Postal Regulatory Commission
Submitted 3/15/2011 2:07:36 PM
Filing ID: 72262
Accepted 3/15/2011
ORDER NO. 694

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

Before Commissioners: Ruth Y. Goldway, Chairman;
Mark Acton, Vice Chairman;
Dan G. Blair;
Tony L. Hammond; and
Nanci E. Langley

Market Dominant Product Prices
First-Class and Standard Mail
Discover Financial Services
Docket No. MC2011-19

Market Dominant Product Prices
Discover Financial Services (MC2011-19)
Negotiated Service Agreement
Docket No. R2011-3

ORDER ADDING DISCOVER FINANCIAL SERVICES 1 NEGOTIATED SERVICE AGREEMENT TO THE MARKET DOMINANT PRODUCT LIST

(Issued March 15, 2011)

I. INTRODUCTION

The Postal Service seeks to add a new negotiated service agreement product identified as Discover Financial Services (DFS) to the market dominant product list. For the reasons discussed below, the Commission approves the Request.

II. BACKGROUND

Pursuant to 39 U.S.C. 3622 and 3642, as well as 39 CFR parts 3010 and 3020, *et seq.*, the Postal Service filed a formal request and associated supporting information to add a Discover Financial Services Negotiated Service Agreement (DFS NSA) to the market dominant product list.[1]

The Postal Service's Request includes the following six attachments:

- Attachment A—a copy of Governors' Resolution No. 11-2, authorizing a negotiated service agreement with DFS;
- Attachment B—a copy of the contract;
- Attachment C—proposed descriptive language changes to the Mail Classification Schedule (MCS);
- Attachment D—a proposed data collection plan;
- Attachment E—a Statement of Supporting Justification as required by 39 CFR 3020.32, which the Postal Service is also using to satisfy the requirements of 39 CFR 3010.42(b)-(e); and
- Attachment F—a financial model, which the Postal Service believes demonstrates that the agreement will improve its financial position by an additional $2 million to $15 million in net contribution.

The Postal Service describes the DFS NSA in its Request. It indicates that the agreement is designed to maintain the total contribution the Postal Service receives from DFS First-Class Mail and Standard Mail and to provide an incentive for net contribution beyond that. *Id.* The Postal Service describes the agreement and what it believes are its five main components: a revenue threshold, a revenue threshold adjustment, a postage commitment, rebates on First-Class Mail, and rebates on Standard Mail.

[1] Notice of the United States Postal Service of Filing of Contract and Supporting Data and Request to Add Discover Financial Services Negotiated Service Agreement to the Market-Dominant Product List, January 14, 2011 (Request).

Specifically, the revenue threshold is based on the amount of DFS's total postage paid for First-Class Mail automation presort letters, Standard Mail automation presort letters, and Standard Mail carrier route letters. The baseline for the revenue threshold is DFS's total postage for these categories for the period February 2010 through January 2011. For the first year of the agreement, the threshold is calculated as an amount 10 percent above the baseline; for the second year, 15 percent above the baseline; and for the final year, 20 percent above the baseline. *Id.* at 3.

If DFS meets or exceeds the threshold in a contract year, it will earn rebates on its qualifying First-Class Mail and Standard Mail postage. The revenue threshold will be adjusted upward by 65 cents for every dollar decline in DFS's First-Class Mail postage. Under this adjustment, to qualify for rebates, DFS must send an extra $1.65 worth of Standard Mail to offset each dollar decline in postage from First-Class Mail. *Id.* at 3.

The agreement also contains a postage commitment, equal to the adjusted threshold. If the amount of DFS's total postage from eligible mail in the first year of the contract is less than the adjusted threshold, DFS must pay a penalty in the amount of 10 percent of the difference between DFS's revenue threshold and the actual total postage paid for contract year 1. Subsequent year threshold adjustments to the penalty are to be negotiated by the parties within 7 months of the previous contract year. *Id.* at 3-4.

If DFS meets or exceeds the adjusted postage thresholds in any given year of the contract, it will earn rebates on its qualifying First-Class Mail and Standard Mail postage. The rebate for First-Class Mail will be equal to 75 percent of the increase in postage as a result of a subsequent cumulative price increase (relative to First-Class Mail prices in existence at the initiation of the agreement) for all qualifying pieces. For Standard Mail, the rebate will be equal to 37.5 percent of the increase in postage as a result of a subsequent cumulative price increase (relative to Standard Mail prices in existence at the initiation of the agreement) for all qualifying pieces. *Id.* at 4.

The Postal Service also describes several other elements of the agreement: (1) a merger and acquisition clause; (2) a termination clause; and (3) a clause that requires the Postal Service to negotiate with DFS on the terms upon which DFS may participate in other incentive programs so there is no double-dipping. The Postal Service expects the value of the agreement to still be positive if the penalty provision is triggered, reducing the risk of the agreement. *Id*.

The Postal Service indicates that the contract will become effective March 1, 2011, and will expire 3 years from the effective date. *Id.* at 1; *see also id.* Attachments A and B. Either party may terminate the agreement for convenience prior to the last 90 days of each contract year, without penalty, with 90 days' written notice to the other party. *Id.* Attachment B at 5.

With respect to potential similarly situated mailers, the Postal Service states that its design imperative, to generate additional contribution, and the basic structure of the agreement described in the Request, will guide the Postal Service in the negotiation of similar agreements as well as those that are substantially different. *Id.* at 4-5; *see also id.* Attachment E at 3. It notes that in assessing the desirability of the agreement, the Postal Service believes that the defining characteristics of DFS are its size, its large but declining billing and statement volumes, its significant volume of advertising mail, and its almost complete reliance on letter-shaped mail. The Postal Service views heavy use of both First-Class Mail and Standard Mail as necessary mailer attributes. *Id.* at 5.

In Order No. 654, the Commission gave notice of the two dockets, appointed a Public Representative, and provided the public with an opportunity to comment.[2] Chairman's Information Request No. 1 (CHIR No. 1), issued January 27, 2011, sought clarification of various elements related to the negotiated service agreement. The

---

[2] Notice and Order Concerning Addition of Discover Financial Services Negotiated Service Agreement to the Market Dominant Product List, January 19, 2011 (Order No. 654).

Postal Service filed its response to CHIR No. 1 on February 2, 2011.[3] On February 4, 2011, Chairman's Information Request No. 2 was issued requesting follow-up information. The Postal Service's response to that request was filed on February 9, 2011.[4] The Postal Service also filed a revised response to CHIR No. 1 on February 22, 2011.[5]

III. COMMENTS

Comments were filed by the Public Representative.[6] Reply comments were filed by DFS[7] and the Postal Service.[8] A clarification in response to the reply comments was filed by the Public Representative.[9] No other interested person submitted comments.

Public Representative comments. The Public Representative states that the agreement appears to attempt to slow the general trend away from high margin mail to low margin mail. However, he believes that the agreement "has cobbled together such an amorphous set of benchmarks, rebates, penalties, and contingencies that the value of the NSA to the Postal Service is highly uncertain, the various sources of risk that it

---

[3] Response of the United States Postal Service to Chairman's Information Request No. 1, February 2, 2011 (Response to CHIR No. 1).

[4] Response of the United States Postal Service to Chairman's Information Request No. 2, February 9, 2011 (Response to CHIR No. 2).

[5] Revised Response of the United States Postal Service to Chairman's Information Request No. 1, Question No. 9, February 22, 2011 (Revised Response to CHIR No. 1).

[6] Comments of the Public Representative in Response to Order No. 654, February 7, 2011 (PR Comments). The Public Representative also filed workpapers related to his comments. Notice of Filing of Workpapers, February 8, 2011.

[7] Reply Comments of Discover Financial Services, February 11, 2011 (DFS Reply Comments). DFS also filed a Motion for Acceptance of the Reply Comments of Discover Financial Services Concerning the DFS NSA, February 11, 2011. The motion is granted.

[8] Response of the United States Postal Service to Comments of the Public Representative, February 11, 2011 (Postal Service Reply Comments). The Postal Service also filed a Motion of the United States Postal Service for Leave to File Response to Comments of the Public Representative, February 11, 2011. The motion is granted.

[9] Clarification of Public Representative Analysis in Response to Reply Comments, February 23, 2011 (PR Clarification). The Public Representative also filed Public Representative Motion for Acceptance of Clarification in Response to Reply Comments, February 23, 2011. The motion is granted.

will lose money are difficult to assess, and any constraints that the Commission might impose that would reduce those risks are difficult to design." PR Comments at 1.

The Public Representative is also concerned with the Postal Service's proposal to observe the non-discrimination safeguards mandated by 39 U.S.C. 3622(c)(10). He notes that the Request lists certain criteria that the Postal Service proposes to use as guiding principles in the negotiation of similar agreements and certain criteria which it believes may result in substantially different NSAs. The Public Representative argues that the Postal Service's proposed safeguards in this regard may be inadequate and run afoul of the statutory and regulatory provisions that require the NSA to "not create an undue or unreasonable preference…, and must not unreasonably harm the marketplace (i.e., must not unreasonably distort competition among mailers in the markets in which they participate, such as the market for credit cards services.)" *Id.* at 4.

To give effect to the statutory and regulatory safeguards, the Public Representative submits that "if the Commission approves this NSA, it should make it clear that it is not approving the Postal Service's view of which terms of the NSA are 'essential' (which terms define a 'functionally equivalent' NSA) and which are not, for purposes of triggering the non-discrimination prohibitions of sections 3622(c)(10) and 403(c)." *Id.* at 5-6.[10] Looking at the industry as a whole, the Public Representative is concerned that if this agreement were to be replicated throughout the credit card industry, it could lock the Postal Service into its unfavorable FY 2010 financial position vis-a-vis such mailers, when the industry is on the rebound. *Id.* at 15.

In reviewing the safeguards that the agreement contains to ensure against the loss of net revenue as required by 39 U.S.C. 3622(c)(10),[11] the Public Representative

[10] For example, the Public Representative believes that the threshold adjustment factor of 1.65 should also be an essential element of the contract, and be calculated specifically for each NSA partner based on its expected unit revenue and unit contribution. *Id.*

[11] The Public Representative submits that section 3622(c)(10) requires special classifications to improve the net financial position of the Postal Service through, *inter alia*, increasing the overall contribution to the institutional costs of the Postal Service. *Id.* at 7-8.

determines that the agreement may "'under certain circumstances'" satisfy that requirement. *Id.* at 8. In support of that conclusion, the Public Representative notes that the Postal Service's demand models estimate the price elasticity of demand for the mail covered by the DFS NSA as -0.346 for presorted First-Class Mail and -0.286 for Standard Regular Mail. Applying the Commission's Docket No. MC2004-3 Opinion and Further Recommended Decision analysis and these elasticity estimates, the Public Representative suggests that there would be little chance that the agreement will increase overall contribution. *Id.* at 11.

Additionally, the Public Representative's analysis finds that in order to have the kind of demand response that the Postal Service's Request assumes, the own-price elasticity of DFS would have to be almost five-fold higher in absolute terms than the average mailer's elasticity for presort First-Class Mail (1.6), and eight-fold higher in absolute terms than the average mailer's elasticity for Standard Regular Mail (2.3). Based on this, the Public Representative believes that there are only two plausible explanations for such a response: "Either DFS has price elasticities for bulk letter mail that can only be described as off the charts, or the incentive effect is illusory, meaning that it is not the small rebate of $.001 that produces 141 million new pieces of Standard mail, but the knowledge or intention of DFS to mail roughly that many new pieces regardless of the rebates." *Id.* at 14.

The Public Representative is also concerned with the "agreements to agree" provisions in the agreement: the penalty provisions for the later years and the ability for DFS to remain eligible for rebates under other potential incentive programs. *Id.* at 17. With respect to the penalty provisions for the later years of the agreement, the Public Representative states that agreements to agree are non-binding and, as such, should not be treated as an operative provision of the proposed NSA. He is concerned that if this provision were treated as an operative provision, agreements to agree could become an all-purpose tool for evading regulatory scrutiny. *Id*. at 18.

With respect to DFS's participation in other potential incentive programs, the Public Representative argues that the effects of such compound provisions on the institutional cost contributions could not be identified even though such action is a regulatory requirement. Accordingly, he argues that such provision should be excised from the NSA. If the Commission approves the NSA, the Public Representative urges the Commission to make clear that an additional round of regulatory approval will be required before mail eligible for rebates under this NSA can also be made eligible for other incentive programs. *Id*.

DFS reply comments. In its reply comments, DFS represents that it, like most other large companies, is diverting its First-Class statement mail to electronic delivery. DFS Reply Comments at 2. It believes that the NSA is designed to compensate the ongoing loss of DFS's First-Class statement mail by creating an incentive to slow the electronic diversion or increase its Standard Mail payments by a dollar amount sufficient to maintain or grow the overall contribution of the totality of DFS's mail. DFS also notes that the contract is a result of negotiations between two parties in which both have balanced a variety of interests, benefits, and risks. *Id*. at 3. It suggests that the Commission should not critique the balancing of interests in the contract or change provisions in the contract as such action would upset the bargain. *Id*. at 4. Additionally, DFS states that the requirement that functionally equivalent agreements need to be available on "public and reasonable" terms to similarly situated mailers was put into the law to ensure that there was no harm to the marketplace. It asks the Commission to get the NSA process working again and allow the Postal Service to "start tapping that money." *Id.* at 5.

Postal Service reply comments. In its reply comments, the Postal Service clarifies that the purpose of this agreement is to maintain and increase the value of DFS's total business with the Postal Service, by offsetting losses in statement mail volume with additional advertising mail. Postal Service Reply Comments at 1. It is not to slow or stop the movement of advertising mail from First-Class Mail to Standard Mail.

In order for DFS to qualify for rebates under the agreement, it "has to create more contribution to the Postal Service from Standard Mail than it destroys from lost First-Class Mail." *Id*. at 2. The Postal Service emphasizes that the exact value of the adjustment factor was not chosen in a vacuum, but rather was determined as part of the negotiating and bargaining process. *Id*.

The Postal Service also claims that the Public Representative's use of average elasticities to estimate the behavior of a particular mailer is problematic and is especially difficult in this case where the change in behavior of the mailer is what the NSA attempts to influence. *Id*. at 3. For such agreements, the Postal Service believes that trying to evaluate each customer using identical models is likely to give misleading results. It states that the "Postal Service has evaluated this agreement based on its best judgment of DFS' future behavior, given current trends, understanding of DFS' business, and expectations of market and economic conditions, and will evaluate actual results based on those same factors." *Id.*[12] In light of this, it believes that "no mechanical model can be substituted for this analysis is not a reason either to doubt the judgment of the Postal Service or reject this agreement." *Id.* at 3-4.

Public Representative clarification. In supplemental comments, the Public Representative argues that the Postal Service is attempting to change the statutory standard to "a requirement that NSAs be approved 'as long as it cannot reasonably be determined whether the NSA will or will not increase contribution.'" PR Clarification at 2.

Additionally, the Public Representative draws the Commission's attention to a recent interview of Andrew Davidson, Senior Vice-President of *Comperemedia*, which is a firm that tracks the credit card direct mail industry. *Id.* at 3. In that interview, Mr. Davidson states that there were 1.4 billion new credit card solicitations received by

[12] The Postal Service states that it will perform the same kind of analysis with regard to other mailers who would like to enter into similar agreements. *Id.*

Americans in quarter 4 of calendar year 2010, up from 575 million for the same quarter of 2009. *Id.* The Public Representative notes that this is an annualized growth rate of 243 percent. Based on this assessment, the Public Representative concludes that "[u]nless Discover's business plans are extremely atypical of the credit card industry as a whole, the odds seem high that Discover will have qualified for this rebate for its mailings in 2011 regardless of the discount." *Id.*

IV. COMMISSION ANALYSIS

The Commission has reviewed the Request, the agreement, the financial analyses, CHIR responses, and all comments filed in this proceeding.

Statutory requirements. The Commission's statutory responsibilities in this instance entail assigning the DFS NSA product to either the market dominant product list or to the competitive product list. 39 U.S.C. 3642. As part of this responsibility, the Commission also reviews the proposal for compliance with the Postal Accountability and Enhancement Act (PAEA) requirements. This includes, for proposed market dominant products, a review of the provisions applicable to market dominant products. 39 U.S.C. 3622.

Product list assignment. In determining whether to assign the DFS NSA product to the market dominant product list or the competitive product list, the Commission must consider whether "the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products." 39 U.S.C. 3642(b)(1). If so, the product will be categorized as market dominant. The competitive product category shall consist of all other products.

The Commission is also required to consider whether the product is covered by the postal monopoly. 39 U.S.C. 3642(b)(2). Mail subject to the postal monopoly may not be transferred to the competitive product list. The Postal Service asserts that since the agreement applies to First-Class Mail letters, Standard Mail letters and Standard Mail Carrier Route, all volume under the agreement, is subject to the postal monopoly. Request, Attachment E at 4.

The Commission is further required to consider the availability and nature of enterprises in the private sector engaged in the delivery of the product, the views of those who use the product, and the likely impact on small business concerns. 39 U.S.C. 3642(b)(3). The Postal Service represents that the user of this product, DFS, supports adding the product to the market dominant product list. The Postal Service also states it is unaware of any small business concerns that could provide a similar service to DFS. *Id*.

No commenter opposes the proposed classification of the DFS NSA product as market dominant. Having considered the statutory requirements discussed above and the support offered by the Postal Service, the Commission finds, for purposes of this proceeding, that the DFS NSA product may be classified as a market dominant product and added to the market dominant product list as Discover Financial Services 1.[13]

Provisions applicable to market dominant products. Upon making the above finding that the DFS NSA product may be added to the market dominant product list, the Commission must then review the proposed agreement to determine compliance with the statutory and regulatory requirements for market dominant products.

The appropriate statutory and regulatory provisions require the Commission to make a finding under 39 CFR 3010.40(a) that the proposed market dominant negotiated service agreement must either "(i) improve the net financial position of the Postal Service" (39 U.S.C. 3622(c)(10)(A)(i)); or "(ii) enhance the performance of various operational functions" (39 U.S.C. 3622(c)(10)(A)(ii)). Additionally, the negotiated

[13] The Commission is labeling this new product Discover Financial Services 1 to accommodate the possibility that the Postal Service may enter into additional NSAs with DFS.

service agreement may not “cause unreasonable harm to the marketplace” (39 U.S.C. 3622(c)(10)(B)) and “must be available on public and reasonable terms to similarly situated mailers.” 39 CFR 3010.40(b), (c).

Financial analysis. The Postal Service states that it is seeking approval of this agreement under section 3622(c)(10) on the basis that it believes the agreement will improve the net financial position of the Postal Service. Response to CHIR No. 2 at 3. In support of this position, it provides high and low estimates for the revenue that DFS is expected to provide for eligible mailpieces in the absence of the agreement. Request, Attachment F. It also provides the adjusted revenue threshold which is the Postal Service’s estimate for the revenue that DFS is expected to provide for eligible mailpieces if the agreement goes into effect. Response to CHIR No. 2 at 2. From this, the Postal Service concludes that the agreement will increase contribution from $2.4 million to $14.9 million over the 3 years of the agreement.[14]

The Public Representative questions these contribution estimates. He calculates that for such actions to occur, the own-price elasticity of DFS would have to be almost five-fold higher than the elasticity for presort First-Class Mail (1.6), and eight-fold higher than the elasticity for Standard Regular Mail (2.3).[15] Based on this analysis, he believes that “[e]ither DFS has price elasticities for bulk-letter mail that can only be described as off the charts, or the incentive effect is illusory.” PR Comments at 14. He also points to a recent article that suggests that Standard Mail solicitations in the credit card industry are growing at a rapid rate.

[14] The $2.4 million increase in contribution is calculated based on the Postal Service’s “high” revenue estimate for DFS’s payments in the absence of the agreement while the $14.9 million increase in contribution is based on the Postal Service’s “low” revenue estimate for DFS’s payments in the absence of the agreement.

[15] The Public Representative’s elasticity figures are negative (-1.6 and -2.3). To facilitate this analysis, the absolute (positive) values are used.

In the Public Representative's workpapers filed on February 8, 2011,[16] the Public Representative demonstrates that if the Postal Service's volume projections are accurate, and assuming that all rebates are given on incremental Standard Mail pieces instead of every DFS eligible mailpiece, then using the elasticity for Standard Regular Mail,[17] with an elasticity test, the agreement will increase the net financial position of the Postal Service. However, he also demonstrates that if the Postal Service's volume projections are not correct, the agreement is unlikely to increase the net financial position of the Postal Service. *Id.*

The Commission has reservations about the methods used by the Postal Service to estimate what DFS's volumes would be in the absence of the agreement. In its initial filing, the Postal Service identifies volume and revenue trends and expectations for current and future economic conditions as the qualitative factors it takes into account to project DFS's volume. Request at 5. In its Response to CHIR No. 2, the Postal Service expands this list of qualitative factors indicating that it takes into account (1) the economic recovery, (2) consumer credit, (3) employment, (4) the system-wide growth rates, (5) consumer spending, (6) household income, and (7) household debt. Response to CHIR No. 2 at 3-4. In its reply comments, the Postal Service also identifies (1) current trends, (2) its understanding of DFS's business, and (3) expectations of market and economic conditions.[18]

No information was provided on how these various qualitative factors were combined to form the quantitative volume range that the Postal Service estimates for DFS's volume estimates in the absence of the agreement. *Id*. at 3-4. The Postal

[16] Notice of Filing of Workpapers, February 8, 2011 (PR Workpapers).

[17] This elasticity reflects the former Standard Regular Mail subclass that consisted of Standard Mail commercial letters, flats, not flat-machinables, and parcels.

[18] *See also* Postal Service Reply Comments at 3 ("The Postal Service has evaluated this agreement based on its best judgment of DFS' future behavior, given current trends, understanding of DFS' business, and expectations of market and economic conditions, and will evaluate actual results based on these same factors.").

Service defends its approach, contending “the fact that no mechanical model can be substituted for this analysis is not a reason either to doubt the judgment of the Postal Service or to reject the agreement.” *Id.* It is incumbent upon the Postal Service to develop a quantitative approach that incorporates the factors it is using to estimate volumes.

In the absence of a quantitative proposal for measuring the effect of the agreement on the Postal Service’s finances, the Commission analyzed the agreement using its previously accepted methodology for determining the effect of negotiated agreements on mail volume. It also separately analyzed the agreement based on a method suggested in the Public Representative’s workpapers.

First, the Commission evaluated the agreement using an elasticity test. *See* Docket No. MC2004-3 Opinion and Further Recommended Decision. This analysis indicates that the agreement is unlikely to increase the net contribution to the Postal Service.[19]

Second, the Commission reviewed the Public Representative’s workpapers filed on February 8, 2011. *See* PR Workpapers. The Public Representative’s analysis demonstrates that the DFS agreement will increase the net financial position of the Postal Service only if the Postal Service’s volume projections absent the agreement are accurate. The Public Representative relies on these volume projections to calculate the implied rebate assuming all rebates are paid on the additional Standard Mail pieces needed to meet the threshold. Assuming all rebates are paid on additional Standard Mail pieces, the rebate is approximately $0.02 per additional Standard Mail piece in contract year 1. Using this higher rebate in the elasticity test results in an increase in the net financial position of the Postal Service. The analysis does demonstrate that if the Postal Service decides to only give rebates on incremental pieces needed to meet

[19] The Postal Service states that “applying system-wide elasticities to estimate the behavior of any particular mailer is problematic.” *Id.* at 3. It does not, however, suggest any alternative elasticities to use, such as industry-wide elasticities.

the threshold (while still giving the same amount of total rebates it would have otherwise), the elasticity test may show an increase in the net financial position of the Postal Service, and therefore satisfy the requirements of section 3622(c)(10). However, the Public Representative's method relies on the accuracy of the Postal Service's volume projections;[20] therefore, the Commission cannot endorse this approach. The Postal Service, however, should consider exploring this approach when analyzing similar agreements.[21]

The context of the Postal Service's proposal is important. This agreement represents the Postal Service's first proposed domestic market dominant NSA under the PAEA. It is part of a broader effort to address the continuing decline in First-Class Mail volumes. Not only does it "provide an incentive for DFS to slow the erosion of First-Class Mail," the agreement's overarching goal is to maintain the overall contribution from DFS's First-Class Mail and Standard Mail volumes and provide an incentive to increase that contribution. Request at 2.

While a quantitative model for measuring estimated volumes absent the agreement would be valuable, the Commission recognizes that non-problematic data are not always available. The Commission attempts to address this, in part, by requiring the Postal Service to collect certain data. In the meantime, the Commission finds that allowing this negotiated service agreement to proceed will allow management to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume. As a result of the experience and information that Postal Service management will gain while this negotiated service agreement remains in place, the Commission finds that the Postal Service will be better off in the long run as a result of

[20] These volume projections may not be reliable. The Public Representative cites an article which indicates that credit card solicitations are up sharply in quarter 4 of calendar year 2010 and are expected to continue that upward trend in 2011. PR Clarification at 3. For its part, the Postal Service expects that economic recovery will continue causing DFS's Standard Mail to grow fairly strongly. It cautions, however, that if consumer spending fails to pick up, it "would expect DFS's volume—in the absence of the agreement—to grow less strongly." Response to CHIR No. 2, question 2.

[21] This approach may also be valuable for performing an after-the-fact analysis of the agreement.

the agreement. Moreover, the agreement may be canceled by either party should experience prove to be at odds with the parties' expectations. Thus, financial risk is minimized. Given the totality of the circumstances presented, the Commission finds that agreement may proceed pursuant to section 3622(c)(10).

"Subsidiaries and affiliates." The agreement and proposed MCS language contain mergers and acquisitions clauses to upwardly adjust the baseline revenue to the extent that DFS merges with or acquires any entity that mails either First-Class Mail or Standard Mail. Similarly, the agreement contains a clause to downwardly adjust the baseline revenue to the extent that DFS sells or closes entities. Additionally, the agreement is executed by the Postal Service and DFS, including its "subsidiaries and affiliates."

The Postal Service represents that, currently DFS has no affiliates but several subsidiaries. Response to CHIR No. 1 at 10.[22] The proposed MCS language states that eligible mail may be sent by DFS, "entities in which Discover Financial Services, Inc. holds controlling shares, and by their venders on their behalf." Request, Attachment C at 1.

Reading these proposed MCS terms together, the Commission understands that to the extent that DFS obtains new subsidiaries and affiliates during the contract term, the mergers and acquisitions contract and MCS terms will be triggered. Similarly, to the extent that DFS removes subsidiaries and affiliates during the contract term, the sale or closure contract and MCS terms will be triggered. The Postal Service shall keep a list of all subsidiaries and affiliates mailing eligible mailpieces under this agreement as well as mergers, acquisitions, sales, and closures occurring that affect this agreement and report such mailing information to the Commission as part of its data collection plan.

[22] *See also* Revised Response to CHIR No. 1, question 9.

Penalty clause. The contract and proposed MCS language state that DFS's penalty for not meeting the adjusted revenue threshold in years 2 and 3 of the contract will be agreed to 90 days before the end of each previous contract year. In CHIR No. 1, question 8, the Commission asked for the Postal Service's view on whether such change requires the Postal Service to submit a notice of price adjustment to the Commission. In response, the Postal Service did not take the position that such a change did not have to be submitted to the Commission, and instead said it was willing to submit such notice to the Commission. Response to CHIR No. 1 at 9.

The Public Representative takes issue with this "agreement to agree." PR Comments at 17. He is concerned that agreements to agree are non-binding under contract law, and as such, should not be treated as an operative provision of the proposed NSA. He is also concerned that if this agreement to agree were treated as an operative provision, agreements to agree could become an all-purpose tool for evading regulatory scrutiny.

The Commission views the penalty provision as an integral part of the contract. As such, the Commission directs the Postal Service to submit the agreed upon penalty within 5 days of reaching agreement with DFS on the penalty terms. If the parties cannot agree on a penalty 90 days before the end of each previous contract year as stated in the contract and proposed MCS language, the Postal Service shall submit a filing to the Commission on the status of the penalty provision and how such failure to agree affects the remaining contract terms.[23]

As a result, the Commission also clarifies the proposed MCS language for the "Penalties" section to state that "Penalties for the second and third years of the contract will be agreed between the Postal Service and Discover Financial Services, Inc. 90 days before the end of each previous contract year, with notification to the Commission, to allow room for adjustment…."

---

[23] The Postal Service shall make such filing in this docket pursuant to 39 CFR 3020.90.

DFS's ability to participate in other incentive programs. Pursuant to the contract, DFS will be eligible to participate in other incentive programs, if such programs are offered in the future, "as mutually agreed upon by the Parties." Request, Attachment B at 2. The Public Representative is concerned that allowing DFS to participate in such activities will make it exceedingly difficult to determine the effects of such compound provisions on institutional cost contributions. Accordingly, he believes that this provision should be excised from the NSA. If, however, the Commission approves the NSA, the Public Representative urges the Commission to make clear that an additional round of regulatory approval will be required before mail eligible for rebates under this NSA can be made eligible for other incentive programs.

It will be difficult to calculate compound effects of various rate incentives. Nonetheless, it is too speculative to hypothesize what the potential incentive programs the Postal Service may propose over the next 3 years. Accordingly, if and when the Postal Service offers future incentive programs to mailers, the issues can be addressed in context.

Similarly situated mailers. The Postal Service states that it regards five elements as "essential."[24] It also asserts that the "design imperative"—to generate additional contribution—and the basic structure of the agreement with DFS "will guide the Postal Service in the negotiation of similar agreements and may, in other NSAs, yield parameters that are substantially different from those in this agreement." *Id.* at 4-5. The Postal Service also declares that in assessing the desirability of this agreement, it believes that the "defining characteristics of DFS are its size, its large but declining

[24] These elements are the revenue threshold, the revenue threshold adjustment, the postage commitment, and First-Class Mail and Standard Mail rebates. *Id.* at 3. In its Request, the Postal Service appears to use the terms "components," "elements," and "parameters" interchangeably. *See id.* at 3-5.

billing and statement volumes, and its significant volume of advertising mail." *Id.* at 5 (footnote omitted).[25]

The Public Representative is concerned that the Postal Service's use of such essential elements, design imperative, and defining characteristics may obfuscate which terms are needed in any future NSA. He cautions the terms "must not create an undue or unreasonable preference…, and must not unreasonably harm the marketplace (*i.e.*, must not unreasonably distort competition among mailers in the markets in which they participate, such as the market for credit card services.)" PR Comments at 4. Accordingly, to give effect to the statutory safeguards, the Public Representative submits that if the Commission approves this NSA, it should make it clear that it is not approving the Postal Service's view of which terms of the NSA are essential.

Market dominant NSAs are permissible when, among other things, they are "available on public and reasonable terms to similarly situated mailers," and if they "do not cause unreasonable harm to the marketplace." 39 U.S.C. 3622(c)(10). Thus, whether the Postal Service would be required to enter into an NSA with another mailer would depend on whether that mailer is similarly situated to DFS or whether there is a demonstration of unreasonable harm in the marketplace. The two entail different considerations.

Whether a mailer is similarly situated to DFS is a factual inquiry. The Commission has addressed the issue previously:

> 'Similarly situated' refers to a comparison of the relevant characteristics of different mailers as the characteristics apply to a particular Negotiated Service Agreement….It is possible that two mailers who are not similarly situated could qualify for functionally equivalent Negotiated Service Agreements, given comparable benefits to the Postal Service.

---

[25] Further, the Postal Service indicates that DFS's "almost complete reliance on letter-shaped mail is also a requirement." *Id.* n.12.

> Discussions of whether mailers are similarly situated are more appropriately reserved for allegations of possible discrimination or discussion of competitive issues. A qualifying mailer that is similarly situated to a mailer participating in a Negotiated Service Agreement must have a similar opportunity to participate in a functionally equivalent Negotiated Service Agreement. Not providing this opportunity would raise the possibility of discrimination. In an attempt to differentiate the concepts of functionally equivalent from the concept of similarly situated, the Commission will strive to use the terminology similarly situated only when addressing concerns of competition or discrimination, and not to use similarly situated when addressing application of the functional equivalency rules.
>
> The issue of discrimination might arise in a separate complaint where a mailer alleges that it is similarly situated to a mailer operating under the terms and conditions of a Negotiated Service Agreement, but that it has been denied a similar opportunity to participate in a functionally equivalent Negotiated Service Agreement.

Order No. 1391, Docket No. RM2003-5, Order Establishing Rules Applicable to Requests for Baseline and Functionally Equivalent Negotiated Service Agreements, February 11, 2004, at 51-52.

The Postal Service believes that DFS's defining characters are "its size, its large but declining billing and statement volumes, and its significant volume of advertising mail." Request at 5 (footnote omitted). The Public Representative's concerns appear to address terms of the agreement that relate to functional equivalency, not whether a mailer is similarly situated. PR Comments at 4-6. He does, however, caution that if what he labels as price terms can be changed at the Postal Service's option "when negotiating with similarly situated mailers (those who send a large amount of First-Class statement mailings and a large amount of advertising mailings) [it] will constitute price discrimination, which section 3622(c)(10) forbids." *Id.* at 5-6. Thus, the Public Representative argues that, if the Commission approves the NSA, it should not define which terms in the agreement "define a 'functionally equivalent' NSA." *Id*. at 6.

Whether a contract is functionally equivalent is, as with similarly situated, a factual determination. DFS and the Postal Service reached a mutually acceptable agreement. The statute requires the agreement to be available on reasonable terms to similarly situated mailers. The Postal Service does not contend that any future NSA has to be made available on terms identical to the original contract. Postal Service Reply Comments at 6. The issue is not now before the Commission and it declines to speculate on what contracts would or would not be functionally equivalent with the instant agreement.

Regarding unreasonable harm to the marketplace, the Postal Service argues that compared to DFS's size, its competitors, and the marketplace, the "relatively small rebates could [not] possibly disrupt the marketplace, much less unreasonably." *Id*. at 5-6. On this record, there has been no showing that the instant agreement will disrupt the marketplace. That does not foreclose the possibility, however, that such a showing could be made subsequently.

The Public Representative expressed concern that mailers who compete in downstream markets may be disadvantaged by the NSA. PR Comments at 5. Mailers competing in the credit card industry could be adversely affected by the NSA even if not similarly situated to DFS. Professor Panzar discussed the consequences of an optional tariff (NSA) in Docket No. MC2002-2:

> [W]hen user demands are independent, any optional tariff offering voluntarily agreed to by a user and a profit-seeking monopolist can be presumed to be efficient because it can make possible a Pareto improvement. No such presumption is possible when there are downstream competitors of the favored user. The elegant, simple argument of the previous section breaks down because the output expansion of the favored user will be (to some extent) offset by an output contraction of users that do not avail themselves of the discount. A foresighted monopolist would of course take such feedback effects into account when designing an optional tariff offering, ensuring that it would be attractive to the (foresighted) large user and profitable if taken up. However, the negative effect on small users will remain, *even if the establish[ed] tariff remains available.*

Docket No. MC2002, Tr. 15/1591-92 (emphasis in original).

Thus, upon a showing of market disruption, a mailer competing in the credit card industry may be entitled to a non-functionally equivalent NSA to neutralize the negative effect of DFS's agreement on it. Such a mailer need not be similarly situated and the case would necessarily turn on the facts presented. If presented to the Commission in a complaint proceeding, an alternative remedy could be to terminate the existing NSA. The Commission urges the Postal Service, if approached by downstream or other competitors alleging market disruption, to consider each claim fairly and promptly.

Data collection plan. The Postal Service's proposed data collection plan states that it will provide certain information to the Commission "not later than 90 days after the end of each contract year." Request, Attachment D. The Commission's rules require such information not later than "60 days after each anniversary date of the implementation." 39 CFR 3010.43. The Postal Service did not seek a partial waiver of the rules, request any additional time for submitting the data collection plan beyond the time frame required by such rules, or provide any discussion as to why additional time might be required in this case. Accordingly, the Commission will require the data collection plan information to be submitted within 60 days after each anniversary date of the implementation as 39 CFR 3010.43 requires.

Furthermore, in light of the Postal Service's limited financial analysis, the Commission has revised the Postal Service's data collection plan to include minimum data necessary to measure the impact of the agreement on the net financial position of the Postal Service. The specifics of the data collection plan are as follows. Not later than 60 days after each anniversary date of implementation, the Postal Service shall file with the Commission a report on DFS, as defined in the instant agreement, of:

1. DFS's volumes entered by qualifying price category for the just ended contract year;

2. DFS's postage paid by qualifying price category for the just ended contract year;

3. The adjusted threshold used to establish DFS's eligibility for rebates and payment of fines, and the calculations underlying the threshold's determination;

4. The index used to establish DFS's average price increase, and the calculations underlying the index's determination;

5. The rebate paid to or penalty paid by DFS (if any) and the calculations underlying their determination;

6. A list of all subsidiaries and affiliates mailing eligible mailpieces during the contract year as well as lists of all mergers and acquisitions and sales and closures of entities or divisions occurring during the contract year, and volumes associated with such enterprises for that contract year;

7. The methodology and calculation used to determine the increase or decrease in net contribution to the Postal Service as a result of the agreement for the just ended contract year, including a narrative explanation of the methodology used;

8. The annual (contract year) actual mailer-specific costs, volumes, and revenues; and

9. A detailed discussion of how the Postal Service believes DFS's own-price elasticities differ from the average elasticities of workshared First-Class Mail and Standard Regular Mail.

Early termination. The Postal Service shall promptly notify the Commission if the DFS agreement terminates earlier than the proposed term, but no later than the actual termination date. The Commission will then remove the applicable agreement from the MCS. In addition, within 30 days of an early expiration, the Postal Service shall file costs, volumes, and revenues data associated with the applicable contract.

V. CONCLUSION

The Commission approves Discover Financial Services 1 as a new product to be assigned to the market dominant product list under 39 U.S.C. 3642 and the implementing regulations. The revisions to the market dominant product list are shown below the signature of this Order.

It is ordered:

1. Discover Financial Services 1 is added to the market dominant product list as a new product under Negotiated Service Agreements.

2. If the instant agreement terminates earlier than the proposed 3-year term, the Postal Service shall notify the Commission and file relevant contract data as set forth in the body of this Order.

3. The Postal Service shall inform the Commission of the implementation and expiration dates of this agreement as discussed in the body of this Order.

4. The Postal Service shall submit information on penalties for the second and third years of this agreement as discussed in the body of this Order.

5. The Postal Service shall report data concerning the instant agreement as set forth in the data collection plan discussed in this Order.

6. The proposed draft Mail Classification Schedule language will be revised as discussed in the body of this Order.

7. The Secretary shall arrange for the publication in the *Federal Register* of an updated product list reflecting the change made in this Order.

By the Commission.

Shoshana M. Grove
Secretary

CHANGE IN MAIL CLASSIFICATION SCHEDULE
CHANGE IN PRODUCT LIST

The following material represents changes to the product list codified at 39 CFR Appendix A to subpart A of Part 3020—Mail Classification Schedule. These changes are in response to Docket Nos. MC2011-19 and R2011-3. The Commission uses two main conventions when making changes in the product list. The addition of text is indicated by underscore. Deleted text is indicated by a strikethrough.

PART A—Market Dominant Products

1000 Market Dominant Product List

* * * * *

Negotiated Service Agreements

* * * * *

Discover Financial Services 1

* * * * *