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

RATE AND SERVICE CHANGES TO IMPLEMENT FUNCTIONALLY EQUIVALENT NEGOTIATED SERVICE AGREEMENT WITH BANK ONE CORPORATION	))))	Docket No. MC2004-3

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
COMMENTS ON COMMISSION CONSIDERATION OF PROPOSED SETTLEMENT
(September 27, 2004)

On September 15, 2004, the Postal Service, Bank One Corporation and J.P. Morgan and Company (hereinafter Bank One), and the Office of the Consumer Advocate (OCA), *inter alia*, filed a "Joint Motion … for Consideration of Stipulation and Agreement as the basis for Recommended Decision." Pursuant to Presiding Officer's Ruling No. MC2004-3/5 (September 16, 2004), Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak) hereby file these comments on the proposed non-unanimous settlement.

The Joint Motion was filed only three business days before the date — September 20, 2004 — when Initial Briefs were due in the case. The non-unanimous settlement would modify the proposed NSA to incorporate a review of the financial effect on the Postal Service after the NSA has been in effect for two full years, in accordance with a particular method of calculating financial impact, and an agreement to terminate the NSA if it has resulted in losses to the Postal Service at that time.

Only four parties have actively litigated this proposed NSA: the Postal Service and Bank One have supported it, while OCA and Valpak have questioned it, but not necessarily opposed it. Although OCA now has indicated its willingness to set aside its questions in order to join in this eleventh-hour settlement, Valpak does not believe that the terms of the proposed settlement would materially improve the proposed NSA and therefore cannot support it. Indeed, Valpak does not believe that the proposed settlement meets even the standards for a good settlement as articulated in the Joint Motion. Valpak has no objection to the Commission considering the Stipulation and Agreement as being reflective of the current position of the co-proponents, supplanting their earlier proposals. Although Valpak is not, in principle, opposed to the proposed NSA, it believes that the NSA should not be recommended as proposed, and is opposed to the Commission's adoption of the Stipulation and Agreement as the sole basis for its Recommended Decision. Accordingly, Valpak urges the Commission to await the filing of Initial Briefs later this week, on Friday, October 1, 2004, before issuing its Opinion and Recommended Decision.[1]

ANALYSIS

Rather than utilize any "stop-loss" provision, the recommended settlement provision would insert into the agreement an intermediate checkpoint when the aggregate profitability of

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[1] Valpak notes that it was never asked to participate in any of the settlement negotiations between the co-proponents and the OCA, and all that it knew about those negotiations was that they had been unsuccessful. The first word of a settlement being reached came from the OCA on Friday, September 10, 2004, and during an after-business hours telephone call with Postal Service counsel later that day. A written version of the basis of the settlement was not received by Valpak until after business hours on Tuesday, September 14. Valpak was never asked to participate in any settlement discussions or to join in the settlement until September 15, 2004, when Valpak counsel pointed this curiosity out to the Postal Service. Nevertheless, on September 24, 2004, Valpak provided the co-proponents and OCA with an advance copy of its analysis of the settlement (similar to that contained herein), and expressed its willingness to settle along those lines, but that effort thus far has been unsuccessful.

the NSA would be evaluated. (Paragraph 612.52, Early Expiration.) The concept of taking an intermediate reading on profitability, and making some interim adjustments to the agreement based on that outcome, is both novel and interesting. However, the approach taken in the settlement — an all or nothing approach — is not well suited to achieving the protection of the Postal Service. Indeed, the Joint Motion identified above states "[t]he parties are attempting to move in the direction of the perfect stop-loss mechanism, namely one that would prevent Postal Service losses without reducing potential gains for the Postal Service and the NSA partner." (Joint Motion, at 1.) It does not elaborate any views on "the perfect stop-loss mechanism." Nevertheless, we have analyzed the proposed settlement from the perspective of what might be described as a "more perfect" stop-loss mechanism. While not completely opposing the NSA, for the reasons set out below, Valpak does not believe that the proposed Stipulation and Agreement should be adopted.

These comments on the proposed Stipulation and Agreement are preliminary, and Valpak reserves the right to modify these comments by the time that the Initial Valpak brief is filed. Nevertheless, these comments are filed to give the Commission the type of input that it appeared to be seeking with respect to the Stipulation and Agreement in Presiding Officer Ruling MC2004-3/5.

These comments begin by assessing where the Postal Service could stand financially, both cumulatively and at the margin, with respect to the NSA at some intermediate checkpoint (*e.g.*, 18, 21, or 24 months) after it could become effective. Because the NSA utilizes declining block discounts, three possible outcomes are:[2]

	Status of Entire Contract	Status at the Margin	Effect of Additional Volume Under NSA
A.	Profitable	Profitable	Adds to Postal Service profits
B.	Profitable	Unprofitable	Each additional increment in volume deducts from cumulative profits. The Postal Service's profits would be enhanced with less volume, and sufficient additional volume will turn the cumulative profits that exist at this intermediate point in time into losses before the contract expires.
C.	Unprofitable	Unprofitable	The Postal Service would be better off with less volume, not more. Any amount of incremental volume will increase losses further.

Having described the three possible outcomes at some intermediate checkpoint, and the effect of additional volume in each case, we turn our attention to what corrective action (in the form of a stop-loss provision), if any, is indicated.

In **Case A**, above, no corrective action is indicated. Additional volume is marginally profitable to the Postal Service, and if such volume also is worthwhile to the mailer, then it deserves to be encouraged, as the Postal Service and all other mailers would benefit from this outcome.

Case C, above, is the situation contemplated by the settlement agreement, and the stop-loss provision envisioned by that settlement agreement is to terminate the NSA forthwith.

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[2] The outcome of "cumulatively unprofitable" but "profitable at the margin" is not feasible with declining block discounts.

From an economic perspective, that may or may not make sense, depending upon just how unprofitable the situation has become. In other words, this all-or-nothing approach could be unwise.

A sensible alternative to complete and abrupt termination of the NSA would be to make mid-term changes that would enable continued mailings under the NSA to become profitable through some combination of reducing expenses and increasing income.[3] This course of action clearly would be more desirable from the Postal Service's point of view, because making profits from this point onward would help it recoup cumulative losses to date. (If Bank One did not like the changes in fees and rates, it appears that it effectively could terminate the NSA unilaterally simply by ceasing to send solicitation mail via First-Class.) Consequently, this approach is better than the complete and immediate termination being proposed.

Case B is ignored by the Stipulation and Agreement, but the likelihood that the Postal Service will find itself faced with Case B is probably higher than the likelihood of Case C. Because Bank One agrees at the outset to convert the existing volume of its First-Class solicitation mail to ACS, the contract starts out being profitable for the Postal Service. Consequently, **before the Postal Service could find itself in the circumstances of Case C, it first would have to experience the circumstances defined by Case B.** Why the settlement agreement is totally mute with respect to Case B is not known.

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[3] If Bank One were to pay the cost of forwards above some incremental threshold, for purposes of this discussion we treat that particular action here as a reduction in, or offset to, expenses. Reducing the marginal discounts (*i.e.*, the effective rates) is treated here as an increase in income.

In Case B, from any additional volume tendered under the contract, the Postal Service faces only losses, with no prospect of any further potential gain. At the same time, from a cumulative perspective the contract — at this point in time — still is profitable. Under both the original agreement and the slightly modified settlement agreement, in Case B nothing will be done, of course.

Since the contract would still be profitable overall, to cancel the contract at this point would seem to be unfair to Bank One. Moreover, abrupt cancellation of the contract could make no sense from the perspective of either the Postal Service or other mailers, despite losses being incurred on marginal volume. At the same time, the Postal Service would be in a precarious position, because the contract contains no cap on the volume that can be mailed and Bank One has a huge volume of unconverted Standard Mail. Figuratively speaking, the Postal Service must hold its breath during the remaining term of the contract and hope that Bank One does not decide to increase sharply the Standard Mail that it migrates to First-Class Mail ("FCM"), because each increment in volume will be handled at a loss, which acts to erode whatever cumulative profit still exists.

Under the circumstances of Case B, the goal of any provision aimed at stopping losses should be to prevent incremental losses from ballooning up. As a regulatory solution, it would seem simple to establish a limit on the volume that could be mailed by Bank One under the contract.[4] An economic solution, on the other hand, would be to use prices and incentives as

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[4] A limit on the cumulative amount of discounts that could be received by Bank One would have this effect, but if such a provision were inserted at the outset of the agreement, it also could choke off growth of profitable volume in the event Case A should materialize.

the regulatory mechanism to achieve an appropriate mid-course correction. This could be accomplished by adjusting the fees (or rates) in a manner that would change the Postal Service's losses on incremental volume to either breakeven or slight marginal profitability. Such a provision would permit Bank One to continue to increase the volume of Standard Mail which may be converted to FCM so long as the bank finds that its reward from doing so exceeds its cost.

By way of elaboration on this economic solution, we note that the Postal Service could find itself losing money at the margin for a number of reasons, such as these:

1. The Postal Service's cost of handling FCM could increase to the point where such costs could cause incremental volume under the NSA to exceed marginal revenues;

2. The rate of Bank One's UAA mail (returns and/or forwards) could be higher than assumed; or

3. The rate of UAA mail could be equal to or less than assumed, but the Postal Service's cost of handling UAA mail could be higher than assumed (*e.g.*, the capture rate for ACS is significantly less than 85 percent).

The above list is not intended to be exhaustive. What it serves to illustrate is that marginal losses could be incurred because of (**i) factors that are not under the control of Bank One** (*e.g.*, items 1 and 3 in the above list), and which therefore should not be the responsibility of Bank One, as well as (ii) other **factors that are not under the control of the Postal Service** (*e.g.*, item 2 in the above list), and which should be the responsibility of Bank One. A much better stop-loss provision would be one that adjusts fees due only to factors not under the control of the Postal Service, while leaving the Postal Service with responsibility for factors not under Bank One's control.

ALTERNATIVE APPROACH

Any provision to stop marginal losses should be triggered only if, at some agreed-to midpoint correction (*e.g.*, after 18 months), the Postal Service were to find itself in Case B or Case C.

If only marginal losses are being incurred by the Postal Service at the time of the interim accounting (Case B), then going forward Bank One should be required to pay fees equal to the Postal Service's costs for its UAA mail (returns and forwards) **that exceed the assumed rates.** To avoid having any punitive aspect on the mailer, the provision should be not be retroactive, no matter how high the rate of UAA mail recorded to date. It should apply only to mail entered subsequent to the trigger date. This way, Bank One would have an appropriate and meaningful incentive to do more to clean up its mailing lists through the end of the contract, should that be indicated.

This provision would be triggered only if the Postal Service were losing money at the margin. It is possible that Bank One's returns of UAA mail could exceed the assumed rates, but the Postal Service nevertheless might not be losing money at the margin for any number of reasons; *e.g.*, the ACS capture rate were between 90-97 percent. Thus, if the Postal Service were not losing money at the margin, Bank One would get the benefit of any doubt because the clause would not even be triggered. In the event the Postal Service were losing money at the margin, the clause would be triggered, but it would affect Bank One only if its UAA returns were excessive, and it would affect Bank One only to the extent that they were, and continued to be, excessive. In this manner, it would provide the Postal Service with some downside protection. At the same time, it would be neither intended nor designed to protect the Postal

Service from any and all marginal losses, regardless of their cause or source. Marginal losses not under Bank One's control would continue to be absorbed by the Postal Service, and — importantly from Bank One's perspective — the NSA would continue in force.

Should the Postal Service find itself in the circumstances of Case C at the intermediate time of stock-taking, the NSA of course will be in more dire straits than in Case B; *i.e.*, losing money both at the margin and cumulatively. This is the case which the settlement contemplates, and in this case the settlement would abruptly and completely terminate the NSA after 2 years and 3 months. Rather than terminate the contract, Valpak recommends implementation of a mid-course correction designed to eliminate further marginal losses to the USPS going forward. The aim is to restore profitability to mailings under the NSA and give the USPS a chance to recoup some or all of its aggregate losses during the remaining term of the contract. At the same time, an appropriate mid-course correction would allow Bank One to continue mailing under the contract and to receive some discounts under the NSA. Presumably, that would be less disruptive to Bank One's mailing program. The mid-course correction for Case C could involve:

a. having Bank One pay the **cost of the excess forwards/returns**, as in Case B, **and in addition**,

b. **reducing the marginal discounts back to the last increment at which the USPS makes money, after including the additional income from Bank One's payment of excess forwards/returns** (in a above) (*i.e.*, the NSA regains profitability). By way of illustration, if the Postal Service finds it is losing money at the 5.0 and 4.5 cent discount levels, but is still making money at the 4.0 cent discount level, the maximum discount for the remainder of the term of the NSA would be reduced to 4.0 cents. Lesser incremental discounts would continue to be triggered at the levels specified in the NSA. So long as the Postal Service makes a profit going forward, Bank One could continue to mail as much as it wants to under the NSA, but with the proviso that for the remaining term of the NSA the maximum discount is only 4.0 cents, once that volume level is reached.[5]

CONCLUSION

Valpak is not a signatory to the proposed Stipulation and Agreement because, for the reasons set out above, it views the amendment to the NSA contained in the agreement as inadequate and not providing appropriate protection for the Postal Service or other mailers. Accordingly, it is urged that the Commission not adopt the proposed non-unanimous Stipulation and Agreement as the basis for its decision and recommended decision in this docket, and instead wait for the merits of the NSA to be further explored in Initial Briefs, including Valpak's Initial Brief, to be filed Friday, October 1, 2004.

Respectfully submitted,

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[5] If the lowest incremental discount does not allow the NSA to become profitable, the NSA would terminate.