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UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Experimental Rate and Service Changes)
to Implement Negotiated Service Agreement) Docket No. MC2002-2
with Capital One Services, Inc.)

OFFICE OF THE CONSUMER ADVOCATE
TRIAL BRIEF
December 20, 2002

The Office of the Consumer Advocate (OCA) hereby presents its trial brief in Docket No. MC2002-2. This proceeding concerns a request of the United States Postal Service for a new Domestic Mail Classification Schedule (DMCS) provision implementing a Negotiated Service Agreement (NSA) between the Postal Service and Capital One Services, Inc. (Capital One). The proposed NSA would provide Capital One with (1) free electronic notification of forwards and returns and (2) access to declining block rates if Capital One mails a specified minimum volume. This brief will summarize the testimony of the OCA's witnesses and explain why the OCA has proposed two experimental classification provisions – Experimental Automated Address Correction Service and Experimental Volume-Based Declining Block Rates – in lieu of an NSA.

At the outset, the OCA will state that it is satisfied that the Postal Service would make money under the proposed NSA *provided that Capital One would have mailed no more than 1,408,000,000 pieces in the absence of the NSA.* However, at issue here is whether Capital One would be likely to mail significantly more than 1.4 billion pieces in the test year absent the NSA, whether the Postal Service has negotiated the best possible deal for itself and its stakeholders, whether the deal is fair to competitors of Capital One, and whether the process of making similar deals available to other mailers can be streamlined.

The testimony of OCA witness Smith (OCA-T-1) demonstrates that volumes well in excess of Capital One's estimate of 1.4 billion pieces are at least plausible in the test year without any rate incentives. The possibility that Capital One would mail more than 1.4 billion pieces in the test year calls into question the profitability of the proposed NSA. This is because the unit cost savings from eliminating physical returns are constant ($0.019 per piece mailed[1]), whereas the unit discounts increase with volume to an amount ($0.06 per piece) far in excess of the unit cost savings. Thus, there exists a volume level at which total revenue leakage exceeds total cost savings. This volume level appears to be in the neighborhood of 1.6368 billion pieces. Thus, if Capital One would have mailed in excess of 1.6368 billion pieces absent the NSA, the Postal Service is literally losing money on the deal.

The testimony of OCA witness Callow (OCA-T-2) presents proposed experimental DMCS provisions that make the desirable features of the proposed NSA available to more mailers (including Capital One). As part of the classification proposals, witness Callow also offers a device for hedging the risk caused by the uncertainty associated with the specified minimum volume (or threshold). Under the

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[1] The $0.019 is the product of 0.096, 0.85, and $0.23. The 9.6 percent is the proportion of Capital One's mailpieces returned; the 85 percent is the proportion of electronic returns; and the $0.23 is the cost difference between a physical and an electronic return. *See* Response Of United States Postal Service To Oral Request Of Chairman Omas At Tr. 2/342, December 9, 2002, at 1.

OCA's proposed DMCS language, discounts would be paid for volume of no more than 15 percent of the discount threshold. Thus, to use Capital One as an example, discounts would only be paid on 183,750,000 (0.15 * 1.225 billion) pieces. This volume cap would limit the maximum amount of discounts paid by the Postal Service to slightly more than $11,000,000 ($0.06 * 183,750,000). If Capital One mailed 1.40875 (1.225 + 0.18375) billion pieces in the test year (as it predicts), the Postal Service (and Capital One) would obtain the financial benefits estimated by witness Crum.

The volume cap proposed by witness Callow is more than ten times the volume that witness Elliot estimates Capital One will mail in response to the availability of declining block rates. A difference of over 900 percent between projected and actual new volume is better interpreted as a threshold projection error than as a "response" to block discounts. The implicit rebate cap of $11,000,000 is more than twice the revenue leakage estimated by witness Crum. The volume cap thus protects the Postal Service from highly unlikely (but potentially *very* expensive) volume projection errors. Since neither the Postal Service nor Capital One have indicated any likelihood of Capital One's mailing in excess of 1.6 billion pieces in the test year, the proposed volume cap would not add a new constraint for Capital One.

While hedging risk to the Postal Service is the single most important advantage of OCA's proposal over the Postal Service's, there are several additional important advantages to the OCA approach. OCA has attempted to devise new classifications modeled after the NSA agreement between the Postal Service and Capital One, but which give fair and equal access to other First-Class mailers who exhibit the same contribution-increasing characteristics as Capital One. In OCA's view, a circumstance could arise that is so unique to a single mailer that an NSA is the only tool that could be used to forge the singular arrangement. However, such a situation is not presented by the Capital One/Postal Service agreement. This is demonstrated by the soundness of the OCA's proposed expansions for other mailers.

OCA has transformed an arrangement thought to be possible for only one customer into two new services that can be accessed by all other First-Class mailers exhibiting the essential contribution-increasing characteristics identified for Capital One. With respect to OCA's proposal for a declining block rate classification, OCA has demonstrated that it is possible to make declining block rates available to First-Class mailers who mail less than Capital One, but whose new contributions to institutional costs should only improve the Postal Service's net institutional cost position beyond the point that the NSA might elevate it. Equally important, other First-Class mailers, particularly competitors to Capital One, can also have the benefits of free USPS-generated electronic return information and discounts on new volumes of First-Class Mail. The Commission would fulfill classification criterion 39 U.S.C. §3623(c)(1) – that fairness and equity be promoted by the postal classification system – far more readily with OCA's proposal than the Postal Service's.

OCA has an asymmetry in its proposed classifications that promotes fairness and maximizes contribution to institutional costs. Under OCA's proposal, First-Class mailers can participate in OCA's Experimental Automated Address Correction Service without being required to participate in the Experimental Volume-Based Declining Block Rates service. By contrast, a qualifying First-Class mailer who wishes to enjoy volume-based discounts is required to participate in the address correction service because participation in this service appears to avoid substantial mail processing costs, thereby minimizing any loss of contribution.

Another important advantage of the OCA's proposal is that it reduces transaction costs, not only for the Postal Service, but for the Commission and other litigants as well. Resources involved in negotiating and litigating the NSA are conserved if other mailers can also have access to the cost savings and improved service developed in the current proceeding. The transaction costs will be spread over a larger number of mailers than Capital One alone. It should not be forgotten that these negotiation and litigation costs are *incremental* to the NSA, although the Postal Service has failed to document them sufficiently so that they can be given appropriate treatment in the instant proceeding. Arguably, there is a stronger justification for treating such transaction costs as institutional when a large number of the members of the new class will also enjoy the benefits that initially were devised for a single mailer.

OCA witness Smith recommends a volume estimation approach that is based upon objective, publicly available information (preferably information in the possession of the Postal Service, from its permit system), as opposed to a volume estimate that is merely the product of a negotiation. To formulate a volume estimate for Capital One, the Postal Service essentially allowed Capital One to describe its plans to mail a particular number of First-Class solicitation pieces in the test year. There is no way to corroborate independently Capital One's volume estimate of 1.4 billion pieces.

OCA witness Smith demonstrates in his testimony that constructing a valid volume estimate for the customer accounts portion of Capital One's test year mailing is feasible and yields reasonable results. Granted, the solicitation portion of the volume estimate poses formidable difficulties for volume estimation. OCA's view, however, is that the risks arising from having an NSA partner merely speculate on a likely volume estimate for a future period of time are too great to be acceptable. The NSA partner, knowing that its savings grow from every incremental underestimate of volume, will naturally predict as small a volume estimate as it can get the Postal Service to believe. How close the volume estimate is to the volume that the company would actually have mailed in the test year is impossible to determine; but the Postal Service loses on every piece that pays a lower rate than it likely would have paid in the test year without the volume discount. Witness Smith describes this as a "free-rider" problem.

A "free-rider" problem is of particular concern in view of the Postal Service's financial structure, as well as because of the fairness and equity issues it obviously raises. In such a situation, the Postal Service gives up, through the discount, contribution dollars that in fact could have been secured without the discount (i.e., because the mailer would have sent the pieces in question even at the undiscounted rate). In a private-sector, profit-making firm, this loss may be masked or diffused since a diminution in net revenue can (if not too large) be absorbed by the shareholders. The Postal Service, however, by law operates on a breakeven basis. 39 U.S.C. § 3621. Lost contribution dollars *must* be recovered; and in the case of a "free-rider" situation they will be recovered from other mailers. Thus the "free rider" enjoys its "free ride" directly at the expense of other users.

The risk of a "free ride" is minimized by objective, verifiable volume estimation data and methods. OCA feels strongly that allowing an NSA partner do little more than state an estimated volume for the future time period is inadvisable in that it is more likely to lead to a loss of contribution to institutional costs than a gain.

The other feature of the Postal Service's volume threshold established by negotiation that OCA rejects is setting the threshold any lower than the full estimate of volume for the future time period. Voluntarily foregoing revenue that likely would have been collected by the Postal Service based upon a probable volume estimate for the future period of time is not reasonable. Unlike the Postal Service's proposal to give Capital One access to declining block rates at 90 percent of its expected volume, OCA would rebate discounted amounts only above the objectively determined discount threshold.

OCA's data collection recommendations are far more comprehensive than the Postal Service's. OCA witness Callow has given serious consideration to the types of data collection and reporting that justify undertaking experimental offerings in the first place. Many of the data collection recommendations proposed by OCA for its experimental classifications are equally compelling for application to the NSA if the Commission approves the agreement between Capital One and the Postal Service.

The concept of NSAs remains controversial. If the beneficial features of the proposed NSA can be implemented as traditional experiments, then litigation over the legality of NSAs can be avoided—or, at least, postponed.

Respectfully submitted,

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