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

Before Commissioners: Ruth Y. Goldway, Chairman;
Mark Acton, Vice Chairman; and
Robert G. Taub

Market Dominant Product Prices
Standard Mail
PHI Acquisitions, Inc.

Docket No. MC2014-21

Market Dominant Product Prices
PHI Acquisitions, Inc. (MC2014-21)
Negotiated Service Agreement

Docket No. R2014-6

ORDER ADDING PHI ACQUISITIONS, INC. NEGOTIATED SERVICE AGREEMENT TO THE MARKET DOMINANT PRODUCT LIST

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ORDER ADDING PHI ACQUISITIONS, INC. NEGOTIATED SERVICE AGREEMENT TO THE MARKET DOMINANT PRODUCT LIST

(Issued June 19, 2014)

I. INTRODUCTION

The Postal Service seeks to add a new negotiated service agreement product identified as PHI Acquisitions, Inc. Negotiated Service Agreement (PHI NSA or Agreement) to the market dominant product list.[1] For the reasons discussed below, the Commission approves the Request.

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[1] Notice of the United States Postal Service of Filing of Contract and Supporting Data and Request to Add PHI Acquisitions, Inc. Negotiated Service Agreement to the Market-Dominant Product List, March 5, 2014 (Request).

II. BACKGROUND

Pursuant to 39 U.S.C. §§ 3622 and 3642, as well as 39 C.F.R. parts 3010 and 3020, the Postal Service filed a formal request to add the PHI NSA to the market dominant product list. Request at 1. The Postal Service asserts that the PHI NSA will improve its net financial position and will not cause unreasonable harm to the marketplace. In addition, the Postal Service states that it will negotiate and implement functionally equivalent agreements with similarly situated mailers. *Id.*, Attachment E at 3.

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

- Attachment A—a copy of Governors' Resolution No. 14-02, authorizing a negotiated service agreement with PHI Acquisitions, Inc. (PHI);
- Attachment B—a copy of the Agreement;
- 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 C.F.R. § 3020.32, which the Postal Service states it is also using to satisfy the requirements of 39 C.F.R. § 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 $13.248 million.[2]

The Postal Service describes the PHI NSA in its Request. It indicates that the Agreement is designed to increase the total contribution the Postal Service receives

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[2] *See* Responses of the United States Postal Service to Chairman's Information Request No. 1, Questions 10 and 11, April 8, 2014, question 11 (Response to CHIR No. 1, questions 10 and 11); PHI_NSA_Financials FINAL_Exigent.xlsx (for the Postal Service's revised 5-year financial results). The Request, and the accompanying Attachment F, initially estimated an aggregate net value of $10.748 million. Request at 13. The financial model was revised various times during this proceeding to reflect a threshold adjustment required by section III.D of the Agreement and to update forecasts of Before and After Rates volume.

from PHI Standard Mail Carrier Route flats.[3] Request at 6. The Postal Service describes the four main components of the Agreement: (1) a volume threshold, (2) a volume threshold adjustment, (3) a volume commitment, and (4) rebates. Eligible mail under the Agreement is limited to Standard Mail Carrier Route flats.[4]

Specifically, the volume threshold is based on PHI's total volume of Carrier Route flats. The baseline volume threshold is defined by the Agreement's terms as PHI's total Carrier Route flats volume for the period October 1, 2012 through September 30, 2013. For the first year of the Agreement, the threshold is the baseline volume. For the second through fifth years, the threshold is the previous year's annual volume growth times an adjustment factor (0.145) plus the previous year's volume threshold. Request at 7-8. This formula will adjust the threshold upward annually to account for growth in PHI's volume as a result of new customers gained due to increased volume incentivized by the PHI NSA. *Id.* at 8. The adjustment factor is set by the Agreement's terms and was formulated based on the expected response rate to the incremental volume incentivized by the Agreement and the aggregate number of catalogs mailed annually to each new buyer. *Id.*

The Agreement also contains a volume commitment equal to the baseline threshold. If PHI's total volume of eligible mail in the first year of the Agreement is less than the threshold, PHI must pay a penalty of $100,000 to the Postal Service. *Id.* at 9.

If PHI's eligible volume exceeds the threshold in a given quarter, it will earn rebates on its qualifying Standard Mail Carrier Route flats volume. *Id.* The rebate is based on the eligible volume that exceeds the baseline volume for a given quarter.

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[3] For the purposes of this Order, "Carrier Route flats" refers to flat-shaped mail meeting the description and requirements contained in the MCS for the Carrier Route and High Density and Saturation Flats/Parcels Standard Mail products.

[4] The Request also states that Flats Sequencing System (FSS) flats would be considered eligible volume under the Agreement. Request at 7. In Response to CHIR No. 1, question 12, the Postal Service clarified that eligible FSS flats under the Agreement are limited to High Density Plus, High Density, and Basic Carrier Route. Response of the United States Postal Service to Chairman's Information Request No. 1, March 26, 2014, question 12 (Response to CHIR No. 1).

Eligible volume up to 10 percent above the quarterly baseline will receive a 10 percent rebate from published rates. Eligible volume between 10.01 percent and 18 percent above the quarterly baseline will receive a 15 percent rebate from published rates. Eligible volume over 18 percent above the quarterly baseline will receive a 20 percent rebate from published rates. *Id.*

The Postal Service also describes several other elements of the Agreement: (1) a termination clause; (2) an acquisitions clause; (3) a divestiture clause; (4) an option to renew clause; and (5) an incentive programs clause that allows PHI to participate in other incentive programs but prevents double-dipping on discounts. *Id.* at 9-10.

The Postal Service states that the Agreement will be implemented on July 1, 2014 or on a date agreed to with PHI, and will expire 5 years from the implementation date. *Id.,* Attachments A and B. The Agreement's terms permit either party to terminate the Agreement with 30 days' written notice under limited circumstances and provide PHI with an option to renew for an additional period if certain criteria are met. *Id.,* Attachment B at 12-13.

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. Request at 10-11; *see also id.,* Attachment E at 3. In assessing the desirability of future agreements, the Postal Service believes that the defining characteristics of PHI are its size, its large but stagnant catalog mail volume, and the availability of company mail and catalog data. Request at 11. In addition, the Postal Service states that a similarly situated customer seeking a similar agreement would need to demonstrate that it had the resources and infrastructure to add significant incremental catalog volume. *Id.*

In Order No. 2009, the Commission gave notice of the two dockets, appointed a Public Representative, and provided the public with an opportunity to comment.[5] Chairman's Information Request No. 1 (CHIR No. 1), issued March 19, 2014, sought clarification of various elements related to the PHI NSA. The Postal Service filed its responses to CHIR No. 1 on March 26, 2014 and April 8, 2014.[6] PHI also responded to question 2 of CHIR No. 1, on March 27, 2014.[7] On March 21, 2014, Chairman's Information Request No. 2 (CHIR No. 2) was issued. The Postal Service's responses to that request were filed on March 27, 2014 and April 8, 2014.[8] On April 11, 2014, Chairman's Information Request No. 3 (CHIR No. 3) was issued and requested follow up information based on the responses to CHIR Nos. 1 and 2. The Postal Service's response to that request was filed on April 16, 2014.[9] On April 29, 2014, Chairman's Information Request No. 4 (CHIR No. 4) was issued and requested additional clarification concerning the Postal Service's revised financial workpapers.

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[5] Notice and Order Concerning Addition of PHI Acquisitions, Inc. Negotiated Service Agreement to the Market Dominant Product List, March 7, 2014 (Order No. 2009). The deadlines for comments were extended twice by the Commission. Order Granting Motion for Extension of Comment Deadlines, April 4, 2014 (Order No. 2039); Order Extending Comment Deadlines, April 14, 2014 (Order No. 2049).

[6] Response to CHIR No. 1; Response to CHIR No. 1, questions 10 and 11.

[7] Response of PHI Acquisitions, Inc. to Chairman's Information Request No. 1, March 27, 2014 (PHI Response to CHIR No. 1).

[8] Response of the United States Postal Service to Chairman's Information Request No. 2, March 27, 2014 (Response to CHIR No. 2); Response of the United States Postal Service to Chairman's Information Request No. 2, Question 1, April 8, 2014 (Response to CHIR No. 2, question 1).

[9] Responses of the United States Postal Service to Chairman's Information Request No. 3, April 16, 2014 (Response to CHIR No. 3).

The Postal Service responses to that request were filed on May 2, 2014, May 6, 2014, and May 21, 2014.[10] PHI also responded to question 1 of CHIR No. 4.[11]

III. COMMENTS

Comments were filed by the Public Representative[12] and by Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak).[13] Reply comments were filed by PHI,[14] the American Catalog Mailers Association (ACMA),[15] the Public Representative,[16] the Postal Service,[17]and

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[10] Responses of the United States Postal Service to Chairman's Information Request No. 4, May 2, 2014 (Response to CHIR No. 4); Response of the United States Postal Service to Chairman's Information Request No. 4, Question 3, May 6, 2014 (Response to CHIR No. 4, question 3); Supplemental Response of the United States Postal Service to Chairman's Information Request No. 4, Question 3, May 21, 2014 (Supplemental Response to CHIR No. 4). The Response to CHIR No. 4, question 3 was accompanied by a motion for late acceptance. Motion of the United States Postal Service for Late Acceptance of Response to Chairman's Information Request No. 4, Question 3, May 6, 2014. The motion is granted.

[11] Response of PHI Acquisitions, Inc. to Chairman's Information Request No. 4, May 2, 2014 (PHI Response to CHIR No. 4).

[12] Public Representative Initial Comments, April 23, 2014 (PR Comments).

[13] Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Initial Comments on PHI Acquisitions, Inc. Negotiated Service Agreement, March 27, 2014 (Valpak Comments); Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Supplemental Initial Comments on PHI Acquisitions, Inc. Negotiated Service Agreement, April 10, 2014 (Valpak Supplemental Comments); Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Further Supplemental Initial Comments on PHI Acquisitions, Inc. Negotiated Service Agreement, April 23, 2014 (Valpak Additional Supplemental Comments).

[14] Reply Comments of PHI Acquisitions, Inc., April 30, 2014 (PHI Reply Comments).

[15] Reply Comments of the American Catalog Mailers Association (ACMA), April 30, 2014 (ACMA Reply Comments).

[16] Public Representative Reply Comments, April 30, 2014 (PR Reply Comments).

[17] United States Postal Service Reply Comments, April 30, 2014 (Postal Service Reply Comments).

Orchard Brands Corporation (Orchard).[18] No other interested person submitted comments.

Public Representative comments. The Public Representative has several concerns about the PHI NSA and makes corresponding recommendations that, if adopted, would lead him to support implementation of the PHI NSA. PR Comments at 2.

The Public Representative raises several questions about the Postal Service's workpapers. He states that the complexity of the Agreement's terms has made it impractical to estimate the net financial impact using the Commission's methodology beyond the first contract year. *Id.* at 4. He also believes additional information is necessary to understand the PHI NSA's projected growth rate and adjustment factor and states that the workpapers used to develop the projected growth rate would be helpful in assessing the validity of the Postal Service's overall projections for years 2-5 of the PHI NSA. *Id.* at 5-6. Despite these observations, he states the PHI NSA appears to generate a net financial benefit under the Commission's methodology, but cautions that billing determinant data are essential to an accurate application of the Commission's methodology. *Id.* at 13.

The Public Representative contends that the Postal Service could have developed more accurate volume thresholds by using the most recent billing determinant data. *Id.* at 9. He notes that PHI has increased its volume in recent quarters. *Id.* at 10. He argues that if the volume threshold has been set too low, PHI could generate mail volume sufficient to eliminate the positive financial benefits of the Agreement. *Id.* at 14. He urges the Commission to utilize its methodology to develop a discount cap for each year of the PHI NSA to limit potential negative impacts. *Id.* He

[18] Motion of PHI Acquisitions, Inc. for Acceptance of Comments of Orchard Brands Corporation, May 7, 2014, Attachment (Orchard Reply Comments). The comments were accompanied by a motion from PHI for acceptance of the comments, citing Orchard's lack of electronic filing account and familiarity with Commission filing requirements. Motion of PHI Acquisitions, Inc. for Acceptance of Comments of Orchard Brands Corporation, May 7, 2014, at 1. The motion is granted.

also seeks clarification of how the volume thresholds will be adjusted when the exigent rates expire. *Id.* at 11.

The Public Representative is concerned that the Postal Service is not adequately protected against the risk of PHI's acquisition of new catalog titles and urges the Commission to review the historic impact of acquired and divested titles on PHI's volume and consider imposing a discount cap to alleviate risk. *Id.* at 14-15. He also recommends that the Commission require the Postal Service to show that the PHI NSA will not cause unreasonable harm to the marketplace. *Id.* at 15. Finally, he recommends that the Commission require the Postal Service to report on the number and status of negotiations with similarly situated mailers. *Id.* at 16.

Valpak comments. Valpak raises concerns about whether the Request is complete and conforms to the Commission's regulations. It argues that the Commission should dismiss the Request without prejudice or put the Postal Service on notice that future filings that are incomplete or not compliant with Commission regulations will be dismissed without prejudice. Valpak Comments at 2-3. It asserts that the Request failed to conform to several of the 39 C.F.R. part 3010 regulations, including rules concerning the data collection plan, application of accepted analytical principles, and analysis of the effects of the Agreement on contribution to institutional costs from mailers not party to the Agreement. *Id.* at 3-5. In addition, it argues insufficient information was provided concerning the length of the PHI NSA and the treatment of similarly situated mailers. *Id.* at 5-6. Valpak asserts that the Postal Service's incomplete Request and delayed responses to CHIR Nos. 1 and 2 diminished Valpak's ability to participate fully in the proceeding and is concerned that such delays and incompleteness may hamper the Commission's review. *Id.* at 8-9.

Valpak also raises several concerns about the financial impact of the PHI NSA. First, it is concerned that the unit contributions under the PHI NSA, particularly for pieces receiving the 20 percent rebate, are too low and believes the estimated elasticity is also low. *Id.* at 10-11. It argues that the Postal Service should focus on maximizing contribution, rather than volume. *Id.* at 11. Second, it asserts that the Postal Service has failed to show that the PHI NSA will improve its net financial position and urges the Commission to reject the PHI NSA for failure to comply with 39 U.S.C. § 3622(c)(10). Valpak Supplemental Comments at 2-4; Valpak Additional Supplemental Comments at 1-2. Third, it points to disparities in the Postal Service's workpapers that it believes "make no sense." *Id.* at 2-3. Finally, it states that the workpapers fail to account for the termination of the exigent price increase, which is scheduled to occur during the PHI NSA's term. *Id.* at 3.

PHI reply comments. PHI states that the PHI NSA will improve the financial position of the Postal Service and that it contains sufficient protections to prevent harm to the Postal Service and mailers from unforeseen changes in the marketplace or PHI's mailing practices. PHI Reply Comments at 1-2. PHI asserts that application of the Commission's methodology demonstrates that the Agreement will provide a net financial benefit in the first year and suggests that the benefit realized by the Postal Service from the PHI NSA will be even greater than the analysis shows. *Id.* at 5. PHI believes that the analysis provided by the Postal Service demonstrating the net financial benefit of the PHI NSA is the most accurate available because it accounts for PHI's particular circumstances. *Id.* at 6. It asserts that the Commission's methodology has more conservative assumptions; uses the subclass rather than mailer elasticity; and is limited in its ability to be applied to the PHI NSA beyond the first year. *Id.* at 7. PHI argues that inability to apply the Commission's methodology to years 2 through 5 of the Agreement should not prevent Commission approval, as the Postal Service should not have to limit negotiations to conform to a specific economic model. *Id.* PHI also identifies several other benefits the Postal Service will receive from the PHI NSA that are not included in the net financial benefit calculation. *Id.* at 8-9.

PHI contests Valpak's criticisms of the Postal Service's workpapers. *Id.* at 8. PHI explains that the Postal Service used incorrect figures for the marginal discount and rebates in its initial analysis. PHI further explains that once those numbers were corrected and inserted into the analysis, the results showed that higher marginal discounts would result in the payment of more rebates, more volume credited to the effect of the discount, and thus a higher total contribution to the Postal Service. *Id.*

PHI argues that concerns about its recent increase in volume are unwarranted. *Id.* at 9. PHI explains that its increases in volume during the first quarter of 2014 were planned prior to implementation of the exigent rates. *Id.* at 9-10. It also notes that some of the volume increase in FY 2014 is due to shifts in timing of mail entry for routine and business reasons. *Id.* at 10. PHI asserts that the Postal Service's volume forecasts were made with the best information available at the time the Agreement was negotiated and if volume forecasts are to be adjusted with quarterly volume shifts, the uncertainty would drive mailers away from negotiating NSAs with the Postal Service. *Id.* at 11.

PHI responds to the Public Representative's and Valpak's questions concerning how volume thresholds will be adjusted when the exigent price increase is rescinded. *Id.* PHI states that it expects that if the exigent rates are terminated, the threshold would be recalculated using the lower rates. *Id.*

PHI objects to the Public Representative's recommendation of a discount cap, arguing it would be extremely complex to implement, would limit the upside of the PHI NSA for both the Postal Service and PHI, and is not necessary given the protections from the Agreement's termination provision. *Id.* at 12. PHI also contests the Public Representative's view that the discount cap is necessary to address the risks associated with possible acquisitions. *Id.* PHI explains that the Agreement protects against achieving discounts through acquisitions and asserts that the Agreement fairly apportions the risks associated with acquisitions. *Id.* at 12-13. Using its two most recent acquisitions as examples, PHI asserts that the Agreement allows the Postal Service and PHI to share in the benefits from acquisitions. *Id.* at 14-15.

PHI contests the Public Representative's claim that the Postal Service has not adequately demonstrated that the PHI NSA will not cause unreasonable harm to the marketplace. *Id.* at 15. PHI asserts the Agreement will not harm the marketplace under the standards of title 39 because the Postal Service is not pricing below cost. *Id.* at 15-16. In addition, PHI states that conventional competitive analysis shows that the PHI NSA will not substantially diminish competition. *Id.* at 16-17.

ACMA reply comments. ACMA also addresses the Public Representative's and Valpak's concerns of harm to the marketplace from the PHI NSA. ACMA asserts that the Agreement provides benefits, both to catalogs specifically and the mailing system as a whole. ACMA Reply Comments at 2. ACMA asserts that the Postal Service has demonstrated that the Agreement will not cause unreasonable harm to the marketplace and thus no harm-prevention action is necessary. *Id.* at 3-4.

ACMA also addresses Valpak's concerns with the Postal Service's workpapers. ACMA explains the Postal Service workpapers submitted in response to CHIR No. 3 corrects errors in the workpapers submitted in response to CHIR No. 2. *Id.* at 5. It explains that the corrected workpapers show that increasing the marginal discount increases the total net value—a result expected under the Commission's methodology. *Id.* at 6.

Finally, ACMA states that the Commission's methodology calls for mailer-specific elasticity, but as a default and in this case, an average elasticity for a category of mail is used. *Id.* Since the after-rates volume projections show PHI's price sensitivity to be consistent with an elasticity higher than the average, the results of the Commission's methodology should be viewed as a conservative estimate. *Id.* at 6-7. ACMA argues that a more customer-specific elasticity would show a higher net value of the PHI NSA to the Postal Service. *Id.* at 7.

Public Representative reply comments. The Public Representative shares Valpak's concerns about the Postal Service's Request. PR Reply Comments at 2. He states that the public interest is served when the Postal Service files a well-supported request that comports with Commission regulations. *Id.* at 2-3. He asserts that the Postal Service's failure to comply with regulations results in confusion and makes it more difficult for the public to participate. *Id.* In this proceeding, he believes the development of the case through comments and CHIR responses rather than the Request created a barrier to providing meaningful comments. *Id.* at 3.

The Public Representative responds to Valpak's concern about small unit contributions. *Id.* He explains that the numbers cited by Valpak were later updated by the Postal Service to show higher unit contribution but cautions that those numbers assume that the exigent rates are still in effect in year 5 of the Agreement. *Id.* He contests Valpak's assertion that the estimated elasticity is low. He states that the Postal Service has targeted the type of mail that can be expected to respond to pricing incentives, which is the primary reason the Agreement may provide a positive net financial benefit. *Id.* at 4-5.

The Public Representative agrees with Valpak that the Postal Service must produce an estimate of the financial impact of the entire agreement. *Id.* at 5. He recognizes that the PHI NSA's structure has made it difficult to make projections about years 2 through 5 of the Agreement. *Id.* at 6.

Postal Service reply comments. The Postal Service argues that many of the Public Representative's concerns were adequately addressed in the Postal Service's Request, CHIR responses, and the Agreement itself. Postal Service Reply Comments at 2. The Postal Service contends these filings address the Public Representative's concerns regarding acquisitions, the calculation of the adjustment factor, and whether the Agreement will cause unreasonable harm to the marketplace. *Id.* The Postal Service asserts that the Public Representative's remaining recommendations are unnecessary, premature, or irrelevant. *Id.* at 3. The Postal Service asserts that it has no obligation to provide reports concerning the status of other contract negotiations or billing determinant data for PHI. *Id.* The Postal Service argues that a discount cap would harm the growth potential of the Agreement. *Id.* The Postal Service states it is premature to demonstrate how the thresholds will be adjusted when the exigent rates expire and to provide a financial analysis using the Commission's methodology for years 2 through 5 of the Agreement. *Id.* at 4. The Postal Service argues that its analysis shows that the PHI NSA will improve the net financial position of the Postal Service. *Id.* Finally, the Postal Service responds to Valpak's specific concerns about disparities in the workpapers, stating "[a] larger marginal discount results in more of the volume above threshold being attributed as a result of the NSA, and thus more net value to the Postal Service." *Id.*

Orchard reply comments. Orchard supports approval of the PHI NSA. Orchard Reply Comments at 1. As a direct competitor of PHI, Orchard contests the assertion that the Agreement may cause unreasonable harm to the marketplace and states that the PHI NSA benefits both Orchard and the industry. *Id.* Orchard notes many benefits of the PHI NSA, including encouraging wider cooperation between industry and the Postal Service, improving economies for prospecting, and increasing the number of potential customers for rent and purchase from PHI. *Id.* at 2.

IV. COMMISSION ANALYSIS

The Commission has reviewed the Request, the Agreement, the financial analyses, CHIR responses, and all comments filed in this proceeding. The Commission's statutory responsibilities in this instance entail assigning the PHI 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.

A. Product List Assignment

In determining whether to assign the PHI 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 consists of all other products.

The Commission is further required to give due regard to 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, PHI, supports adding the product to the market dominant product list. Request, Attachment E at 5. The Postal Service also states that no private sector enterprises engage in the delivery of the product and that it is unaware of any small business concerns that could provide a similar service to postal services provided to PHI. *Id*.

No commenter opposes the proposed classification of the PHI 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 PHI NSA product may be classified as a market dominant product and added to the market dominant product list as PHI Acquisitions, Inc. Negotiated Service Agreement.

B. Provisions Applicable to Market Dominant Products

Upon making the above finding that the PHI NSA product is properly classified as a market dominant product, the Commission must then review the Agreement to determine compliance with the statutory and regulatory requirements for market dominant products.

The applicable statutory and regulatory provisions require that the proposed market dominant negotiated service agreement either: (1) improve the net financial position of the Postal Service; or (2) enhance the performance of operational functions. *See* 39 U.S.C. § 3622(c)(10)(A) and 39 C.F.R. § 3010.40(a). Additionally, the negotiated service agreement "may not cause unreasonable harm to the marketplace" and "must be available on public and reasonable terms to similarly situated mailers." 39 C.F.R. § 3010.40(b), (c).

1. Impact on the Net Financial Position of the Postal Service

Section 3622(c)(10)(A) and 39 C.F.R. § 3010.40(a) require that a proposed market dominant NSA either improve the net financial position of the Postal Service or enhance operational performance. The Postal Service asserts that the Agreement will improve its net financial position. Request at 14.[19] Commenters raise several issues, calling into question the accuracy of the Postal Service's estimates of the net financial benefit, questioning the Postal Service's failure to apply the Commission's methodology, and raising concerns about recent increases in PHI's mail volumes.

a. Background and Methodologies Concerning Calculation of the Net Financial Impact

Postal Service's calculations and methodology. The Postal Service states that it is seeking approval of the PHI NSA on the basis that the Agreement will improve its net financial position. Request at 14. In support, the Postal Service filed financial workpapers with the Request, which estimate that the PHI NSA will generate approximately $1.3 million in net value during the first year of the Agreement and approximately $10.7 million in net value over the Agreement's 5 year term. *Id.*, Attachment F.

The Postal Service's net financial impact estimate relies on a different methodology than the Commission's accepted methodology. The Postal Service

[19] In Response to CHIR No. 1, question 4, the Postal Service states that "[b]y limiting PHI Eligible Mail to Carrier Route flats . . . which bear a full-service Intelligent Mail Barcode, the structure and eligibility requirements of the NSA create economies of scale and scope, which will enhance preparation of all Flats mail." The Postal Service continues, "[o]ther than these eligibility requirements, no components of this Agreement are specially designed to enhance the performance of mail preparation, processing, transportation, or other functions." Response to CHIR No. 1, question 4.

estimates the increase in net contribution from the Agreement by first estimating the Before Rates[20] and After Rates[21] volumes. It then calculates the increase in net contribution for each year of the Agreement by subtracting the rebates PHI would receive at the forecasted After Rates volumes from the contribution that would result from the estimated incremental volume. Finally, the Postal Service sums its annual estimates of increased net contribution to determine the value of the Agreement over its 5 year term.

According to the Postal Service, PHI's mail volume has remained relatively stable since 2010, with an average annual volume growth of 0.7 percent. Response to CHIR No. 1, question 9. Despite PHI's record of consistent annual mail volume, the Postal Service estimates that in the absence of the Agreement, PHI's Before Rates volume will decrease by about 1 percent per year. Response to CHIR No. 1, questions 10 and 11. The Postal Service explains that its Before Rates volume estimate was adjusted for statistical outliers, PHI's recent catalog title acquisitions, and growth of PHI's Carrier Route volume as a percentage of total volume. *Id.* In addition, the most recent volumes for Standard Mail Flats and Carrier Route flats for the third and fourth quarters of FY 2013 were down significantly compared to the same quarters in FY 2012. *Id.* The Postal Service represents that "[t]he adjustments were made judgmentally, based on experience with catalog volumes, and in light of customer discussions, knowledge of industry economics . . ., and expectation for the effects of future general economic conditions on volume and revenue growth." *Id.*

In Response to CHIR No. 1, question 11, the Postal Service revised its workpapers to reflect threshold adjustments required by section III.D of the

[20] Before Rates volume estimate refers to the volume of eligible mail PHI would send absent the Agreement.

[21] After Rates volume estimate refers to the volume of eligible mail PHI would send with the Agreement in place.

Agreement.[22] Application of this provision decreased the threshold for year 1 of the Agreement from 202,626,000 to 189,112,000 mailpieces. The Postal Service also revised the Before and After Rates volume estimates to reflect the effect of the price increase that was implemented on January 26, 2014. Based on these adjustments and using the same methodology it used in its initial calculations, the Postal Service calculates a net value of approximately $1.6 million for the first year of the Agreement and approximately $13.2 million in net value over the Agreement's 5 year term.[23]

The Commission's accepted methodology applies an elasticity test over a range of possible volume outcomes. In its Response to CHIR No. 3, question 1, the Postal Service applies the elasticity test to its forecasted After Rates volume for year 1 of the Agreement. Under that approach, it estimates $1.5 million in net benefit for the Postal Service as a result of the first year of the PHI NSA.[24]

The Postal Service's volume forecasts. The dependability of the Postal Service's estimate of net financial benefit hinges on the accuracy of the Postal Service's volume forecast. The Postal Service's forecast was based, in large part, on PHI's record of relatively stable volumes. Assuming that PHI's volumes would remain stable until the implementation of the Agreement, the Postal Service set the threshold for the first year of the Agreement equal to PHI's FY 2013 volume of eligible mail.

The Postal Service's forecast suggests that PHI's annual volume is expected to decrease slightly without the incentives provided in the Agreement. Response to CHIR No. 1, questions 10 and 11. However, the Postal Service provides data showing that PHI mailed 71 million eligible pieces in the first quarter of FY 2014, representing a 33

[22] Section III.D of the Agreement adjusts the thresholds for certain increases in PHI's postage costs. Request, Attachment B at 5-6. For an extended discussion of that provision of the Agreement, *see* section IV.C.2 of this Order, *infra.*

[23] Response to CHIR No. 1, questions 10 and 11; PHI_NSA_Financials FINAL_Exigent.xlsx.

[24] Response to CHIR No. 3, question 1; Panzar_CHIR3Q1.xlsx.

percent increase compared to FY 2013, quarter 1.[25] In the second quarter of FY 2014, PHI mailed 42 million eligible pieces, representing a 6.6 percent increase in eligible mail compared to FY 2013, quarter 2. PHI Response to CHIR No. 4, question 1. Overall, PHI's FY 2014 first and second quarter volume increased by 22 percent over the same quarters of the prior year.

The Public Representative raises concerns that the baseline volume threshold may be set too low, particularly in light of PHI's significant volume increase in the first quarter of FY 2014. PR Comments at 12-14. He argues that if the volume threshold is set too low, the financial benefits of the Agreement could be eliminated. *Id.* at 14. He urges the Commission to develop a discount cap for each year of the PHI NSA to limit the possibility of negative impacts. *Id.*

In response to CHIR No. 4, PHI provides three explanations for the volume increase between quarter 1 of FY 2014 and quarter 1 of FY 2013. First, the mail entry dates fall in different quarters in different calendar years. Second, PHI implemented its Add-A-Name refinements allowing volume that would have been mailed as Carrier Route to be mailed as lower rate High Density flats, resulting in additional mail volume without increasing postage. Third, PHI's most recently acquired title was integrated into PHI's mail streams. PHI Response to CHIR No. 4, question 1. PHI also states that much of its planning for FY 2014 mailings occurred prior to the Commission's ruling on the exigent rates and thus PHI will not have fully reacted to the exigent rates until the fall of 2014. PHI Reply Comments at 9-10. PHI objects to the Public Representative's suggestion of a discount cap, arguing it will limit the upside of the Agreement. *Id.* at 12. The Postal Service also argues that a discount cap would harm the growth potential of the Agreement. Postal Service Reply Comments at 3.

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[25] To calculate PHI's FY 2014, quarter 1 eligible volume, the Commission used ExigencyAdj_CHIR3Q3.xlsx, tab "Exigent Impact Calculation," cell B53 (which contains PHI eligible volume for the period FY 2013, quarter 2 through FY 2014, quarter 1) and ExigencyAdj_CHIR3Q3.xlsx, tab "Summary of Steps," cells C19 through C21 (containing PHI's eligible volume from FY 2013, quarters 2-4).

b. Calculation of the Net Financial Impact

The Commission's regulations state that a request setting rates for a market dominant NSA must contain "[d]etails regarding the expected improvements in the net financial position . . . The projection of change in net financial position as a result of the agreement shall be based on accepted analytical principles." 39 C.F.R. § 3010.42(f). The regulations also allow the Postal Service to use an alternative methodology "[i]f the Postal Service believes the Commission's accepted analytical principles are not the most accurate and reliable methodology available," files an explanation of its belief, and a projection of the change in financial position using the alternative methodology. *Id.*

Valpak argues that the Commission should not approve the PHI NSA because the Postal Service fails to apply the Commission's methodology to years 2 through 5 of the Agreement and thus fails to comply with 39 U.S.C. § 3622(c)(10). Valpak Supplemental Comments at 2-4; Valpak Additional Supplemental Comments at 1-2. The Public Representative states that the complexity of the contract terms make it impractical to estimate the net financial impact using the Commission's methodology beyond the first year. PR Comments at 4. He concludes that, using the Commission's methodology, the Agreement will likely have a net financial benefit, but urges the Commission to use PHI's billing determinant data to derive a more accurate estimate. *Id.* at 13. He argues an estimate of the net financial impact of the entire agreement is necessary, but acknowledges that the PHI NSA's structure makes it difficult to make projections about years 2 through 5 of the Agreement. PR Reply Comments at 5-6.

In response, PHI asserts that the PHI NSA will improve the net financial position of the Postal Service. PHI Reply Comments at 1-2. Since the Commission's methodology cannot easily be applied beyond the first contract year, PHI believes the additional analysis provided by the Postal Service for years 2 through 5 accurately reflects the net financial impact of the PHI NSA. *Id.* at 6-7. The Postal Service asserts that its analysis shows that the PHI NSA will improve the net financial position of the Postal Service. Postal Service Reply Comments at 4.

The Commission's methodology must be applied to assess the likelihood that a market dominant NSA will provide the Postal Service with a net financial benefit. The Postal Service applied the Commission's elasticity based methodology for year 1, but used its After Rates volume estimates rather than the range of values required by the Commission's methodology. The Commission has repeatedly rejected the use of Postal Service estimates based solely on qualitative factors, unsupported by a quantitative methodology.[26]

The Commission's methodology examines the likelihood that the Agreement will provide the Postal Service with a net financial benefit by assessing a range of possible volumes, rather than using point estimates. Using the Commission's methodology, the Commission finds that the PHI NSA will provide the Postal Service with a net financial benefit during the first year as long as PHI's eligible volume during year 1 does not exceed 265 million pieces. To exceed 265 million pieces, PHI would have to increase its FY 2013 mail volume by 31 percent.

Given PHI's historical volume trend, as reported in Attachment F to the Request, the possibility of a 31 percent increase would seem unlikely. However, PHI's volume increased 22 percent year-over-year in FY 2014 quarters 1 and 2. Assuming that the increase for the first half of FY 2014 persists through the remainder of the year, an increase in volume in response to the rebate exceeding 7 percent would surpass 265 million pieces, resulting in a negative net financial benefit for the Agreement's first year.[27] If the first two quarters of FY 2014 reflect a permanent departure from PHI's previous slow-growth trend, then there is greater risk that PHI's volume will exceed 265

[26] *See, e.g.,* Docket Nos. MC2011-19 and R2011-3, Order Adding Discover Financial Services 1 Negotiated Service Agreement to the Market Dominant Product List, March 15, 2011, at 13-14 (Order No. 694). *See also* Docket No. MC2004-3, Opinion and Further Recommended Decision, April 21, 2006, at 21-22.

[27] Negative net financial benefit refers to the situation where an agreement fails to generate a net financial benefit for the Postal Service because the rebates given on volume that the mailer would have generated without the agreement exceed the contribution generated by volume incentivized by the agreement.

million pieces in the first year. However, there are several reasons that the FY 2014, quarter 1 volume may not be indicative of a new PHI volume trend.

PHI explains that it takes 6 to 9 months for a catalog company to react to significant changes in mail costs and FY 2014 quarter 1 and 2 volumes do not reflect the impact on volume of the January 26, 2014 exigent price increase. PHI Reply Comments at 9-10. To examine how eventual reaction to the exigent rates may impact the net financial benefit calculation, the Commission considered the following scenario. First, the Commission assumed the FY 2014 first and second quarter increase persists and PHI's eligible volume in year 1 is 22 percent higher than FY 2013's volume. Then the Commission adjusted the volume downward using the subclass elasticity estimate to reflect the effect of the exigent price increase on PHI's volume. Under these circumstances, PHI would have to increase its eligible volume by more than an additional 11 percent to result in a negative net financial impact for the first year of the Agreement.

As PHI's mail volume was relatively stable between FY 2010 and FY 2013, the 22 percent increase in volume in the first half of FY 2014 may not continue. Assuming that this growth rate will persist in the second half of FY 2014 may overstate PHI's Before Rates volume. While volume in the first quarter of FY 2014 increased sharply compared with the first quarter of the previous year, the second quarter increase was much less pronounced. The volatility in volume in the first half of FY 2014 makes it difficult to predict volume growth for the remainder of the year. While it is likely that PHI's Before Rates volume will be higher than the Postal Service's estimate, one quarter with a sharp volume increase is not sufficient information to conclude that PHI will continue to mail at that much higher volume level.

As described by the Public Representative and PHI, the application of the Commission's methodology beyond the first year is complicated by the structure of the PHI NSA, which sets thresholds annually based on the previous year's threshold and the actual volume of eligible mail sent during the previous year of the Agreement.

Applying the Commission's methodology to the second year of the Agreement would require the elasticity test to be applied to the range of possible second year volumes evaluated with a range of possible second year thresholds. The possible combinations of volumes and thresholds increases exponentially for each year of the Agreement. Thus, as the Commission's workpapers demonstrate, the Commission uses the quantitative principles underlying its methodology to consider the impact of volume increases of differing magnitudes on the overall net financial impact for years 2 through 5 of the Agreement. *See* PRC-LR-MC2014-21-R2014-6/1.

Even if PHI's volume exceeds 265 million in the first year, the PHI NSA is likely to provide the Postal Service with a net financial benefit over the Agreement's term. As demonstrated in the Commission's workpapers, if PHI's volume increases minimally in years 2 through 5 of the Agreement, those years should offset a potential negative first-year financial impact caused by a substantial volume increase. *Id.* Thus, the Commission finds it is likely that the PHI NSA will provide a net financial benefit to the Postal Service over the 5 year term.[28]

Additionally, the Agreement is likely to generate further benefits for the Postal Service. First, it is likely that PHI's volumes in the years following the Agreement's expiration will be higher than they would have been without the PHI NSA. The Agreement incentivizes PHI to increase its prospecting volume. Prospecting volume is volume sent to prospective customers, with the expectation that some prospects will become PHI's customers. By increasing its prospecting volume, PHI is expected to expand its customer base during the period the Agreement is in effect. PHI mails catalogs to customers at a higher frequency than it mails to prospects. Therefore, in the years following the Agreement's expiration, PHI's volume will likely be higher than it would have been without the Agreement. Second, as PHI increases its volume, it is

[28] The Commission notes that an option to renew clause in the PHI NSA may incent larger year-over-year volume increases in years 2 through 4 of the Agreement's term. *See* Request, Attachment B, at 12-13. A smaller increase in year 1 volumes offsets the risk associated with higher levels of growth in later years of the Agreement.

likely that volume will migrate from Standard Mail Flats to the more profitable Carrier Route category because the additional volume should allow PHI to have more catalogs meeting the Carrier Route density requirements. These potential benefits bolster the likelihood that the Agreement will provide the Postal Service with a net financial benefit. The Commission is satisfied that the Agreement is likely to provide the Postal Service with a net financial benefit as required by 39 U.S.C. § 3622(c)(10)(A)(i).

The Commission considered the discount cap proposed by the Public Representative as a potential means to mitigate risk under the Agreement. Under the Public Representative's proposal, PHI would no longer be eligible for the discounted price once it accrued a certain amount of rebates.[29] The price of the mailpiece at the margin would increase from the discounted price to the non-discounted price. Faced with a higher price at the margin, PHI may forego mailing pieces it would have otherwise mailed at the discounted price. Under this Agreement, PHI's volume is expected to generate revenues that cover costs and provide contribution to the Postal Service, even at the highest rebate tier. Imposing a discount cap in this proceeding could deny the Postal Service the additional contribution. Therefore, the Commission will not impose a cap on the rebates PHI may accumulate.

2. Unreasonable Harm to the Marketplace

Section 3622(c)(10)(B) and 39 C.F.R. § 3010.40(b) require the Commission to consider whether a proposed agreement would cause unreasonable harm to the marketplace. The Postal Service asserts the PHI NSA will not cause unreasonable harm to the marketplace because the PHI NSA prices exceed unit attributable costs. Request, Attachment E at 3-4. The Public Representative states that the Commission should require the Postal Service to show that the PHI NSA will not cause unreasonable harm to the marketplace. PR Comments at 15. In response, PHI, ACMA, Orchard, and

[29] In this context, the discounted price is the price PHI pays per piece minus the rebate it receives on that piece.

the Postal Service assert that the PHI NSA will not cause unreasonable harm to the marketplace. PHI Reply Comments at 15; ACMA Reply Comments at 1-4; Orchard Reply Comments at 1-2; Postal Service Reply Comments at 2.

The Public Representative suggests the relevant market consists of catalog companies that sell products that are close substitutes to PHI products. PR Comments at 15. In addition, Valpak states that it is unclear from the Request whether the PHI NSA will have an adverse effect on PHI's competitors. Valpak Comments at 4. PHI urges the Commission to retain the approach it applied in Order No. 1448 and states under the Public Representative's suggested approach "it is impossible to 'affirmatively' define the relevant market." PHI Reply Comments at 15-16. These suggestions conflate the service provided under the NSA, *i.e.,* the distribution of catalogs, with the products PHI's catalogs offer.

To assess whether a market dominant agreement may cause unreasonable harm to the marketplace, the Commission assesses the potential effects of the agreement on competition as a whole, rather than the impact on individual competitors, utilizing precedent consistent with antitrust law.[30] The Commission uses an economic test to measure harm. Under this test, as long as the Postal Service is not pricing its products below cost to drive competitors out of business, it is not creating an unreasonable level of harm to the marketplace. Order No. 1448 at 27.[31]

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[30] Docket Nos. MC2012-14 and R2012-8, Order Approving Addition of Valassis Direct Mail, Inc. Negotiated Service Agreement to the Market Dominant Product List, August 23, 2012, at 26 (Order No. 1448). The Commission's reasoning was affirmed on appeal. *See Newspaper Assoc. of Am. v. PRC,* 734 F.3d 1208, 1215-16 (D.C. Cir. 2013).

[31] In Order No. 1448, the Commission also considered broader policy considerations in its assessment of unreasonable harm to the marketplace. *Id.* at 28-33. This analysis was conducted in response to commenters' qualitative and policy-driven arguments.

The prices under the PHI NSA are compensatory and in excess of attributable costs.[32] Thus, the economic test is satisfied, and the PHI NSA is not expected to cause unreasonable harm to the marketplace.

3. Treatment of Similarly Situated Mailers

In its Request, the Postal Service states that it regards four elements of the Agreement as "essential."[33] The Postal Service states the design imperative—to generate additional contribution—and the basic structure of the Agreement would provide guidance in the negotiation of similar agreements and might, in those agreements, yield parameters that were substantially different from those in this Agreement. Request at 10-11. The Postal Service identifies the defining characteristics of the PHI NSA as its size, large but stagnant catalog mail volume history, and the availability of company mail and catalog data. *Id*. at 11.[34] It later clarifies that PHI's catalog mail volume history could also be classified as stable or low-growth, in addition to stagnant. Response to CHIR No. 1, question 9. In offering similar agreements, the Postal Service states it will look for these characteristics, as well as a demonstration by the similarly situated customer that it has the resources and infrastructure to add significant incremental catalog volume. Request at 11. Assuming data are available from similarly situated customers, the Postal Service represents that it would perform

[32] For each year, unit contribution for tier C is calculated by subtracting unit cost from the product of undiscounted unit revenue and 0.8. PHI_NSA_Financials FINAL_Exigent.xls, tab "4_Tier" contains the unit revenue and unit cost estimates. For Year 1, the Commission calculates a unit contribution of $0.016 ((Cell C15*0.8)-Cell C16), for year 2, $0.014 ((Cell I15*0.8)-Cell I16), for year 3, $0.012 ((Cell O15*0.8)-Cell O16), for year 4, $0.010 ((Cell U15*0.8)-Cell U16), and for year 5, $0.012 ((Cell AA15*0.8)-Cell AA16). Since tier C is the largest discount tier, eligible mail receiving no discount or a discount in tiers A and B will have higher levels of unit contribution. The Commission notes that these unit contribution figures to do not take into account the expiration of the exigent rates. In section IV.C.2 of this Order *infra*, the Commission orders the Postal Service to file an amendment accounting for the expiration of the exigent rates.

[33] These elements are the threshold, threshold adjustment, volume commitment, and rebates. Request at 10.

[34] In Response to CHIR No. 1, question 7, the Postal Service clarified that the availability of data and willingness to share and allow data to be verified will also be critical to future negotiations.

the same qualitative and quantitative analysis that was performed using PHI's historical trends and macroeconomic variables that tend to trend with the customer's mail volume. Response to CHIR No. 1, question 8.

The Public Representative does not object to the Postal Service's description of "similarly situated" mailers, but urges the Commission to monitor the process by requiring the Postal Service to report on negotiations with similarly situated mailers. PR Comments at 16. In response, the Postal Service asserts that it has no obligation to provide on-going reports concerning the status of NSA negotiations. Postal Service Reply Comments at 3. Valpak comments that the Postal Service has not provided sufficient information to determine which mailers would be considered "similarly situated" to PHI. Valpak Comments at 5-6.

Market dominant NSAs are permissible when, among other things, they are "available on public and reasonable terms to similarly situated mailers." 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 PHI. Whether a mailer is similarly situated to PHI 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.
>
> 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.

Docket No. RM2003-5, Order No. 1391, Order Establishing Rules Applicable to Requests for Baseline and Functionally Equivalent Negotiated Service Agreements, February 11, 2004, at 51-52. Like the question of whether a mailer is similarly situated, the question of whether an agreement is functionally equivalent is a factual determination. Order No. 694 at 21. The statute requires the Agreement to be available on reasonable terms to similarly situated mailers. The Commission expects the Postal Service to negotiate in good faith with mailers seeking similarly situated status. Since the Commission's assessment of whether a particular mailer is similarly situated to PHI is a factual determination, the issue is not now before the Commission and the Commission declines to speculate on how it may rule on whether a particular mailer is similarly situated. Allegations of possible discrimination may be appropriately addressed in a complaint proceeding.

C. Other Issues

1. Delays and Incomplete Filings

Late and incomplete responses to information requests necessitated an extension of comment deadlines by nearly four weeks, thus delaying the proceeding in its entirety. Order No. 2049 at 1-3. The Postal Service filed late responses to all but one of the Chairman's Information Requests, and many responses were incomplete and required additional follow up. The Postal Service did not provide the complete response to CHIR No. 4 until May 21, 2014. *See* Supplemental Response to CHIR No. 4. Valpak urges the Commission to dismiss the Postal Service's Request as incomplete and for failure to comply with the Commission's regulations. Valpak Comments at 2-3. Valpak argues information remains missing from the record and that the Postal Service's incomplete Request and delayed responses to CHIRs harmed its ability to participate fully in the proceeding. *Id.* at 5, 8-9. The Public Representative shares Valpak's concerns and asserts that the Postal Service's failure to comply with Commission regulations in the Request has resulted in confusion and made it difficult for the public to participate in the proceeding. PR Reply Comments at 2-3.

The Commission finds that commenters were not materially prejudiced by the number of incomplete and late-filed filings by the Postal Service. The Commission twice extended the comment deadlines to allow interested persons to comment on late-filed information.[35] The extended deadlines resulted in three rounds of initial comments from Valpak. In addition, the Commission accepted and considered comments filed after the comment deadlines passed. *See* Orchard Reply Comments.

The late and incomplete filings adversely affected the parties to the Agreement by delaying the Commission's consideration of the Request. The Agreement is to be implemented "July 1, 2014, or a date mutually agreed upon by the Parties." Request, Attachment B at 3. The Postal Service urged the Commission to expedite its review of the Request because PHI needs lead time to prepare catalog marketing campaigns and to ready fulfillment activities.[36] The multiple late and incomplete filings by the Postal Service narrowed the window between Commission approval and the proposed implementation date. Despite these delays, the Commission is issuing this Order less than a month after the Postal Service's complete response to CHIR No. 4.

The Commission shares Valpak's and the Public Representative's concerns about the completeness of Postal Service filings, including the failure to provide all of the information required by 39 C.F.R. §§ 3010.42 and 3010.43 in its Request. In future requests to add NSAs to the market dominant product list, the Postal Service shall

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[35] Order No. 2039; Order No. 2049.

[36] *See* Response of the United States Postal Service to Public Representative Motion for Extension of Comment Deadlines, April 3, 2014, at 1-2; Response to CHIR No. 4, question 3; *see also* PHI Response to CHIR No. 1, question 2.

ensure that the request contains all of the information required by the Commission's 39 C.F.R. § 3010.40 *et seq.* regulations.

2. Expiration of the Exigent Rates

Section III.D of the Agreement contains a provision that adjusts the volume thresholds if "there are postal rate increases or changes in classification or classes or other changes on Standard Flats mail or FSS pricing that would result in a year-over-year Increased Total Annual Postage . . . for PHI Eligible Mail greater than twenty (20) basis points more than the January CPI-U preceding the implementation of that postal change." Request, Attachment B at 5. In Response to CHIR No. 1, question 11, the Postal Service confirms that the exigent rates that went into effect January 26, 2014 activated this provision. Response to CHIR No. 1, questions 10 and 11. To make the threshold adjustment for the exigent rates, the Postal Service derived an adjustment percentage of 6.67 percent by determining the actual postage increase PHI would have experienced on its volume mailed during the four quarters prior to the increase, subtracting the change in CPI-U, and applying an adjustment factor.[37] Accordingly, PHI's baseline threshold was decreased by 6.67 percent to account for the exigent rate increase.

While no commenter objects to the threshold adjustment in accordance with section III.D of the Agreement, both the Public Representative and Valpak seek clarification of how the threshold will be adjusted when the exigent rates expire. Valpak Additional Supplemental Comments at 3; PR Comments at 11. In response, PHI explains that when the exigent rates are terminated, it expects the threshold to be recalculated using the lower rates. PHI Reply Comments at 11. Similarly, the Postal Service states that it "would apply the same methodology in section III.D. of the NSA to

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[37] Response to CHIR No. 3, question 2. The adjustment factor of 1.4 was negotiated between PHI and the Postal Service based on the behavioral characteristics of PHI's internal models and business practices, as well as the methodology used by PHI to plan its mailings. Response to CHIR No. 1, questions 10 and 11.

reverse the effect of the exigency" and describes five steps it would use to recalculate the threshold. Response to CHIR No. 4, question 2.

Section III.D of the Agreement provides for a threshold adjustment when PHI's year-over-year total annual postage, as calculated in accordance with the Agreement's terms, is increased "greater than twenty (20) basis points more than the [relevant] January CPI-U." Request, Attachment B at 5. The Postal Service and PHI do not contemplate a corresponding threshold adjustment if PHI experiences an equally significant decrease in rates. However, both PHI and the Postal Service support adjusting the thresholds when the exigent rates expire. The Commission agrees and finds that an upward threshold adjustment corresponding with the expiration of the exigent rates reduces the risk that the Agreement will not provide the Postal Service with a net financial benefit. Within 90 days of the date of this Order, the Postal Service shall file an amendment containing a threshold adjustment mechanism for a price decrease, applying the steps described in its Response to CHIR No. 4, question 2. The Postal Service shall also provide workpapers containing the information required by 39 C.F.R. § 3010.42(f) and demonstrating the effects of the threshold adjustment on the net financial benefit of the Agreement in accordance with the Commission's methodology.

3. Data Collection Plan and Reporting

The data collection plan included with the Request states that no later than 90 days after the end of each contract year, the Postal Service will report to the Commission: (1) PHI volumes entered by qualifying price category for the contract year; (2) PHI postage paid by qualifying price category for the contract year; (3) PHI package fulfillment volumes by service level; (4) the adjusted annual threshold and corresponding quarterly volumes that will be used for the next contract year; and (5) the rebate paid to or penalty paid by PHI. Request, Attachment D. In Response to CHIR No. 1, question 1, the Postal Service states that "[b]y providing actual volumes, revenues, rebates, and the calculations performed to determine those rebates, the Postal Service will have provided all the available data information to be used . . . to estimate a value for the agreement." In addition, the Postal Service indicated that it will file its report within 60 days of the Agreement's anniversary date as required by 39 C.F.R. § 3010.43(b), rather than within the 90 days contained in the data collection plan. Response to CHIR No. 1, question 1.

In addition to the information it proposes to include in its data collection reports, the Postal Service shall, consistent with the Commission's rules, also provide the following:[38]

- Calculation of the change in net financial position of the Postal Service as a result of the PHI NSA, using the Commission's methodology. 39 C.F.R. § 3010.43(b)(1).
- PHI-specific costs, volumes, and revenues by qualifying price category for the contract year. If PHI-specific costs are not available, the source and derivation of the costs that are used shall be provided, including a discussion of the currency and reliability of those costs, and their suitability as a proxy for mailer-specific costs. 39 C.F.R. § 3010.43(b)(1)(A),(C).
- An analysis of the effects of the Agreement on the net overall contribution to the institutional costs of the Postal Service. 39 C.F.R. § 3010.43(b)(1)(B).
- A discussion of the changes in operations of the Postal Service that result from the Agreement. 39 C.F.R. § 3010.43(b)(2).
- An analysis of the impact of the Agreement on the marketplace, including a discussion of any and all actions taken to protect the marketplace from unreasonable harm. 39 C.F.R. § 3010.43(b)(3).

[38] The Commission's rules require the Postal Service to provide certain information in its data collection reports. The Postal Service is reminded that all data collection reports must contain the information required by 39 C.F.R. § 3010.43(b).

- A list of all of PHI's acquisitions and divestitures that occurred during the contract year, and the volumes and threshold impacts associated with any such acquisitions or divestitures.[39]

The Postal Service's data reports are due no later than 60 days after each anniversary date of implementation of the PHI NSA. 39 C.F.R. § 3010.43(b).

4. Acquired and Divested Titles

The PHI NSA contains provisions detailing how thresholds will be adjusted if PHI acquires or divests a catalog title during the Agreement's term. Request, Attachment B at 8-11. The Public Representative is concerned that the Agreement does not adequately protect the Postal Service against the risk of PHI acquisition of new catalog titles. PR Comments at 14. In response, PHI explains that the Agreement protects against the risks of achieving discounts through acquisitions and asserts that risk associated with acquisitions is fairly apportioned between PHI and the Postal Service. PHI Reply Comments at 12-15. The Postal Service asserts that sufficient information concerning acquisitions has already been provided. Postal Service Reply Comments at 2.

If PHI were to acquire a new title during the NSA term, the Agreement states that the threshold would be adjusted to include "mail volumes equal to 80% (eighty percent) of *the total Standard Mail flats* mailed by the acquired catalog brand or title in each of the four (4) most recent completed Agreement quarters." Request, Attachment B, at 8 (emphasis added). By incorporating 80 percent of the total Standard Mail flats volume into the threshold, rather than solely the mail volume that would be considered eligible mail under the Agreement, PHI has an incentive to convert acquired volumes into more profitable mail for the Postal Service. Both PHI and the Public Representative state that

[39] In light of the requirement set forth in sections IV. F and IV. G of the Agreement that the threshold be adjusted to account for acquisitions and divestitures, providing the volume and threshold impacts of acquisitions and divestitures in data collection reports should not cause any additional burden on the Postal Service.

according to ACMA, Carrier Route flats average only about 70.5 percent of combined Standard Mail Flats and Carrier Route volume for the catalog industry. PR Comments at 14; PHI Reply Comments at 12. Thus, a catalog title acquired by PHI would be expected to have Carrier Route flats volume of about 70.5 percent of its Standard Mail flats volume. Since 80 percent of the total Standard Mail flats volume is incorporated into the threshold and PHI only receives rebates on Carrier Route flats above the threshold, PHI is incentivized to increase the Carrier Route volume of the acquired catalog title, which provides the Postal Service with more profitable mail.

However, acquisitions do create some additional risk that the Agreement may not produce a net financial benefit for the Postal Service. If PHI acquires a title and converts greater than 80 percent of the title's volume into eligible mail, those additional discounts could cause the Agreement to fail to provide a net financial benefit. However, because acquisitions, if any, are likely to have only a negligible effect on the overall eligible mail volume under the Agreement, the Commission finds the actual risk posed by acquisitions to be relatively small. As an additional precaution, the Commission is requiring that specific information about acquisitions and divestitures occurring during the Agreement's term be included in the Postal Service's data collection reports, which will allow the Commission to assess the impacts of acquisitions and divestitures in future Annual Compliance Determinations. *See supra* section IV.C.3.

5. Description of FSS in Proposed MCS Language

The Request states that FSS mailpieces would be included in the definition of eligible mail and volume threshold "in the event FSS becomes a category or sub-category during the term of this NSA." Request at 7 n.14. In Docket No. R2013-10, the Commission approved new FSS pricing categories for Standard Mail Flats, Carrier Route, and High Density and Saturation Flats and Parcels.[40] FSS pricing was

[40] Docket No. R2013-10, Order on Price Adjustments for Market Dominant Products and Related Mail Classification Changes, November 21, 2013, at 73-74 (Order No. 1890).

implemented on January 26, 2014, over a month before the Postal Service filed the Request.

CHIR No. 1, question 12 sought clarification of which FSS flats will qualify as eligible mail under the Agreement. In response, the Postal Service explained that the FSS flats considered eligible mail under the PHI NSA will be limited to High Density Plus, High Density, and Basic Carrier Route FSS flats. Response to CHIR No. 1, question 12.

Like the Request, the proposed MCS language for the PHI NSA includes FSS flats in the calculation of eligible mail, if FSS becomes a category or sub-category during the term of the NSA. Request, Attachment C at 1. In Docket No. R2013-10, the Postal Service did not propose that FSS flats become its own category or sub-category of Standard Mail. Instead, it proposed and the Commission approved an FSS pricing structure for some Standard Mail products. Order No. 1890 at 73-74. Since the Postal Service states that High Density Plus, High Density, and Basic Carrier Route FSS flats are the only FSS flats considered eligible mail, the references to FSS flats in the proposed MCS language are duplicative. The Commission will strike the language including an FSS category or sub-category from the proposed MCS language. The MCS language will clarify that eligible mail under the Agreement includes all Carrier Route flats, including those receiving FSS pricing.[41]

6. Other Issues Raised by Commenters

Adjustment factor. The Public Representative states the number of significant digits to be used when the adjustment factor is calculated is unclear. PR Comments at 6. He also asserts that it is unclear whether the adjustment factor will change during the duration of the Agreement. *Id.* The Postal Service responds that the calculation

[41] The Commission makes additional conforming changes to the Postal Service's proposed MCS language. This includes clarifying that Carrier Route flats means flat-shaped mail meeting the description and requirements contained in the MCS for the Carrier Route and High Density and Saturation Flats/Parcels Standard Mail products.

and application of the adjustment factor are clear from the Agreement's terms. Postal Service Reply Comments at 2.

On its face, the Agreement contemplates the calculation of the adjustment factor to three significant digits. In the provision of the Agreement describing the calculation of the adjustment factor, the adjustment factor is rounded to three significant digits and defined as 0.145. Request, Attachment B at 4. Section III.B.4.iii of the Agreement allows the Postal Service to review the most recent data that underlie the adjustment factor calculation at any time during the Agreement's term. *Id.* The Agreement allows the adjustment factor to be revised by mutual agreement of the parties. *Id.* If the adjustment factor is revised during the term of the PHI NSA, the Postal Service shall file appropriate notice of the revised adjustment factor in this docket no later than 30 days after the revised adjustment factor is agreed to by the parties.

Elasticity. Valpak asserts that the estimated elasticity of PHI is too low. Valpak Comments at 11. In response, ACMA and the Public Representative explain that the Postal Service uses the former Enhanced Carrier Route (ECR) subclass elasticity, which they assert is an appropriate proxy for PHI's elasticity. ACMA Reply Comments at 6; PR Reply Comments at 4. ACMA and PHI note that if PHI has a higher elasticity than the average, the analysis under the Commission's methodology is more conservative than an analysis using a higher PHI-specific elasticity. ACMA Reply Comments at 6-7; PHI Reply Comments at 7.

The Commission finds that the estimated elasticity for PHI used by the Postal Service, that is, the former ECR subclass elasticity, is a reasonable proxy for a PHI-specific elasticity. The former ECR subclass consisted of Carrier Route, High Density, High Density Plus, and Saturation products and reflects the higher than average elasticity for those products.

Unit contributions. Valpak is concerned that the unit contributions appear low for the fourth and fifth years of the Agreement and argues the Postal Service should focus on attracting more of the most profitable volume. Valpak Comments at 10-12.[42] Regardless, as previously described, 39 U.S.C. § 3622(c)(10) requires that the Commission analyze the net financial benefit of the Agreement, rather than the individual unit contributions of mailpieces sent under the Agreement. Thus, the Commission's analysis focuses on the net financial impact, as calculated using the Commission's methodology, rather than based on the projected unit contribution of any one mailpiece.

Contribution loss from other mailers. Valpak asserts that "the Commission cannot approve the NSA without knowing about any possible loss of contribution from mailers not party to the NSA." Valpak Supplemental Comments at 3. In Response to CHIR No. 1, question 3, the Postal Service stated that it "expects the contribution from mailers not party to the Agreement will not change as a result of the Agreement." No commenter, including Valpak, argues that contribution from mailers not party to the NSA will be lost as a result of the NSA. In fact, several commenters point out that volume and contribution from other mailers should increase as a result of the Agreement. ACMA Reply Comments at 2; Orchard Reply Comments at 2; PHI Reply Comments at 3. *See also* Request at 6. Thus, the Commission finds that there is no evidence that the PHI NSA is likely to result in contribution loss from other mailers.

[42] Valpak also asserts that the workpapers associated with the Response to CHIR No. 2, question 1 and Response to CHIR No. 3, question 1 "make no sense." Valpak Additional Supplemental Comments at 2. In response, PHI, ACMA, and the Public Representative offer responses to Valpak's concerns. They explain the workpapers filed in response to CHIR No. 3, question 1 correct figures for marginal discounts and rebates that were incorrect in the workpapers associated with the response to CHIR No. 2, question 1. PHI Reply Comments at 8; ACMA Comments at 5-6; PR Reply Comments at 6. Once the corrections were made, the workpapers associated with the response to CHIR No. 3, question 1 show that higher marginal discounts result in more rebates, more volume being credited to the effect of the discount, and a higher total contribution to the Postal Service. PHI Reply Comments at 8; ACMA Comments at 5-6.

7. Implementation and Termination

The PHI NSA has an implementation date of “July 1, 2014, or a date mutually agreed upon by the Parties.” Request, Attachment B at 3. The Agreement is set to expire 5 years from the implementation date. *Id.,* Attachment B at 12.[43] The Postal Service shall promptly notify the Commission of the implementation date of the Agreement. Upon termination of the Agreement by either party prior to the PHI NSA’s expiration date, the Postal Service shall promptly inform the Commission of this development and the date of termination. In addition, within 60 days of an early expiration, the Postal Service shall file costs, volumes, and revenues associated with the PHI NSA, as well as a final data report for the partial year that the Agreement was in effect.

8. Future Agreements

Future requests to add NSAs to the market dominant product list must contain all of the information required by the Commission’s 39 C.F.R. 3010.40 *et seq.* regulations. In addition, the Commission suggests that the Postal Service consider the following modifications, which would alleviate some of the uncertainty, eliminate several areas of commenter concern, and facilitate a more expedited regulatory review:

- To the extent practicable, the most recent quarterly mailer data should be used to establish the baseline threshold, avoiding the lag between the data available at negotiation and the agreement’s implementation date.
- If a future NSA contains a provision analogous to section III.D of the PHI NSA, ensure that the request and accompanying workpapers apply the provision, if applicable.[44]

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[43] Valpak seeks additional explanation as to why the PHI NSA has a 5 year term, when prior NSAs approved by the Commission have had 3 year terms. Valpak Comments at 5. Neither title 39 nor the implementing regulations place limitations on the length of market dominant NSAs. The Commission will monitor the PHI NSA’s on-going performance in each year’s Annual Compliance Determination.

[44] For a discussion of section III.D of the PHI NSA, *see* section IV.C.2 of this Order *supra.*

- If a future NSA contains a provision analogous to section III.D of the PHI NSA, provide a mechanism in the agreement to modify thresholds for comparable decreases in rates.
- Describe the categories of mail considered eligible in future requests, agreements, and proposed MCS language by referring to the most recent product and category descriptions in the MCS.
- Consider whether an alternative structure to the option to renew clause would better protect the Postal Service against the risk that the Agreement fails to provide it with a net financial benefit.

V. CONCLUSION

The Commission approves the negotiated service agreement with PHI Acquisitions, Inc. 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.

VI. ORDERING PARAGRAPHS

It is ordered:

1. PHI Acquisitions, Inc. Negotiated Service Agreement is added to the market dominant product list as a new product under Negotiated Service Agreements. Revisions to the market dominant product list and the Mail Classification Schedule appear below the signature of this Order and are effective immediately.

2. The Postal Service shall report data concerning the PHI NSA as set forth in the data collection plan discussed in the body of this Order.

3. Within 90 days of the date of this Order, the Postal Service shall file the amendment discussed in the body of this Order.

4. The Postal Service shall promptly notify the Commission of the implementation date of the PHI NSA.

5. If the PHI NSA terminates earlier than the proposed 5 year term, the Postal Service shall notify the Commission and file relevant contract data as discussed in the body of this Order.

6. If adjustment factor is revised during the term of the PHI NSA, the Postal Service shall file notice of the revised adjustment factor as discussed in the body of this Order.

7. The Secretary shall arrange for 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 in Appendix A to 39 C.F.R. part 3020, subpart A—Mail Classification Schedule. These changes reflect the Commission’s order in Docket Nos. MC2014-21 and R2014-6. The Commission uses two main conventions when making changes to the product list. New text is underlined. Deleted text is struck through.

Part A—Market Dominant Product

1000 Market Dominant Product List

* * * * *

Negotiated Service Agreements

Domestic

* * * * *

PHI Acquisitions, Inc. Negotiated Service Agreement

* * * * *

CHANGES TO THE MAIL CLASSIFICATION SCHEDULE

The following material represents a change to the Mail Classification Schedule. The Commission uses two main conventions when making changes to the Mail Classification Schedule. New text is underlined. Deleted text is struck through.

Part A—Market Dominant Products

1000 Market Dominant Product List

* * * * *

Negotiated Service Agreements

Domestic

* * * * *

PHI Acquisitions, Inc. Negotiated Service Agreement

* * * * *

1001 Market Dominant Product Descriptions

* * * * *

1600 Negotiated Service Agreements

* * * * *

1601 Domestic

* * * * *

1601.2 Negotiated Service Agreement Groups

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- PHI Acquisitions, Inc. Negotiated Service Agreement (1601.5)

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1601.5 PHI Acquisitions, Inc. Negotiated Service Agreement

1601.5.1. Eligible Mail

PHI Acquisitions, Inc. Eligible Mail (PHI Eligible Mail) is flat-shaped Standard Mail within the High Density and Saturation Flats/Parcels and Carrier Route products, which bear a Full-service Intelligent Mail Barcode (IMb) and is sent by PHI and by entities in which PHI holds controlling shares, and by vendors on behalf of PHI. Only PHI Eligible Mail is eligible for discounts. At least 90 percent of PHI's overall annual Standard Mail flats volume should remain PHI Eligible Mail. If PHI obtains or creates new titles or changes the permit numbers for existing titles to enter PHI Eligible Mail, PHI must notify the Postal Service within 30 days of the creation of the new permit number.

1601.5.2 Eligible Mail Thresholds and Calculations

The following adjusted volume thresholds for otherwise eligible mail, which bear a Full-service IMb, must be met before any rebates under this section are payable. If PHI participates in any program in which discounts or rebates are based on the incremental volume of mail that PHI enters during the incentive period (Volume Based Incentive), it shall provide notice to the Postal Service specifying (in a manner acceptable to the Postal Service) (1) how it will account for the volume entered pursuant to such Volume Based Incentive and (2) the amounts of any such volumes that earn the incentive discount mailed by PHI or discounts earned by PHI as the result of its participation in such Volume Based Incentive. Volumes and discounts from a Volume Based Incentive may be adjusted to ensure that discounts or incentives are not double-counted. Any discounts, rebates earned, or volumes mailed by PHI pursuant to any incentive program which is not a Volume Based Incentive are not subject to deduction from the computation of volumes eligible for rebates or rebates pursuant to the Negotiated Service Agreement.

a. Baseline Volume

The Year One Baseline Volume is the aggregate volume of PHI Eligible Mail presented to the Postal Service in each of the 4 quarters in the 12 month period beginning October 1, 2012 and ending September 30, 2013, as adjusted by the Negotiated Service Agreement's terms.

b. Annual Baseline Threshold Adjustment

The Baseline Volume shall be adjusted upward annually to account for the growth of PHI's customer house file due to Negotiated Service Agreement incremental volume.

c. Annual Baseline Threshold Adjustment Calculation

The Annual Baseline Threshold Adjustment for Years Two through Five shall be calculated by multiplying the Annual Volume Growth by the Adjustment Factor (0.145) and adding it to the previous year's Baseline Volume. The Annual Baseline Threshold Adjustment for each Negotiated Service Agreement Baseline Quarter shall be the annual percentage increase in the Baseline Volume applied to each quarter's baseline.

i. Annual Volume Growth – The Annual Volume Growth represents incremental volume above the Baseline Volume for the previous Agreement year.

ii. Adjustment Factor – The Adjustment Factor represents the average response rate for the incremental volume created by prospecting across all PHI titles (0.898 percent) multiplied by the number of times each new-to-file buyer is mailed a PHI title annually (16.13). The Adjustment Factor is therefore 0.145 (0.00898 X 16.13).

iii. Review of Adjustment Factors – The Postal Service reserves the right, upon written request, to review the Adjustment Factor figures (the most recent 12 month mailings to new buyers to PHI's house file and the analysis of the average incremental response rate) at any time during the term of the Negotiated Service Agreement. PHI will provide the data and analysis of those Adjustment Factors within 45 days of such request in a form and method comparable to the data provided for the Negotiated Service Agreement. After review, the Adjustment Factors may be revised by mutual agreement of the Parties, to be implemented for the next Agreement Year that begins 6 or more months after the data request; the revised Adjustment Factors will be used for all future such calculations unless they are further revised as specified herein.

d. Annual Volume Threshold

i. Year One Volume Threshold. The volume threshold for Year One of the Negotiated Service Agreement is the Baseline Volume.

ii. Year Two Volume Threshold. The volume threshold for Year Two of the Negotiated Service Agreement is: Year One Annual Volume Growth x Adjustment Factor + Year One Volume Threshold.

iii. Year Three Volume Threshold. The volume threshold for Year Three of the Negotiated Service Agreement is: Year Two Annual Volume Growth x Adjustment Factor + Year Two Volume Threshold.

iv. Year Four Volume Threshold. The volume threshold for Year Four of the Negotiated Service Agreement is: Year Three Annual Volume Growth x Adjustment Factor + Year Three Volume Threshold.

v. Year Five Volume Threshold. The volume threshold for Year Five of the Negotiated Service Agreement is: Year Four Annual Volume Growth x Adjustment Factor + Year Four Volume Threshold.

1601.5.3 Rebate

The Negotiated Service Agreement rebate price structure set forth below applies only to PHI Eligible Mail and any such rebate will be credited to PHI's permit or Centralized Account Processing System (CAPS) account. PHI shall be eligible each Quarter for a discount in the form of a rebate on all PHI Eligible Mail above the Quarterly Baseline Volume for that quarter, subject to accounting adjustments, the amount of which shall be payable on a quarterly basis. All mail that is entered under the Negotiated Service Agreement will pay the applicable published prices in effect at the time of mailing, subject to the quarterly rebate based on the following Agreement price schedule by tiers:

Tier	**Volume Increase Above Quarterly Baseline Threshold**	**Rebate**
Tier A	Up to 10 percent	10 percent off published rates at the time of mailing
Tier B	10.01 to 18 percent	15 percent off published rates at the time of mailing
Tier C	Above 18 percent	20 percent off published rates at the time of mailing

a. Calculation and Payment

The rebate shall be calculated as the difference between the postage actually paid at the time of entry and the postage that would have been paid under the above Agreement price schedule. The quarterly rebate so calculated shall be paid to PHI within 45 days after the end of each Negotiated Service Agreement Baseline Quarter.

b. PHI Eligible Mail Accounting

PHI will provide the Postal Service with a list of the PostalOne! permit accounts and their locations that will determine PHI's eligibility for discounts. Permit accounts will be used in determining eligibility for discounts only upon the Postal Service's written acknowledgement of their transmission from PHI.

The data in these permit accounts will be used to determine whether the Negotiated Service Agreement Baseline Quarter volumes and Agreement Year Threshold volumes have been reached and the volumes that qualify for rebates in the Negotiated Service Agreement.

1601.5.4 Penalties

In Agreement Year One, if PHI does not meet the Annual Baseline Threshold, as adjusted, PHI shall pay the Postal Service $100,000.00 and such penalty determination shall be made within 60 days of the end of said period. If, at the end of any Agreement Year, PHI has not met the Annual Volume Threshold for that Agreement Year, the Postal Service may terminate the Agreement upon 30 days' written notice. Such termination shall be effective as of the first day of the next Agreement Quarter after notification.

1601.5.5 Acquisition or Creation of New Catalog Title

a. The Quarterly Baseline Volumes and Annual Volume Thresholds will be adjusted when PHI acquires any existing catalog brand or title from another entity (Revised Quarterly Baseline Volumes and Revised Annual Volume Thresholds).

b. The adjustment shall be based on mail volumes equal to 80 percent of the total Standard Mail flats mailed by the acquired catalog brand or title in each of the four most recent, completed Agreement Quarters preceding the closing date of acquisition.

c. Volume of the acquired title will be added to the respective and current Quarterly Baseline Volumes starting with the next Agreement Quarter beginning after the date of acquisition to establish Revised Quarterly Baseline Volumes through the fourth Agreement Quarter of that Agreement Year (YOA).

d. The Revised Quarterly Baseline Volume will become effective on the first Agreement Quarter that begins after the acquisition, and the Revised Annual Volume Threshold will be the sum of the four Quarterly Baseline Volumes, using any Revised Quarterly Baseline Volumes that had mail volume added due to the acquisition.

e. The quarterly volumes from the acquired company that apply to the next Agreement Year (YFA) will be added to their respective quarters after the Annual Baseline Threshold Adjustment and the resulting Quarterly Baseline Volumes are calculated for that year.

f. The Annual Volume Threshold adjustment calculation for the YFA and the resulting Quarterly Baseline adjustments will be calculated using the Revised Annual Volume Threshold of YOA described above; after the new Quarterly Baseline Volume calculation for YFA, the quarterly volume adjustments from the acquisition that were not added in the YOA will be added to the respective Quarterly Baseline Volumes in the YFA.

g. The Annual Volume Threshold for the YFA is then the sum of the four Quarterly Baseline Volumes after adjustment for the acquisition.

h. The Parties agree to promptly review and agree on all adjustments for the YOA Revised Quarterly Baseline Volumes and YOA Revised Annual Volume Thresholds within 30 days of any acquisition.

i. New catalog brands or titles created by PHI, which will be mailed as PHI Eligible Mail will be added to this Negotiated Service Agreement volume for purposes of meeting the Annual Baseline Thresholds and the Quarterly Baseline Volumes and will be treated as incremental mail after notification to the Postal Service that a new catalog brand or title has been created.

j. Since this new volume is incremental, the Annual Baseline Threshold and the Quarterly Baseline Volumes will not be adjusted for newly created catalogs or titles.

1601.5.6 Divestiture of Existing Catalog Title

a. The Parties agree that the Quarterly Baseline Volumes and Annual Volume Thresholds will be adjusted downward to the extent that PHI divests itself of a catalog brand or title that was included in PHI Eligible Mail and Annual Volume Threshold calculations.

b. The adjustment shall be based on mail volumes equal to the total PHI Eligible Mail volume lost from that catalog brand or title in each of the four most recent completed Agreement Quarters preceding the closing date of divestiture of the catalog brand or title.

c. Such volume of the divested title will be subtracted from the respective and current Quarterly Baseline Volumes starting with the next Agreement Quarter beginning after the date of divestiture to establish new Quarterly Baseline Volumes through the fourth Agreement Quarter of that Agreement Year (YOD).

d. The Revised Quarterly Baseline Volume will become effective on the first Agreement Quarter that begins after the divestiture, and the Revised Annual Volume Threshold will be the sum of the four Quarterly Baseline Volumes, using any Revised Quarterly Baseline Volumes that had quantities subtracted due to the divestiture.

e. The quarterly volumes from the divested brand that apply to the next Agreement Year (YFD) will be subtracted from their respective quarters after the Annual Baseline Threshold Adjustment and the resulting Quarterly Baselines Volumes are calculated for that year.

f. The Annual Volume Threshold adjustment calculation for YFD and the resulting Quarterly Baseline Adjustments will be calculated using the Revised Annual Threshold of the YOD described above; after the new Quarterly Baseline Volume calculation for YFD, the quarterly volume adjustments from the divestment that were not subtracted in the YOD will be subtracted from the respective Quarterly Baseline Volumes in the YFD.

g. The Annual Baseline Threshold for the YFD is then the sum of the four Quarterly Baselines after adjustment for the divestment.

h. The Parties agree to promptly review and agree on all adjustments for the YOD Revised Quarterly Baseline Volumes and YOD Revised Annual Thresholds within 30 days of any divestment.

1601.5.7 Assignment, Sale, Transfer, or Merger

Neither Party may, or shall have the power to, assign its rights or delegate its obligations under the Negotiated Service Agreement except in connection with a transfer of all or a majority of PHI assets or stock to new ownership, without the prior consent of the other; such written consent is not to be unreasonably withheld. In addition, in the event that PHI is merged with or into another entity in connection with such sale or transfer, pricing under the Negotiated Service Agreement following such merger shall apply only to mail sent by the entity existing prior to the merger. Following any such merger, the Parties may negotiate in good faith to extend, modify or enter into a new Agreement applicable to the merged entity.

1601.5.8 Termination

Throughout the term of the Negotiated Service Agreement, either Party may only terminate the Negotiated Service Agreement with 30 days written notice to the other Party as a consequence of (i) an act of God, (ii) fraud, (iii) indictment, (iv) insolvency, (v) inability of either Party to perform under the Negotiated Service

Agreement, (vi) total PHI domestic package volume originating from a PHI warehouse, delivered to a residence by the Postal Service is less than 80 percent of PHI's total outbound residential package volume, (vii) the determination by the Postal Service at the end of any Agreement Year, based on published Postal Service cost data, that the agreement failed to produce positive contribution to Postal Service fixed costs from on the total incremental Negotiated Service Agreement volume in that year, or (viii) if ordered to terminate the Negotiated Service Agreement by a court with valid jurisdiction, or the Postal Regulatory Commission.

1601.5.9 Expiration

The Negotiated Service Agreement shall expire 5 years from the Implementation Date, unless (i) terminated or cancelled by one of the Parties; (ii) renewed by mutual agreement in writing, and subsequent approval by the Governors and the Commission; (iii) superseded by a subsequent Agreement between the Parties; (iv) ordered by a court; or (v) otherwise required to comply with subsequently enacted legislation.

1601.5.10 Renewal Option

PHI has the option to renew the Negotiated Service Agreement for an additional period not to exceed 5 years provided it meets certain criteria.

a. To qualify for the exercise of the renewal option, PHI must have had an average annual volume of PHI Eligible Mail during Agreement Years Two, Three, and Four that exceeds the average Annual Thresholds for such years by at least 10 percent.

b. If PHI qualifies to exercise such option, it shall give written notice of the exercise not more than 3 months after the completion of Agreement Year Four.

c. Within 90 days after the exercise of the option, the parties shall complete a review of the discount structure specified in the Negotiated Service Agreement on the basis of the actual mix by sortation and drop entry level of PHI Eligible Mail, and the contribution received by the Postal Service therefrom, and shall in good faith negotiate such changes in the discount structure as may be appropriate to preserve the value of the Negotiated Service Agreement to both parties

d. Any such amended agreement shall be submitted for review and approval by the Board of Governors. Upon approval by the Board of Governors, the Postal Service shall make the requisite filings at the Postal Regulatory Commission to secure renewal of the Agreement, including temporary extension of the original term, if necessary, to complete the renewal.

e. If the Agreement is renewed as herein provided, it shall remain in full force and effect for the term of years specified in the option.

f. The Baseline Quarterly and Annual Thresholds for the First Year of the renewal period (Year Six of the Agreement) shall be calculated from the Annual and Quarterly Baselines in Year Five as specified in Section III of the Agreement, Eligible Mail Thresholds and Calculations.