Postal Rate Commission
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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

EXPERIMENTAL CHANGES TO IMPLEMENT
CAPITAL ONE NSA

Docket No. MC2002-2

DIRECT TESTIMONY
OF
MICHAEL K. PLUNKETT
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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AUTOBIOGRAPHICAL SKETCH

My name is Michael K. Plunkett. I have worked for the Postal Service in various capacities for nearly 18 years. From 1984 to 1990 I held a number of positions in delivery and customer service operations. In 1990 I entered the Postal Service's Management Intern program, where I performed a series of short term assignments in several different functional specialties, both in the field and at headquarters. Upon leaving the Intern program I was hired as an economist in the office of Budget and Financial Analysis. Subsequently I worked as an economist in the office of Pricing from 1998 through 2000. After leaving the Pricing organization I worked as the product manager for the Postal Service's Mailing Online service, and later as the Associate VP of Business Development. I am currently serving as manager of the newly formed Pricing Innovation group.

I have testified before the PRC on several previous occasions. In Docket No. MC97-1, I presented pricing testimony supporting an experimental packaging service. In Docket No. MC 98-1, I provided pricing testimony in support of Mailing Online, and in Docket No. MC 2000-2, I was the pricing witness in the Mailing Online experiment case. I also provided policy testimony in the same docket. In previous omnibus cases I have presented pricing testimony supporting parcel post, Express Mail, and various special services.

I have an honors degree in economics and a bachelor's degree in finance from Pennsylvania State University. I also have a master's degree in business administration from the Wharton School at the University of Pennsylvania.

I. PURPOSE OF TESTIMONY

The purpose of my testimony is to describe the policy and business considerations that support the Postal Service's negotiated service agreement (NSA) with Capital One Services, Inc. (Capital One). In so doing I will describe how Capital One's use of the mail creates unique opportunities for accomplishing three distinct goals. First, the NSA allows the Postal Service to reduce costs and increase revenue. Second, it creates an incentive for Capital One to maintain and increase its use of First-Class Mail. Finally, and perhaps most importantly, it reduces the overall burden on postal ratepayers by creating incremental contribution gains.

My testimony will also explain why a negotiated service agreement is the best vehicle for accomplishing these goals. I will also show that the agreement conforms to the relevant pricing and classification criteria, and I will explain why a more generally applicable rate category is not appropriate in this situation.

My testimony does not make use of workpapers. The agreement between the Postal Service and Capital One has been filed as Attachment G to the Request and I refer to it throughout my testimony.

II. THE IMPORTANCE OF NEGOTIATED SERVICE AGREEMENTS

The concept of NSAs is a familiar one. Although this is the first time the Postal Service has entered into an NSA affecting domestic rates, customer-specific pricing arrangements have been used in other industries, by foreign posts, and by the Postal Service with its international customers. The Postal Service has concluded that application of this technique to domestic services is a viable tool that will advance the fulfillment of the Postal Service's public service mission. (See USPS-T-1, p. 3).

The Postal Service considers the NSA with Capital One to be an excellent example of the ways in which NSAs may prove to be a valuable component of the Postal Service's pricing and classification system. It presents cost savings opportunities that arise from Capital One's unique and innovative use of First-Class Mail in its business model, and it tests the utility of declining block discounts as a method for retaining and increasing First-Class Mail volume. Moreover, as I describe below, the combination of these two components allows the Postal Service to experiment with customized pricing in a way that minimizes risk and that benefits all users of the mail.

III. THE POSTAL SERVICE'S AGREEMENT WITH CAPITAL ONE

The Postal Service has entered into an agreement with Capital One, which is presented in Attachment G to the Request. In order for the Postal Service to be able to execute this agreement, certain changes in rate and fee schedules and the domestic mail classification schedule are needed. My testimony focuses on these requested changes, which are set forth in the proposed DMCS provisions and rate schedules in Attachments A and B to the Request.

A. Electronic Address Correction Service

As explained in the testimony of witness Jean (COS-T-1), Capital One uses First-Class Mail to send millions of solicitations annually. By using First-Class Mail for this purpose, Capital One avails itself of all of the features inherent in First-Class Mail, including forwarding and return of pieces that are undeliverable-as-addressed (UAA). Because solicitations are sent to recipients with whom Capital One may not have an established relationship, they result in a higher proportion of UAA mail than the bills and statements that comprise the bulk of First-Class Mail. As explained in the testimony of witness Crum, Capital One's solicitation volume generates approximately one return for every ten pieces sent (USPS-T-3, p. 6), while the average for all of First-Class Mail is approximately one in every one hundred pieces. This results in significant costs that are ultimately borne by all users of First-Class Mail.

The proposed agreement would allow Capital One access to declining block rates for First-Class Mail in exchange for the receipt of address change information electronically, rather than the physical return of the mail piece. Capital One has also agreed to update its address lists with new address information within two days of receipt. The Postal Service's agreement with Capital One also calls for Capital One to continue a number of mail quality programs that it currently employs. For example, Capital One agrees to continue monthly National Change of Address (NCOA) and Coding Accuracy Support System (CASS) updates. If Capital One mails more than 750 million pieces of qualified First-Class Mail annually, the fees for address correction will be waived. The Postal Service currently charges 20 cents for each electronic address correction and 70 cents for each manual correction. For mailers that receive the normal proportion of UAA mail and use address correction service, the fees generally represent a modest amount relative to their total postage expenditures. In the case of Capital One, however, these fees would total to an amount ten times larger than for a typical mailer. Not surprisingly, Capital One has instead chosen to receive returns physically at no charge. Because the cost of returning mail pieces is much greater than the electronic address correction fee, the Postal Service reduces its overall cost of serving Capital One even if the fee is waived (USPS-T-3, p. 6).

B. Declining Block Rates

The Postal Service's agreement with Capital One calls for the implementation of discounts in the form of declining block rates according to the following schedule.[1] The discounts are on incremental volume, *i.e.*, no discount would be applied to the first 1.225 billion pieces, a discount of 3 cents would be applied to the next 50 million pieces, etc.

Volume Block		Incremental Discounts
1,225,000,001	– 1,275,000,000	3.0¢
1,275,000,001	– 1,325,000,000	3.5¢
1,325,000,001	– 1,375,000,000	4.0¢
1,375,000,001	– 1,450,000,000	4.5¢
1,450,000,001	– 1,525,000,000	5.0¢
1,525,000,001	– 1,600,000,000	5.5¢
1,600,000,001	and above	6.0¢

As is explained in the testimony of witness Jean, these discounts are likely to result in volume growth above the before rates projection (COS-T-1, pp. 3-4). The Postal Service believes that Capital One's business model offers a promising opportunity for testing declining block rates as a strategy for retaining and increasing First-Class Mail volume. Because of Capital One's size, discounts that are large at the margin (the maximum discount of 6 cents is just above 20 percent of the rate for 3-digit automated First-Class letters) are relatively small when considered relative to Capital One's total First-Class Mail revenue.[2] In fact, at the projected volumes, the total amount

[1] The Postal Service's agreement with Capital One calls for activation of a second tier of discounts in the event that Capital One's First-Class Mail volume falls below 1.025 billion pieces. This discount schedule is contained in Appendix A of my testimony.
[2] As shown in the testimony of witness Crum, the expected discount value in the test year is $6.7 million. With projected test year volumes of 1.408 billion, this amounts to

of the discounts will be approximately one percent of Capital One's postage expense in the test year (USPS-T-3, p. 7). As witness Crum explains, this will produce a total net contribution gain of $8.2 million in the test year. While modest relative to the total institutional cost burden borne by First-Class users, this contribution, which equals approximately 2 percent of Capital One's First-Class Mail revenue, would not have been earned in the absence of this agreement.

C. The Discount Threshold

According to the terms of the instant agreement. Capital One will be entitled to discounted postage rates when annualized qualified First-Class Mail volume exceeds 1.225 billion pieces, with the absolute size of the discounts increasing as volume increases. This discount structure was negotiated by the Postal Service and Capital One, and consequently represents a compromise that both parties consider a fair basis for sharing the benefits of the agreement. As I explain above, this threshold provides meaningful discounts at the margin, yet results in modest revenue leakage at the expected volume levels. The testimony of witness Elliott (COS-T-2) contains Capital One's volume projections, and describes some of the factors that influence Capital One's use of the mail (COS-T-2, p. 5). Because many factors other than postage rates influence Capital One's use of the mail, the discount tiers—and mechanisms for adjusting the tiers—are meant to balance two objectives: the Postal Service's goal of retaining and increasing First-Class Mail volume, and Capital One's goal of growing its business.

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an effective per piece discount of approximately one-half cent per piece (less than 2 percent).

As a result of the negotiated agreement, the initial threshold has been set at 1.225 billion pieces. While this amount is lower than Capital One's expected volume for FY 2002, it is consistent with Capital One's historical usage of First-Class Mail during the less volatile period prior to FY 2002. As described in the testimony of witness Jean, Capital One made a number of changes in its mailing strategy in response to unique circumstances in the fall of 2001. COS-T-1, p. 3. Consequently, this period could be considered anomalous and not necessarily a reliable indicator of a permanent change in Capital One's volume trend. Thus, this threshold provides adequate incentives for Capital One to continue, and increase, its use of First-Class Mail as a central part of its business strategy, while accounting for anomalous results observed in the first half of FY 2002. Lastly, the threshold as negotiated allows some balancing of benefits. Under the terms of the agreement, the Postal Service begins to benefit immediately through cost savings from not returning UAA First-Class Mail solicitations, whereas Capital One may receive no or limited discounts if the thresholds were set too ambitiously.

IV. THE PROPOSED AGREEMENT SERVES THE INTEREST OF THE POSTAL SERVICE AND ITS CUSTOMERS

A. Contribution Will Increase As a Result of this Agreement

As described in the testimony of witness Crum, the Postal Service anticipates that this agreement will have a positive net contribution impact of $8.2 million. USPS-T-3, p. 7. Though small relative to the overall size of the Postal Service's finances—an expected change in contribution of this amount in the test year would be approximately 0.01 percent of total revenue—this amount represents contribution to institutional costs that would not exist in the absence of this agreement.

B. Discounts Funded by Cost Savings Are Fair and Equitable in these Circumstances

As shown in the testimony of witness Crum (USPS-T-3, p. 6), much of the value to the Postal Service of this agreement arises from the avoidance of costs incurred by handling undeliverable-as-addressed (UAA) mail. Because the costs of forwarding and returning mail are included in the costs of First-Class Mail, any mailer whose return or forwarding volumes exceed the average imposes a larger cost burden than mailers whose return and forwarding volumes are below average. Capital One's size makes it advantageous to seek a customized solution that will isolate and reduce these costs.

In addition to being one of the Postal Service's largest customers, Capital One uses the mail in ways that warrant unique consideration. As indicated in the testimony of witness Jean (COS-T-1, p. 2-3), Capital One relies significantly on First-Class Mail as a means of sending solicitations, while much of the rest of First-Class Mail is bills, statements, and business correspondence. Unlike such bills and statements, solicitations are generally sent to recipients with whom Capital One does not have an established business relationship. Accordingly, and despite Capital One's efforts to ensure address quality, a higher proportion of this mail is returned than is with respect to bills, statements, and the like. Because First-Class Mail service includes forwarding and return, the cost of handling forwarded and returned solicitations is included in First-Class Mail-related forwarding and returns costs and included in the cost basis used in the development of First-Class Mail rates. Furthermore, Capital One documents its return volume, and incorporates return information into its mail preparation operations These conditions create an opportunity for a NSA that benefits all customers as well as the parties directly involved.

In the course of developing the NSA, the Postal Service has not identified any other customers with Capital One's combination of attributes that makes this agreement uniquely valuable. The Postal Service recognizes that if there were other mailers that use First-Class Mail as an advertising medium, and that if they exhibited similar mail usage and growth potential, it could be beneficial to enter into a similar agreement with those mailers.

C. This Agreement Poses Minimal Risk to Other Customers

While Capital One's use of the mail is sufficient justification to warrant a negotiated service agreement, the specific terms of this agreement are such that the overall impact on First-Class Mail revenues—or on any particular First-Class Mail user—will likely be modest. This is because, although the proposed declining block discounts may be large enough to induce volume growth at the margin (COS-T-2), they are small when considered relative to Capital One's total volume. For example, at the volume levels forecast by Capital One, the per-piece value of the discounts is approximately half a cent. When considered relative to total First-Class Mail presort revenues, the discounts are not significant. As indicated above, when considered relative to the overall finances of the Postal Service, the expected value of the discounts is barely measurable.

V. THE REQUESTED CHANGES IN RATES, FEES, AND CLASSIFICATIONS ARE CONSISTENT WITH THE CRITERIA OF THE ACT

Title 39, Section 3623 requires that the Commission make recommended decisions on changes in the classification schedule in accordance with the policies of the Title and the following factors:

1. the establishment and maintenance of a fair and equitable classification system for all mail;
2. the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;
3. the importance of providing classifications with extremely high degrees of reliability and speed of delivery;
4. the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;
5. the desirability of special classifications from the point of view of both the user and of the Postal Service; and
6. such other factors as the Commission may deem appropriate.

Section 3622(b) requires that postal rates and fees reflect the policies of the Postal Reorganization Act, and accord with the following factors:

1. the establishment and maintenance of a fair and equitable schedule;
2. the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to, the collection, mode of transportation, and priority of delivery;
3. the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type;
4. the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters;
5. the available alternative means of sending and receiving letters and other mail matter at reasonable costs;
6. the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service;
7. simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services;
8. the educational, cultural, scientific, and informational value to the recipient of mail matter; and
9. such other factors as the Commission deems appropriate.

The proposed agreement between Capital One and the Postal Service satisfies these criteria. First, the Postal Service believes that by negotiating directly with individual customers, it may be possible, through negotiated service agreements such as the one submitted here, to more accurately present prices that represent the value that the user places on the service being provided (pricing criterion 2) for mail classifications that are desirable to the mailer and the Postal Service (classification criterion 5). In this case, the Postal Service has directly negotiated with the sender of the mail to arrive at classifications and prices that the Postal Service considers to be fair and equitable (classification criterion 1 and pricing criterion 1). As indicated in the testimony of witness Crum, there can be no doubt that the prices presented in this case will cover the costs of providing the service (pricing criteria 3). In fact, the address improvement steps that Capital One has agreed to will serve to lower costs currently borne by other customers (pricing criterion 6). For this reason, the classifications and prices presented in this agreement confer beneficial effects on the general public and other ratepayers (classification criterion 1 and pricing criterion 1). The proposed rates do not have an adverse impact on the rates paid by the general public, or other business mail users (pricing criterion 4). The proposed declining block rate structure is relatively simple and maintains a transparent, identifiable relationship between volume levels and applicable rates and fees (pricing criterion 7). As witness Jean (COS-T-1, pp. 2, 4) points out, Capital One has alternatives to the use of First-Class Mail, such as telemarketing for solicitations, and electronic bill presentment for statement mailings. These facts are compelling reasons why customization of prices is appropriate in this instance (pricing criterion 5).

VI. A MULTI-YEAR EXPERIMENT IS THE APPROPRIATE VEHICLE FOR IMPLEMENTING THIS AGREEMENT

A. The Experimental Rules Apply

For the reasons presented above, the Postal Service is convinced that its agreement with Capital One is in the best interest of the Postal Service and its customers. Nonetheless, the agreement is a significant departure from previous classification and rate proposals in that it attempts to set prices according to the usage patterns of a particular mailer. As such, it requires information, and relies on assumptions, that depart from past Commission practice. For example, Capital One is presenting an after rates volume forecast that is, at least implicitly, based on a company-specific price elasticity, in that Capital One uses First-Class Mail in a way that may not be fully represented in the aggregate own-price elasticity for First-Class presort.[3] Given this departure from ratemaking convention, the Postal Service considers the establishment of an experimental classification a prudent approach.

B. Expeditious Litigation Is Appropriate and Important in this Case

As witness Bizzotto explains, the Postal Service considers the use of NSAs to be a potentially valuable application of the pricing criteria to meet the needs of its customers in a way that is consistent with the Act. While this is the first NSA underlying a request to the Commission, the Postal Service expects to consider a number of other agreements in the foreseeable future. If NSAs are to be used fairly and to the benefit of all postal customers, it is important that the time and expense associated with litigation be limited to the extent possible. While the costs of litigation are not prohibitive to the Postal Service, or to a company as large as Capital One, smaller customers might be deterred from otherwise beneficial agreements if an uncertain outcome in litigation also proves to be unduly costly. The Postal Service believes that a rulemaking designed to

[3] The own-price elasticity for presorted First-Class Mail is not intended to describe particular mailers. Instead, it is reflective of the classification as a whole. It is not unrealistic to expect that specific customers within the classification would have varying reactions to price changes.

develop specific procedures for the expeditious and customized litigation of NSAs may offer a solution to this dilemma.

C. Data Collection

This agreement represents a new way to set prices, and as such merits further analysis. The Postal Service believes that the information gathered in this case could prove illuminating, not just in evaluating the benefits of the instant agreement, but in providing guidance on how to better craft future NSAs.

In order both to implement and analyze the effect of the agreement, the Postal Service will be collecting the following data either from its existing data systems (permit system, address management systems) or from special studies, as needed:

- volume by rate category of First-Class Mail solicitations in eligible permit accounts;
- volume by rate category of First-Class Mail customer mail in eligible permit accounts;
- the amount of discounts applied by rate category;
- the number of electronic address correction notices sent for First-Class Mail solicitations; and
- the number of solicitation pieces returned manually.

The Postal Service will report these data annually following the end of each fiscal year's data reconciliation. The first report will be made after the end of FY 2003.

VIII. SUMMARY AND CONCLUSION

For the reasons given above, the Commission should recommend the changes in rates, fees, and classifications proposed by the Postal Service to allow it to effectuate its agreement with Capital One. As witness Crum (USPS-T-3) describes, the agreement will produce incremental contribution gains of $8.2 million in the test year. And, as I have indicated, these gains are achievable with minimal risk that other rate payers will be adversely impacted. More importantly, this agreement offers a unique opportunity to test the value of customized pricing arrangements. As witness Bizzotto has described (USPS-T-1), the Postal Service considers the concept of NSAs to be an essential component of its ongoing effort to meet customer needs and to be consistent with the increasingly customized direction the Postal Service and the Postal Rate Commission have taken in pricing postal products.

Appendix 1.

Declining Block Rates

Discount Threshold Adjustments

In the event Capital One's First-Class volume in any year of the agreement is below 1.025 billion pieces, the following discount structure would be activated.

Volume Block		Incremental Discounts
1,025,000,001	– 1,075,000,000	1.0¢
1,075,000,001	– 1,125,000,000	1.5¢
1,125,000,001	– 1,175,000,000	2.0¢
1,175,000,001	– 1,225,000,000	2.5¢
1,225,000,001	– 1,275,000,000	3.0¢
1,275,000,001	– 1,325,000,000	3.5¢
1,325,000,001	– 1,375,000,000	4.0¢
1,375,000,001	– 1,450,000,000	4.5¢
1,450,000,001	– 1,525,000,000	5.0¢
1,525,000,001	– 1,600,000,000	5.5¢
1,600,000,001	and above	6.0¢

If 90 percent of the average annual Capital One First-Class Mail volume from FY 2000 to FY 2002 exceeds 1.225 billion pieces, the initial threshold will be adjusted upward to be equivalent to 90 percent of the annual Capital One First-Class Mail volume during that period. If for example, Capital One's FY 2002 were to be such that this number equaled 1.3 billion pieces, the discount structure would be as follows

Volume Block		Incremental Discounts
1,300,000,001	– 1,325,000,000	3.0¢
1,325,000,001	– 1,375,000,000	4.0¢
1,375,000,001	– 1,450,000,000	4.5¢
1,450,000,001	– 1,525,000,000	5.0¢
1,525,000,001	– 1,600,000,000	5.5¢
1,600,000,001	and above	6.0¢