of savings in designing the stop-loss provision. The Commission sets the stop-loss amount at 95 percent of the estimated cost avoidance over the three years of the contract. Since the estimate of savings is $14.259 million in the test year, over the term of the agreement $42.776 million in costs should be avoided. Applying the 95 percent passthrough results in a three-year stop-loss amount of $40.637 million.

C. Application of Statutory Public Policies

[8032] In every rate and classification decision the Commission is required to evaluate how the criteria of section 3622 and 3623 apply to the pending proposal. The Commission has reviewed each of the applicable factors and determined that on balance, its recommended decision is consistent with those policies.

[8033] The primary focus in this proceeding has been on the requirement that a fair and equitable system of rates and classifications be maintained. §§ 3622(b)(1), 3623(c)(1). Several participants have challenged the concept of negotiated service agreements as resulting in discriminatory distinctions between mail users. The Commission has evaluated whether the unique preferences inherent in the proposed NSA with Capital One result in undue or unwarranted distinctions. It concludes that the distinctions can be justified.

[8034] The theoretical basis for establishing a classification with associated rates available only to one mailer is set out in detail in Chapter V. In Chapter VI, the factual record developing the expected cost savings from substituting electronic address corrections for returning Capital One's UAA First-Class solicitation mail is reviewed, and found largely persuasive as support for the proposed rates. Cost avoidance estimates have been derived using systemwide cost figures. The Commission recognizes that customer specific costs, if available, would have provided more robust estimates of test year results; however, the Commission finds the available analysis sufficiently reliable to justify the rates it recommends.

[8035] A more difficult problem stems from the absence of reliable forecasts of Capital One volumes. Neither the Postal Service nor Capital One has been able to provide a projection of volumes that can be used to estimate impacts over the life of the proposed NSA. The flaws in the record evidence relating to volume estimates is set forth at Chapter V, Section M.

[8036] The absence of reliable volumes raises the possibility that the Postal Service, and indirectly all mail users other than Capital One, could sustain significant financial harm as a result of the NSA. An NSA that could reasonably be expected to cause significant financial harm to many mailers while providing significant gains to one mailer could violate the requirement that rates and classifications be fair and equitable. To prevent that eventuality, the Commission has recommended a simple stop-loss provision.

[8037] The stop-loss provision limits the financial exposure of the Postal Service to $40.6 million over the life of the NSA, a figure that reflects the expected benefits arising from the electronic address correction service provisions of the agreement. This provision will assure that nonparticipating mailers are not made worse off by the NSA.

[8038] The statute directs the Commission to consider both the policies of the Act, and factors not specified in Title 39. *See* §§ 3622(b)(9), 3623(c)(6). The Postal Service presents as justification for this NSA, the opportunity to explore the feasibility of specialized, mailer-specific agreements designed to allow the Service to take advantage of unique cost saving or service enhancing opportunities.

[8039] The feasibility of negotiated service agreements has been debated within the postal community for more than a decade. The Postal Service offers this NSA as a test of its ability to administer and extend mutually beneficial agreements to its customers. This docket also serves as a test of the Commission's ability to respond to innovative rate initiatives.

[8040] The Commission finds that it is consistent with the policies of the Act for the Postal Service and the Commission to explore new methods of improving postal service efficiency through new economically beneficial rate programs. *See* § 403(a). During the course of this proceeding both the Commission and the Postal Service have gained knowledge about how NSAs may impact the postal system and its users. Continuing this process should lead to a healthier, more flexible system of economically efficient rates.

[8041] These benefits are also relevant to the charge that the desirability of special classifications from the point of view of both the user and the Postal Service should be considered by the Commission. USPS-T-2 at 8-10 (Plunkett, citing § 3623(c)(5)). This NSA can be assumed to be beneficial to Capital One. With the addition of a stop loss provision, the NSA will also be beneficial to the Postal Service. Furthermore, as agreements of this type are shown to be feasible, it can reasonably be expected that other agreements will be developed to the benefit of both mail users and the Postal Service, consistent with § 3623(c)(2).

[8042] The final relevant classification factor is § 3623(c)(3), which focuses on the importance of providing classifications with a high degree of reliability. This NSA is designed, among other things, to improve Capital One's address lists and allow it to reduce undeliverable mail. This attribute also is consistent with rate factor § 3622(b)(6), which focuses on the preparation of mail by the mailer to eliminate costs to the Postal Service. The NSA should reduce undeliverable mail thereby reducing Postal Service costs.

[8043] The requirement that the costs of each class of mail and type of service recover an appropriate share of total Postal Service costs, § 3622(b)(3), is easily met by this recommendation. The stop-loss provision added by the Commission assures 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. Another frequently controversial consideration, the effect on competition, is also a minor concern. See § 3622(b)(4) and (b). No participant, including the OCA which represents the general public, has argued that this NSA will cause competitive harm.[84] Witness David suggests that future NSAs might have negative competitive impact, Tr. 6/981-84, and the Commission recognizes that such claims will remain germane in future cases.

[8044] NAA argues that this NSA, and the potential proliferation of like agreements, is directly contrary to the statutory goals of a simple and understandable rate structure, and simple and identifiable relationships between available rates. NAA Brief at 5, 14-15. Clearly an extensive system of rate categories open only to single

[84] The participant most likely to represent entities that compete with Capital One, the American Bankers Association, supports approval of the NSA.

mailers would not be consistent with the simplicity goals set out in § 3622(b)(7). However this fact alone does not prevent the Commission from recommending this NSA.

[8045] The Commission must balance the multiple, occasionally conflicting rate factors and determine whether, on balance, each individual Postal Service request is, or is not, consistent with the policies of the Act. Here, the Commission must balance the potential harm of the reduced clarity that would result from numerous special rate categories against the potential efficiency benefits that might result from NSAs able to capture unique cost saving opportunities available by altering the mailing practices of individual mailers.

[8046] On the record of this case the potential efficiency benefits, estimated at tens of millions of dollars, outweigh the limited additional complexity of a single, limited term NSA. However, NAA is correct to raise this issue now, while the Commission considers this initial Postal Service Request to establish an NSA. The Postal Service seems intent on exploring the feasibility of NSAs, and is looking at this case as a forum for examining the legal and administrative ramifications of such a program. The Commission must consider whether its recommendation of a single NSA is akin to allowing the proverbial camel's nose into the DMCS tent.

[8047] The Postal Service has made it quite clear that it has limited manpower and resources available to pursue additional mailer-specific agreements. Tr. 3/514-15; and Tr. 9/1888, 1941, 1945. Furthermore, it has been explicit in denominating its proposal as an experiment. The Commission finds that § 3622(b)(7) considerations are outweighed by the other, previously enunciated statutory policies that support recommending this otherwise meritorious proposal. At the same time, the Postal Service is put on notice that the benefits of maintaining simple and identifiable rate relationships must be borne in mind in the future if it begins to structure the scope of any program to widely extend NSAs.

IX. MISCELLANEOUS

A. Domestic Mail Classification Schedule

[9001] The Postal Service proposes to add a new Domestic Mail Classification Schedule (DMCS) section 610, to specify the general parameters of the Capital One NSA. *See* Request at Attachment B. The Commission recommends the addition of section 610 to the DMCS, but makes several modifications to the language as proposed by the Postal Service to reflect other decisions and recommendations appearing in this Opinion.

[9002] The Commission has incorporated salient features of the Stipulation and Agreement into its recommendations. The Stipulation and Agreement proposes additional DMCS language, as a footnote, to express the intent of the Postal Service to allow other qualifying customers access to comparable NSAs. *See* Stipulation and Agreement at Attachment A. Thirteen participants signed the Stipulation and Agreement, with one participant objecting to using the document as the basis for this Opinion. The Commission considers the availability of comparable NSAs to similarly situated customers as a general requirement to the acceptability of NSAs. The proposed language reflects this policy. The Commission recommends the addition of the proposed language to the DMCS as section 610.12, with the appropriate renumbering of the preceding paragraphs.[85]

[9003] The Commission has recommended that a limit be placed on the cumulative discount available to Capital One. *See* Chapter 8, Section B. The addition of section 610.35 to the proposed DMCS language incorporates this recommendation. Section 610.35 titled "Discount Limit" states: "The maximum cumulative discount available to Capital One over the duration of this NSA shall not exceed $40.637 million."

[85] Generally, footnotes do not fit into the format of the existing DMCS. Therefore, the proposed language is added as a separate section.

[9004] Section 610.5, as proposed, specifies the expiration date of this NSA as three years from the implementation date set by the Board of Governors. The Commission recommends modifying the proposed language to allow the Board of Governors to insert the actual expiration date into the DMCS language as part of their decision. This will add clarity to the DMCS and allow a customer to consult only one document to determine the expiration date of the NSA.

[9005] The Commission recommends several non-substantive changes to the proposed language such as capitalization, a correction to a referenced paragraph number, and minor stylistic changes. There also is one instance of essentially redundant language that appears in the Postal Service's proposed language at sections 610.1 and 610.6. The Commission has removed the redundant language from section 610.1. The DMCS language recommended by the Commission is included as part of this Opinion at Appendix Two.

[9006] The Postal Service proposes the addition of four new rate schedules to the DMCS: 610A, 610B, 610C, and 610D. *See* Request at Attachment B. The Commission recommends the addition of the rate schedules as proposed by the Postal Service. The rate schedules recommended by the Commission are included as part of this Opinion at Appendix One.

B. Data Collection Plans

[9007] The Capital One Negotiated Service Agreement is expected to be in effect for a period of three years. During the term of the NSA the Postal Service plans to collect certain information concerning the mailing patterns of Capital One. Information collected during this time should prove valuable in determining whether the NSA was a success, and ought to be continued. Such information could point the way to other creative opportunities for the Postal Service to raise new contribution and lower the costs of providing its services.

[9008] The Postal Service and the OCA formulated specific data collection plans. The plans include information on volumes, discounts, and mailing practices of Capital One. Other parties make specific suggestions concerning data to evaluate the Capital One NSA.

[9009] Postal Service Witness Plunkett: Postal Service witness Plunkett initially proposes a data collection plan that includes reporting annually the volume by rate category of First-Class Mail solicitations and the volume by rate category of First-Class customer mail for Capital One Services. The “amount of discounts applied by rate category” would also be reported. In addition, witness Plunkett proposed to report the number of electronic address correction notices sent for First-Class Mail solicitations and the number of solicitation pieces returned manually. USPS-T-2 at 12. While the Postal Service does not currently collect this information specifically for Capital One, witness Plunkett testifies that this is “the type of data the Postal Service may find useful in developing new policies.” Tr. 4/736. These data would be reported following the end of each fiscal year's reconciliation with the first report being made after the end of fiscal year 2003.

[9010] Witness Plunkett testifies that the Postal Service would use several of its existing data systems to obtain the information outlined in his direct testimony.

> Volume and revenue information (including the amount of discounts earned) will be captured by the Postal Service's permit system according to the terms stipulated in its agreement with Capital One. The Postal Service's address management systems identify individual permit holders using a unique identifier, which will enable automated measurement of Capital One's address correction activity, since the agreement requires Capital One to inform the Postal Service of the permit numbers it will be using for purposes of the agreement. Physical returns are sent to post office box addresses in Richmond, Virginia, thus facilitating estimation of total physical returns.

Tr. 4/699.

[9011] Witness Plunkett also testifies that the Postal Service currently is unable to associate returned mail with Capital One's solicitation mailings or that of other individual customers.

> The Postal Service currently has no way of measuring physically returned mail by originating customer. Under the terms of the proposed agreement, Capital One will be receiving information about its undeliverable-as-addressed mail electronically, at which time the volume of UAA mail that would have been returned can be collected.

Id. at 686.

[9012] Capital One, however, already keeps records on the number of returned pieces and "incorporates return information into its mail preparation operations." USPS-T-2 at 7. Witness Plunkett further states that Capital One "has a process in place for capturing information from returned pieces that is used to improve addressing practices." Tr. 4/696.

[9013] The agreement between Capital One and the Postal Service anticipates some necessary data being provided by Capital One. It requires that each party bear its costs of necessary data collection. Request, Attachment G at 8. As a result, there appear to be two ways in which return mail data can be obtained. As witness Plunkett testifies, the electronic address change information will be available to both the Postal Service and to Capital One. Capital One will continue to document its return volume using the electronic notifications received from the Postal Service and adjusting its mailing lists accordingly. A relatively small number of Capital One's solicitation pieces still will be physically returned. These are pieces that will not be processed in Computerized Forwarding System (CFS) or Postal Automation Redirection System (PARS) operations.[86] Tr. 5/887. Witness Plunkett's data collection plan includes these pieces because Capital One will be able to report this information to the Postal Service.

[9014]   Witness Plunkett was asked to describe what measures, if any, the Postal Service has in place, or intends to implement, that would enable it to know whether Capital One is, during the NSA, shifting Standard to First-Class Mail rather than originating new First-Class Mail. Volume shifting from Standard Mail to First-Class Mail represents a smaller increase in contribution than that provided by new First-Class Mail. Witness Plunkett's response was as follows:

> The Postal Service will not be instituting any specific measures to capture this information. During the course of the Agreement, the Postal Service will of course monitor Capital One's volume, but as witness Jean (COS-T1, p. 3) points out, the Agreement is not expected to result in switching of mail from Standard to First-Class Mail.

Tr. 4/704.

[9015]   Capital One may move mail between these two classes as a necessary part of its overall marketing strategy during the term of the agreement. Over time it may be possible to discern trends in Capital One's use of these two mailstreams. That knowledge could prove beneficial both to the Postal Service and to Capital One.

[9016]   Postal Service Witness Eakin: 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

[86] PARS will not be fully implemented until FY 2005. *See* Chapter VI, Section D. 2.

important element of monitoring the NSA. Tr. 10/2094. Witness Eakin testifies that to the extent possible, it would be desirable to monitor trends in solicitation mail volumes by the credit card industry as a whole. Eakin posits that other credit card issuers may increase solicitation efforts as a result of the implementation of the Capital One NSA. *Id.* at 2072. Although a precise measurement of competitive response to Capital One's increases in solicitation mailings will not be possible, a fuller understanding of the overall solicitation mailing practices of credit card providers could yield knowledge helpful in assessing subsequent NSA proposals.

[9017] In addition to First-Class Mail and Standard Mail volume information, witness Eakin recommends measuring changes in Capital One's percentage of undeliverable First-Class Mail after the NSA is implemented. Witness Plunkett's initial data collection plan would allow derivation of this information as it includes the number of electronic address correction notices sent for First-Class Mail solicitations and the number of solicitation pieces returned manually. USPS-T-2 at 12.

[9018] Presiding Officer Witness Panzar: 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. Tr. 8/1781-2.

[9019] Vak-Pak criticizes the Postal Service for not providing mailer-specific cost data in its initial filing, particularly "data that are specific to the physical handling of Cap One's Non-forwardable UAA Mail." Valpak Brief at 22 (footnote omitted). The Alliance of Nonprofit Mailers states that it is appropriate to use a combination of customer-specific and non-customer-specific information to evaluate NSAs. ANM Brief at 13.

[9020] Stipulation and Agreement: The Stipulation and Agreement filed by the Postal Service, OCA, and Capital One, and joined by ten other parties, includes as Attachment C a document entitled "Capital One NSA Data Collection Plan". This plan lists data the Postal Service agrees to provide at the end of each fiscal year.

1. Volume of First-Class Mail solicitations by rate category in eligible Capital One permit accounts.

2. Volume of First-Class Mail customer mail by rate category in eligible Capital One permit accounts.

3. Amount of discounts paid to Capital One for First-Class Mail by incremental volume block.

4. Volume of First-Class Mail solicitations bearing the ACS endorsement that are physically returned to Capital One.

5. Number of electronic address correction notices provided to Capital One for forwarded solicitation mailpieces, including the number of notices processed by CFS units and separately for PARS (when fully operational).

6. Number of electronic address correction notices provided to Capital One for solicitation mailpieces that would otherwise be physically returned, including the number of notices processed by CFS units and separately for PARS (when fully operational).

7. Monthly estimate of the amount of time spent on compliance activity and a description of the activities performed.

8. For each First Class solicitation mailing list run against NCOA, Capital One will provide NCOA contractor reports that separately identify the number of address records checked and the number of corrections made.

9. For each Change of Address record that is used to forward a piece of Capital One solicitation mail through ACS under the Agreement, the Postal Service will provide the date the record was created, its move effective date, whether it was for a family or individual move, and each date that the record was used to forward a mail piece. No other information from the record would be provided.

10. As part of each data collection plan report, the Postal Service will provide an evaluation of the impact on contribution. It will also provide an assessment of trends of Capital One's First-Class Mail volume as compared to overall First-Class Mail volume.

[9021] In addition to the above list, witness Plunkett testifies that the Postal Service "will be closely monitoring potential factors such as the overall rates of adoption of electronic bill presentation and payment." Tr. 4/768. Witness Plunkett goes on to suggest that "Cap One will also be available to provide its own insights into how developments exogenous to the NSA might have affected its observed levels of mailing." *Ibid.*

[9022] The Capital One NSA Data Collection Plan also provides for a monthly estimate of time spent on compliance activities and a description of those activities (Item 7). The Postal Service will need to ensure that timely corrections of address are incorporated into Capital One's solicitation mailing lists. The number of times a change of address record is accessed and the time frame during which address corrections are generated should assist the Postal Service in determining whether Capital One's records are being updated in a timely fashion.

[9023] An important feature of the Stipulation and Agreement is the separate identification of electronic address corrections from CFS units and PARS units (when fully operational). PARS will be implemented during the three-year period of the NSA.[87] PARS is described as a system which uses new and enhanced optical character readers (OCRs) to identify and intercept undeliverable as addressed (UAA) letters earlier in the mail sorting process, automatically label such letters, and redirect them to the correct address. PARS is expected to reduce the total processing time (and cost) for UAA letters, as compared to the current method of processing. OCA Brief at 19, note 13.

[9024] The Stipulation and Agreement list of data does not include information on the volume of Standard Mail sent by Capital One. This information would be extremely helpful in evaluating the experiment. Capital One argues that converting to Standard Mail is the only practical way to eliminate the physical return of ten percent of its First-Class Mail solicitations. Capital One Brief at 26. Information on Capital One's

[87] The Postal Service might also monitor mall advertising trends as a whole for purposes of comparison with credit card industry trends. Current regulatory and legislative efforts regarding telemarketing and spam may have a positive impact on direct mail in general.

pattern of use of Standard Mail during the course of the experiment should be a useful input to the Postal Service's assessment of Capital One's particular mailing practices. During the course of the experiment mailing patterns may emerge to shed light on the extent to which Capital One and perhaps other mailers substitute First-Class Mail for Standard Mail. Variations in the uses of these two mail classes by Capital One should provide information useful in formulating future NSAs. These data should be incorporated into the Postal Service's “evaluation of the impact on contribution.” Postal Service Brief at 46.

[9025] Witness Plunkett testifies that the Postal Service will use other data not enumerated in the Data Collection Plan to assess the success of the NSA.

> Data regarding potential factors such as movements in interest rates, GDP, unemployment rates, bankruptcy rates, and other macroeconomic variables which might help explain deviations from the baseline are always readily available. Trends specific to the broader credit card industry can be gleaned from trade press reports, and similar research sources. Certainly the Postal Service will be closely monitoring potential factors such as the overall rates of adoption of electronic bill presentation and payment.
> Tr. 4/767-8.

Witness Plunkett goes on to state that Capital One will provide insights on how exogenous factors might have affected its mailing patterns. A variety of data sources such as those mentioned in witness Plunkett's response can provide useful input for the Postal Service's impact assessment over the three-year period of the NSA.

[9026] Thirteen parties in all signed the Stipulation and Agreement filed by joint motion of the Postal Service, Capital One, and the OCA. Pitney Bowes points out that Capital One's agreement to the settlement indicates that it does not consider the data collection and reporting requirements unduly burdensome. Pitney Bowes Brief at 7.

[9027] The Stipulation and Agreement contains an additional data reporting provision. The Postal Service “agrees to report annually on the number of requests made for comparable NSAs, the industry of each requestor, the volume of First-Class Mail mailed annually by the requestor within the following ranges - less than 100 million pieces, 100 to 250 million pieces, and more than 250 million pieces - and the status of negotiations, or if negotiations were terminated, the reason(s) therefore." Stipulation and Agreement at 2-3. The Commission commends the Postal Service, Capital One, and the OCA for including this provision. The number of such requests will assist in gauging the interest of mailers in similar arrangements. While the Commission does not ratify the Stipulation and Agreement in its entirety, it endorses this provision and the Data Collection Plan as contained in the Stipulation and Agreement. These data will prove valuable in assessing the success of the agreement. The Commission is encouraged that the Postal Service plans to use a wide variety of information sources in its evaluation of the Capital One NSA. These data will assist both the Commission and the Postal Service in evaluating other NSAs for similarly situated mailers.

[9028] The Commission also endorses witness Eakin's recommendation that data on Standard Mail be collected in order to gain a clearer picture of the mailing patterns of Capital One. These data, like the information listed in the Data Collection Plan, should be reported as monthly data for the previous year. Each report is to be provided within 120 days after the end of each fiscal year during which the NSA is in effect.[88] The data collection and reporting required during the NSA are set out below.

[9029] Data Required During the NSA[89]

1. Volume of First-Class Mail solicitations by rate category in eligible Capital One permit accounts.

2. Volume of First-Class Mail customer mail by rate category in eligible Capital One permit accounts.

3. Amount of discounts paid to Capital One for First-Class Mail by incremental volume block.

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[88] Witness Plunkett initially states that the first report will be provided at the end of FY 2003. USPS-T-2 at 12. Attachment C to the Stipulation and Agreement states that the first report will be made after FY 2004.

[89] Items 1, 2, 4 through 7, and 12 are to be reported as monthly data for the previous fiscal year.

4. Volume of First-Class Mail solicitations bearing the ACS endorsement that are physically returned to Capital One.

5. Number of electronic address correction notices provided to Capital One for forwarded solicitation mailpieces, including the number of notices processed by CFS units and separately for PARS (when fully operational).

6. Number of electronic address correction notices provided to Capital One for solicitation mailpieces that would otherwise be physically returned, including the number of notices processed by CFS units and separately for PARS (when fully operational).

7. Monthly estimate of the amount of time spent on compliance activity and a description of the activities performed.

8. For each First Class solicitation mailing list run against NCOA, Capital One will provide NCOA contractor reports that separately identify the number of address records checked and the number of corrections made.

9. For each Change of Address record that is used to forward a piece of Capital One solicitation mail through ACS under the Agreement, the Postal Service will provide the date the record was created, its move effective date, whether it was for a family or individual move, and each date that the record was used to forward a mail piece. No other information from the record would be provided.

10. As part of each data collection plan report, the Postal Service will provide an evaluation of the impact on contribution. It will also provide an assessment of trends of Capital One's First-Class Mail volume as compared to overall First-Class Mail volume.

11. As part of each data collection report, the Postal Service will provide the number of requests made for comparable NSAs, the industry of each requestor, the volume of First-Class Mail mailed annually by the requestor within the following ranges — less than 100 million pieces, 100 to 250 million pieces, and more than 250 million pieces — and the status of negotiations, or if negotiations were terminated, the reason(s) therefore.

12. Volume of Standard Mail solicitations by rate category in eligible Capital One permit accounts.[90]

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[90] This item was not originally included in the Stipulation and Agreement or in witness Plunkett's testimony.

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners: Chairman Omas,
Vice Chairman Covington,
Commissioner Goldway,
and Commissioner Hammond

Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One — Docket No. MC2002-2

RECOMMENDED DECISION

(Issued May 15, 2003)

A full public hearing having been held in the above-entitled proceeding, and the Commission, upon consideration of the record, having issued its Opinion, which is attached hereto and made a part hereof,

IT IS ORDERED:

1. That the Commission's Opinion be transmitted to the Governors of the Postal Service and that the Governors thereby be advised that:

   a. The rates of postage and fees for postal services set forth in Appendix One hereof are in accordance with the policies of title 39 of the United States Code and the factors set forth in § 3622(b) thereof; and they are hereby recommended to the Governors for approval.

b. The proposed amendments to the Domestic Mail Classification Schedule set forth in Appendix Two are in accordance with the policies of title 39 of the United States Code and the factors set forth in § 3623(c) thereof; and they are hereby recommended to the Governors for approval.

2. Except to the extent granted or otherwise disposed of herein, all motions, exceptions, and other outstanding requests filed in Docket No. MC2002-2 hereby are denied.

By the Commission.
(S E A L)

Steven W. Williams

Steven W. Williams, Secretary

CONCURRING OPINION OF COMMISSIONER GOLDWAY

I support the recommended decision, but with reservations.

I have long been a supporter of Postal Service innovation. For example, in remarks before the Direct Marketing Association's 1999 Government Affairs Conference (available on the PRC website) I favored permitting Postal Service experiments for new types of services that had a nexus to its core mission. I also have spoken out in favor of innovative pricing, such as seasonal discounts. I agree with the fundamental message of the opinion that selective discounts can be in the public interest. Furthermore, the legislative history behind the Postal Reorganization Act suggests that the PRC should work cooperatively with the Postal Service, and I do not want this agency to be a stumbling block to Postal Service innovation.

The Postal Service's first NSA proposal, though lawful, raises questions about the soundness of its business strategy. The Postal Service has ample authority to regulate the preparation and hygiene of its mail — the Domestic Mail Manual is filled with such examples. It is continually seeking solutions to address hygiene problems. Thus, the April 15, 2003 edition of DMNews online stated that the Postal Service in May will start reclaiming postage discounts from First-Class mailers who do not comply with its Move Update rules, citing as its source Angelo Wider, USPS manager of finance, in remarks at the New Orleans Spring National Postal Forum. Move Update is designed to reduce undeliverable as addressed mail, whereby mailers using automation or presort rates are required to update addresses every 180 days using USPS-approved methods. The same report cites other proposed changes that should improve address hygiene as well.

In this proceeding, Postal Service witness Plunkett states that the Service will be evaluating the type of hygiene program to which Capital One has agreed for possible wider implementation. But one wonders, once the Postal Service became aware of the alleged substantial benefits of such a program for one mailer why did it not ask itself — "Why not mandate specific hygiene practices for all First Class mailers using the medium for advertising? Is it necessary or most efficient to give postage discounts to obtain what can be done by rule?" It is clear that Capital One likes to use First Class Mail for advertising and that barring some huge change in corporate strategy and fortunes such reliance will continue. It does not appear that Capital One was threatening to leave the First-Class mail advertising medium. *See* Tr. 4/714 (witness Plunkett), Tr. 2/70 (witness Jean).

The Postal Service has for some time wanted to be able to price its domestic product in the same way its private sector counterparts successfully do — by granting selective discounts to win or retain business. But there are major differences in how most private sector companies offer discounts to large accounts. First, private sector discounts are offered secretly so that other big customers do not demand the same or better deals, consequently eroding profit margins. Under the current system of postal regulation, where the Postal Service has been granted a monopoly, discounts cannot be made in secret. (Nor should a monopolist be able to price secretly.)

Second, discounts are offered based on specific competitive challenges ("I can't do business with you at that price — I've got a better offer.") and estimates of the customer's alternatives. Here, the evidence shows no specific competitive challenge, just the Postal Service's general desire to build volume. Indeed, with the current regulatory attacks on spam and telemarketing, some of the Postal Service's competitive threats to advertising mail could be lessened.

Third, private sector discounters know their costs of doing business with customers under the current arrangement and can assess any proposed new arrangement for its benefits to them, e.g., determining whether a discount will generate in fact scale economies. The evidence on this record concerns only hygiene related savings — there are no cost savings on this record associated with the potential for higher volumes . Even for those projected savings, Postal Service testimony shows it does not know with much precision its current costs of handling Capital One's mail and how these costs will change under the future arrangement (e.g., the effect of PARS).

It may be that the Postal Service needs to reconsider its reliance on NSAs as the best option for pricing flexibility in the monopoly context and reconsider the niche classification approach, as some of the intervenors in this case suggest. The niche classification approach also reduces the possibility that discrimination will occur against mailers whose volumes are smaller and who cannot afford the litigation transaction costs of supporting an individual NSA, or the discrimination that could occur if the Postal Service focuses its (admittedly) limited negotiation resources on just the largest mailers. I would note that the Postal Service has pricing freedom for its international mail business, yet this practice does not appear to have helped it measurably, as volumes, revenues, and profits are declining in this sector.

This case profited from the observations of economists Panzar and Eakin concerning potential economic effects of the discounts available under the NSA on competitors of Capital One. Commission deliberations would be facilitated in future cases if the Postal Service analysts examined more thoroughly the current competitive conditions in the industry in which the NSA was being sought. For example, industry concentration, entry and exit conditions and other factors may indicate, e.g., that the slight advantage granted to one player in an industry from a lower rate will have merely the effect of a pebble thrown into a large lake — a mere ripple that soon disappears. Analysis of the credit card industry might show that there are a large group of well financed competitors, many of whom have their own particular competitive advantages (e.g., retailers who can advertise credit cards in their stores).

In light of the overall modest amount of money involved in this case (in relation to the Postal Service's total budget) and the economic experts' views about the potential benefits of contractual rates I am persuaded that new arrangements of this nature should be encouraged. However, I do not regard this case as precedent except for the general proposition that NSAs can be beneficial, and would ask the Postal Service and Board of Governors to carefully consider my reservations.

Ruth Y. Goldway, Commissioner

CAPITAL ONE NSA
RATE SCHEDULE 610A

Volume Block	Incremental Discounts
1,225,000,001 - 1,275,000,000	3.0¢
1,275,000,001 - 1,325,000,000	3.5¢
1,325,000,001 - 1,375,000,000	4.0¢
1,375,000,001 - 1,450,000,000	4.5¢
1,450,000,001 - 1,525,000,000	5.0¢
1,525,000,001 - 1,600,000,000	5.5¢
1,600,000,001 and above	6.0¢

CAPITAL ONE NSA
RATE SCHEDULE 610B

Volume Block	Incremental Discounts
1,025,000,001 - 1,075,000,000	1.0¢
1,075,000,001 - 1,125,000,000	1.5¢
1,125,000,001 - 1,175,000,000	2.0¢
1,175,000,001 - 1,225,000,000	2.5¢

CAPITAL ONE NSA
RATE SCHEDULE 610C
FOR ADJUSTED THRESHOLD (A.T.)

Volume Block	Incremental Discounts
A.T. + 1 - A.T. + 50,000,000	3.0¢
A.T. + 50,000,001 - A.T. + 100,000,000	3.5¢
A.T. + 100,000,001 - A.T. + 150,000,000	4.0¢
A.T. + 150,000,001 - A.T. + 225,000,000	4.5¢
A.T. + 225,000,001 - A.T. + 300,000,000	5.0¢
A.T. + 300,000,001 - A.T. + 375,000,000	5.5¢
A.T. + 375,000,001 and above	6.0¢

CAPITAL ONE NSA
RATE SCHEDULE 610D
FOR ADJUSTED THRESHOLD (A.T.)

Volume Block	Incremental Discounts
A.T. + 1 - A.T. + 50,000,000	1.0¢
A.T. + 50,000,001 - A.T. + 100,000,000	1.5¢
A.T. + 100,000,001 - A.T. + 150,000,000	2.0¢
A.T. + 150,000,001 - A.T. + 200,000,000	2.5¢

NEGOTIATED SERVICE AGREEMENTS CLASSIFICATION SCHEDULE

610 CAPITAL ONE NEGOTIATED SERVICE AGREEMENT

610.1 Eligible First-Class Mail

610.11 **Capital One.** Eligible First-Class Mail under this section is defined as Capital One's First-Class Mail customer correspondence with established account holders and First-Class Mail solicitations 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.

610.12 **Other Mailers.** Comparable NSAs, involving adoption of electronic Address Correction Service in lieu of physical returns for First-Class Mail that qualifies for Standard Mail rates and declining block rates for First-Class Mail, may be entered into with other customers, as specified by the Postal Service, and implemented pursuant to proceedings under Chapter 36 of Title 39, of the United States Code.

610.2 Waiver of Address Correction Fees

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

a. Capital One mails more than 750 million pieces of eligible First-Class Mail within the first year after implementation of this section, and

b. updates its databases within 2 days after receipt of address correction information and uses the information in all future First-Class Mail marketing campaigns.

If, during the first year after implementation, Capital One mails fewer than 750 million pieces of eligible First-Class Mail, Capital One 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) $1,000,000.

610.3 First-Class Mail Discounts

610.31 **Discount Threshold.** The Discount Threshold is defined as the greater of either 1.225 billion pieces of eligible First-Class Mail, or 90 percent of Capital One's average eligible First-Class Mail volume for FY2000, FY2001 and FY2002. The Discount Threshold may be adjusted in accordance with section 610.34.

610.32 **Discounts.** Capital One's 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 610A, for each year in which Capital One 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.

610.33 **Additional Discounts (Year 2 and Year 3).** If eligible First-Class Mail volume for the first year is less than 1.025 billion pieces, the additional discount tiers shown in Rate Schedule 610B shall apply to the incremental volumes in the second and third years in addition to the incremental discounts in Rate Schedule 610A.

610.34 **Threshold Adjustment.** In the event that Capital One 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, Capital One 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. In that event, beginning in the succeeding fiscal quarter following the date of acquisition or merger, Rate Schedule 610C would apply in lieu of Rate Schedule 610A, and, if the conditions in section 610.33 are also met, Rate Schedule 610D would apply in lieu of Rate Schedule 610B.

610.35 **Discount Limit.** The maximum cumulative discount available to Capital One over the duration of this NSA shall not exceed $40.637 million.

610.4 Rates

The rates applicable to this Agreement are set forth in the following rate schedules:

610A
610B
610C
610D

610.5 Expiration

The provisions of section 610 expire on [insert date three years from implementation date set by the Board of Governors].

610.6 Precedence

To the extent any provision of section 610 is inconsistent with any other provision of the Domestic Mail Classification Schedule, section 610 shall control.

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Donald Jean	COS-T-1
Robert Shippee	COS-RT-1
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Charles L. Crum	USPS-T-3
B. Kelly Eakin	USPS-RT-2
Michael K. Plunkett	USPS-T-2, USPS-RT-1
James D. Wilson	USPS-T-4
PRESIDING OFFICER'S WITNESS[2]	
John C. Panzar	JCP-T-1

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[1] Association of Postal Commerce, The Direct Marketing Association, and Parcel Shippers Association.

[2] *See* Chapter II, Section D.

REVIEW OF PREVIOUS REQUESTS FOR EXPERIMENTS

[1] The Postal Service previously filed 11 proposals for consideration under the experimental rules. Review of these 11 proposals provides insight into what the Commission has considered experimental in character in the past.

[2] MC86-1 "Destination-BMC Parcel Post Classification and Rate Changes (Experiment), 1985" (1st experimental case): The Postal Service proposed a two-year experiment, with the anticipation of seeking a future permanent classification, for a cost based worksharing discount available to mailers who bring parcel post to the BMC serving the area to which the mail piece is addressed. The experiment was designed to allow the Postal Service to test the feasibility of the new service, and to generate data that could be used in support of a request for permanent change. The Postal Service's data collection plan proposed collecting information on costs, number of participants, total mailings, pieces, revenues, and distribution of pieces by weight and zone. The Postal Service also proposed undertaking market research on mailer practices and opinions in regard to this new service. The Commission did not recommend the experimental classification because the proposed rates were below attributable costs, among other difficulties, for a product positioned in the competitive marketplace. Docket No. MC86-1, Opinion and Recommended Decision, June 5, 1986.

[3] MC96-1 "Experimental First-Class and Priority Mail Small Parcel Automation Rate Category" (2nd experimental case): The Postal Service proposed a two-year experiment, with the anticipation of seeking a future permanent classification, to provide a worksharing discount for qualifying pre-barcoded First-Class Mail and Priority Mail bulk small parcels processed on sorters equipped with barcode scanning devices. The Postal Service wanted to assess mailer interest in the discount, particularly among businesses involved in merchandise distribution, and evaluate the costs of manually keying address information on parcels without barcodes, versus automated scanning of

similar parcels with ZIP Codes embedded in a prescribed barcode. In recommending the experiment, the Commission reflected agreement with the Service's assessment that the experiment posed no appreciable risk of significant, negative financial results or other harm to the Service, mailers, or competitors. The Postal Service's data collection plan was recommended as proposed. Docket No. MC96-1, Opinion and Recommended Decision, March 13, 1996.

[4] MC97-1 "Experimental Nonletter-Size Business Reply Mail Categories and Fees" (3rd experimental case): The Postal Service proposed a two-year experiment, with the anticipation of seeking a future permanent classification, to test "reverse manifest" and "weight averaging" accounting methods, and the associated fees, for nonletter-size Business Reply Mail (BRM). The experiment involved a limited number of recipients of significant quantities of nonletter-size BRM. In recommending the experiment, the Commission evaluated the yearly impact on revenue and potential cost savings. The Commission recommended the data collection plan, as proposed, to collect data on costs, volumes, and BRM characteristics, and to perform additional market research. Docket No. MC97-1, Opinion and Recommended Decision, April 2, 1997.

[5] MC98-1 "Mailing Online Service" (4th experimental case): The Postal Service concurrently requested consideration of a three-month market test, under the market test rules, and a two-year follow-on experiment, under the experimental rules, with the anticipation of seeking a future permanent classification, to test the feasibility of, and market for, a novel Mailing Online service. Mailing Online service would allow individuals and small businesses to enter First-Class Mail and Standard Mail electronically into the mailstream using a personal computer with internet access and a Web browser. The Postal Service would then batch all submitted jobs and send them via dedicated lines to one or more digital printing contractors, who would print the document, finish and place it in a letter or flat envelope, and enter it as mail at a local postal facility. The Commission bifurcated, procedurally, the request to consider a market test, and the request to consider an experiment. In approving the request for a market test, the

Commission recommended a data collection plan that expanded on the plan proposed by the Postal Service. The recommended plan required weekly, biweekly and accounting period periodic reports. Docket No. MC98-1, Opinion and Recommended Decision on Market Test, October 7, 1998. The Postal Service subsequently withdrew its proposal to consider a Mailing Online experiment, effectively ending the Commission's consideration of the Postal Service's proposal.

[6] MC99-1 "Renewal of Experimental Classification and Fees for Weight-Averaged Nonletter-Size Business Reply Mail" (5th experimental case): The Commission recommended a Postal Service proposal for extension of the "weight averaging" aspects of the Docket No. MC97-1 experiment for nonletter-size Business Reply Mail.[1] The extension would allow additional time to resolve remaining technical administrative issues, and provide for uninterrupted service while considering a separate request to make this service permanent. The recommendation included adjustments to fees. Docket No. MC99-1, Opinion and Recommended Decision Approving Revised Stipulation and Agreement, May 14, 1998.

[7] MC2000-1 "Experimental 'Ride-Along' Classification Change for Periodicals" (6th experimental case): The Commission recommended a two-year experiment, as proposed by the Postal Service, allowing one qualifying Standard Mail (A) attachment or enclosure to be included (or "ride-along") in a Periodicals publication for a flat charge of 10 cents. Opinion and Recommended Decision Approving Stipulation and Agreement, February 3, 2000. The Postal Service intended to use the experimental period to determine the reaction to this new, low-cost alternative (especially among advertisers) and the effect on costs. The data collection plan originally proposed was enhanced in a stipulation and agreement that was incorporated into the Commission's recommendation.

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1 The experimental rules were invoked to request an administrative change to an ongoing experiment, which was previously recommended under the experimental rules.

[8] MC2000-2 "Mailing Online Experiment" (7th experimental case): The Postal Service proposed a three-year experiment, with the anticipation of seeking a future permanent classification, as a follow-on to the Mailing Online market test recommended in Docket No. MC98-1. This replaced the experiment that the Commission bifurcated procedurally from the MC98-1 request, and that was subsequently withdrawn by the Postal Service. The three-year experimental period was the longest duration proposed for an experiment to date. After reviewing the Postal Service's financial projections over the complete duration of the experiment, the Commission recommended that the Postal Service proceed with the experiment. Significant modifications to the Postal Service's original proposal were recommended to allow service providers with functionally equivalent mailing systems to access the same presort discount rates provided to the Postal Service in Mailing Online. The Commission also recommended a periodic data collection plan that expanded on the Postal Service's original proposal. Docket No. MC2000-2, Opinion and Recommended Decision, June 21, 2000.

[9] MC2001-1 "Experimental Presorted Priority Rate Categories" (8th experimental case): The Postal Service proposed a three-year experiment, with the anticipation of seeking a future permanent classification, to test three categories of Priority Mail discounts based on depth of sort reflecting different levels of worksharing performed by mailers. A stipulation and agreement, and further statements of understanding submitted by the participants, expanded upon the Postal Service’s data collection plan and proposed reducing the experiment’s duration to two years. The Commission recommended a two-year experiment, which included the expanded data collection plan. Docket No. MC2001-1, Opinion and Recommended Decision Approving Stipulation and Agreement, May 25, 2001.

[10] MC2001-2 "Experimental Suspension of Fee for Manual Delivery Confirmation Category" (9th experimental case): The Postal Service proposed to offer Delivery Confirmation without fee to retail Priority Mail customers for 16 days in December, with the anticipation of seeking a future permanent seasonal classification.

The experiment was designed to test giving postal customers an incentive to mail packages before the busiest week of the holiday mailing season, to reduced Postal Service resource needs during the peak period, and to introduce retail Delivery Confirmation service to customers who otherwise would not be aware of it. The request for experimental classification was subsequently withdrawn by the Postal Service. PRC Order No. 1330, November 6, 2001.

[11] MC2001-3 "Ride-Along Experiment Extension" (10th experimental case): The Commission recommended, as proposed by the Postal Service, an extension of the Ride-Along Experiment, originally recommended in Docket No. MC2000-1, until such time as the Board of Governors set the implementation date for the rates and classifications recommended in the then ongoing omnibus rate case Docket No. R2001-1.[2] The Postal Service's request for a permanent rate and classification was pending in that rate docket. Docket No. MC2001-3, Opinion and Recommended Decision Approving Stipulation and Agreement, January 11, 2002.

[12] MC2002-3 "Experimental Periodicals Co-Palletization Dropship Discounts, 2002" (11th experimental case): The Commission recommended a two-year experiment, as proposed by the Postal Service, to test whether new worksharing discounts will encourage senders of relatively low volume/low density Periodicals mailings to make several key adjustments in their mailing practices. One adjustment entails consolidating otherwise independent mailings so that they meet or exceed, on a combined basis, the 250-pound minimum for a pallet load. A related adjustment requires dropshipping the co-palletized mail to a specified destination entry area distribution center (ADC) or destination entry sectional center facility (SCF). The original proposal for a data collection plan discussed data collection only in general terms. The Commission requested additional information on the specific data items to be collected that could be used to determine whether the experiment was successful or not. An

[2] The experimental rules were invoked to request an administrative change to an ongoing experiment, which was previously recommended under the experimental rules.

expanded and more specific data collection plan was included as part of the stipulation and agreement underlying the Commission's recommendation. Docket No. MC2002-3, Opinion and Recommended Decision Approving Stipulation and Agreement, December 20, 2002.