

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

RATE AND SERVICE CHANGES TO)
IMPLEMENT FUNCTIONALLY EQUIVALENT) Docket No. MC2004-4
NEGOTIATED SERVICE AGREEMENT WITH)
DISCOVER FINANCIAL SERVICES, INC.)

INITIAL BRIEF

OF

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

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STATEMENT OF THE CASE

Postal Service Request

On June 21, 2004, the United States Postal Service filed a request, pursuant to sections 3622 and 3623 of the Postal Reorganization Act of 1970 (39 U.S.C.) ("the Act"), for a recommended decision by the Postal Rate Commission to implement a proposed three-year Negotiated Service Agreement ("NSA"), and related discounts and fee waivers, for qualifying First-Class mailings entered by Discover Financial Services, Inc. ("DFS").

The Postal Service's case-in-chief consists of the testimony of one Postal Service witness and one DFS witness:

Witness Ali Ayub

USPS-T-1

Witness Karin Giffney

DFS-T-1

This case is one of the two first NSA proposals, filed with the Commission the same day, pursuant to the new rules for handling functionally equivalent NSAs.¹

Commencement of Commission Proceedings

On June 24, 2004, the Commission issued a Notice and Order on filing of the Postal Service's request (Order No. 1410).

In accordance with Order No. 1410 and Rule 20 of the Commission's Rules of Practice and Procedure (39 CFR 3001.20), Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. each filed a notice of intervention on July 12, 2004. These two intervenors have proceeded jointly in this proceeding, and are referred to collectively as "Valpak."

On July 20, 2004, the Commission issued Presiding Officer's Ruling No. MC2004-4/1 in which it decided to treat the Postal Service's request as a functionally equivalent NSA under rule 196.

Discovery of the Co-Proponents' Case-in-Chief

Valpak conducted written cross-examination of the following two witnesses with respect to their direct testimony:

USPS Witness Ali Ayub

VP/USPS-T-1-14

¹ The other proposed NSA submitted under these rules is MC2004-3, Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Bank One Corporation.

DFS Witness Karin Giffney

VP/DFS-T-1-15²

Valpak filed all of its interrogatories by August 5, 2004, the deadline for written discovery. Before the September 1, 2004 deadline, Valpak designated all of the responses received to its interrogatories for inclusion into the record, and on September 7, 2004 designated the amended response by witness Ayub to a previously designated response.

Prehearing Conference and Settlement Process

The Commission conducted a prehearing conference on July 15, 2004, in which Valpak participated. The Postal Service, as designated settlement coordinator, conducted settlement conferences on July 14, 2004 and July 21, 2004, in which Valpak participated. The Postal Service submitted reports on the settlement process to the Commission on July 22, 2004, August 5, 2004, August 19, 2004, and September 2, 2004.

Limitation of Issues

At the commencement of the docket, the Postal Service filed on June 21, 2004 a Proposal to Limit Issues to those three issues automatically made part of a functionally equivalent NSA case by operation of Commission Rule 196(a)(6):

- (i) The financial impact of the Negotiated Service Agreement on the Postal Service over the duration of the agreement;

² On July 27, 2004, DFS objected to interrogatories VP/DFS-T1-1, 3-7, 9, and 11-12, but without waiving its objections, submitted answers to all of the questions except 1, 4-5, and 11-12, to which no substantive response whatsoever was received.

(ii) The fairness and equity of the Negotiated Service Agreement in regard to other users of the mail; and

(iii) The fairness and equity of the Negotiated Service Agreement in regard to the competitors of the parties to the Negotiated Service Agreement.

At the prehearing conference on July 15, 2004, Valpak stated its concerns that the proposed NSA raised issues not encompassed in these three issues. However, on August 5, 2004, Valpak notified the Commission that it had no objection to limiting the issues as proposed, so long as it had permission to include in its brief two other issues (the preferability of a niche classification, and the merits of a system-wide fix for the Undeliverable as Addressed (“UAA”) pricing discrepancy). The Presiding Officer’s Ruling expressly authorized Valpak to address these issues in its brief for future benefit, but stated that discussion of these two additional issues would not form the basis for a recommended decision in this docket. Presiding Officer’s Ruling No. MC2004-4/2, at 5-6.

Hearing

At the prehearing conference, the issue of whether a hearing would be held was raised, and Valpak made a verbal protective request for a hearing. Subsequently, on July 23, 2004, Valpak filed a written Restated Request for Hearing, again making a protective request until the need for such a hearing could be determined and factual issues that needed to be addressed could be identified. DFS took the position that Valpak had identified no issues deserving of a hearing and that hearings generally should not be held to gather evidence to evaluate functionally equivalent NSAs. When

Valpak was able to determine that a hearing would not be needed based on the responses that were filed to its interrogatories, it withdrew its protective request, on August 20, 2004. Therefore, the Commission never established, in this docket, any limitation on the right of intervenors to seek a hearing, as urged by DFS.

ARGUMENT

I. Designation of the Proposed NSA with DFS as Functionally Equivalent to the Capital One NSA Masks the Significance of Several Meaningful Differences Between the Two NSAs that the Commission Should Consider

The initial procedural issue that confronted intervenors was the Postal Service's request that the case be considered under the functionally equivalent rules, requiring the Commission to issue its Opinion and Recommended Decision within 60 days if no hearing were requested, or 120 days if a hearing were held. No party, including Valpak, chose to challenge the treatment of this NSA as functionally equivalent. After all, the NSA with DFS included the same two basic components as the Capital One Services, Inc. ("Capital One") NSA — substitution of electronic return for physical return of UAA mailpieces for a credit card company, combined with declining block discounts for additional volumes of First-Class Mail. However, it is now clear that the allegedly functionally equivalent NSA for DFS differs significantly in important respects from the Capital One NSA (which now, under rules adopted after the original NSA, is considered (retroactively) the baseline NSA). The principal differences are as follows.

First, the Capital One NSA involved a mailer which routinely used First-Class Mail for a substantial portion of its solicitations, and all additional First-Class Mail projected to be generated by that NSA added to the total volume of mail.³ Since the additional First-Class Mail represented new volume, all contribution to institutional

³ Docket No. MC2002-2, *Op. & Rec. Dec.*, para. 5049.

costs from this volume was new contribution. **This is not so for the NSA with DFS,** which uses Standard Mail for the vast majority of its solicitations. **None of the First-Class Mail that would be generated by this NSA is projected to be new volume, but instead will be migrated volume from Standard Mail.**⁴ Since none of the additional First-Class Mail is reckoned to be new volume, all of the incremental contribution to institutional costs must be offset by the loss of contribution now being earned from this volume in Standard Mail. To the casual observer, it may seem obvious that the Postal Service would earn a substantially greater contribution when mail is entered as First-Class Mail rather than Standard Mail. As discussed in Section III, *infra*, a substantially greater contribution cannot be assumed; in fact, it is rather small and, at the maximum discount level, it easily could turn out to be negative

Second, the Capital One NSA was based on a mailer which maintained its own internal solicitation lists. The electronic address correction information received from the Postal Service should be of benefit to such a mailer, and over time result in reducing the return and forwarding rates.⁵ By contrast, DFS relies exclusively on rented lists.⁶ This difference could have a significant effect on the appropriate forwarding rate. If the mailing practices of Capital One and DFS are not comparable,

⁴ USPS-T-1, p. 11, ll. 16-18.

⁵ Docket No. MC2002-2, *Op. & Rec. Dec.*, para. 6003.

⁶ *See* response to VP/DFS-T1-8.a.

it is not reasonable to rely on the Capital One NSA forwarding rate. *See* Section III., C., 2, *infra*.

Third, in the Capital One docket, the Postal Service filed a case based on subclass average costs, rather than mailer-specific costs, and the Commission reluctantly agreed, at least for that docket.⁷ In this docket, the Postal Service cherry-picked costs — using mailer-specific costs in certain instances, but sometimes using systemwide data, whichever was more helpful to achieve its desired objective. For example, the Postal Service uses the profile of DFS' Standard Mail to compute the contribution from such mail.⁸ At the same time, it spurns use of the systemwide forward/return ratio for Standard Mail.

Fourth, in the Capital One docket, the Postal Service proposed an NSA which did not raise the issue of whether a very small, forecasted additional contribution would be adequate for an NSA where the cost estimates were uncertain and may be overly optimistic. OCA demonstrated through its discovery to the Postal Service that, in the Capital One NSA, the net contribution earned on the most highly discounted pieces was approximately 10.4 cents per piece.⁹ In the NSA for DFS, the Postal Service's

⁷ Docket No. MC2002-2, *Op. & Rec. Dec.*, para. 6018-6019.

⁸ USPS-T-1, App. A, pp. 8-9.

⁹ Response to OCA/USPS-T1-42.

projected net contribution at the maximum discount level is in the range of 2 cents per piece, assuming none of its assumptions are overly optimistic.¹⁰

Because of these major fact differences between the baseline Capital One NSA and the DFS NSA, the present docket has the potential to set important new precedents which were not obvious at the outset. Not the least of these precedents would be that an NSA simply converting Standard Mail to First-Class Mail qualifies as being functionally equivalent to the Capital One NSA.

Under Presiding Officer's Ruling No. MC2004-4/2, the Commission expressly authorized Valpak to comment on certain policy issues for the Commission's benefit in future dockets. To that end, a factor is present in this docket which also was present in the Capital One NSA — namely, the fact that no cost savings could result from use of electronic UAA if returns of UAA mail were rationally priced by the Postal Service. Both the Capital One NSA and the DFS NSA in this docket rely on an anomalous pricing structure for UAA mail to justify the Address Correction Service ("ACS") "saving." If the Postal Service were to fix this anomaly, when the foundation of these functionally equivalent NSAs would collapse, causing the Postal Service either to cancel the NSAs (if possible, under the terms of the agreements), or to continue to offer financial incentives after any discernable benefit to the Postal Service has ceased to exist. Valpak remains concerned that approval of such NSAs could either discourage or financially penalize the Postal Service should it take the logical step of correcting

¹⁰ Response to VP/USPS-T1-14.

this anomaly in the next omnibus rate case. A related concern is that the existence of this functionally equivalent NSA (and that for Bank One) will cause the Postal Service to postpone taking the logical and much needed step of correcting this anomaly in the next omnibus rate case.

Lastly, unlike the Capital One NSA which involved new First-Class volume, the NSA for DFS involves migrated Standard Mail — overwhelmingly Standard Regular Mail. As discussed in Section II, *infra*, the contribution earned on Standard Regular Mail is small when compared to Standard ECR Mail, and Valpak is also concerned that approval of this NSA will discourage the Postal Service — fearing a financial penalty — from correcting that anomalous imbalance in coverage in the next omnibus rate case.

Valpak does not oppose this NSA, but believes that it must be evaluated on its own merits, not on an assumption that it is “just like” the Capital One NSA.

II. Valpak’s Involvement in this Docket Has Been in Pursuit of its Important Postal Interests

Valpak’s active intervention in this docket has been viewed with suspicion and even criticized by DFS as causing unnecessary delay and expense in the implementation of the reduced rates for DFS which have been available to Capital One for the past year. *See, e.g.*, Objection of Discover Financial Services, Inc. to Valpak Interrogatories, July 27, 2004, at 1. Concerns about the delay in DFS obtaining an NSA functionally equivalent to the Capital One NSA should be addressed neither to the Commission nor intervenors, for the Commission issued its *Opinion and Recommended*

Decision in the Capital One case on May 15, 2003, fully **14 months before** the prehearing conference in the DFS case on July 15, 2004. On the other hand, Valpak, Office of the Consumer Advocate (“OCA”), and the Postal Service have worked diligently to obtain through written discovery information that could allow a 60-day timetable for this litigation to be followed, without the need for a hearing.

Any NSA is, in essence, a special deal between the Postal Service and DFS. It is easy to understand why benefitted mailers may have a desire to have an NSA rubber-stamped by the Commission, expeditiously and without meaningful scrutiny. But it should not be difficult to understand why another large mailer, even one which is not a direct competitor, would want the assumptions underlying the NSA made transparent on the public record.

The purpose of Valpak’s interrogatories in attempting to understand and examine the rationale for this NSA should have appeared clear when filed, but this brief demonstrates their significance and Valpak’s interest beyond question. Nevertheless, the issue having been raised, some additional comments detailing Valpak’s reason for interest in this docket would seem useful.

First, as one of the two initial functionally equivalent NSAs, it should be clear that the procedural and other rulings in this docket have substantial precedential importance for all further such dockets, in the same way that the Capital One NSA has had precedential importance. Although Valpak is not a credit card company which competes with DFS, it is entirely foreseeable that Valpak could be directly affected by

the policy of the Postal Service and the Commission toward NSAs in the future. It is entirely possible that Valpak could be either: (i) a co-proponent of a baseline NSA, or (ii) a co-proponent of a functionally equivalent NSA, or (iii) an excluded competitor for an NSA provided to other companies in its industry. Insofar as it is impossible for Valpak to anticipate the specific economic interest that it could have with regard to future NSAs, it is in Valpak's best interests to urge that the procedures and principles which govern all NSAs be rational and fair to all. Two issues relating to such concerns which have already arisen in this docket are the following: (i) how cases that may be functionally equivalent to a prior baseline case should be litigated when they incorporate a fact pattern quite different from the baseline case, and (ii) when intervenors should be entitled to a hearing. This brief addresses the first issue. The Commission was not required to decide the second issue in this docket, as neither the OCA nor any intervenor sought a hearing. The issue will recur, however, and, when resolved, it is earnestly hoped that the Commission will not sacrifice equity and procedural due process for speed and expediency.

Second, although it can be assumed that the two co-proponents have negotiated this NSA with each other, faithfully representing their own interests, there is no reason to assume that either co-proponent has any particular motivation to share information concerning their NSA in a way that would permit others to determine at a later time whether the NSA was in fact a success. Valpak believes that the Postal Service's proposal in this docket, and its responses to interrogatories, have been well presented,

and, indeed, forthcoming, but the kind of transparency that would lead to accountability cannot always be anticipated. For example, in this proposed NSA, the economic model presented made certain assumptions about the forwarding rate for DFS' mail that were not expressly set out in the model. If the forwarding rate actually experienced should exceed the 2.0 percent assumed by the Postal Service, it would reduce contribution to institutional costs from the NSA, but this would not be revealed by the model. Also, the Postal Service model does not explicitly show marginal profitability. The litigation process has allowed interrogatories to be posed, the answers to which have allowed Valpak to present an alternative display to the model used by the Postal Service to calculate the net financial effect on the Postal Service, which is now contained in Appendix A hereto. Valpak urges the Commission to use this revised model to analyze the financial impact of each marginal increment in volume (including the cost of forwards), which is a significant improvement from that originally submitted by Postal Service witness Ayub.

Third, if the Postal Service loses money on the NSA, those losses will become institutional costs that, ultimately, will be paid not by the Postal Service, but by other mailers. Although it would seem that the Commission could rely on the Postal Service to protect its own revenues, in a real way other mailers have a greater incentive to protect Postal Service revenues than does the Postal Service. For in the final analysis, any losses from any NSA will not be absorbed by the Postal Service, as it has no residual shareholder, but will be passed on to all other mailers. And those mailers who

will pay the bulk of these lost revenues are mailers who utilize high coverage subclasses, such as Standard ECR, which is the dominant subclass used by Valpak.

Fourth, the major reason that this proposed NSA “works” financially as to mail which migrates from Standard Regular Mail to First-Class presorted mail is that there is a particular spread in the rates and profitability of those two products. The lower the Standard Regular rates being charged by the Postal Service, the less contribution is being earned by those pieces before their migration, and the higher are the discounts that the Postal Service can offer this mail in First-Class and still be able to argue that contribution improves. However, since the creation of Standard ECR Mail in Docket No. MC95-1, Valpak’s position has been that Standard Regular Mail has been undercharged relative to ECR. As a heavy user of ECR, Valpak would not want this NSA to create a disincentive to increasing coverage for Standard Regular and to decreasing coverage for Standard ECR Mail.

III. The Proposed NSA with DFS Poses Certain Financial Risks for the Postal Service and Other Mailers Not Party to the NSA

One issue of undisputed, critical importance to both the Postal Service and mailers not party to the proposed NSA, and anticipated always to be relevant under Rule 196(a)(6), is whether the NSA will improve or harm the Postal Service’s financial condition. In this regard, the Commission is urged to focus its financial analysis not only on **average profitability**, but also on **marginal profitability**. That is, on whether

each increment of volume that might arise under the NSA will make at least a minimal, meaningful contribution to the Postal Service's non-attributed institutional costs, and leave the Postal Service financially better off than it would be in the absence of the NSA. Such marginal analysis would appear to be mandated by 39 U.S.C. Section 3622(b)(3), which requires that **all postal rates** cover attributable costs, **not just the average rate** paid by a mailer which is a party to an NSA.

The proposed NSA with DFS incorporates declining block discounts for incremental volumes of First-Class Mail ("FCM"). Because of this feature, it is important that the analysis of profitability, or contribution to institutional costs, look beyond averages, and focus on what happens at the margin as the volume of FCM increases to trigger the deepest discounts under the proposed NSA. Marginal profitability is especially important in the case of the proposed NSA with DFS because (i) DFS has a substantial amount of marketing mail volume that could shift from Standard to FCM, and (ii) the volume shift that is forecasted to occur may be conservative.¹¹ Further, with numerous threats to FCM volume, it is urged that the Commission ensure that nothing in the NSA adversely affects the costs (and rates) of all FCM, as that would jeopardize the very FCM volume this NSA seeks to increase.

¹¹ Response to POIR 1, Question 7.

A. The Proposed NSA Could Increase the UAA Cost Burden on All FCM.

1. Significant volumes with higher-than-average UAA mail will be induced into First-Class from Standard.

Returns. The current systemwide average return rate for UAA mail that cannot be forwarded is 1.23 percent. USPS-T-1, App. A, p. 1. For DFS’s solicitation mail, however, in each year of the three-year span when the NSA will be in effect, the return rate is assumed to be 9.3 percent. USPS-T-1, App. A, p. 1. In Years 2 and 3, as shown below, the volume of UAA marketing mail returns resulting from the proposed NSA is projected to increase by almost 1.7 million pieces, or 11.5 percent.¹²

Accordingly, DFS’s projected returns of UAA mail before and after rates are as follows:¹³

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Before Rates			
Statement Mail	885,000	870,000	855,000
Marketing Mail	<u>14,508,000</u>	<u>14,508,000</u>	<u>14,508,000</u>
Total	15,393,000	15,378,000	15,363,000
 After Rates			
Statement Mail	885,000	873,000	861,000
Marketing Mail	<u>15,717,000</u>	<u>16,182,000</u>	<u>16,182,000</u>
Total	16,602,000	17,055,000	17,043,000

¹² DFS witness Giffney states that DFS’s volume response to the block discounts in the proposed NSA represent “minimum projections” and “anticipates that [DFS] will mail more than [projected].” Response to VP/DFS-T1-15.

¹³ Return rate forecasted in USPS-T-1, App. A, p. 1 multiplied by forecast volumes, shown in USPS-T-1, App. A, p. 2.

DFS forecasts that in Years 2 and 3 of the NSA its First-Class letter marketing mail volume will increase by **36 million pieces**, from a base of 138 million in 2003.¹⁴ Those 36 million pieces represent **only 7.4 percent** of the 484 million pieces that DFS entered as Standard Mail in 2003.¹⁵ Therefore, the remaining volume of DFS Standard Mail that potentially could migrate to First-Class, 448 million pieces, is massive in comparison with the projected migration of 36 million pieces. Further, based on its 2000 volume, DFS could generate as much as 680 million additional pieces that would be potential candidates for migration.¹⁶ If the NSA proposed in this docket subsequently induces DFS to convert hundreds of millions of pieces of Standard Mail to First-Class, that development would result in a significant increase in the total volume of UAA returns in First-Class Mail.

Forwards. The current systemwide First-Class forwarding rate is **1.96 percent**.¹⁷ The forwarding rate for DFS's First-Class solicitation mail is assumed by the Postal Service to be **2.00 percent**, which is virtually equal to the systemwide average.¹⁸

¹⁴ USPS-T-1, App. A, p. 2.

¹⁵ See response to OCA/DFS-T1-5 for DFS Standard Mail volumes for the years 2000 to 2003.

¹⁶ *Id.*

¹⁷ Docket No. MC2002-2, response to APWU/USPS-T3-4(e).

¹⁸ As noted in section C.2, *infra*, considerable uncertainty attaches to this assumed forwarding rate. It could range up to four or five times the systemwide average.

The combined **systemwide average** for First-Class UAA mail, both forwards and returns, is **3.19 percent**, while **DFS** marketing mail under the NSA is assumed by the Postal Service to have a UAA rate of forwards and returns combined equal to **11.3 percent**.

It does not appear that any provision in the NSA will operate to reduce or offset this high volume of UAA mail. For instance, any benefit from using address correction information to cleanse mailing lists will be limited strictly to DFS's own mailings, because DFS understands that "passing corrected list information back to others is forbidden by terms of the contract."¹⁹ The DFS marketing lists that contain a high percentage of UAA addresses will thus continue to circulate among other mailers with no improvement whatsoever on account of the NSA. Under the circumstances, NSAs clearly offer no improvement — much less a solution — to the problem of mailing lists that contain a high percentage of UAA addresses. Furthermore, any improvement to lists used by DFS could be relatively short-lived, since terms of rental lists generally specify or limit the number of times that the list may be used by DFS.²⁰

2. The Postal Service's total cost of handling UAA mail could increase.

If a substantial volume of DFS Standard Mail, which contains a high percentage of UAA addresses, were to migrate to First-Class, such migration could increase the Postal Service's total cost of handling UAA mail, more than offsetting any savings from

¹⁹ Response to VP/DFS-T1-9.

²⁰ Response to VP/DFS-T1-9.

adoption of lower-cost electronic ACS. As noted previously, the DFS forecast anticipates that only **7.4 percent** of its 2003 Standard Mail volume, or 36 million pieces, will migrate to First-Class. Postal Service witness Ayub concurs with DFS witness Giffney that the projected migration is a **minimum, conservative forecast**.²¹ The possibility of substantially more migration by DFS is thus very real.

In due course, the higher costs associated with higher levels of UAA mail will come to be reflected in the unit cost for all FCM, because the Postal Service averages the cost of returning and forwarding UAA mail over all FCM, including single-piece FCM. At that point, single-piece FCM, as well as discounted (bulk) non-solicitation FCM that generates a low rate of UAA mail (*e.g.*, statement mail, such as that of DFS), will be called upon to absorb any cost increases attributable to higher levels of UAA mail. As those higher costs work their way into the systemwide average unit cost, those First-Class mailers that submit solicitation mailings with a markedly higher UAA rate will get the benefit of a **“free ride” through cost averaging**. This predictable consequence is an important matter requiring the Commission’s consideration.

²¹ USPS-T-1, p. 13, ll. 1-3 and 12-14.

B. At the Block Discount Level, the Projected Marginal Contribution to Institutional Costs Is Rather Low, and Could Result in Marginal Losses before the NSA Expires.

1. The projected rate of UAA returns for DFS's solicitation mail may be low, but it is not unreasonably low.

When a piece of FCM is UAA, under the current Domestic Mail Manual ("DMM") regulations, it must be either returned or forwarded. In the ordinary course of business, routine disposal of First-Class marketing mail without Address Correction Service has not been an option for mailers or the Postal Service, even under terms of an NSA. On the basis of its actual experience, DFS projects that when it converts a solicitation mailing from Standard to First-Class, **9.3 percent** of the volume mailed will be returned.²² This assumption has not been challenged by any party. Although the projected return rate for DFS is less than the 10.0 percent return rate experienced by Capital One,²³ it is slightly higher than the 9.0 percent return rate projected by Bank One Corporation in Docket No. MC2004-3, and it does not appear to be unreasonably low. The 9.3 return rate assumed for DFS is over seven times the systemwide average of 1.23 percent.

²² Response to POIR 1, Question 1; USPS-T-1, App. A, p. 1.

²³ Response to POIR 1, Question 2.

2. **The projected rate of UAA forwards for DFS's solicitation mail is at the low end of a wide range of uncertainty and could turn out to be several times the projected rate.**

When First-Class UAA mail is forwarded, the Postal Service incurs a unit cost of **\$0.345** (in Year 1). Under terms of the NSA, the Postal Service also will incur a unit cost or **\$0.074** (in Year 1) to supply the mailer with an electronic address correction. (This ACS service for forwarded mail is not provided free to any First-Class mailers, except those with an NSA). The current total cost for each forward under the NSA thus amounts to **\$0.419**. Because of these very high costs associated with each piece forwarded, achieving positive marginal revenue at the maximum discount level is highly dependent upon validity of the Postal Service's assumption that the volume of First-Class forwards will average only 2.0 percent of the incremental volume of FCM. This assumption was not incorporated expressly into the Postal Service's economic model as proposed, but has been done in response to Valpak interrogatories. (The spreadsheet in Appendix A hereto is the spreadsheet attached to VP/USPS-T1-14, with revisions necessitated by witness Ayub's responses thereto. It was furnished informally by the Postal Service to Valpak after the final errata by witness Ayub to VP/USPS-T1-14 were filed on September 3, 2004.)

Despite the fact that DFS has sent in excess of 138 million pieces of First-Class marketing mail in each of the years 2001-2003,²⁴ neither the Postal Service nor DFS has any data specific to DFS that would indicate the percentage of DFS marketing mail

²⁴ USPS-T-1, App. A, p. 2.

that has been forwarded, or is likely to be forwarded. The assumed forwarding rate of 2.0 percent is **based solely on unaudited data for only one mailer** (Capital One), and those data are for less than one year.²⁵ However, Capital One's **mail list practices may differ** in important ways from those of DFS. Namely, Capital One maintains and mails from a nationwide master list, whereas DFS does not maintain such a list.²⁶ Instead, DFS buys and experiments with new lists.²⁷ The 2.0 percent figure is specific only to Capital One.

Aside from speculation and unsupported assumptions, the Postal Service has offered no substantive reason for applying this Capital One mailer-specific datum to DFS. Indeed, good reason exists to believe otherwise. DFS witness Giffney states that DFS has "no reason to doubt that the lists [used] for First-Class and Standard mailings are of the same quality for UAA purposes."²⁸ She also states that DFS purchases lists based on a number of drivers that do not relate "to the quality of the postal addresses in the lists."²⁹ Thus, the forwarding rate for DFS's solicitation mail could turn out to be more in line with the systemwide average for Standard Mail.

²⁵ See response to POIR 1, Question 2.

²⁶ Response to VP/DFS-T1-8.

²⁷ The profile of DFS Standard Mail volume in 2003, approximately 430 million pieces (based on Permit System data), is shown in USPS-T-1, App. A, p. 8. See also response to OCA/DFS-T1-5 for DFS Standard Mail volume in prior years.

²⁸ Response to POIR 1, Question 1.

²⁹ DFS-T-1, p. 13, ll. 11-15.

For Standard UAA mail, a combined forwarding and return service is available as an option for any mailer that elects to pay the applicable fee. Under that option, pieces are forwarded, if possible; otherwise, they are returned. For ratemaking purposes, **Standard Mail is assumed to have 1.472 forwards for each piece returned.**³⁰ The Postal Service asserts that the forwarding-return ratio is based on a solid statistical foundation. It is said to be the result of a special field survey in which data were collected from a representative sample of 2,303 representative delivery units distributed throughout all five postal regions, for six days spread over a test period of one month.³¹ A forward rate of **13.7 percent** results when the forward-return ratio for Standard Mail is applied to the 9.3 percent return rate assumed for solicitation mail that DFS converts to First-Class.

On a monthly basis, DFS procures over 40 mailing lists.³² That amounts to 480 mailing lists annually. The speculation that forwards from those 480 lists would average only a small fraction, 0.22,³³ of the DFS return rate, as opposed to the established Standard Mail ratio of 1.472, constitutes a monumental statistical leap of faith — especially when “the quality of the addresses in the lists” is not a factor in their selection. No credible substantive reason has been provided on the record to support

³⁰ Response to VP/USPS-T1-3(d). Mailers that elect to use this optional forwarding and return service pay only for the pieces returned.

³¹ Response to VP/USPS-T1-12(a).

³² DFS-T-1, p. 6, l. 7.

³³ This is the ratio of 2.0 percent forwards divided by 9.3 percent returns.

the speculation that the forward-return ratio of DFS's Standard marketing mailings will deviate significantly from the systemwide average for all Standard Mail.

The Postal Service cannot have it both ways simply because this docket involves an NSA with only one mailer. It should not be allowed to disregard record data used for many years for ratemaking purposes regarding Standard Mail whenever those data do not suit its immediate purpose. To permit the Postal Service to do so would be grossly unfair, not only to all Standard mailers who pay for the ACS option, but also to all other Standard mailers who must continue making decisions based on the existing fee for returning and forwarding Standard Mail. It makes no sense to disregard well-established systemwide averages and substitute not mailer-specific costs, but instead speculation based on unaudited results of less than one year from a **different mailer** with significantly **different mailing practices**.

It is true that the expected return rate for DFS might be lower than 13.7 percent, since lists used for Standard Mail need only comply with Coding Accuracy Support System ("CASS"), whereas lists used for FCM need to comply with a more rigorous move update requirement within six months of the time when the mail is entered.³⁴ It appears unlikely, though, that compliance with the move update requirement would reduce the expected forwarding rate from 13.7 percent to only 2.0 percent, as that would imply a success rate of 85 percent, which exceeds anything heretofore claimed

³⁴ Response to VP/USPS-T1-13(d). Although not required *per se*, one way for a mailer to comply with the move update requirement is to run the mailer's list against the NCOA file.

for National Change of Address (“NCOA”),³⁵ the method used by DFS to comply with the move update requirement.³⁶

Marginal profitability under the proposed NSA with DFS is shown in Appendix A hereto. In Year 1 (2004) of the NSA, the Postal Service has a projected profit of only **2.3 cents** per piece from any mail that receives the maximum discount of 4.5 cents. By Year 3 (2006), the projected profit declines to **1.8 cents** per piece. At the same time, it is virtually impossible for the NSA in this docket to become effective prior to the final days or weeks of 2004. Consequently, the third year under the NSA will fall at the end of 2007, not 2006. Inflating the projected costs by another year beyond 2004 and 2006— *i.e.*, to 2005 and 2007 — while accepting the Postal Service’s assumptions reduces the marginal profitability at the maximum discount level of 4.5 cents to only 1.7 and 1.1 cents even further.

The preceding discussion illustrates (i) the narrow margin of profitability at the maximum discount level, and (ii) the wide range of uncertainty, from 2.0 to 13.7 percent, surrounding the percentage of DFS’s UAA mail that will need to be forwarded. If the assumed 2.0 percent rate for DFS’s UAA forwards subsequently turns out to be too low, then, at the maximum block discount rate of 4.5 cents, the small projected marginal contribution easily could evaporate, causing a marginal loss.³⁷

³⁵ See Docket No. MC2002-2 (Capital One NSA), Tr. 3/637-650.

³⁶ See DFS-T-1, p. 13, ll. 18-20.

³⁷ Deviation from other assumptions could have a similar effect. For example, if the cost of manual returns *for letters* is 3 cents lower than assumed, that too

The Postal Service then could find itself in the classic position of “losing a little bit on each unit, and trying to make up for it on the volume.” This possibility reflects the wisdom of incorporating some form of further stop-loss provision or corrective device in NSAs until more experience, as well as more and better data, become available.³⁸

(See Section V, *infra*.)

3. The net profitability of converting solicitation mail from Standard to First-Class is inversely related to the marginal contribution made by Standard Regular Mail.

All of DFS’s new First-Class volume of solicitation mail is assumed to represent a migration of mail that otherwise would have been entered at the Standard rate.³⁹ In other words, DFS projects no net increase in the combined volume of its First-Class and Standard Regular solicitation mail. Consequently, as shown on the bottom three rows of the two spreadsheets in Appendix A, the net profitability depends critically — and inversely — on the contribution to institutional costs that the Postal Service derives from DFS’s Standard Regular Mail (*see* spreadsheets). The higher the unit profitability of DFS’s Standard Mail, the lower the net unit profitability after such mail converts to First-Class. Stated otherwise, a major reason why profitability of the proposed NSA with DFS appears enticing to the Postal Service is because the marginal contribution to

would reduce the net profitability of the NSA at every discount level (*see* Appendix A), and cause the Postal Service marginal losses at high discount levels.

³⁸ The basic stop-loss provision contained in the proposed NSA seemingly would limit any extreme hemorrhaging by the Postal Service, but does not appear to be adequate to protect postal finances in and of itself.

³⁹ DFS-T-1, p. 9, ll. 8-15.

institutional costs from Standard Regular Mail is low in comparison to the marginal contribution derived from FCM.

Moreover, the unit cost from **Standard Regular Mail** is low not only in comparison with FCM, but also in comparison with Standard ECR Mail. DFS's use of Standard mail is overwhelmingly (96 percent) Standard Regular.⁴⁰ In Years 1 and 3, respectively, DFS's Standard Mail is forecast to contribute \$0.0886 and \$0.0836 per piece to the Postal Service's institutional costs. According to the 2003 Cost and Revenue Analysis ("CRA") report, the systemwide marginal contribution per piece of **Standard Regular Mail** was only **\$0.070**. That marginal contribution, however, includes Nonprofit Standard Mail, which has a lower markup and makes a lower contribution to institutional costs. That, and the small increment of Standard ECR Mail used now by DFS, seem to explain why that the estimated marginal contributions from DFS's Standard Regular Mail in 2005 and 2007 will exceed the systemwide marginal contribution from all Standard Regular Mail in 2003.

At the same time, the 2003 CRA reveals that the marginal contribution of all **Standard ECR Mail** (also including nonprofit ECR) was **\$0.100**, which exceeded the systemwide contribution of Standard Regular Mail by \$0.030. That same CRA also indicates that the marginal cost of Standard ECR (\$0.061) is less than half the marginal cost of Standard Regular (\$0.135). **For each piece of Standard Regular Mail, the Postal Service spends over twice the marginal cost of Standard ECR in order to**

⁴⁰ In 2003, DFS mailed 413,844,493 pieces of Standard Regular, and only 17,033,886 pieces of Standard ECR.

earn 30 percent less. In light of the lower unit cost of ECR vis-a-vis that of Standard, the fact that the marginal contribution from ECR exceeds the marginal contribution from Standard Mail by \$0.030, or 42 percent, can be viewed as something of a **pricing anomaly**. Financially, this NSA “works,” in part, due to this pricing anomaly.

IV. Pricing of the Postal Service’s First-Class Return Services Is Anomalous

In addition to the alleged financial benefit to the Postal Service, the proposed NSA is asserted by Postal Service witness Ayub to have other ancillary benefits that support certain policy and business goals of the Postal Service. For example, an increase in First-Class volume from DFS would help offset the continuing erosion in the Postal Service’s First-Class Mail volume.⁴¹ Since ancillary considerations have been offered to support the proposed NSA with DFS, this section of Valpak’s comments discusses various other ancillary considerations that arise from the record in this docket. Some of these comments relate to fairness to other mailers under Rule 196(a)(6)(ii). (In any event, comments on certain policy issues were authorized by Presiding Officer’s Ruling No. MC2004-4/2 at 5.)

A. The cost-price relationship of manual returns vis-a-vis that of electronic Address Correction Service is highly illogical.

⁴¹ USPS-T-1, p. 4, l. 22, through p. 5, l. 8.

Manually returning a UAA letter costs **\$0.55**, whereas providing an **electronic** address correction for a UAA letter costs only **\$0.34**. The fact that electronic returns cost the Postal Service less to provide than manual returns is not surprising.

What ought to surprise even a casual observer is that the Postal Service provides high-cost manual returns **free of charge** for FCM, but, for its low-cost electronic Address Correction Service, it **charges a fee of \$0.20**. It is difficult to conceive how economic signals could be more badly distorted than they are for these two substitute services. It is this irrational pricing structure that provides the underpinning for the NSA proposed in this docket, as well as other functionally equivalent NSAs.

Electronic Address Correction Service not only has a lower cost to the Postal Service, but also may offer users of discounted First-Class Mail some advantages not obtainable from manual returns, such as easier use of the information when dealing with electronic address records. Despite those potential advantages, however, for most First-Class Mail, any gains from using electronic address correction seemingly fail to outweigh the \$0.20 fee. This is especially the case for solicitation mail. Some reasons why mailers prefer free manual returns are discussed in the next section.

B. Mailers appear to place a low value on return information, especially for solicitation mail, hence the fee for electronic Address Correction Service seemingly constitutes a formidable disincentive for mailers to switch from free manual returns.

During the 15 years that the fee for electronic Address Correction Service has been in existence, the Postal Service has encouraged First-Class mailers to adopt

electronic Address Correction Service in lieu of manual returns.⁴² Yet, as of September 19, 2003, only 1,786 mailers were using electronic Address Correction Service, and the annual volume of electronic Address Correction Service returns was approximately 1.9 million.⁴³ In 2003, the Postal Service collected a mere \$380,000 in fees for electronic Address Correction Services provided to FCM.⁴⁴

To put the above-cited usage of ACS into perspective, note that the annual volume of returns of First-Class UAA mail is about 1.2 billion pieces.⁴⁵ Approximately half, or 600 million of those returns, can be assumed to be for discounted FCM.⁴⁶ If all of those 600 million returns used electronic Address Correction Service, the potential annual revenues (at 20 cents each) would amount to \$120 million. Thus, after 15 or so years of marketing effort by the National Customer Support Center, the total fees of \$380,000 represented only 0.32 percent of the \$120 million potential revenue.

The market could scarcely have responded more clearly (or rationally) to the illogical pricing of return services, as the Postal Service seems to recognize. “In general, customers seem to prefer the free option.”⁴⁷ In the case of DFS, it used manual return information on an experimental basis for some of its First-Class Mail

⁴² Docket No. MC2004-3, response to VP/USPS-T1-27(e).

⁴³ Docket No. MC2004-3, response to VP/USPS-T1-27.

⁴⁴ Docket No. MC2004-3, response to VP/USPS-T1-27(c).

⁴⁵ Docket No. MC2004-3, response to VP/USPS-T1-7(a).

⁴⁶ Docket No. MC2004-3, response to VP/USPS-T1-25(b).

⁴⁷ Docket No. MC2004-3, response to VP/USPS-T1-27(d).

prior to 2003, but ceased such use because of the expense involved.⁴⁸ DFS makes no use whatsoever of the forwarding and address correction option that is available for Standard Mail.⁴⁹

One reason that the \$0.20 fee for ACS constitutes a formidable barrier to widespread ACS use is that mailers perceive the information from free manual returns of solicitation mail to be of little or no value. For example, DFS witness Giffney states that “[p]resently we are not doing anything with the physical returns and therefore are incurring no costs,” (OCA/DFS-T1-6) and “[c]urrently, we are not using any information from our physically returned First-Class marketing mail” (OCA/DFS-T1-9).

The low perceived value by mailers can result from a number of factors. For example, a mailer’s cost to use the information from manual returns is high, even though the returns themselves are provided free of charge by the Postal Service. Second, the return information from the Postal Service can be, and sometimes is, inaccurate. That is, some pieces that are returned as UAA, in fact, may be deliverable as addressed. In each such instance, the return can be described reasonably as “misinformation,” which has negative value that detracts from any positive information on other returns. Third, some, perhaps many, of the mailing lists used to generate solicitation mail may be the source for only one mailing; for such lists, it seems fairly

⁴⁸ Response to VP/DFS-T1-3.

⁴⁹ Response to VP/DFS-T1-2.

obvious that return information has little or no value. Similarly, all rental lists have a limited life. Consequently, even when a rented list is used for more than one mailing, there always is a last mailing using that list. Return information from that last mailing is of little or no value to the mailer. Moreover, when mailers decide that they want to re-use some lists, they sometimes buy a more recent list — *e.g.*, a list of magazine subscribers — and any address cleansing to the earlier list might be of limited help in cleansing addresses in the later list. Fourth, other lists with names of potential new customers likely can be acquired at a lower cost per name than the mailer's cost of manually inputting free return information.⁵⁰

The real demand for UAA returns would be revealed rather quickly if the Postal Service were to charge all bulk First-Class mailers a fee for providing UAA information which correlated to its cost — currently, \$0.34 for electronic Address Correction Service, \$0.55 for a manual return — **along with an option to avoid the fee altogether** by means of an endorsement that would allow the Postal Service to dispose of UAA mailpieces that cannot be forwarded.

⁵⁰ More precise information concerning the cost of acquiring new names is not available; *see* DFS objection to VP/DFS-T1-11. (Valpak did not file a motion to compel.)

C. The proposed NSA partially corrects the totally distorted pricing signals for return of UAA mail for DFS, but, for all other bulk First-Class mailers, the price signals fail to improve.

Under the proposed NSA, the \$0.20 fee for electronic address correction is waived. For DFS, this provision eliminates any fee difference with respect to manual versus electronic returns. In addition, information received via electronic returns will be less costly to use than manual returns for DFS, since it will obviate manual inputting of return information by DFS.⁵¹ Giving DFS a zero price for each of the two return services admittedly fails to reflect both (i) the cost difference involved in providing each respective service, and (ii) the greater value of electronic returns. For DFS, however, it at least equalizes the price for each return service (at zero), thereby removing the economic disincentive to use ACS, and partially rationalizing the anomalous inverse price relationship discussed, *supra*, in Section IV.A.

By the same token, equalizing the price for the Postal Service's two return services also would be a logical first step to take with respect to all bulk First-Class mailers. As a hypothetical, if bulk First-Class mailers could have either return service for the same price (*e.g.*, free), as offered to DFS under the proposed NSA, many might need no further inducement (such as declining block discounts) to opt for electronic returns in lieu of manual returns. In this docket, the gradually widening spread in the cost difference between manual returns and electronic Address Correction Service shows that if several large bulk First-Class mailers opted for electronic returns, the

⁵¹ Response to VP/DFS-T1-3.

Postal Service could achieve meaningful reductions in its astonishing **\$1.8 billion expense for UAA** mail. Of course, the immediate effect of any such savings in the cost of handling UAA mail would be to increase the net contribution to institutional costs.

For the future, the Commission needs to consider the fairness to other First-Class mailers of perpetuating the illogical pricing of return services, especially when such pricing serves as the primary justification for NSAs, such as the one proposed in this docket. A **niche classification** case easily could eliminate the ACS fee for FCM. That at least would rationalize in part the pricing of return services, and it clearly would be fairer to all mailers than an NSA that is exclusive to only one mailer (or a small number of functionally equivalent NSAs that are exclusive to a few mailers). In the interest of fairness to all mailers, the Commission should continue to express a strong preference for reform via such non-discriminatory niche classification cases.

D. Computation of ACS “savings” under the proposed NSA is critically dependent on continuation of (i) the highly dysfunctional pricing of return services described above, and (ii) mailer resistance to pay the fee for electronic address correction.

The testimony of Postal Service witness Ayub points out that “the Commission stated that an agreement that is functionally equivalent to Capital One would need to have ACS cost savings.” USPS-T-1, p. 7, ll. 9-11. The critical importance of such ACS savings to the proposed NSA is shown elsewhere in witness Ayub’s testimony,

which estimates the value to the Postal Service of all three value drivers, over the three years of the NSA, as follows:⁵²

ACS cost savings:	\$8.2 million
Increased contribution (less incremental discounts):	\$2.1 million
Discount exposure:	(\$3.2) million.

Without the indicated \$8.2 million of ACS savings, the NSA clearly would have a negative value. That is, the negative discount exposure of \$3.2 million would swamp the \$2.1 million of increased contribution. What does not receive explicit mention by witness Ayub is the implicit assumption underlying computation of those savings — namely, that in the absence of the inducements contained in the NSA, there is virtually no possibility that electronic Address Correction Service would be adopted by DFS (or any other large mailer, especially one that uses First-Class for solicitation mail). In other words, the “implicit baseline” used to compute ACS savings assumes **non-adoption of ACS without substantial inducements**. So long as the Postal Service perpetuates the existing illogical pricing relationship, that presumption is not unreasonable, and the “implicit baseline” remains intact.

Note, however, that the resistance among mailers to switch from manual returns and pay the \$0.20 ACS fee is almost, but not quite, universal. As noted above in Section II.B, as of September 19, 2003, some 1,786 mailers were using ACS. Since these mailers already are using ACS (and paying for it), it clearly would be impossible to generate any “ACS cost savings” by inducing them to switch. An issue that the

⁵² USPS-T-1, p. 12, ll. 5-9, amended.

Commission should consider is the fairness of the proposed NSA to these 1,786 mailers, as well as any others that might elect to use ACS during the next three years.⁵³

The fairness issue mentioned in the preceding paragraph has ramifications that extend well beyond the current 1,786 ACS users. To illustrate, one need only assume that a slightly more rational pricing scheme — such as providing both return services free (or for the same price which would leave mailers indifferent between the two return services) — were to be adopted. Following such an event, a substantial number of large mailers might convert to ACS with no further inducement. In that context, the issue of giving significant inducements in NSAs to some mailers, but not to others, would loom as a much larger issue. Of course, if a more rational pricing scheme were to be adopted while inducements for switching from manual returns to ACS are being widely disbursed, mailers might be reluctant to convert because that effectively would remove their opportunity to bargain for such inducements (*e.g.*, declining block discounts). At that point, all existing functionally equivalent NSAs would have a counterproductive effect.

Also, if the existing illogical pricing relationship of return services were to be eliminated, the ACS “implicit baseline” for computing “savings” under the NSA with DFS (and any other functionally equivalent NSA) might vanish into thin air. That is,

⁵³ These ACS users averaged only 1,064 returns per year, and their average annual fee amounts to only \$213. By any standard, their usage of ACS is relative minor in comparison to that projected for DFS.

no longer might it be reasonable to presume that mailers require a further inducement, such as declining block discounts, in order to adopt ACS.

The above consideration gives rise to a closely-related issue: whether the existence of the proposed NSA, in conjunction with any other functionally equivalent NSAs, will significantly **delay**, or even **preclude** altogether, steps by the Postal Service to **rationalize** — either partially or completely — the existing illogical pricing relationship of its UAA return services. It is not inconceivable that the Postal Service would be reluctant to eliminate the rationale for existing NSAs. It would seem that the Postal Service has covered this possibility by allowing for it to terminate the NSA under certain circumstances. However, should DFS and the Postal Service not believe the NSA could be terminated, then this NSA could be a serious obstacle to systemwide improvement, which would be unfair to other mailers.

E. The NSA fails to reflect a good balance between the value that mailers derive from return information and the cost that Postal Service incurs to provide such information.

Handling of UAA mail is somewhat expensive for the Postal Service, even with electronic Address Correction Service. As discussed in preceding Section II.B, the evidence strongly suggests that, for solicitation mail, the UAA return costs exceed the mailer's perceived value of the information by a substantial margin. Inducing Standard solicitation mail to convert from Standard to First-Class — as the proposed NSA would do — results in mailers receiving substantial amounts of a high-cost service that they

perceive to be of low value. That constitutes a rather unlikely basis for a successful business model. To develop the basis for a sound business model, **the Postal Service needs to tailor the services provided under NSAs in ways designed to assure that the value mailers derive from those services will exceed the costs that the Postal Service incurs to provide those services.** In theory, NSAs are supposed to provide the Postal Service with a means to escape from the “one-size-fits-all” approach. To date, however, it scarcely seems to work that way. For the Postal Service to continue providing full, costly UAA services to all First-Class solicitation mail, regardless of the value-cost relationship, cannot achieve a rational outcome.

In the Bank One docket, Postal Service witness Michael K. Plunkett (USPS-T-1) states that “the Postal Service would presumably still want to provide incentives for large mailers to adopt electronic returns [in lieu of manual returns] because of the [approximately 20 cents per unit] cost difference.”⁵⁴ Insofar as it goes, the logic of this statement is unassailable. But, by the same logic, the Postal Service also should want to provide incentives for large First-Class solicitation mailers to forego returns altogether because of the 37 cent per-unit cost difference between returning and simply disposing of UAA mail. That would improve the Postal Service’s profitability equation markedly. A savings of 37 cents per piece is, after all, almost double a savings of 20 cents per piece. Barring any move by the Postal Service to eliminate those costs that greatly exceed any value rendered and capture some or all of the resulting savings, any

⁵⁴ Docket No. MC2004-3, response to VP/USPS-T1-12.

gain in profitability under the proposed NSA is likely to be marginal at best (unless the Postal Service is able to increase its productivity dramatically, or otherwise reduce its unit costs below the levels assumed in USPS-T-1).

V. Final Recommendations

In addition to the comments set out above (*e.g.*, use of system-wide forwarding rate, *see* Section III.B.2), Valpak raises the following issues and makes the following final recommendations concerning the proposed NSA.

A. Protecting Against Adverse Financial Impact of the Negotiated Service Agreement

If the proposed NSA with DFS were approved by the Commission and the Governors, it likely would take effect during the last weeks of 2004, and be effective for three years, nearly through the end of 2007. Unfortunately, the cost data underlying the Postal Service's profitability model do not coincide precisely with the time frame of the NSA. Instead, the data of record herein are for 2004 to 2006. It may be possible to project the record costs into the future, such as by accepting the Postal Service assumption that costs will increase at the rate of 4.0 percent annually. Assuming validity of all assumptions underlying the Postal Service's profitability model, and assuming this cost escalation, that means the actual contribution to institutional costs over the three-year time span certainly will be less than the projected

\$6.8 million. Nevertheless, if the assumptions turn out to be anywhere near correct, the contribution to institutional costs still should be positive.

Under the Postal Service's assumptions, at the maximum discount of 4.5 cents per piece, the marginal per-piece profitability in the first year of the NSA is not large. In each successive year, cost inflation causes marginal profitability to decline, but it remains positive over the three-year span of the contract. It is important to look at profitability of the NSA at the margin, as these are the actual rates being charged and they must cover cost. Should some of the Postal Service's assumptions prove to be overly optimistic, it is entirely possible that the Postal Service could lose money on all volume that receives the maximum 4.5 cent discount. Since marginal profitability declines each year, the risk of incurring a marginal loss increases with each successive year. If the Postal Service incurs losses, the negotiated cap contained in the agreement would neither assure nor restore marginal profitability. However, because the cap limits the volume that can receive the maximum discount, it would limit the extent to which any such possible marginal losses could offset more certain marginal profitability at lower discount levels.

Over a range of foreseeable outcomes, the proposed NSA does appear likely to yield the Postal Service a positive, albeit modest, contribution to institutional costs. However, in light of the uncertainties in the underlying assumption, the Commission needs to determine whether the projected marginal profitability need be only slightly better than breakeven (*i.e.*, more than zero), or whether it needs to be higher to account

for the fact that projections could prove optimistic. The Commission needs to apply the statutory rate setting requirements to each marginal rate in an NSA that employs declining block discounts.

If this NSA with DFS does not cross whatever threshold the Commission deems minimally adequate to assure that marginal rates charged cover marginal costs, a modified stop-loss provision would appear capable of providing the requisite assurance that the NSA will not lose money. One such meritorious provision, being recommended by OCA in its Initial Brief, would be a mechanism for making interim adjustments in the discounts on the basis of actual data. Another possible provision would be a requirement that DFS pay the cost of all forwards in excess of the assumed level. As it did in the Capital One NSA, the Commission should seek to develop methods to protect the Postal Service and mailers.

B. Fairness and Equity Issues Raised by the Negotiated Service Agreement in Regard to Other Users of the Mail

Despite the fact that the NSA with DFS has been considered functionally equivalent to the one with Capital One, it nevertheless raises new fairness issues that the Commission needs to consider. One critical fairness issue arises from the fact that, under the proposed NSA, all new First-Class volume from DFS will migrate from Standard Mail. In this respect, the NSA with DFS differs materially from the Capital One NSA. One important issue is the forwarding rate that is assumed for DFS Standard Mail which will be induced by the NSA to convert to First-Class. For

Standard Mail, the Postal Service charges an ACS fee that is based on a well-established ratio of 1.472 forwards for each return. Yet, for DFS Standard Mail that converts to First-Class, the Postal Service assumes a ratio of only 0.215 forwards for each return, and that assumed ratio is used to help justify the declining block discounts offered to DFS.⁵⁵

In the absence of any data whatsoever regarding the forward rate for any of DFS's UAA mail — either Standard or First-Class — Valpak questions whether it is fair to those Standard mailers who use and pay the ACS fee that the DFS NSA, which assumes a reduction in the forward-return ratio of 85 percent without any mailer-specific supporting data or other adequate justification, be approved.⁵⁶ Such inconsistency could appear to be favoritism to a large-volume mailer, or even undue discrimination. If the Postal Service now has better data that would justify a lower forward-return ratio for Standard Mail, it should file a proposal to reduce the ACS fee. Until then, the Commission should rely on the systemwide ratio for Standard Mail as the best proxy for DFS Standard Mail that converts to First-Class.

A second fairness issue that did not impede the Capital One NSA and therefore will not impede this NSA, but needs to be addressed by the Postal Service in the near future, pertains to the fact that 1,786 First-Class mailers are paying the Postal Service a

⁵⁵ Of course, if this assumption by the Postal Service proves substantially wrong, the financial justification for this NSA erodes.

⁵⁶ In the absence of mailer-specific data, the Postal Service generally relies on — and the Commission generally accepts — systemwide averages. *See, e.g.*, response of Postal Service to POIR 1, Question 3.

fee for ACS in lieu of manual return of their UAA mail, while the Capital One and proposed NSAs not only waive that fee for certain mailers, but also offer them a substantial further inducement, in the form of declining block discounts, for using ACS in lieu of manual returns. This is a fairness issue vis-a-vis other First-Class mailers, and it raises two questions. First, are the discounts and fee waiver that are being given to DFS fair when contrasted with the fees paid by those 1,786 mailers who, without any other inducement, have been and are saving the Postal Service money by adopting ACS? Second, are the fee waiver and the discounts for certain mailers fair to all those other bulk First-Class mailers that potentially are eligible to use ACS and would prefer ACS **but for the fee**? Clearly, the Postal Service could remedy this fairness issue for all First-Class mailers in the next omnibus rate case, and, we submit, should be encouraged to do so by the Commission.

CONCLUSION

Valpak does not oppose this NSA, but urges the Commission to condition any approval of the Domestic Mail Classification Schedule (“DMCS”) provisions requested by the co-proponents relating to the proposed NSA on the mechanism designed to protect the Postal Service from adverse financial impact, as described *supra*.

Respectfully submitted,

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September 8, 2004

DFS FCM vs STD Comparison for 2005		(1)	(2)	(3)	(4)	(5)	(6)	(7)
	STD	FCM	FCM	FCM	FCM	FCM	FCM	FCM
(1) (Discount)	(No discount)	(No discount)	\$0.0250	\$0.0300	\$0.0350	\$0.0400	\$0.0450	
(2) Marketing Volume (millions)	10	10	10	10	10	10	10	10
(3) Price per Piece	\$0.175	\$0.292	\$0.267	\$0.262	\$0.257	\$0.252	\$0.247	
(4) Total Revenue (millions)	\$1.75	\$2.92	\$2.67	\$2.62	\$2.57	\$2.52	\$2.47	
(5) Cost per Piece including 1.23% return rate	\$0.087	\$0.104	\$0.104	\$0.104	\$0.104	\$0.104	\$0.104	\$0.104
(6) Total Cost including 1.23% return rate (millions)	\$0.87	\$1.04	\$1.04	\$1.04	\$1.04	\$1.04	\$1.04	\$1.04
(7) Contribution Millions	\$0.880	\$1.880	\$1.630	\$1.580	\$1.530	\$1.480	\$1.430	
(8) Incremental Contribution/per piece	\$0.088	\$0.188	\$0.163	\$0.158	\$0.153	\$0.148	\$0.143	
(9) Return Rate	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%
(10) Systemwide Return Rate	0.00%	1.23%	1.23%	1.23%	1.23%	1.23%	1.23%	1.23%
(11) Excess Return Rate	0.00%	8.07%	8.07%	8.07%	8.07%	8.07%	8.07%	8.07%
(12) UAA Volume (millions)	0.93	0.807	0.807	0.807	0.807	0.807	0.807	0.807
(13) Electronic Returns (millions)	0.000	0.000	0.686	0.686	0.686	0.686	0.686	0.686
(14) Manual Returns (millions)	0.000	0.807	0.121	0.121	0.121	0.121	0.121	0.121
(15) Electronic Return Cost per Piece	\$0.350	\$0.350	\$0.350	\$0.350	\$0.350	\$0.350	\$0.350	\$0.350
(16) Manual Return Cost per Piece	\$0.567	\$0.567	\$0.567	\$0.567	\$0.567	\$0.567	\$0.567	\$0.567
(17) Total electronic return cost (millions)	\$0.000	\$0.000	\$0.240	\$0.240	\$0.240	\$0.240	\$0.240	\$0.240
(18) Total manual return cost (millions)	\$0.000	\$0.457	\$0.069	\$0.069	\$0.069	\$0.069	\$0.069	\$0.069
(19) Total Return Cost	\$0.000	\$0.457	\$0.309	\$0.309	\$0.309	\$0.309	\$0.309	\$0.309
(20) Cost of Destruction per Piece	\$0.015	\$0.015	\$0.015	\$0.015	\$0.015	\$0.015	\$0.015	\$0.015
(21) Total Cost of destruction (millions)	\$0.014	\$0.000	\$0.010	\$0.010	\$0.010	\$0.010	\$0.010	\$0.010
(22) Contribution after return cost adjustments (millions)	\$0.866	\$1.423	\$1.311	\$1.261	\$1.211	\$1.161	\$1.111	
(23) Incremental Contribution/pc after return cost adjustment	\$0.087	\$0.142	\$0.131	\$0.126	\$0.121	\$0.116	\$0.111	
(24) Assumed Forwarding Rate	0.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
(25) Systemwide Forwarding Rate	0.00%	1.96%	1.96%	1.96%	1.96%	1.96%	1.96%	1.96%
(26) Excess Forwarding Rate	0.00%	0.04%	0.04%	0.04%	0.04%	0.04%	0.04%	0.04%
(27) Excess Forward pieces from conversion (millions)	0	0.004	0.004	0.004	0.004	0.004	0.004	0.004
(28) Cost per Forward, Year 1	\$0.345	\$0.345	\$0.345	\$0.345	\$0.345	\$0.345	\$0.345	\$0.345
(29) Total Excess Cost of Forwards, Year 1	\$0.000	\$0.001	\$0.001	\$0.001	\$0.001	\$0.001	\$0.001	\$0.001
(30) ACS Notices for forwarded mail (millions)	0	0	0.2	0.2	0.2	0.2	0.2	0.2
(31) Cost per ACS notice, Year 1	\$0.074	\$0.074	\$0.074	\$0.074	\$0.074	\$0.074	\$0.074	\$0.074
(33) Total Cost ACS notices for Forwarded Mail (millions)	\$0.000	\$0.000	\$0.015	\$0.015	\$0.015	\$0.015	\$0.015	\$0.015
(34) Contribution after forwards cost adjustment (millions)	\$0.866	\$1.421	\$1.295	\$1.245	\$1.195	\$1.145	\$1.095	
(35) Incremental Contribution/pc after forward cost adjustment	\$0.0866	\$0.142	\$0.129	\$0.124	\$0.119	\$0.114	\$0.109	
(36) Incremental Contribution of Standard Mail (millions)	\$0.866	\$0.866	\$0.866	\$0.866	\$0.866	\$0.866	\$0.866	\$0.866
(37) Contribution after Standard Mail conversion (millions)	\$0.000	\$0.555	\$0.429	\$0.379	\$0.329	\$0.279	\$0.229	
(38) Incremental Contribution/PC after forward cost adjustment	\$0.000	\$0.056	\$0.043	\$0.038	\$0.033	\$0.028	\$0.023	

DFS FCM vs STD Comparison for 2007		(1)	(2)	(3)	(4)	(5)	(6)	(7)
	STD	FCM	FCM	FCM	FCM	FCM	FCM	FCM
(1) (Discount)	(No discount)	(No discount)	\$0.0250	\$0.0300	\$0.0350	\$0.0400	\$0.0450	
(2) Marketing Volume (millions)	10	10	10	10	10	10	10	10
(3) Price per Piece	\$0.177	\$0.292	\$0.267	\$0.262	\$0.257	\$0.252	\$0.247	
(4) Total Revenue (millions)	\$1.77	\$2.92	\$2.67	\$2.62	\$2.57	\$2.52	\$2.47	
(5) Cost per Piece including 1.23% return rate	\$0.094	\$0.112	\$0.112	\$0.112	\$0.112	\$0.112	\$0.112	
(6) Total Cost including 1.23% return rate (millions)	\$0.94	\$1.12	\$1.12	\$1.12	\$1.12	\$1.12	\$1.12	
(7) Contribution Millions	\$0.829	\$1.795	\$1.545	\$1.495	\$1.445	\$1.395	\$1.345	
(8) Incremental Contribution/per piece	\$0.083	\$0.180	\$0.155	\$0.150	\$0.145	\$0.140	\$0.135	
(9) Return Rate	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%	9.30%
(10) Systemwide Return Rate	0.00%	1.23%	1.23%	1.23%	1.23%	1.23%	1.23%	1.23%
(11) Excess Return Rate	0.00%	8.07%	8.07%	8.07%	8.07%	8.07%	8.07%	8.07%
(12) UAA Volume (millions)	0.93	0.807	0.807	0.807	0.807	0.807	0.807	0.807
(13) Electronic Returns (millions)	0.000	0.000	0.686	0.686	0.686	0.686	0.686	0.686
(14) Manual Returns (millions)	0.000	0.807	0.121	0.121	0.121	0.121	0.121	0.121
(15) Electronic Return Cost per Piece	\$0.368	\$0.368	\$0.368	\$0.368	\$0.368	\$0.368	\$0.368	\$0.368
(16) Manual Return Cost per Piece	\$0.595	\$0.595	\$0.595	\$0.595	\$0.595	\$0.595	\$0.595	\$0.595
(17) Total electronic return cost (millions)	\$0.000	\$0.000	\$0.252	\$0.252	\$0.252	\$0.252	\$0.252	\$0.252
(18) Total manual return cost (millions)	\$0.000	\$0.480	\$0.072	\$0.072	\$0.072	\$0.072	\$0.072	\$0.072
(19) Total Return Cost	\$0.000	\$0.480	\$0.324	\$0.324	\$0.324	\$0.324	\$0.324	\$0.324
(20) Cost of Destruction per Piece	\$0.016	\$0.016	\$0.016	\$0.016	\$0.016	\$0.016	\$0.016	\$0.016
(21) Total Cost of destruction (millions)	\$0.015	\$0.000	\$0.011	\$0.011	\$0.011	\$0.011	\$0.011	\$0.011
(22) Contribution after return cost adjustments (millions)	\$0.814	\$1.315	\$1.210	\$1.160	\$1.110	\$1.060	\$1.010	
(23) Incremental Contribution/pc after return cost adjustment	\$0.081	\$0.132	\$0.121	\$0.116	\$0.111	\$0.106	\$0.101	
(24) Assumed Forwarding Rate	0.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
(25) Systemwide Forwarding Rate	0.00%	1.96%	1.96%	1.96%	1.96%	1.96%	1.96%	1.96%
(26) Excess Forwarding Rate	0.00%	0.04%	0.04%	0.04%	0.04%	0.04%	0.04%	0.04%
(27) Excess Forward pieces from conversion (millions)	0	0.004	0.004	0.004	0.004	0.004	0.004	0.004
(28) Cost per Forward, Year 1	\$0.374	\$0.374	\$0.374	\$0.374	\$0.374	\$0.374	\$0.374	\$0.374
(29) Total Excess Cost of Forwards, Year 1	\$0.000	\$0.001	\$0.001	\$0.001	\$0.001	\$0.001	\$0.001	\$0.001
(30) ACS Notices for forwarded mail (millions)	0	0	0.2	0.2	0.2	0.2	0.2	0.2
(31) Cost per ACS notice, Year 1	\$0.080	\$0.080	\$0.080	\$0.080	\$0.080	\$0.080	\$0.080	\$0.080
(32) Total Cost ACS notices for Forwarded Mail (millions)	\$0.000	\$0.000	\$0.016	\$0.016	\$0.016	\$0.016	\$0.016	\$0.016
(33) Contribution after forwards cost adjustment (millions)	\$0.814	\$1.314	\$1.192	\$1.142	\$1.092	\$1.042	\$0.992	
(34) Incremental Contribution/pc after forward cost adjustment	\$0.0814	\$0.1314	\$0.1192	\$0.1142	\$0.1092	\$0.1042	\$0.0992	
(35) Incremental Contribution of Standard Mail (millions)	\$0.814	\$0.814	\$0.814	\$0.814	\$0.814	\$0.814	\$0.814	\$0.814
(36) Contribution after Standard Mail conversion (millions)	\$0.000	\$0.500	\$0.378	\$0.328	\$0.278	\$0.228	\$0.178	
(37) Incremental Contribution/pc after Standard Mail adjust.	\$0.000	\$0.050	\$0.038	\$0.033	\$0.028	\$0.023	\$0.018	

FOOTNOTES

Shaded footnotes indicate that the calculation for the Standard Mail column is different.

- (1) Price incentive level.
- (2) Marketing letter volume.
- (3) Revenue per piece from Appendix A page 3 at (9) less price incentive for First Class Mail; and page 8 at (3) for Standard Mail .
- (4) (2) * (3)
- (5) In Appendix A page 1 change return rates for Marketing mail - Letters (3) to 1.23%. Cost from Appendix A page 4 at (18).
Standard Mail = page 9 at (21) * contingency.
- (6) (2) * (5)
- (7) (4) - (6)
- (8) (7) / (2)
- (9) Appendix A page 1 at (2)
- (10) Appendix A page 1 at (4)
- (11) (9) - (11)
- (12) (11) * (2)
- (13) .85 (ACS success rate) * (12)
- (14) .15 (ACS failure rate) * (12)
- (15) Appendix A page 1 at (7)
- (16) Appendix A page 1 at (9)
- (17) (13) * (15)
- (18) (14) * (16)
- (19) (17) + (18)
- (20) Place holder. I have no estimate for the cost of destruction however because the same procedures for FCM and Standard the cost is the same.
- (21) For FCM = (13) * (20) and for Standard Mail = (12) * (20)
- (22) (7) - (19) - (21)
- (23) (22) / (2)
- (24) Unaudited Postal data from Capital One and expected for this customer.
- (25) MC2002-2 POIR-2, Q7 (Tr. 2/319.)
- (26) (24) - (25)
- (27) (26) * (2)
- (28) FCM forwarding costs from MC2002-2, POIR-2, Q7 (.307*1.04^3) inflated to 2005, and (.307*1.04^5) to 2007. For Standard Mail is
destruction cost because no forwards, only destruction. (Tr. 2/320.)
- (29) (27) * (28)
- (30) (2) * (24)
- (31) ACS notices costs from MC2002-2, POIR-2, Q7 inflated by 4% for 3 years to 2005, and 5 years to 2007. (Tr. 2/320.)
- (33) (30) * (31)
- (34) (22) - (29) - (33)
- (35) (33) / (2)
- (36) Total Contribution of Standard Marketing pieces
- (37) (34) - (36)
- (38) (37) / (2)