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

RULES APPLICABLE TO BASELINE AND FUNCTIONALLY EQUIVALENT NEGOTIATED SERVICE AGREEMENTS	)))	Docket No. RM2003-5

VALPAK DIRECT MARKETING SYSTEMS, INC., AND
VALPAK DEALERS' ASSOCIATION, INC.
COMMENTS ON PROPOSED NSA RULES
PURSUANT TO COMMISSION ORDER NO. 1383
(September 29, 2003)

On August 27, 2003, the Postal Rate Commission issued Order No. 1383, commencing this docket, initiating a rulemaking proceeding, and proposing rules applicable to Commission consideration of so-called "baseline" Negotiated Service Agreements ("NSAs"), as well as "functionally equivalent" NSAs.

These comments on those proposed rules are filed on behalf of Valpak Direct Marketing Systems, Inc. and Valpak Dealers Association, Inc. (hereinafter "Valpak"), and are submitted pursuant to the terms of Order No. 1383.

1. Docket No. MC2002-2

In Docket No. MC2002-2, the Commission, in its *Opinion and Recommended Decision* recommending the Capital One ("Cap One") Negotiated Service Agreement, stated its intention to initiate one or more rulemakings to determine the procedures which would govern Commission consideration of future NSAs. *See, e.g.,* Docket No. MC2002-2*, Op. & Rec. Dec.*, at ¶ 1006. This docket is the first step in fulfillment of that promise.

Valpak actively participated in Docket No. MC2002-2, and submitted a 41-page Initial Brief on April 3, 2003, as well as an 18-page Reply Brief on April 14, 2003. In these briefs,

Valpak offered for the Commission's consideration seven principles drawn from the Postal Reorganization Act that we believe that the Commission should take into account when considering whether to approve or disapprove a proposed NSA.

Succinctly stated, these principles are as follows:

I. NSAs cannot substitute for fixing systemwide pricing problems

II. NSAs must demonstrate that they do not result in net financial loss to the Postal Service

III. NSAs must be evaluated using mailer-specific costs

IV. NSAs must not result in undue or unreasonable preferences to certain mailers or discrimination against similarly-situated mailers

V. NSAs must not provide discounts based solely on high volume

VI. NSAs must not provide unfair rewards for high-cost mailers discontinuing high-cost behavior

VII. NSAs must attempt to anticipate and avoid unintended consequences

As discussed below, the Commission's proposed rules appear to be an excellent effort to implement the lessons learned from consideration of the Cap One NSA. Moreover, the proposed rules appear generally consistent with most of Valpak's seven recommended principles. Our comments on these proposed rules, as well as proposals for improvement to these rules, appear below.

2. Recommendations of the President's Commission on the United States Postal Service

Since the Commission issued its *Opinion and Recommended Decision* in the Cap One NSA docket, the President's Commission on the United States Postal Service issued its report on July 31, 2003. This report recommends legislative changes under which regulatory review

of NSAs be changed to a way not now permitted by the Postal Reorganization Act. This report also recommends that NSAs should be presumed valid without proceedings before a recommended new "Postal Regulatory Board," as long as they meet general criteria that would be established by such Board. The Board would be able to conduct an expedited, *ex post facto* review of a particular agreement only if a complaint was lodged with the Board that the agreement did not meet the general criteria. Stated simply, there would be no review of a particular NSA by the Postal Regulatory Board unless a complaint has been filed regarding that NSA. *See* "Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service, Report of the President's Commission on the United States Postal Service," p. 89.

Although it may have been tempting to write proposed rules to implement administratively the legislative recommendations of the President's Commission, the Postal Rate Commission was wise not to do so. Fortunately, the Commission understands that it must operate under the Postal Reorganization Act as the law stands at present, and not as it may be changed in the future. However, the Postal Rate Commission did implement some of the policies underlying the President's Commission's discussion on NSAs, providing for expedition while preserving the rights of other mailers.

3. Competing Considerations

In its Order No. 1383 (pp. 2-3), the Commission identified several competing considerations that it had to weigh in developing its proposed rules. These factors could be succinctly restated as:

1. Compliance with Postal Reorganization Act;
2. Development of adequate record;

3. Minimize burdens on participants and the Commission;

4. Result in timely review; and

5. Protect due process requirements.

We agree that all of the above considerations are important, but we particularly agree with the Commission that the first standard, compliance with the Postal Reorganization Act, must be the "foremost" goal of this rulemaking. (Order No. 1383, p. 3.)

4. Functional Equivalence

The Commission's Order noted that the "proposed rules do not include a definition for what qualifies as a functionally equivalent Negotiated Service Agreement…. The Commission will be left to decide, on a case by case basis, whether the Postal Service has met this burden." Order No. 1383, p. 3. Although Valpak agrees with the general structure for classifying the different types of NSAs as either "baseline" or "functionally equivalent," Valpak believes that there should be clear criteria for determining whether a proposed NSA is "functionally equivalent" to a baseline NSA.

We are concerned that, in the absence of Commission-established criteria, such a "case by case" approach could create problems for mailers. There would be no objective standard, however general it may be, by which anyone could know whether its situation would be considered by the Commission (or the Postal Service) as "functionally equivalent."

The Commission's rulemaking purpose of establishing an NSA as "functionally equivalent" to one that has come before is to bypass certain procedural and evidentiary requirements, thereby reducing materially the time and expense required for a Commission determination. However, as a practical matter, the determination that the situation of another

mailer is "functionally equivalent" may determine if it is offered as an NSA at all. Indeed, since the initial burden is on the Postal Service to negotiate and propose the NSA, it is the Postal Service in the first instance that must determine which other mailers present "functionally equivalent" situations. And if the Postal Service refuses to propose an NSA where the competitor mailer believes its situation is "functionally equivalent," that decision being made without any Commission-articulated criteria, the second mailer could scarcely know how to argue its case for comparable treatment. Criteria relevant to the mailer might be deemed irrelevant to the Postal Service, or vice versa. Indeed, with limited Postal Service resources available to address possibly scores of NSAs, one can anticipate that, even with a Commission-issued set of criteria, it may be sufficiently difficult for a mailer to convince the Postal Service that it presented a "functionally equivalent" situation.

Neither would the lack of any articulated criteria help the Postal Service. For without written criteria, the Postal Service and a co-proponent could propose an NSA under the "functionally equivalent" NSA rules when, in fact, it may serve the Commission and the public interest to consider it as a "baseline" NSA. Under the proposed rules, such a decision is to be addressed early in the litigation, but then, if the Commission were to disagree with the Postal Service's proposed use of a follow-on case, it would require the NSA to be supplemented significantly, or, more likely, to be refiled and relitigated as a "baseline" NSA docket, with associated delay and additional cost.

The Commission actually appears to offer some guidance (Order No. 1383, at p. 3, fn. 3) as to how it views functional equivalency. Although we may be inferring somewhat more than the Commission implied, we derive from this guidance three standards:

- First, Order No. 1383 states that "functional equivalency is broader than the literal terms and conditions" of the NSA, encompassing, for example, whether Postal Service savings from the follow-on NSA would be comparable.
- Second, it states that a functionally equivalent NSA need not have terms and conditions identical to a baseline NSA.
- Third, it states that a functionally equivalent NSA need not involve a mailer which is identical to the mailer in the baseline NSA.

We would submit that these three points, as modified below, should form the beginning of a list of criteria for functional equivalence.

As to the first point, the savings to the Postal Service should not need to be comparable in terms of gross savings, but rather unit savings. Likewise as to the third point, the follow-on mailer need not have a mailing profile identical to that of the baseline NSA. Otherwise, this criterion could operate to bar follow-on NSAs to any baseline NSA previously provided to a larger mailer. The Postal Service's Senior Vice President and Chief Marketing Officer, Anita Bizzotto, testified before the Commission in the Cap One docket that offering an NSA to Cap One, which was "unique as one of the Postal Service's largest First Class mailers," should not imply any requirement that only the largest mailer in a subclass be eligible to have an NSA. (Docket No. MC 2002-2, Tr. 3/491-94.)

In Docket No. MC2002-2, Valpak proposed Principle No. V, that NSAs must not provide discounts based solely on high volume. It is essential that the Commission's rules not be construed to give preference to an NSA for a mailer based on the fact that the mailer has particularly (or even uniquely) high volume. *See* 39 U.S.C. § 403(c). Such an approach

would be viewed as implementing a non-cost-based quantity or volume discount, and, since passage of the Postal Reorganization Act, it has been commonly agreed that such discounts are prohibited.

It is possible, of course, that a mailer with large volume could, in part due to that large volume, be able to prepare or enter its mail in a novel way, not currently required by the Postal Service, that would generate real cost savings for the Postal Service. Large volume may open the door for a mailer to be able to do additional work justifying some cost-based benefit, but large volume alone can never be a sufficient rationale for the benefit provided to the mailer. An NSA must be based on a demonstrated Postal Service cost savings, specific to the mailer, and not just on the presence of large volume.

As an illustration of how criteria can be established to help mailers understand what is "functionally equivalent," it is instructive how the Domestic Mail Classification Schedule defines this same term in the context of the Netpost Mailing Online service:

> **981.62 Definition.** A **functionally equivalent** system is one which is capable of all of the following, comparable to Netpost Mailing Online, as specified by the Postal Service:
>
> > a. accepting documents and mailing lists from remote users in electronic form, such as via the Internet or converting documents and mailing lists to electronic form;
> >
> > b. using the electronic documents, mailing lists, and other software including sortation software certified by the Postal Service that sorts to the finest level of sortation possible, to create barcoded mailpieces meeting the requirements for automation category mail, with 100 percent standardized addresses on all pieces claiming discounted rates;

> c. commingling mailpieces from all sources without diversion to any other system and batching them according to geographic destination prior to printing and mailing; and
>
> d. generating volumes that exceed on average any otherwise applicable volume minimums. [39 CFR Part 3001, Subpart C, Appendix A (emphasis added).]

Valpak recommends that an effort be made to articulate specific criteria for "functional equivalence" similar to the way in which criteria were established for Mailing Online.

5. Avoiding Unintended Consequences

In Valpak's Initial Brief in Docket No. MC2002-2, it recommended, as proposed Principle No. VII, that NSAs must attempt to anticipate and avoid unintended consequences. The Commission's proposed rules deal with this policy, *inter alia*, through the requirement that the Postal Service in its filing discuss the degree to which the NSA would affect contribution to institutional costs. However, it is believed that the proposed rules could be revised to implement this principle more fully.

In the context of NSAs, a more technical, but perhaps better, term for "unintended consequences" would be "external diseconomies," which have been discussed extensively in the economic literature. Succinctly, "external diseconomies" are economic effects on third parties that are not reflected in market prices and market transactions. (Here, this would mean effects of the NSA on third parties.) The environmental literature is replete with examples — *e.g.*, acid rain that harms fish and forests, smog in cities that causes respiratory ailments in surrounding counties, downstream pollution from upstream polluters, etc.

The Cap One NSA presents the best available illustration of the principle of unintended consequences. As discussed in the Valpak Initial Brief:

[T]he highest-cost service (physical return) is available free of charge to mailers, while the lowest-cost service (electronic return) costs mailers 20 cents per return.

For purposes of discussion, we might categorize the incentives implicit in pricing strategies in a threefold manner. **First**, there is the **"inverse"** incentive, which is implicit in the current rate schedule. Decision makers (*i.e.*, mailers) are given price signals that perversely encourage them to do the wrong thing. **Second**, there is the **"neutral"** incentive, which would involve charging the same price for physical and electronic return services. They both could be free, they both could be charged 20 cents each, or whatever, so long as the price for each was the same, and left mailers feeling indifferent with regard to the price for each alternative. **Third**, there is the **"positive"** incentive scheme, in which mailers are given signals that encourage them to make the most efficient choices. Here the (unbundled) prices for return services would either equal the underlying cost or would be in proportion to the underlying cost (*e.g.*, cost plus some markup). Under this third pricing scheme, the higher-cost alternative would have a higher price to mailers, who then would have an incentive to use the lower-cost alternative unless they had a special need for the higher-cost alternative. With this framework in mind, let us turn to further analysis of the instant NSA.

Exclusively for Cap One, the Postal Service in the NSA proposes to substitute a **"neutral"** incentive scheme for an **"inverse"** incentive scheme. Viewed in isolation, this is a small step in the right direction. Ostensibly, it does no "harm" to other mailers, and on this basis perhaps it should be approved by recommendation of the Commission, with the Commission strongly urging the Postal Service, at a minimum, to extend such pricing to all other First-Class bulk mailers who otherwise must continue to elect their address options solely in the context of the **"inverse"** incentive scheme. Better yet, of course, would be to file a case that would substitute a **"positive"** pricing scheme for all mailers. That, of course, is beyond the proposal under review here.

But there is another consideration, which overlaps with fairness issues, but comes from the department of unintended consequences. Specifically, some — perhaps many — First-Class mailers may feel that forcing them to pay 20 cents for each electronic return while (i) not charging Cap One for electronic returns, and also (ii) giving Cap One a further rebate via a declining block discount, is treating them unfairly. The feeling of unfairness may cause some — perhaps many — of these other mailers to resist adopting the more efficient and less costly electronic return service. When evaluating the benefits of the NSA, all losses from "failure to adopt" **because of resistence created by the Cap One NSA** must be offset against any gains derived directly from the Cap One NSA. Considering that Cap One's Non-forwardable UAA Mail is but a very small percentage of all Non-forwardable UAA Mail, the losses from "failure to adopt" — admittedly an unintended consequence — could easily swamp the Postal Service's gains from the NSA.

> The Postal Service appears to have focused myopically on how the NSA will affect it and Cap One, and to have given little thought to the principle enunciated here. The Commission, however, should evaluate the NSA from a broader perspective. [Docket No. MC2002-2 Valpak Initial Brief, pp. 38-40.]

To avoid a situation such as occurred in the Cap One NSA docket, where the Postal Service's initial filing was devoid of information on the broader implications of its proposal on users of the type of mail involved with that NSA, Commission rules should require that such issues be addressed by the Postal Service in its filing.

The following is an illustration of how the Postal Service could be required to present information on the broader implications of a proposed NSA. Suppose that a proposed NSA contains one or more characteristics that permit the Postal Service to reduce costs or gain an increase in volume and revenue of profitable mail. The additional contribution to institutional costs will permit the Postal Service to offer some form of rebate to the mailer. (In the Cap One NSA, costs were reduced by substituting electronic returns for physical returns, and a declining block discount was the mechanism selected for sharing some of the savings with Cap One.) The Postal Service should be required to identify all other types of mail having cost-causing characteristics similar to those at issue in the pending NSA. (In the Cap One NSA, this would be the total volume of physically returned Undeliverable as Addressed ("UAA") First-Class Mail entered in "bulk" — *i.e.*, not single piece UAA mail. Such data were, in fact, produced in the course of the Cap One case.) For all mail that has similar cost-causing characteristics, but which is excluded from the NSA, the Postal Service should be required to discuss what effect the approval and existence of the NSA may have on: (i) the behavior of mailers who originate mail with similar cost-causing characteristics, but who are excluded

under the NSA, and (ii) Postal Service finances. In other words, the Postal Service should be required to consider and address possibly wider consequences that the NSA may have on any "third-party" mailer who is not a party to the agreement, most especially those that send mail with similar cost-causing characteristics. A requirement to address such wider "third-party" issues could be likened to the requirement for environmental impact statements in other venues.

Conclusion

With the promulgation of these new rules, the Commission will materially reduce the problem it faced with the Cap One NSA — making it up as we go along. Although that process was painful, it led this Commission to a deeper understanding of the problems associated with NSAs and the likelihood of a much better set of rules than could have been written without that experience. We applaud the Commission for this effort to systematize the rules for handling NSAs.

For the reasons set forth above, Valpak urges that the proposed rules be modified in accordance with these comments, and adopted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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

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William J. Olson

September 29, 2003