

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

Experimental Rate and Service Changes  
To Implement Negotiated Service Agreement  
With Capital One Services, Inc.

Docket No. MC2002-2

INITIAL BRIEF  
OF  
ALLIANCE OF NONPROFIT MAILERS  
DIRECT MARKETING ASSOCIATION, INC.  
MAGAZINE PUBLISHERS OF AMERICA, INC.  
PARCEL SHIPPERS ASSOCIATION

April 3, 2003

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## I. INTRODUCTION

USPS witness Bizzotto points out “[n]egotiated service agreements have been discussed within the postal community over the last decade.” USPS-T-1 at 4. Provisions concerning negotiated service agreements (NSAs) have been included in various postal reform bills introduced in Congress.<sup>1</sup> Their desirability has been discussed among members of the mailing community in connection with “ratemaking summits” and most recently before the President’s Commission on the United States Postal Service.

Now, for the first time, the Postal Rate Commission (PRC or the Commission) has the opportunity to consider a request for a change in the mail classification schedule that would implement an NSA. Request of the United States Postal Service for a Recommended Decision on Classification, Rates and Fees for Capital One Services, Inc. Negotiated Services Agreement (Request). The proposed negotiated service agreement is appended to the Request as Attachment G. As the Request notes, approval of this NSA “will...allow the Postal Service and the Commission to test the effectiveness of the NSA approach, as a means of providing flexibility under the existing statutory ratemaking scheme.” Request at 2-3.

The Request proposes rate and service changes that would be available for certain forms of high-volume First-Class Mail use. Capital One would be eligible for

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<sup>1</sup> The suggestion of one party “that Congress chose to reject such proposals” is incorrect. Comments of the Newspaper Association of America on Order No. 1346 (October 17, 2002) at 1. In the course of eight years of consideration of postal reform legislation, there has never been a vote in either House of Congress, or even in a committee, on the specific question of negotiated service agreements. In fact, omnibus reform bills considered during that period contained provisions authorizing negotiated service agreements.

new incremental per-piece discounts (declining block rates) for certain of its First-Class Mail solicitation and customer 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.”

USPS-T-2 at 4. The total amount of the discounts were originally estimated to be about one percent of Capital One’s postage expense in the test year, an effective per piece discount of approximately one-half cent per piece (less than 2 percent), and may turn out to be much less. See USPS-T-3 at 7; Tr. 9/1845 (Elliott).

In exchange for these discounts, Capital One agrees to forgo its current practice of receiving free return of certain undeliverable First-Class Mail and to perform specific actions to maintain and improve the address quality of its First-Class Mail.

In ruling that the normal procedures for considering mail classification requests should apply and that issues in this proceeding should not be limited, the Presiding Officer noted the novelty of this proceeding and the importance of establishing a full record. P.O. Ruling MC2002-2/3 at 5.

The issues have now been fully explored. In this brief, we discuss the criteria by which we believe the Commission should judge requests for NSAs and the why the NSA proposed in this proceeding meets those criteria and should be recommended by the Commission.

## **II. SUMMARY OF ARGUMENT**

For the first time the Postal Rate Commission has the opportunity to consider a request for a change in the mail classification schedule that would implement an NSA. Approval of this NSA will allow the Postal Service and the Commission to test the effectiveness of the NSA approach as a means of providing flexibility under the existing statutory ratemaking scheme.

This Request should be judged primarily against 39 U.S.C. §3623(c) that governs changes in the Domestic Mail Classification Schedule. Because, however, this Request also would establish new rates and fees, it is necessary to explore the role of the pricing criteria in 39 U.S.C. §3622(b).

An NSA should be (1) fair to the postal system and other mailers; (2) fair to those who compete with the firms that are parties to the NSA; and (3) fair to the parties to the NSA. The Capital One NSA is fair. “Similarly situated” mailers should be afforded the opportunity to enjoy rates and fees similar to those negotiated by parties to an NSA. The Commission should develop expedited procedures for recommending similar (but not necessarily the same) agreements between the Postal Service and competitors to other parties to approved NSAs.

The Capital One NSA also satisfies the rate setting criteria set forth in 39 U.S.C. §3622(b). NSAs that increase contribution will almost by definition satisfy those nine ratemaking criteria. When considering NSAs these criteria should be applied consistently with how they are applied to set rates and fees for “a category within a subclass”. The proposed NSA is not discriminatory, it is fair. It does not make any undue or unreasonable discrimination among users of the mails, nor

does it grant any undue or unreasonable preferences to any such users. In fact, the Postal Service says it is negotiating with ten other parties potentially similarly situated to Capital One. However, even if Capital One's situation is unique, uniqueness should not be confused with discrimination.

The data used to analyze the financial impact of an NSA need not be solely customer-specific. It is appropriate to use a combination of customer-specific information and reasonable non-customer-specific proxies to evaluate NSAs. In evaluating the financial impact of NSAs the analysis should be developed using the best data available including the Postal Service's understanding of the characteristics and requirements of specific mailers. At the same time it is not practical to expect that the Postal Service's data systems can be used to measure the costs for selected customers in the same way they are designed to measure costs for entire classifications in the aggregate.

The record in this docket shows that this particular NSA benefits not just the parties to the agreement, but the entire postal system and users of the mail because it improves the financial health of the Postal Service. The Commission should recommend approval of the Capital One negotiated service agreement.

### **III. APPLICATION OF THE POSTAL REORGANIZATION ACT IN NSA CASES**

In this docket the Postal Service styled its Request as one for a recommended decision on "classification, rates, and fees." Request at 1. The Commission styles it "Experimental Rate and Service Changes." See *e.g.* Order No. 1359 (February 3, 2003) at 1. We believe this Request should be judged primarily against 39 U.S.C. §3623(c) that governs changes in the Domestic Mail

Classification Schedule. Because, however, this Request also would establish new rates and fees, it is necessary to explore the role of the pricing criteria in 39 U.S.C. §3622(b).

**A. Application of the Classification Criteria, 39 U.S.C. §3623(c), in this Docket**

Section 3623(c) provides that the Commission shall make a recommended decision on establishing or changing the mail classification schedule in accordance with the policies of the Postal Reorganization Act, Public Law 91-375, 84 Stat. 719, 39 U.S.C. §§ 101 et seq. (the Act), and factors set forth in that section. In the next section we discuss why this Request is in accordance with the policies of the Act. Here we examine the application to this Request of the specific section 3623(c) 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.

39 U.S.C. §3623(c)(1)-(6).

**1. Applicability of the First Classification Criterion (39 U.S.C. §3623(c)(1)).**

We suggest in this docket the applicability of the first criterion—*the establishment and maintenance of a fair and equitable classification system for all*

*mail* — has three dimensions: (1) fairness to the postal system and other mailers; (2) fairness to those who compete with the firms that are parties to the NSA; and (3) fairness to the parties to the NSA.

**a. Fairness to the postal system and other mailers.**

An important indicator of the fairness of an NSA to the postal system and other mailers is the effect that the agreement will have on “contribution,” i.e., the extent to which postal rates and fees under the agreement will contribute to the institutional (overhead) costs of the Postal Service. While it is not clear that every NSA that results in a net loss in contribution is inequitable, it is clear that an agreement that increases the contribution from a mailer that is party to an NSA is fair to other mailers since it will, over the long run, decrease the contribution those other users must make to institutional costs thus benefiting the postal system as a whole.

We stress that the Commission need only ensure that the postal system and users of the Postal Service benefit from the agreement, not that the Postal Service or other parties to the NSA negotiated the best deal possible. These parties dealt at arms length and reached agreement. Their agreement demonstrates that they believe the NSA is fair and equitable as it affects them. We believe Commission efforts that have the effect of renegotiating an NSA for the benefit of either of the parties to the NSA will ultimately harm the Postal Service and mailers since doing so will discourage both from entering into future negotiations that could result in NSAs that benefit both. Tr. 9/1941-43 (Plunkett).



**b. Fairness to those who compete with the firms that are parties to the NSA.**

An NSA must be fair to those who compete with the firms that are parties to the agreement. The fact that a party to an NSA may pay a rate or fee different from its competitors is not *per se* unfair. Mailers who compete with each other currently pay different rates based upon the degree of worksharing that they perform or the class of mail or service that they use. In fact, according to Capital One witness Shippee, it is likely that competitors in the credit card industry currently pay different rates based upon differences in worksharing. Tr. 9/1804 (Shippee). For example, while some mailers presort their mailings to five-digit ZIP Codes, some of their competitors may only presort to three-digit ZIP Codes. In these instances, competitors appropriately pay different rates because it is less costly for the Postal Service to process five-digit pieces. An NSA such as the one in this docket is simply an extension of such worksharing discounts. In exchange for agreeing to an operational change that will reduce Postal Service costs, Capital One will receive discounts.

We believe that “similarly situated” mailers should be afforded the opportunity to enjoy rates and fees similar to those negotiated by parties to an NSA. We suggest that the Commission should develop expedited procedures for recommending similar (but not necessarily the same) agreements between the Postal Service and competitors to other parties to approved NSAs. The Postal Service has expressed a willingness to negotiate such agreements. Tr. 9/1943 (Plunkett).

We suggest, however, that an important consideration for determining whether an NSA is fair to competitors of parties to the NSA other than the Postal Service is whether any competitor challenges the agreement as it is entitled to do under law. Has any competitor even suggested competitive harm? Has any competitor questioned whether the NSA is in accordance with applicable law? If, as in this docket, no competitor challenges the agreement, it should be presumed to be fair to those who compete with firms that are parties to the agreement.<sup>2</sup>

**c. Fairness to the parties to the NSA.**

The testimony of witnesses Plunkett and Shippee aptly demonstrate and detail the extensive, drawn out, complicated, and sometimes contentious negotiations that preceded this agreement. See e.g., Tr. 9/1803 (Shippee); Tr. 4/730 (Plunkett); Tr. 9/1933 (Plunkett). NSAs should be presumed to be fair to the NSA parties since, as discussed above, they would not have signed it if they did not feel that it was so.

**2. Application of Criteria 2 through 6 (39. U.S.C. §3623(c)(2)-(6)).**

The second criterion—*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*—and the fifth criterion—*the desirability of special classifications from the point of view of both the user and of the Postal Service*—are satisfied. An agreement that improves Postal Service finances, such

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<sup>2</sup> FleetBoston Financial, while not a participant in this docket, said it “believes that if the proposal with Capital One is approved, that similar arrangements with other high-volume mailers should also be approved in a timely fashion.” Letter of Susan B. Shadle, Senior Relationship Manager, Mail Services, to Steven W. Williams, Secretary, Postal Rate Commission, dated October 17, 2002. Ms. Shadle’s letter also says “FleetBoston strongly supports the concept of Negotiated Service Agreements (“NSAs”) such as the one being considered for Capital One Services, Inc. (“Capital One”). We applaud the United States Postal Service (“USPS”) for looking at innovative ways to serve its customers.” Ibid. In this Brief we support expedited procedures to approve NSAs for “similarly-situated” mailers.

as this one, is desirable to both NSA parties. It is desirable to the Postal Service because it improves its financial position and to the mailer because it would not otherwise have signed the agreement. Who better is there to attest to the desirability of an agreement than those who made it?

The third criterion—*the importance of providing classifications with extremely high degrees of reliability and speed of delivery*—is satisfied. The agreement is expected to reduce Capital One's return and forwarding rates, Tr. 9/1802 (Shippee), which in addition to lowering Postal Service costs will improve the reliability and speed of delivery for Capital One's mailings. The fourth criterion—*the importance of providing classifications, which do not require an extremely high degree of reliability and speed of delivery*—is not relevant to this agreement.

The sixth criterion—*such other factors as the Commission may deem appropriate*—is open-ended. We note that many observers of postal ratemaking agree that providing the Postal Service with additional pricing flexibility is appropriate and that NSAs are a step in that direction. The Commission should encourage NSAs that promote pricing flexibility.

**B. Application of the Ratemaking Criteria, 39 U.S.C. §3622(b), in this Docket.**

Rather than performing a detailed analysis of this NSA under each criteria, this section discusses why NSAs that increase contribution will almost by definition satisfy the nine ratemaking criteria of 39 U.S.C. §3622(b). While we believe it is settled that these nine criteria apply at the mail class and subclass level, the Act is silent as to how they apply to rate categories. In a previous docket, however, the

Commission suggested that setting rates within a subclass on the basis of costs avoided owing to worksharing is consistent with the Act's policy factors:

[An earlier docket] did not attempt to decide whether a Postal Service proposal should be incorporated as a separate class or subclass *(to which all of the Act's policy factors would be applied in setting rates)*, or merely as a category within a subclass *(rates for which would normally be set on the basis of costs avoided owing to worksharing)*.

PRC Op. MC95-1, para. 2069 (emphasis added).

With one expansion, we believe that rates and fees for NSAs should be set consistent with how they are set for "a category within a subclass." The expansion is that rates for an NSA should be established taking into account all of the benefits of the NSA to the Postal Service, including contribution from new volume, not only costs avoided. This is because the Postal Service can benefit from other factors – such as volume growth – to the same extent or more than from just avoiding costs. All of these benefits should therefore be considered in connection with NSAs. This NSA certainly meets such a pricing standard. Actions to be taken by Capital One to improve address quality and to forego forwarding and return will yield substantial worksharing savings, some of which will be returned to Capital One in the form of discounts. This represents usual and customary treatment of worksharing discounts for rate categories within a subclass.

We also note that this NSA, when considered from the perspective of the subclass as a whole, is clearly consistent with the command of section 3622(b)(3) that "each class of mail or type of mail service bear the direct and indirect postal costs attributable to [it] plus that portion of all other costs of the Postal Service reasonably assignable to [it]." First, an NSA that increases contribution (such as

this one) improves the ability of any affected subclasses (in this case, First-Class Mail letters) to bear the direct and indirect postal costs attributable to it. Second, the increase in the portion of “all other costs of the Postal Service” paid for by the subclass affected by the NSA is reasonable because the increase is being paid for entirely by the NSA party who, by signing the agreement, has willingly agreed to bear this increase.

**C. NSAs Must Be In Accordance With The Policies of the Postal Reorganization Act (39 U.S.C. §3623(c)).**

The Postal Reorganization Act establishes general policies that are applicable to mail classifications, rates, and fees. See 39 U.S.C. §§101(a), 403. We briefly address section 403 here because one party has suggested that in this docket the Postal Service has entered “a negotiated deal on a selective and discriminatory basis,” Comments of the Newspaper Association of America on Order No. 1346 at 1, citing “Section 403(c) in particular.” Id. at 2. Section 403(c) provides that “in establishing classifications, rates, and fees...the Postal Service shall not make any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue or unreasonable preferences to any such users.” 39 U.S.C. §403(c).

In part III.A. above we explain how we believe the Commission should determine whether an NSA is “fair and equitable,” and we explain three dimensions that we believe should be considered in determining whether mail classifications, rates and fees, under a negotiated service agreement are fair and equitable—(1) fairness to the postal system and other mailers; (2) fairness to those who compete with the firms that are parties to the NSA; and (3) fairness to the parties to the

NSA. In part VI, below, we explain why we think this particular NSA is fair and equitable. Clearly, mail classifications, rates and fees that are fair and equitable in this framework do not make “any undue or unreasonable discrimination among users of the mails...nor grant any undue or unreasonable preferences to any such users.” 39 U.S.C. §403(c).

We also note that the Postal Service says it is negotiating with ten other parties potentially similarly situated to Capital One. Tr. 9/1890 (Plunkett). This establishes there is no intent to favor one mail user over another. Some may argue that others could not meet the requirements the NSA imposes on Capital One. Indeed, Capital One’s situation may be unique. According to witness Plunkett, who heads the newly formed Postal Service Pricing Innovation group, USPS-T-2 at ii, “[i]n 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.” Id. at 8. Uniqueness, however, should not be confused with discrimination.

Capital One uses substantial volumes of First-Class Mail as a means of sending solicitations, while much of the rest of First-Class Mail is bills, statements, and business correspondence. Tr. 2/38-39 (Jean). As Plunkett explains: “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....” USPS-T-2 at 3. Capital One’s return rate is ten times the average. USPS-T-3 at 6. And, of course, Capital one is the largest originator of First-Class Mail. Tr. 2/38 (Jean); Tr. 4/726 (Plunkett). “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. USPS-T-2 at 8.

#### **IV. USE OF CUSTOMER-SPECIFIC INFORMATION AND REASONABLE PROXIES TO EVALUATE THE FINANCIAL IMPACT OF NSAs.**

Another issue that has been debated extensively in this docket is whether the data used to analyze the financial impact of an NSA must be customer-specific. As discussed below, it is appropriate to use a combination of customer-specific information and reasonable non-customer-specific proxies to evaluate NSAs.

Specifically, in evaluating the financial impact of NSAs, we agree with the Postal Service's Chief Marketing Officer, witness Bizzotto, that the analysis "should be developed using the best data available including the Postal Service's understanding of the characteristics and requirements of specific mailers... At the same time it is not practical to expect that the Postal Service's data systems can be used to measure the costs for selected customers in the same way they are designed to measure costs for entire classifications in the aggregate." Tr. 3/423 (Bizzotto).

Given the practical limitation in Postal Service systems discussed by Bizzotto, analyzing the financial impact of NSAs will almost always (if not always) require the use of a combination of reasonable proxies from Postal Service systems and customer-specific information. In instances where use of a proxy is required, we suggest the Commission should assess whether the proxy is reasonable, not whether the Postal Service could or should have performed an additional (and potentially very costly) study to develop a better estimate.

While there is no perfect formula for evaluating the reasonableness of a proxy, the Postal Service's use of average costs for First-Class Mail electronic and physical returns and the own-price elasticity of workshared First-Class Mail letters in this case provides a good example of the reasonable use of proxies.

As witness Crum testified, use of the average cost of First-Class Mail returns (as adjusted to remove postage due and accountable mail unit costs) was reasonable due to "the vast predominance of letters in both the overall First-Class Mail mix and Capital One's mail mix...." Tr. 2/328 (Crum). Given this similarity, it is not even clear that performing a costly Capital One-specific study would have improved the cost estimates.

Additionally, as discussed above, unlike in rate cases where it is necessary to develop a point estimate of the financial impact of each rate proposal, the purpose of analyzing the financial impact of an NSA is to confirm that it will benefit the Postal Service. In this docket, even if the Postal Service overstated the cost savings from electronic returns by a factor of nearly three (a highly unlikely possibility), this agreement would still increase the test year contribution that Capital One makes to institutional costs.<sup>3</sup> Therefore, developing a more precise customer-specific estimate of the savings from electronic returns is not necessary to show that the agreement will benefit the Postal Service.

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<sup>3</sup> Based upon Capital One's initial volume forecast, even if the unit cost of physical and electronic returns is 64% less than calculated by the Postal Service, and therefore its cost savings estimate overstated by a factor of 2.8, the NSA would still be approximately contribution neutral. Given the revised volume forecasts presented by Dr. Elliott, Tr. 9/1843-44 (Elliott), the NSA would increase contribution even if the Postal Service overstated savings even more dramatically.



The use of the own-price elasticity of workshared First-Class Mail letters as a proxy for the own-price elasticity of Capital One's First-Class Mail is reasonable and, in fact, conservative. Specifically, use of the very small own-price elasticity (-0.071) of workshared First-Class Mail letters, Tr. 2/205 (Elliott), is likely to understate Capital One's volume response to the proposed discounts because the majority of Capital One's First-Class Mail are solicitations, Tr. 2/206 (Elliott), which are likely to be much more price elastic than other First-Class Mail.<sup>4</sup> The use of a conservative proxy (if a customer-specific figure is not available) is reasonable for evaluating the NSA since if the agreement is estimated to benefit the Postal Service based upon conservative assumptions, it certainly will benefit the Postal Service in reality.

Finally, it is reasonable to use non-customer-specific proxies in NSAs is that they often will be limited experiments to test the impact of new forms of discounts and changes in operational procedures and collect data on whether these experiments should be introduced more broadly.<sup>5</sup> The data requirements for such experiments should be lower than for omnibus rate cases.

## **V. THE PROPOSED STIPULATION AND AGREEMENT**

We support the pending request for a Commission recommendation based on the Stipulation and Agreement entered into by the Postal Service, Capital One, and the Office of the Consumer Advocate. Joint Motion of the United States Postal

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<sup>4</sup>For example, while the own-price elasticity of workshared First-Class letters is -0.071, the own-price elasticity of the Standard Regular subclass, which is comprised almost entirely of solicitations, is -0.388. Tr. 2/205 (Elliott).

<sup>5</sup> While this NSA is not being considered under the Rule 67 procedures for experimental classifications, P. O. Ruling MC2002-2/3, the fact that it is a limited test suggests that the use of data similar to what would be filed in support of experimental classifications is appropriate.

Service, Capital One Services, Inc, and the Office of the Consumer Advocate for Consideration of the Stipulation and Agreement as the Basis for Recommended Decision (March 31, 2003)(Stipulation and Agreement).

We anticipate this Stipulation and Agreement may be a template for future NSA requests despite its representation in paragraphs 8 through 10 that it is non-precedential. We support its terms in this case in large part because the affected parties support it and because its terms appear reasonable in this instance. We stress different terms may be, indeed probably will be, appropriate with respect to future NSA requests that are not comparable to this one.

#### **VI. THE PROPOSED NSA IS IN ACCORDANCE WITH THE POSTAL REORGANIZATION ACT**

We explain above how we believe the Commission should determine whether a negotiated service agreement is in accordance with the policies of the Postal Reorganization Act and how we believe those policies and the Act's classification and pricing criteria apply in this docket. We are confident others will discuss in detail how the record in this docket supports a Commission recommended decision that the Postal Service's Request be approved.

We do, however, stress here that the record in this docket shows that this particular NSA benefits not just the parties to the agreement, but the entire postal system and users of the mail because it improves the financial health of the Postal Service.

USPS witness Plunkett believes the NSA "reduces the overall burden on postal ratepayers by creating incremental contribution gains." USPS-T-2 at 1. USPS witness Crum quantifies the "net positive contribution impact of \$8.2 million.

USPS-T-3 at 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.*” Id. at 6 (emphasis added). Capital One witness Elliott, in fact, finds, that the effect on net contribution will likely be even higher than estimated by the Postal Service. Tr. 9/1845 (Elliott). The record is devoid of evidence to the contrary.

## **VII. CONCLUSION**

The Commission should recommend approval of the Capital One negotiated service agreement. The record establishes that this particular NSA is in accordance with the policies of the Postal Reorganization Act and its statutory classification and rate setting criteria. The NSA is not discriminatory and, in fact, benefits not just the parties to the agreement, but the entire postal system and users of the mail because it improves the financial health of the Postal Service.

Respectfully submitted,

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