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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.

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INITIAL BRIEF

OF

CAPITAL ONE SERVICES, INC.

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

OTHER

STATEMENT OF THE CASE AND
STATEMENT OF CAPITAL ONE SERVICES, INC.

The Commission has before it, for its approval and recommendation, an innovative, first of its kind, negotiated agreement between the Postal Service and Capital One, its largest First-Class Mail customer. This is the first time that the Postal Service has sought to negotiate and obtain approval of specific services and postal rates with a single customer. It is the position of Capital One that this Negotiated Service Agreement (NSA) complies with all the provisions of Sections 3622 and 3623 of the Postal Reorganization Act, and that the Commission should recommend its adoption.

This NSA is relatively simple: rather than return to Capital One First-Class Mail pieces that have addresses the Postal Service believes are undeliverable, as it does for all other First-Class mailers, the Postal Service will electronically notify Capital One that a particular address is not deliverable. Because it costs the Postal Service almost 54¢ per piece to return a piece of undeliverable First-Class Mail, the Postal Service believes that, even providing electronic address correction service to Capital One at no cost, it will still save over 17¢ per piece on Capital One's returned mail, saving over $13 million in the first year of the agreement.

The Postal Service has suffered serious declines in First-Class Mail volume, the class of mail which provides the most contribution to the overhead of the Postal Service; in other words, its most profitable class of mail. As part of the inducement to Capital One to enter into the NSA, the Postal Service has agreed to give a discount ranging from 3¢ to 6¢ a piece to Capital One, during the three year term of the agreement, on all its First-Class Mail over and above 1.225 billion pieces a year. The most recent Test Year

First-Class volume estimates for Capital One predict a Test Year volume approximating the threshold. There is good reason to believe that any First-Class volume that earns the discount will be volume that would not have materialized in the absence of the discount. To the extent that the volume is new volume, even with the discount the contribution to Postal Service overhead is very substantial; on the other hand, to the extent that the volume earning the discount would have materialized in any event, the cost of those discounts to Capital One are paid for many times over by the cost savings achieved from not having to physically return undeliverable mail to Capital One, as the Postal Service must do for all other First-Class mailers. In an environment where there are other choices available to Capital One to solicit new customers, it is important that the Postal Service be able to create incentives for Capital One to continue using First-Class Mail to solicit new customers and, if possible, to increase that usage.

This NSA, thus, will increase contributions to Postal Service overhead, will reduce Postal Service costs from returns; will make Capital One more efficient and provide it with better addresses, thereby also reducing costs; and because of the increased contributions to overhead, all users of the postal system will benefit to some extent.

Some might say that this agreement is a relatively small deal when compared to the many billions of dollars of costs and revenues of the Postal Service. That really isn't the case; it isn't that small. The Postal Service will net millions and millions of dollars from this deal. More importantly, this experiment will light the way for a host of other special arrangements which will have the potential of benefiting the customers, the Postal Service, and, through increased contributions to overhead, all stakeholders.

Capital One competitors will be able to get this or a similar deal or to negotiate for themselves based on their own unique circumstances and possibilities for saving Postal Service costs or enhancing contribution. No competitor of Capital One intervened in this proceeding to complain that Capital One was getting an unfair advantage. On the contrary, the Postal Service testified at length about the number of other mailers with whom it is discussing an NSA, including 9 of the 10 other largest credit card companies.

Will this deal benefit competitors of the Postal Service? Probably not, and that explains the opposition of the Newspaper Association of America. They are fierce competitors of the Postal Service for the advertising dollar. They understandably are concerned that the Postal Service, through the future use of other NSAs or niche classifications, may become more competitive with them. The Postal Service's competitors for advertising and delivery of packaged goods have become sleek and comfortable, used to a Postal Service that is unimaginative and inefficient, creating opportunities for the competitor to capture business by giving their customers a better deal. Now the Postal Service wants to give its customers a better deal and perhaps its competitor does not like it. That is the best evidence that this deal makes sense.

Customized pricing arrangements such as NSAs have been the norm in private industry for decades. Such deals create an enhanced competition. The only caveat is that, in the case of a regulated industry such as the Postal Service, those deals have to be scrutinized for their fairness, and their likelihood of benefiting the whole system, by the Commission. And that is exactly what the Commission has done in this case. It has developed a record of over 2000 pages of evidence which show this NSA benefits the whole postal system and is not unfair to other mailers.

This NSA creates a unique solution to the problem of the high returns for any First-Class Mailer who would utilize that medium for solicitations. Except for the solution suggested by this NSA, the only alternative solution to eliminating the high cost of Capital One's physical returns would be the conversion of that First-Class Mail to Standard Mail, where returns are not provided, at a loss in contribution to the Postal Service ranging from $36 million to $52 million – obviously not an acceptable solution.

There have been suggestions that the Capital One deal should have been several deals or that parts of it were too favorable to Capital One. The evidence clearly shows that this is the only deal that Capital One was willing to negotiate, and it was the one that the Postal Service itself wanted. It is pointless to speculate on whether one or the other party might have been able to get a better deal; rather, what is significant is whether the Postal Service itself benefits to the extent that it increases contribution, increases efficiency for itself and its customer, and creates benefits for all users of the system. The answer to that is clearly yes as the evidence amply shows.

In this case, the Postal Service has used average costs to determine the amount of cost avoidances, and Capital One has used acceptable methodologies for projecting First-Class Mail volumes for the Test Year before and after rates. Those average costs have been adjusted for Capital One's known deviations from the norm. The Postal Service and parties to negotiated agreements need to be able to rely on the use of average costs because neither the Postal Service nor potential partners are going to be willing to endure the transaction costs of specialized cost studies which try to determine what each postal function costs for that particular mailer, even if that could be done.

Finally, this NSA is important and symbolic because it is the first such experiment. During the course of the three years of operations of this experiment, it is expected that the data reporting that is called for will provide the parties and the Commission with a great deal of information about how very costly operations such as handling undeliverable mail and forwarding can be improved, not just for individual mailers, but perhaps for all mailers. It will also be a valuable instruction for all parties as to whether discount incentives based solely on volume can be used to generate additional contribution to overhead. The opportunities for learning and advancing innovation here are great; the risk to the Postal Service and to other postal users is insignificantly small. The Commission should recommend the adoption of the experimental DMCS and Rate Schedule provisions necessary to implement this agreement.

I. NEGOTIATED SERVICE AGREEMENTS, SUCH AS THE CAPITAL ONE NSA, THAT INCREASE CONTRIBUTION TO POSTAL OVERHEAD, AND ARE NOT UNREASONABLY DISCRIMINATORY, MEET THE RATE AND CLASSIFICATION CRITERIA OF THE POSTAL REORGANIZATION ACT

A. The Commission Has Asserted Its Authority To Recommend Negotiated Service Agreements And Has Stated The General Criteria For Their Approval.

The Postal Rate Commission has correctly concluded that Sections 3622 and 3623 of Title 39, United States Code, granted joint authority to the Postal Service and the Commission to adopt new mail classifications that would help the Postal Service innovate to provide services that were adapted to the needs of the nation's mailers and that, pursuant to that authority, negotiated service agreements are legally permissible under certain conditions. [1] The Commission notes that Section 3623(c) directs them to consider "the desirability and justification for special classifications and services of mail," and "the desirability of special classifications from the point of view of both the user and of the Postal Service." Criterion 2 and 5 of Section 3623(c). Coupling those provisions together with criterion 6 of Section 3622(b), "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," the Commission found justification for changes in rates and classes that are "tailored to the capabilities and needs of particular mailers." The Commission concluded that "agreements negotiated by the Postal Service and mail users

[1] Authority of the United States Postal Service to Introduce New Products and Services and to Enter into Rate and Service Agreements with Individual Customers or Groups of Customers: A Report to the Congress by the Postal Rate Commission, February 11, 2002.

are permitted under current law, if the procedure and substantive requirements of the Postal Reorganization Act are satisfied*.*"[2]

Noting that a negotiated service agreement was just a species of the broader category of niche classifications, the Commission found such arrangements agreed upon by the Postal Service and mailers to be legally authorized if three conditions are satisfied:

1. a public proceeding before the PRC to review the agreement;
2. a finding that the rate and service changes work to the mutual benefit of mail users and the Postal system as a whole; and
3. the negotiated deal is "made available on the same terms to other potential users willing to meet the same conditions of service."[3]

The Capital One NSA proposal meets all three conditions:

1. there has been a hearing with all interested parties able to be fully represented with the full panoply of procedural and substantive protections;
2. the proposal will add millions of dollars in contribution to institutional costs through the reduction of Postal Service costs; will increase the efficiency of Capital One as a mailer, with the prospect of more accurate addresses and a reduction in forwarding costs; and holds the potential of increasing Capital One's First-Class volumes through the incentive of discounts which volumes, if materialized, could also add millions of dollars in contribution to Postal Service overhead; and

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[2] *Id.* at 11-12. In the first instance where the federal courts had an opportunity to review the Postal Service's authority to enter into experimental agreements with a few mailers, the courts spoke approvingly if such agreements are submitted to the Postal Rate Commission for their approval. *United Parcel Service v. United States Postal Service*, 455 F. Supp. 857 (E.D. Pa. 1978), aff'd 604 F.2nd 1370 (3rd Cir. 1979), cert. denied, 446 U.S. 957 (1980). The Court held that such contracts would have to comply with Sections 3622 and 3623 of the Act and, of course, be subject to the Commission's review. *Id.* at 1381-1382. Also, the Courts appreciated such contracts as being innovative and market-responsive. 455 F. Supp. At 881; 604 F. 2nd at 1375.

[3] *Id.* at 14-15

3. the proposed DMCS language and regulations provide that the Capital One deal will be available on the same terms to other potential users willing to meet the same conditions of service.

Much of the hearing has been about proving the agreement meets these conditions. We believe that the evidence of record overwhelmingly proves the agreement meets those conditions and the rest of this brief will document that evidence.

B. Customized Pricing Arrangements Such As NSAs Fit The Needs Of Both The Postal Service And Postal Customers And Are Considered Routine Arrangements In Many Other Regulated Industries.

The principal Postal Service policy witness, Senior Vice President Bizzotto, argued for customization of service and pricing as a way to benefit all postal customers by providing positive net contribution to institutional costs. She said: "One size fits all pricing, we come to see ignores the needs of some customers and that targeted customer responsive pricing is not discriminatory. Rather, it is a natural step in the evolution of Postal pricing." USPS-T-1, p.3. Ms. Bizzotto very helpfully described the ways that the Postal Service can customize its offerings to targeted customers: providing additional services not included in the existing schedule; combining or bundling services in a way not contemplated in existing schedules; reducing service offered within a classification; and customizing work-sharing to a mailer's unique abilities. Id. at 4. She adds that there is the further possibility of adding to such combinations, such as incentives to maintain or increase mail volumes with the goal that the needs of customers are better met, greater contribution to institutional cost is promoted, and it is done in such a way that the special arrangement will not unreasonably differentiate among customers. *Id.*

Robert Posch, of Bookspan, who testified on behalf of three very large mailer associations, Postcom, the Direct Marketing Association and the Parcel Shippers Association, explained why the members of those associations believe that the Postal Service should be encouraged to enter into bilateral agreements with individual mailers, noting that, in some cases, niche classifications more readily available to a number of users will not meet the specific needs and opportunities that can be achieved with one particular mailer, while at the same time recognizing the legitimate but different purposes of the two species. Tr. 10/1972. Mr. Posch explained why many mailers do not fully avail themselves of the rate incentives available under the current work-sharing initiatives. Very specifically, if the cost to the mailer to meet the conditions of the special rates is greater than the savings in postage for that particular business operation and cost structure, the NSA might be the right vehicle for resolving that problem, and, as well, a niche classification could be a resolution of a different problem. Tr. 10/1974.

As Postal Service witness Eakin pointed out, there are pricing structures in other regulated industries that have the features of an NSA, citing as examples the optional tariff, negotiated or specialized contracts, and the application of a non-linear pricing structure. Tr. 10/2086. An example of non-linear pricing is the electric utility industry. He further found that optional tariffs were common in other regulated industries and they have the appeal that it is unlikely that the well informed customer will be made worse off because the optional tariff is voluntary. These innovative pricing programs are typical of the electricity industry. And among these voluntary pricing programs are declining block pricing, time of day pricing, two-part real-time pricing, fixed bill pricing programs and special contracts, which he finds analogous to NSAs. Tr. 10/2090. And as Professor

Panzar pointed out, such optional tariffs "… allow customers to choose between an established tariff and an alternative outlay schedule." Tr. 8/1578. Dr. Eakin finds that negotiated contracts have become more common in the electricity industry over the past 20 years. Tr. 10/2091-92.

In other words, there is nothing at all radical about negotiated service contracts as an optional alternative pricing mechanism in regulated industries; and, of course, they have always been common business practice in unregulated industries. The only thing that is perhaps shocking is that it has taken the Postal Service so long to propose this standard pricing arrangement for the Postal Service.

II. THE CAPITAL ONE NSA WILL SIGNIFICANTLY REDUCE USPS COSTS.

A. The NSA Will Reduce The Cost Of Returns By At Least 20 Cents Per Piece, Resulting In A Total Cost Savings Of At Least $11.4 Million And More Likely $13.9 Million.

Under the agreement, the Postal Service will provide Capital One with "electronic" returns of its undeliverable, unforwardable First-Class Mail solicitations, rather than physically returning the mailpiece. As estimated by the Postal Service, this will reduce the Postal Service's unit cost for these returns by 20.3 cents, from 53.5 cents to 33.2 cents. USPS-LR-1. Because the Postal Service is not likely to capture all of the returns for electronic processing, it conservatively assumed that it will only realize these savings on 85 percent of returns.

Based upon this 20.3-cent per piece savings, the 85 percent success rate, and the point volume forecast of 1.21 billion pieces, the agreement will reduce Postal Service costs for returns by $11.4 million in the Test Year. Tr. 9/1845. These significant savings indicate that the NSA's return procedures are "an improvement over what would happen in the absence of the NSA if they had to follow existing tariffs and rules with respect to returns." Tr. 8/1786.[4] This is a conservative estimate of the savings from electronic returns since the Postal Service likely overstated the unit cost of electronic returns, and thereby understated the cost savings from electronic returns.[5]

Specifically, the Postal Service's unit cost estimate for electronic returns includes a 14.5-cent cost for processing electronic returns at the Computerized Forwarding System (CFS) units. (In USPS-LR-1, this cost is referred to as the "eACS" cost.) The eACS cost is likely to be significantly lower, less than ten cents per piece. Tr. 9/1960. The cause of this overstatement is that the Postal Service developed its eACS cost by averaging the unit cost of the ACS nixie processing operation (more than 20 cents per piece), which is entirely a nonmechanized operation, and the cost of the ACS COA notification operation (less than ten cents per piece), which is primarily a mechanized operation. Since Capital One's electronic returns will be processed primarily in a mechanized operation, the best estimate of the eACS cost for Capital One's electronic returns is that of the mechanized

[4] We agree with Dr. Panzar that the return procedures in the NSA should be evaluated on whether they are an improvement over what would happen in the absence of the NSA, not "whether the return procedures…agreed to are the best that one could think of for dealing with this issue." Tr. 8/1786.

[5]NAA witness Kent, on the other hand, argues that the cost savings from electronic returns may be overstated because the unit cost of physical returns may be overstated. Tr. 6/1010-1013. Despite the fact that he is not an expert on mail processing (Tr. 6/1128) and has not developed any estimates of the unit cost of physical returns (Tr. 6/1033), he contends that two reasons for this overstatement is because the shape mix of Capital One's First-Class Mail is different than for First-Class Mail as a whole and the implementation of PARS will reduce the unit cost of physical returns. Tr. 6/1010-1013. As discussed by Postal Service witnesses, he is wrong. Tr. 2/328; Tr. 4/778-780. He also contends that Capital One's returns may require less sorting. Tr. 6/1011. In fact, the opposite could very well be true since Capital One's mailings are national in scope (as discussed by witness Crum), Tr. 2/320, 328, and therefore will need to be handled at (and transported between) multiple facilities. Furthermore, it is likely that the presence of a POSTNET barcode on the vast majority of Capital One's First-Class Mail (USPS-T-3, Attachment A, Page 1) could further increase the cost of Capital One's physical returns. This is because "when the POSTNET barcode for the original delivery address is contained in the address block, the Postal Service cannot use the LMLM to cover the POSTNET. In that case, the Postal Service may use a grease pencil to manually block out the original POSTNET." Tr. 5/955.

ACS COA notification operation, an operation that costs less than ten cents per piece. Tr. 9/1959-1960.[6]

Since Capital One is projected to have 55 million solicitations returned electronically in the Test Year (9.6% return rate x 669 million solicitations (COS-LR-4, Exhibit 3) x 85% success rate), this mistake understates the cost savings from electronic returns by approximately $2.5 million (55 million electronic returns x 4.5 cents (the difference between 10 cents and 14.5 cents)). Adding this to the $11.4 million in cost savings calculated by Dr. Elliott yields a savings estimate of $13.9 million.

B. The Cost Savings From Reducing Repeat Forwards Will Far Exceed The Postal Service's Cost Of Providing Capital One With eACS Notifications For Forwarded Mail. Including These Net Savings Would Increase The NSA's Cost Savings By $2.2 To $3.1 Million.

In estimating the NSA's contribution, the Postal Service did not include the costs for providing eACS forwarding notifications or the savings resulting from the reduction in repeat forwards, implicitly assuming that the cost savings that will result from providing no-fee eACS notifications for forwarded mail will be entirely offset by the cost of providing these notifications to Capital One. As shown by the Postal Service in response to POIR No. 2, Question 7 and as can be illustrated by a simple example, this assumption significantly understates the cost savings that will result from the NSA.

Specifically, the Postal Service, in response to a request from the Presiding Officer, estimated the savings that would result under two sets of reasonable assumptions.

[6] NAA witness Kent, on the other hand, suggested that the cost of the ACS nixie processing operation represents the best estimate of the eACS cost for electronic returns. 10/1967 F. Given that he is not an expert on mail processing operations, Tr. 6/1128, we presume that his contention was based solely upon a superficial examination of the title of the operation. Witness Kent is again wrong. As discussed by Mr. Plunkett, Capital One's returns will be processed in a mechanized operation at a much lower cost than the nonmechanized ACS nixie processing operation. Tr. 9/1959-1960.

The analysis indicated that the savings from a reduction in repeat forwards will save $2.2 to $3.1 million more than the cost of providing eACS notifications. Tr. 2/320-321. In the same response, the Postal Service noted that "[o]nly by making a variety of conservative – even ridiculous – assumptions can one get the costs of providing electronic address corrections to Capital One to approximate the avoided costs." Tr. 2/321.

While Postal Service witness Crum conceded upon cross examination that the Postal Service's calculations are not perfect, Tr. 2/384, the analysis (which remains the only analysis on the record) clearly shows that the savings from eliminating repeat forwards will more than offset the cost of providing eACS notifications for forwarded mail, and likely by a significant amount. This point remains unrebutted.[7]

Furthermore, since the unit cost of forwarding mail is 30.7 cents, and the unit cost of eACS forwarding notifications is only 6.6 cents, Tr. 2/320, providing eACS notifications to Capital One will be profitable for the Postal Service even if it takes more than four eACS notifications to eliminate one forwarded piece.[8] It is hard to imagine that one forwarded piece will not be eliminated for each four eACS notifications that the Postal Service provides to Capital One.

In fact, it is more likely that each eACS notification will eliminate multiple repeat forwards. For example, witness Crum conservatively calculated that Capital One annually sends 5.6 pieces per delivery point. Tr. 2/320. If Capital One corrects an address before it sends the next mailpiece to it, receiving one eACS notification (at a cost

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[7] NAA witness Kent contends that Capital One's forwarding rate is higher than estimated by the Postal Service. While he is again wrong, Tr. 3/552; Tr. 5/862, if he were correct, it would imply that the net cost savings from providing eACS notifications would be even higher than estimated by the Postal Service.

[8] This relationship also holds true if one uses NAA witness Kent's unit cost estimate of 30.6 cents per forwarded piece. Tr. 6/1018. After all, Kent's purported correction to witness Crum's estimate only represents a change of 0.3 percent. Tr. 6/1034.

of 6.6 cents) would eliminate the need for the Postal Service to forward the remaining 4.6 mailpieces that would have been sent to that address over the next year (assuming the address was not corrected by NCOA), thereby generating a savings of $1.41 (30.7 cents x 4.6) over the next year. If Capital One corrects the address after it sends the next mailpiece, but before the third mailing, two eACS notifications (costing 13.2 cents) would eliminate three forwards (generating a savings of $1.11).

As is clear from these calculations, the savings from eliminating repeat forwards would exceed the savings even if it took three or four notifications for Capital One to update its address list. Given that Capital One will receive eACS information daily and will immediately update its address databases, which it uses for all of its mailings (regardless of the mailing list's source), Tr. 9/1802, 1833, and utilizes NCOA frequently, it is extremely unlikely that it will take three or four notifications for Capital One to correct an address.[9]

C. The Postal Service's Method For Estimating The Unit Cost Of Physical And Electronic Returns Is Reasonable.

Witness Crum's method for estimating the cost of Capital One's physical and electronic returns – using average subclass costs, but adjusting them for known differences (such as removing postage due and accountable mail unit costs) Tr. 2/328 – is appropriate for two reasons: it yields the most accurate results and is the only practical alternative.

First, as noted by Postal Service witnesses Bizzotto and Plunkett during cross examination, the Postal Service has developed costing systems to accurately estimate

[9] Immediately updating its addresses using eACS information will also reduce Capital One's return rate, further increasing the savings from the NSA. Tr. 9/1802.

average costs for classifications of mail, not for individual customers. Tr. 9/1938-1939. Dr. Panzar indicated that this was not atypical, stating, "[a]t this point, you know, the numbers for individual mailers aren't typically collected so it's not surprising that they are averages now." Tr. 8/1782. Witness Crum's method leveraged these existing systems to estimate the cost of returns. Furthermore, for the purpose of this case, there is no significant drawback to this methodology since Capital One's returns are similar to First-Class Mail returns as a whole. In particular, like First-Class Mail as a whole, Capital One's First-Class Mail is comprised primarily of letters. Tr. 2/328.

The alternative to using adjusted subclass averages would have been to perform a special study to estimate the costs of Capital One's returns. Given that Capital One's undeliverable-as-addressed mail destinates at every one (or at least almost every one) of the Postal Service's tens of thousands of delivery units, it is hard to believe that the Postal Service could design a study (at any cost) that would produce as reliable a cost as produced by its established systems.

Second, as stated by witness Posch, requiring a company-specific analysis is often unrealistic and impractical since "many mailers do not collect or retain the data that the Postal Service would need to perform modeling and forecasting at the level of specificity expected in omnibus rate cases. Further, even if the data are available or could be collected in a form suitable for modeling with rate case specificity, the transaction costs to the Postal Service and the private sector NSA participant would be such as to completely wipe out the benefits that both parties…expect to realize." Tr. 10/1976-1977.

III. THE VOLUME THRESHOLDS ARE REASONABLE.

A. Thresholds For Volume Discounts Need Only Be Set Such That The NSA Increases Contribution. Therefore, The So-Called "Free Rider" Issue Is Not A Problem.

As Dr. Panzar noted during cross examination, "in looking at the NSA and its contribution you have to look at the whole package." Tr. 8/1685. In other words, when assessing whether the agreement benefits the Postal Service, the Commission should calculate (as did the Postal Service) the impact of the agreement as a whole, not whether individual components increase contribution.

Based upon this logic, the appropriate test of whether the volume threshold is reasonable is to determine, using the threshold, whether the NSA increases contribution. As discussed below, the threshold need not be set exactly equal to Test Year Before Rates volume for this to be the case. Furthermore, according to this logic, the so-called "Free-Rider" issue – "payment of an incentive… for pieces which would have been sent absent an incentive" Tr. 7/1241 – is not a problem in and of itself. Rather, it is only a problem if it causes the agreement as a whole to reduce the contribution that the mailer makes to institutional costs. This is not the case for this agreement.

Furthermore, despite the fact that the volume threshold need not be set equal to Test Year Before Rates volume for the agreement to benefit the Postal Service, Dr. Elliott projects that Capital One's Test Year Before Rates First-Class Mail volume will be near the threshold. Tr. 9/1843-1844.

B. Capital One's Test Year Before Rates Volumes Are Expected To Be Close To The Volume Threshold.

As noted by Dr. Elliott, Capital One is currently on pace to mail 1.268 billion pieces of First-Class Mail in the Test Year. After adjusting this figure for seasonality and past growth rates, he projects two estimates of Capital One's Test Year Before Rates volume, 1.21 and 1.245 billion, both of which are extremely close to the volume threshold.[10] Tr. 9/1843-1844. Furthermore, Mr. Shippee concurred that Dr. Elliott's forecasts are reasonable. Tr. 9/1809, 1834. These forecasts indicate that there will be no Free-Rider problem.

Some have interpreted Dr. Elliott's Test Year point forecast of 1.21 billion First-Class Mail pieces to indicate that Capital One will definitively not mail a sufficient volume of First-Class Mail to access the declining block rates. This, however, is a gross misinterpretation of his and Mr. Shippee's testimony. In addition to developing an alternative forecast of 1.245 billion pieces, Dr. Elliott noted quite clearly that it is not his testimony that Capital One's volume will definitively be below the threshold, stating: "Of course, we cannot forecast with certainty Capital One's Test Year volumes. The real import of our new analysis, based on new volume data, is that the established threshold of 1.225 billion in the NSA is a reasonable one -- one that may or may not be met; and that predictions of volumes greatly in excess of that threshold are devoid of any practical or theoretical substance." Tr. 9/1846.

Similarly, during cross examination, Mr. Shippee noted, "we feel there's a very strong chance of actually achieving the threshold in years two and three. In fact, there's a

[10] It is worth noting that, consistent with witness Callow's recommendation, Dr. Elliott depended on Capital One's "known, historical mail volume" to develop his forecast. Tr. 7/1372.

fairly good chance we'll reach it in year one, in the company's opinion." Tr. 9/1815-1816. Mr. Shippee also stated that being close to the volume threshold may cause them to mail additional volume to reach the threshold. Tr. 9/1835.

Furthermore, as witness Shippee stated, even if SLS shows that Test Year volume is under the threshold, the volume discounts remain valuable to Capital One: "Irrespective of what the SLS forecast may show, including a below-threshold Test Year volume, Capital One values the volume discounts that are at the heart of this deal. It is of real value to us to have the potential to earn these volume discounts throughout the three-year term of the NSA." Tr. 9/1801.

C. Even If Capital One's Test Year Before Rates Volume Is Significantly Higher Than 1.225 Billion Pieces, The Agreement Still Increases Capital One's Contribution To Institutional Costs.

As calculated by the Postal Service, even if Capital One's Test Year Before Rates volume is 1.408 billion pieces, the deal generates $8.2 million in additional contribution in the Test Year. USPS-T-3, Attachment B. Furthermore, in response to a request by Commissioner Goldway, Tr. 2/396-397, the Postal Service calculated the net contribution over the 3-year duration of the NSA if Capital One's mail volume grew by 10 to 15 percent per year.

The Postal Service's calculation found that, even if Capital One's Before Rates First-Class Mail volume were 1.408 billion in the Test Year, 1.619 billion in FY 2004, and 1.830 billion in FY 2005, the agreement would still increase Capital One's contribution to the Postal Service. Tr. 5/962, 965.[11] As discussed above, Before Rates

[11] The agreement would increase the NSA's contribution at even higher Before Rates volumes if the Postal Service corrected its cost savings estimates as discussed in Section II of this brief.

volumes this high are extremely unlikely in the Test Year or outyears, effectively guaranteeing that the agreement will increase the contribution that Capital One makes to institutional costs.

The Postal Service's analysis serves as a good illustration of why the agreement is unique and is appropriately viewed as one integrated package. Specifically, it shows that the significant cost savings resulting from the eACS component of the agreement ensures that, even if Before Rates volume is not perfectly estimated, contribution will still be increased.

D. Use Of The Own-Price Elasticity For First-Class Mail Workshared Letters Is Reasonable And, In Fact, Yields A Conservative Estimate Of The NSA's Contribution To Institutional Costs.

As noted by witness Callow, "Establishing a volume threshold is best achieved by determining each mailer's demand. That said, no mailer is likely to provide, and the Postal Service is unlikely (or unable) to calculate, each mailer's price elasticity. In the absence of such information, use of the price elasticity for First-Class workshared letters of -0.071 becomes the next best alternative." Tr. 7/1476. Therefore, because there may be no other reasonable alternatives, not allowing the use of the average elasticity would likely result in the end of NSAs.

Furthermore, because Capital One's First-Class Mail includes solicitations, Capital One's own-price elasticity is likely to be higher than estimated by Dr. Elliott.[12] As shown by Dr. Elliott, if Capital One reaches the volume threshold, use of a larger own-price elasticity, such as that for Standard Mail, would have resulted in a larger

[12]For example, the own-price elasticity for Standard Mail (-0.388), which is comprised of solicitations, is nearly five times larger than the own-price elasticity for First-Class workshared letters (-0.071). Tr. 2/205.

volume increase, which would, in turn, have resulted in the NSA making an even higher contribution. Tr. 2/205; USPS-T-3 at 7. Therefore, use of the First-Class Mail workshared letters own-price elasticity is much more likely to understate the NSA's contribution to institutional costs than to overstate it, making its use conservative.

E. Postal Service Profitability Will Not Be Lessened Because Of The NSA's Impact On Capital One's Competitors

In his testimony, Dr. Panzar raised the issue that the NSA could possibly harm competitors and this could indirectly reduce the NSA's "profitability." Tr. 8/1591-1592. While we agree that this is a theoretical possibility, it is not of practical importance. As Mr. Shippee noted in his testimony,

> "At various times in these proceedings, comments have been offered regarding the potential effects of this NSA on the Company's competitors. Indeed, Dr. Panzar raised the potential for deleterious competitive effects as his chief concern in this case. In my experience, including direct conversations with those who make marketing decisions at the Company, I am aware of no meaningful linkage between one company's mail volumes and competitors' volume. We compete, often rabidly, on product offerings and features, but competitor mail volumes typically do not lead Capital One to change its mailing plans. Nor is Capital One's planning affected by the likelihood that, even today, some of our competitors (due to greater work-sharing and/or density discounts) may enjoy lower average postal rates. The competitive concern, which is admittedly plausible using purely theoretical economic logic, simply does not appear to exist in practice in the credit card industry." Tr. 9/1803-1804.

As further proof that competitors will not be harmed by this agreement, Capital One's competitors have not testified in opposition of this agreement or even intervened in this docket.

Furthermore, even assuming for argument's sake that the NSA would indirectly harm the Postal Service by reducing the mail volume sent by competitors, the agreement would still increase the total contribution that Capital One and its competitors make to institutional costs.

Upon cross examination, Dr. Panzar agreed that it is unlikely that Capital One's competitors would reduce their mail volume by more than Capital One increases its mail volumes. Tr. 8/1705. He then confirmed calculations showing that, even under this worst case scenario, the NSA will still increase contribution significantly. Tr. 8/1707-1709. After being led through these calculations, he endorsed the exercise as a useful way to bound the impact that potential reductions in competitors' mail volumes could have on Postal Service finances, stating:

> [A]s I mentioned earlier, the line of questioning or hypothetical exercises put forth by Mr. May is a useful strategy to in more detail, but plotting out the dollar amounts of these unmeasurable effects, but putting bounds on them based on reasonable and clearly spelled-out assumptions could be a useful exercise by the staff for giving the Commission some quantitative evidence on which to weigh the benefits. Tr. 8/1774.
>
> I must admit if I had thought – if I had talked to him earlier, I would have tried to put in some examples like that in my testimony. Tr. 8/1785.

Upon further examination, Dr. Panzar agreed that the negative impact (if any) on competitor's volume would likely be smaller than the increase in Capital One's volume due to the availability of indirect substitutes and other effects. Tr. 8/1744-1749. In fact, he noted that, if the NSA spurs increases in Capital One's advertising mail volumes, competitors' mail volumes may increase, further benefiting the Postal Service:

> You could imagine the situation where as a result of the rivalry between the NSA firm and its competitors more postal services were consumed by both parties. So obviously that modifies my conclusions because in those cases then one doesn't need to worry about the profitability of the -- profitability loss from the impact on competitors. It would actually re-enforce the main contribution effect. Tr. 8/1788-1789.

Finally, it is worth noting that Dr. Panzar did not testify that harm to competitors would be a sufficient reason to reject an NSA. Tr. 8/1595. He actually testified to the contrary, stating, "the starting point for an economist [evaluating an NSA is] whether the gains to the winners are greater in dollar terms than the losses to the losers," Tr. 8/1773, not whether competitors were harmed.

In fact, despite his discussion of potential impacts to competitors, he stated that he supported NSAs in general and the logic of this NSA in particular, "I, in general, support NSAs … I am quite pleased to see the issue of NSAs in general being considered by the Commission and evaluated…. Without commenting on the numbers, the logic of [this NSA] seems to generate an improvement by avoiding sending returned material that Capital One doesn't want." Tr. 8/1771-1772, 1786.

IV. THE NSA WILL PRODUCE A NET CONTRIBUTION OF AT LEAST $11.4 MILLION AND LIKELY AS MUCH AS $17 MILLION.

Based upon the Postal Service's methodology for estimating the contribution for the NSA, Dr. Elliott calculated that the NSA will increase Capital One's contribution to institutional costs by $11.4 million. Tr. 9/1845. This is an extremely conservative estimate for two major reasons. First, as shown in Section II of this brief, the Postal Service significantly understated the cost savings from the agreement. Correcting for these understated cost savings, the NSA's contribution will be in the $16 to $17 million range.[13] Second, as stated by Mr. Shippee, if Capital One's Test Year Before Rates mail

[13] $11.4 million + $2.5 million + $2.2 to $3.1 million

volume is near the threshold, Capital One will likely attempt to increase its volumes so that it can access the discount, thereby increasing contribution further. Tr. 9/1835

V. BECAUSE OF CAPITAL ONE'S UNIQUE USAGE OF FIRST-CLASS MAIL, AN NSA IS REQUIRED IN ORDER TO MAXIMIZE THE OPPORTUNITIES FOR POSTAL SERVICE COST AVOIDANCE AND STIMULATION OF CAPITAL ONE'S FIRST-CLASS MAIL VOLUMES.

A. Capital One Uniquely Uses First-Class Mail For Solicitations.

As witness Jean explained, Capital One values First-Class Mail for its solicitations because of its forwarding and return mail information. The forwarding feature is a great benefit because of the increasingly mobile nature of the American public, as is the speed to market for many of its campaigns. Tr. 2/39.

As the Postal Service itself points out, Capital One is unique in its greater use of First-Class Mail to advertise. USPS-T-2 at 1. Part of that uniqueness is that Capital One's First-Class solicitations have 1 in 10 returns compared to the average of 1 in 100 for other First-Class mailers. *Id.* at 3. As Mr. Plunkett states, despite exemplary address management, far exceeding requirements, Capital One generates proportionally more returned UAA compared to traditional First-Class users (Tr. 9/1863) because those First-Class advertisements are sent to recipients with whom Capital One does not have an established relationship unlike the usual bills and statements that comprise the First-Class mailstream. USPS-T-2 at 2.

B. The Unusually High Percentage Returns Of Solicitation Mail Unique To Capital One Is What Creates The Significant Cost Avoidance Opportunity In This NSA.

As Postal Service witness Crum pointed out, if the Postal Service did not have to process this UAA mail, the Service could avoid a net of $13.2 million in return costs in the Test Year, USPS-T-2 at 4. As Mr. Plunkett points out, this creates a unique opportunity for the NSA to reduce those costs that would otherwise have to be borne by all users of First-Class Mail for the return of Capital One's UAA solicitation First-Class Mail volumes. *Id.* at 1.

Witness Bizzotto pointed out that the Postal Service did not consider a niche classification because of the uniqueness of the Capital One return situation. According to her, the Postal Service simply did not have enough information at the time to know whether to do a niche classification for a larger group of other mailers who would trade their physical returns for free electronic address correction service (eACS). Tr. 3/487, 489. Capital One was, as far as they knew, unique. *Id.* at 415-16.

C. Capital One Engages In Exemplary Address Hygiene Management Well In Excess Of USPS Requirements, And Is Not Being Rewarded For Having Poor Address Hygiene.

Capital One currently runs NCOA far more frequently than the Postal Service requirement of every 180 days, and furthermore commits under the NSA to run NCOA every 30 days for customer addresses and 60 days to process mailing lists. Tr. 9/1801. As witness Jean pointed out, an additional indicator of Capital One's mail piece quality is that its Richmond production site was certified under the Mail Preparation Total Quality Management (MPTQM) program, the first US list mailer to accomplish that. *Id.* at 5.

Under the NSA, Capital One has further committed to incorporate eACS into its solicitation campaigns and that commitment extends to any eACS information. *Id.* at 2. Under the NSA this eACS information will be received more quickly and provide more information, thereby improving the company's ability to determine which returns are unlikely to be delivered on subsequent attempts, reducing the likely number of returns. *Id.* at 3.

D. The Current Address Correction Service, With Its 20¢ Per Transaction Fee, Is Not A Practical Alternative For Reducing UAA Mail For Capital One Nor For Most First-Class Mailers.

The current usage by First-Class mailers of address correction service at a 20¢ fee is so little used as to be simply not a factor for almost all First-Class mailers. Commissioner Goldway asked USPS witness Plunkett about the viability of a new classification proposal which would require First-Class Mail solicitations to use eACS and pay the 20¢ fee, thereby, presumably, improving the UAA rate for First-Class Mail solicitations. Tr. 4/ 847. Mr. Plunkett said he did not believe Capital One would have any interest in such a classification, that in fact the outcome likely would be to accelerate the conversion of Capital One's solicitations from First-Class Mail to Standard Mail, with a resultant significant decline in the Postal Service's net contribution to institutional costs. *Id.*

E. Other Than The Proposed NSA, The Only Practical Way For Capital One To Eliminate The Physical Return Of 10% Of Its First-Class Mail Solicitations Is To Convert To Standard Mail With The Consequent Loss Of Contribution Between $36 Million And $52 Million.

Mr. Plunkett testified that this proceeding brought important pricing issues for correction services to the fore, pointing out that he was speaking of the current pricing that imposes a fee on a transaction basis having the undesirable consequence of keeping most of the largest users from using that service, including Capital One. At the rate that Capital One generates UAA mail, if they were subscribing to that service today, they would incur millions of dollars in additional costs. "They have been able to identify what in their minds is an appropriate substitute at a much lower cost. I think it has also been stated, that it appears to be typical". Tr. 10/1973-74.

Thus, Mr. Plunkett concluded that, absent the current NSA, the only way to address the high return percentage on Capital One's First-Class solicitations would be for Capital One to shift all of its First-Class solicitations to Standard Mail. Mr. Plunkett testified that he knew of no other way for Capital One to eliminate 10% returns on their First-Class solicitation other than converting to Standard: "It is an inevitable consequence of using First-Class as an acquisition medium, as opposed to a purely communication tool between an organization and its existing customer base." Tr. 9/1957-8). He described that as a serious financial mistake. Tr. 9/1864. Mr. Plunkett presented a Table in which he made an estimate of the losses of contribution to overhead which could result from the conversion of all Capital One's First-Class solicitations to Standard solicitations. His Table shows that there would be about a $53 million loss in contribution to overhead. *Id.* at 1865.

The Consumer advocate introduced a cross-examination exhibit which purports to show that the loss of contribution to overhead from a conversion of Capital One's solicitation mail to Standard would be $36 million, not $53 million. There were two different methodologies employed to compute the loss of contribution, but, as Mr. Plunkett points out, he was simply trying to show hypothetically the consequences that would ensue if the solution to the high UAA rate was, rather than this NSA, a conversion to Standard Mail. Tr. 9/1905. And, as Mr. Plunkett says, it really doesn't matter if it is $36 million, or $53 million, the fact of the matter is it is a very large number and the overall loss to the Postal Service would have an enormously negative effect on the Postal Service. *Id. at 1906-07.*

Witness Plunkett concluded: "While it is true that above average UAA rates have the effect of causing costs that are ultimately shared by all users of First-Class Mail, this effect is dwarfed by the substantial contribution that Capital One's discretionary use of First-Class Mail as an advertising medium has on other mailers." *Id.* at 1866.

VI. NSA'S ARE NOT, *PER SE*, DISCRIMINATORY AND UNFAIR, AND THE CAPITAL ONE NSA IS NOT UNFAIR TO CAPITAL ONE'S COMPETITORS.

A. The Settlement With The OCA Should Allay Concerns About The Fairness And Equity Of The Capital One NSA

It is of signal importance that the Office of the Consumer Advocate, the only disinterested opponent of the Capital One NSA classification, has signed a Stipulation and Agreement in which the OCA, after negotiating important changes in the proposal in terms of data reporting, procedures for others to seek comparable NSAs, and general procedures for the future to handle other NSA requests, has withdrawn its proposal and has endorsed, as changed, the Postal Service/Capital One NSA request.

Much of the legitimate concern with the fairness of the Capital One proposal to its competitors and other similarly situated mailers has now been put to rest thanks to the OCA's efforts on this issue in arriving at the Stipulation and Agreement to which it is a signatory. The DMCS language proposed has been amended to specifically provide for other mailers to negotiate, and have considered, NSAs comparable to the Capital One NSA. Additionally, the Postal Service has agreed to issue implementing regulations that describe the required features of a comparable agreement as well as other factors that will be evaluated. The regulation to be issued, a draft of which has been attached to the Stipulation and Agreement, will provide a process for a mailer to seek an NSA comparable to the Capital One NSA, including an opportunity for reconsideration in case negotiations fail. As important, the Stipulation and Agreement also provides for a procedure where the Postal Service will give annual reports on requests for comparable NSAs and the status of those requests. Moreover, an enhanced data collection plan has been agreed to so that the Commission and other parties will know the results of the Capital One NSA.

As the Joint Motion agreed to by the Postal Service, Capital One and the OCA states: "The OCA believes that the Settlement addresses the issues and concerns it raised in its case-in-chief and in rebuttal to the Postal Service's direct case".

B. The Postal Reorganization Act Criterion With Respect To Competition Relates To The Competitive Process And Does Not Protect A Competitor Of The United States Postal Service.

Both this Commission and the Courts have held that the test is whether or not Commission recommendations promote competition, not whether a particular postal competitor is entitled to protection. To quote from the D.C. Circuit's review of the R97-1 Decision: "… the Commission has consistently, and reasonably, held that it [Factor 5] authorizes a reduction in rates to maintain the position of the Postal Service as a competitor in the mail delivery industry." *United Parcel Service, Inc. v. U.S. Postal Service, 184. F.3d. 827, 845 (D.C. Cir. 1999).*

Professor Panzar, speaking as an economist, agrees. "Competitors of the Postal Service, such as providers of advertising media other than direct mail, might find themselves adversely affected by an NSA. However, I do not believe that competitors should have economic standing to protest Postal Service pricing policies unless they are anti-competitive." Tr. 8/1637.

C. The Capital One NSA Is Not Unfair To Capital One's Competitors.

It is a legitimate concern of the Commission to ensure that its recommendation of an NSA for one particular mailer will not unfairly harm that mailer's competitors, and to ensure that there are likely to be equal opportunities for the mailer's competitors to achieve their own special arrangements with the Postal Service if they can themselves increase contributions to overhead greater than the transaction costs of the deal.

There is a fundamental question of whether NSAs are inherently inequitable for individual customers because they are treated differently, and Postal Service witness Eakin's response to that was: "While an agreement giving a rate reduction without a net increase in contribution would be inequitable, the agreement between the Postal Service and Capital One provides a net increase in contribution." Tr. 10/1974. Witness Posch, testifying on behalf of a coalition of businesses in three different mailer associations, dismissed the view that specific company agreements would be unfair because of the unknown possibility that other mailers might be willing and able to undertake the same deal. He said he was confident that the Postal Service would act in good faith to extend the terms and conditions of an NSA, once approved, to other mailers, if those mailers have closely comparable mail and meet the same eligibility thresholds and are willing to assume all the other obligations of the deal. *Id*. at 1975.

The argument was advanced during the proceedings that, because no other mailer could achieve the exact requirements imposed on Capital One, then the NSA is unfair. However, the OCA witness stated that he thought it would be fair and equitable for the Postal Service to refuse to enter into an NSA with another company, if that other company's costs and their potential for cost savings was not the same as Capital One, pointing out that it was, after all, a negotiation, and the Postal Service could do that and it would be fair and equitable. Tr. 7/1563-64.

And, as already pointed out, Mr. Shippee testified that, in his judgment, this NSA would have no practical impact on competitors in the credit card industry, that any actual competitive affect was so remote as to not be measurable. Tr. 9/1803-04.

D. The Postal Service Has Made It Clear It Is Willing And Eager To Do More Deals, Including With Capital One Competitors.

The Postal Service gave assurances during the hearings that they would be willing to negotiate a substantial number of other deals; and that they have the resources to negotiate deals and that in fact too many deals is not their current problem. Tr. 3/526-27.

A number of hypothetical situations were presented to Postal Service witnesses as to whether they would consider such deals. For example, would the Postal Service consider an offer from a First-Class flat mailer of 700 million pieces to convert that to a letter thereby saving the Postal Service considerable cost, if the Postal Service would grant a discount to that mailer. Mr. Plunkett's response was that "to the extent we're about making sure that the expected benefits exceed the transaction cost of negotiating an agreement and litigating it, that fact [700 million pieces] makes it perhaps more appealing hypothetically." Tr. 9/1882. Witness Plunkett testified that the Postal Service has had discussions with roughly 8 to 10 financial services companies, all but one of the significant credit card companies, about doing an NSA. Tr. 9/1889-1890. When asked if all ten of those companies were to come forward for a deal, would they be given priority consideration, and Mr. Plunkett said it all depended on what other opportunities there were, but probably they would be. Tr. 9/1932-1933. He also responded that, if a competitor of Capital One came in with many similarities to the Capital One deal, and entered into an agreement, the Postal Service would send such a deal to the Commission for its recommendation. Tr. 9/1934.

Mr. Plunkett also made it clear that the huge volumes of Capital One were not the controlling consideration. He said that even if Capital One's volumes were only one quarter of what they were, the Postal Service would still be interested in the deal and pointed out that: “We are in active discussions with companies smaller than one quarter the size of Capital One in terms of overall Postal Service spending, so there is certainly no floor of that kind that has been established.” Tr. 9/1886.

At the same time, Mr. Plunkett made it clear that the future pace of negotiation of NSAs and the volume of NSAs the Postal Service will be able to handle will heavily depend upon the Commission’s decision in this case; on Commission guidance on what constitutes a similarly situated mailer; whether a rulemaking issues that results in more expedited sets of procedures; and whether the promise held out by the Commission’s decision would warrant the major investment in the infrastructure necessary to support a much larger number of NSAs, an infrastructure that does not yet exist, an infrastructure that would require serious investments and the assurance that would be required that these NSA agreements will produce the intended results. Tr. 9/1888.

An important thing to bear in mind when considering this NSA is that it is still an experiment. It is not just the fact that this is the first NSA; it is also the fact that this is an experiment from which a great deal will be learned that will guide both the Postal Service and the Commission when they review the results, and will guide the future of NSAs and their value to the Postal Service.

VII. THE APPROPRIATE MEASURE FOR THE EFFECTS OF THE CAPITAL ONE NSA IS THE FISCAL YEAR FOR 2003, CHOSEN BY THE POSTAL SERVICE AS THE TEST YEAR.

Postal Service witness Plunkett laid out the rationale for the use of the single fiscal year as the appropriate period and Test Year, as opposed to using the three year duration of the experiment. His reasons were as follows:

1. FY2003 was the Test Year in the most recent omnibus rate proceeding, R2001-1. Therefore, there is a complete set of data in the form the Commission used that exists for that year.

2. On the grounds of fairness and equity, because the use of 2003 results in rates for Capital One that are based on data of the same vintage as the data upon which the current postal rates were based.

3. The Capital One agreement is not one under which a new product will be offered with unique start up costs and a long period before the customer begins to become aware of the existence of the new product and to adjust its behavior accordingly. Rather, Capital One's response will be virtually immediate after its implementation with no predictable trend from one year to the next; thus, the first year of the agreement is likely to be just as representative a test period as would a period consisting of the entire three years of the experiment. And there is the fact that the FY2003 forecast is undoubtedly likely to be more accurate than those of a longer time horizon.

4. Perhaps more important, the use of a single Test Year complies with the Commission's own rules of procedure. It is the same methodology employed by the Commission for over 30 years in determining the rates in omnibus rate proceedings, rates which have not only on average been in existence more than 2 years, but it has also been known by the Commission that they will be effective for more than a 2 year period, yet only a one year prospective Test Year has been employed in every one of those proceedings. Tr. 8/1769-70.

Witness Posch pointed out in his testimony that the Test Year was the appropriate measure, stating that NSAs by their very nature require the participant mailer to agree to change the way it conducts business, and the mailer has to take the risk that it will be able to meet its obligations and have sufficient time both to recover from the upfront and the ongoing costs. He does not believe that the Commission will ever see an NSA which terminates at the end of one Test Year. In fact, in his opinion, even the 3 year period required by the experimental rules has an inhibiting effect in some large and complex deals. He also sees no reason for the Commission to change the way it has been doing business for the last 30 years. Tr. 10/1977-78.

VIII. IN JUDGING THE MERITS OF THE CAPITAL ONE NSA THE COMMISSION SHOULD NOT ATTEMPT TO SECOND GUESS THE PARTIES NEGOTIATING THE DEAL ON WHETHER OR NOT ONE OR OTHER PARTY GOT THE BEST DEAL THEY COULD HAVE.

A. The Parties Are Entitled To The Presumption That Each Got The Best Deal It Could Negotiate.

As witness Posch concisely put it, the Commission's responsibility is simply to see to it that the deal does not harm the interests of other stakeholders and that, in one way or another, it adds value to the bottom line. He asserts that the Commission should be comfortable with the fact that the normal negotiation process yields the best deal that the parties could get under all the circumstances and that the process yields a result that benefits both parties, or, at least, they believe so. Otherwise, as he points out, one or the other party would have refused the deal and there would be nothing before the Commission. Tr. 10/1978.

There have also been attempts during the proceeding to weigh the relative merits of individual parts of the whole agreement; and even to suggest that it was not necessary to include all the parts in order to conclude an agreement. The Commission should heed Professor Panzar's advice to "look at the whole package." Tr. 8/1685.

Capital One's Shippee and the Postal Service's Plunkett, the lead negotiators of the two parties, both emphasized how hard fought the negotiations were, with Shippee citing the issue of the volume threshold for the discount as being particularly hard fought. Tr. 9/1830.

B. Speculating On Whether Or Not There Were Ways, Other Than The Capital One Deal, To Force Capital One To Improve Its First-Class Mail Solicitation Return Rate, Were Just That – Speculation.

One such speculation was a Postal Service classification change wherein certain First-Class Mail solicitations would be required to use the ACS service and pay the current 20¢ fee. Mr. Plunkett advised that he did not believe that Capital One would be interested in such a classification; that the likely outcome of such a classification would be to accelerate Capital One's conversion of their solicitations from First-Class to Standard Mail, producing a significant decline in the Service's net contribution to institutional costs that it currently receives from Capital One. Tr. 4/847. He advised that it simply would be impractical for Capital One to pay the 20¢ fee. He pointed out that, at the rate Capital One generates UAA mail, "… if they were subscribing to that service today, they would incur millions of dollars in additional costs. They have been able to identify what is in their minds an appropriate substitute at a much lower cost. I think as has also been stated, that appears to be typical." Tr. 9/1873-74.

Another suggestion was the creation of a niche classification for Standard Mail where free eACS would be given to Standard mailers as a way of attracting First-Class mailers to Standard. While that might be an interesting idea for certain large First-Class solicitation mailers, the loss of contribution for the Postal Service from such a Capital

One conversion, as Mr. Plunkett and the OCA have pointed out, would cost the Postal Service anywhere from $36 million to $52 million in contribution to institutional costs. Mr. Plunkett made it plain that such approaches were not to the Postal Service's liking. Tr. 4/829-848.

Even if such speculations did lead one to conclude that there was a better plan, albeit one that the Postal Service did not like, that is no reason to reject the Capital One deal which creates a positive contribution for all stakeholders. The Commission should not reject this deal simply because it is not thought by the Commission to be the best solution. Such an approach to weighing the merits of the Capital One NSA, or other NSAs, would be a perversion of the institutional balances between Postal Management and the Postal Rate Commission, and contrary to the intentions of the Postal Reorganization Act.

C. The Commission Should Not Consider It Relevant To Their Judgment Of The NSA Whether Capital One Would Have Agreed To An NSA That Only Contained The Trade Of Free eACS For Physical Returns Of UAA Mail.

Testimony and argument in this proceeding have suggested that it would be unrealistic to assume that Capital One would not agree to give up physical returns of their UAA mail in exchange for free electronic address correction only, Tr. 7/1316-17, and that there was no evidence to suggest that Capital One would not agree to the deal without the volume discounts. *Id.* at 1319. However, in response to questions from the Commissioners, USPS witness Plunkett stated that during negotiations the Postal Service presented the option of a waiver of ACS fees in exchange for the address hygiene requirements and elimination of physical returns. Mr. Plunkett stated that Capital One was not interested and that his recollection was that, from their perspective, they had in place a process that allowed them to capture the information they need from the physical returns, and that a limited change such as suggested would have at best limited benefits and that therefore they would not be interested in pursuing or undertaking the enormous effort required to execute and litigate an NSA for such marginal benefits. Tr. 4/848.

D. The Fact That The Latest Volume Forecasts For Capital One Suggest That Their Test Year Volumes Will Not Meet The Threshold Required For A Discount Has No Bearing On Whether The Volume Discounts Are Necessary, Integral, And A Valuable Part Of The Agreement, Both For The Postal Service And For Capital One.

The most significant thing about the latest volume forecast for Capital One for the Test Year is that it validates the legitimacy of the threshold established in the agreement. If the forecasts were significantly in excess of the threshold, the critics of the agreement, as they did during the proceeding, would claim that the Postal Service was wasting discounts on First-Class volumes that it was already going to receive. That issue seems now to be addressed. On the other hand, as Capital One's Shippee pointed out, in the three year time frame of the experiment, Capital One has seen from recent years' experience that enough changes occur in a business climate that he felt there was a very strong chance of achieving and exceeding the thresholds in the second and third years of the agreement and a fairly good chance in the first year, in the Company's opinion. Tr. 9/1815-16. Also, it is the case that Mr. Shippee said that he was comfortable with the new alternative volume estimates made by Dr. Elliott which were somewhat above the threshold, finding they were in a reasonable range and, more to the point, Mr. Shippee added: "I think it is worth noting that the existence of the incentives are very likely to prompt us to try to meet and exceed the 1.225 billion, especially since we are so close in the before rates." Tr. 9/1834-35.

The question was put, now that the new estimate suggested that Capital One would not earn discounts, why there was any rationale left for the combination of the two parts of the agreement since it now appears Capital One is willing to accept the agreement even though it will not get the discounts. The question was put why then would not just the eACS part of the agreement be enough, and why did not the Postal Service and Capital One negotiate a separate agreement with respect to volume. As Mr. Plunkett responded, when the parties were negotiating they did what they thought was in their own best interests without actually being able to know the future. At the time of negotiations and the filing of the agreement with the Commission, the estimate was 1.4 billion, 175 million pieces above the threshold, but he said that Capital One knew, as did the Postal Service, that there were a wide range of outcomes possible around that number including some well below the threshold. He pointed out that Capital One was then willing to incur the risk that that might happen and that the Postal Service, on the other hand, was willing to incur the risk that the volumes may well exceed the threshold, because they viewed the agreement as a whole. Tr. 9/1936-38.

Now that the lower volume estimate has been made, Mr. Plunkett stated that the Postal Service itself, in addition to Capital One, regards the declining block rates as an important part of the agreement in addition to the avoided costs portion. "We want that incentive to exist for Capital one to send more mail and believe very strongly that the alternative tariff schedule that is embedded in this agreement … is a very important characteristic and provides an important incentive to Capital One to stay in First-Class

Mail and to send more of it." Tr. /1936-38. Mr. Plunkett emphasized that this agreement was not a trade off between something the Postal Service wanted and something Capital One wanted, with things that the other did not want. Rather, he said that from the outset the Postal Service believed strongly that the declining block rates produce an overall benefit to the Postal Service that takes a number of forms. *Id.* In other words, this is not the usual situation as discussed by Professor Panzar, where he speaks about both parties achieving their own gains with an impact on the outcome and the division of those gains between the parties on the basis of bargaining power, a process that Professor Panzar finds perfectly normal. Tr. 8/1642. This is a unique case where the gains desired by the two parties are equivalent: a trade off of a more expensive notification process, physical returns, for a less costly and more effective one, eACS; and an incentive to increase the use of First-Class Mail for solicitations. The Postal Service did not reluctantly give volume discounts; as Mr. Plunkett testified, they were interested in them from the start, as was Capital One. The most contentious issue was the threshold as Mr. Shippee testified. That threshold which emerged from very hard bargaining, in the light of actual experience, now appears to have been a rather good compromise between the negotiating parties.

It is these kinds of factors that the Commission should be weighing in making its recommendations, not moot speculation as to what might have been if the negotiators were more enlightened or had better information or had a crystal ball.

IX. CONCLUSION

The Commission should recommend adoption of the Capital One NSA because, as witness Plunkett succinctly put it, by doing so, "… the Commission would create an experiment capable of testing the merits of the NSA approach in the context of a low-risk agreement likely to benefit both the Postal Service and Capital One, as well as all First-Class mailers." Tr. 9/1871. Specifically, this agreement holds great promise for the elimination of Postal Service costs of physically returning UAA First-Class Mail, immediately in the case of Capital One and prospectively for other First-Class mailers. As Capital One's witness Shippee pointed out, responding to Commissioner Covington's questions about the Commission's duty to monitor closely the address management part of this case: "I think the Commission should look at the address management portion of this agreement as a huge opportunity because we are going to get so much more information about why a piece of mail is not deliverable than we have today that it's going to help us make much more intelligent decisions, I hope, about who to mail to and why certain pieces do not get to the intended recipient. I think there's a huge opportunity in this agreement." Tr. 9/1832.

From the Postal Service's point of view, an important part of this NSA is the opportunity to grow or at least to retard the volume losses of First-Class Mail. As Postal Service witness Bizzotto pointed out, she thought the most exciting thing about the agreement was the opportunity to keep and grow the First-Class Mail of a very large customer, and that retaining First-Class Mail was as important as growing mail. As she put it: "Given First-Class Mail trends I would be happy to retain present volume." Tr. 3/469.

The record will show that the Capital One agreement meets all of the rate and classification criteria in the Act, and those issues are dealt with explicitly by Postal Service witness Plunkett in his testimony where he considers each one of the rate and classification criteria and explains why they are met by the Capital One agreement. USPS-T-2 at 9 and 10.

The outcome of this case has added importance for the Postal Service and for all Postal Stakeholders. As Postal Service witness Plunkett stated: "Well, certainly if this produces a good result, the Postal Service will believe that repeating the process is worth doing. If it produces a negative result, some people will conclude that the Postal Service should not do any more." Tr. 9/1939. When queried whether, even if the Commission were "to disallow or advise against this NSA isn't it possible that you could have discussions about different kinds of agreements that were continuing", the witness responded : "It's possible, but one thing I do not know is the tolerance that Postal Service management would have for continuing to undertake such discussions and invest in the time and resources necessary to enter into agreements and litigate them if the first time out the results aren't favorable." *Id.* at 1940-41. And it would not just be the Postal Service that would be discouraged. Mr. Plunkett pointed out that all of the companies with which the Postal Service is currently in discussions about other NSAs continue to be alert and informed about the progress of this case. *Id.* at 1942. While he believes that a number of these companies are ready to go forward once this NSA is approved, and some would sign on to agreements that mimic the Capital One deal and the Postal Service would be willing to take those to their Board and then presumably file those as experiments with the Commission, should there be an unfavorable outcome to the current case, he believed that certainly one or more of those companies would stop discussions altogether. *Id.* at 1943.

Dr. Eakin succinctly summarized, from an economist's view, the merits and value of the Capital One NSA:

1. It appears to be in the public interest. Tr. 10/2094.
2. It displays both product and price flexibilities. *Id.* At 2095.
3. Other Postal Service customers are likely to request similar NSAs. *Id.*
4. NSAs and innovative pricing structures are important in regulated industries. Id. at 2095-96.
5. The Capital One NSA compares favorably to similar arrangements in other industries. Id. at 2096.

As Dr. Eakin summarized, "the Capital One NSA creatively introduces a value-creating new product and effectively applies non-linear pricing. It has the potential of achieving the objectives of achieving net revenues and maintaining and possibly increasing First-Class Mail volumes. The end result is greater efficiency so that the Postal Service resources yield more social value." Tr. 10/2096-97.

PROPOSED FINDINGS AND CONCLUSIONS

1. The Commission finds, as a matter of law, that it has the authority, after a hearing on the merits, to recommend the adoption of negotiated service agreements.

2. The Commission finds that negotiated service agreements are responsive to criterion 6 of Section 3622(b) of the Postal Reorganization Act, and criteria 2 and 5 of Section 3623(c) of the Act.

3. The Commission finds that negotiated service agreements in general, and the Capital One NSA in particular, meet the needs of both the Postal Service and postal customers for customized arrangements that benefit both the customer and the Postal Service as a whole.

4. The Commission finds that the Capital One NSA will significantly reduce Postal Service costs by eliminating physical returns and substituting electronic returns, netting a savings to the Postal Service of at least $11 million.

5. The Commission finds that the NSA provision to supply notification to Capital One of forwarded mail will result in cost savings from avoiding repeat forwards that far exceed the cost of the notification.

6. The Commission finds that the Postal Service's methodologies for estimating the unit costs of physical and electronic returns for Capital One are reasonable, and will yield the most accurate results, and were the only practical alternative.

7. The Commission finds that the most recent Capital One estimates of before and after rates Test Year First-Class Mail volumes were derived by reasonable methods and are reasonable estimates.

8. The Commission funds that the volume threshold established under the NSA to determine whether Capital One is eligible for volume discounts is a reasonable threshold.

9. The Commission finds that it is not possible to forecast a specific mailer's volumes with exact certitude; and that volume forecasts, such as the Capital One forecast, derived from the use of reasonable methodologies, are of evidentiary quality and can be relied upon by the Commission and the parties in this proceeding.

10. The Commission finds that it is not material whether the forecast is slightly under or slightly over the threshold for volume discounts; the Commission further finds that the forecast is within a reasonable range of the threshold so that it is unlikely that discounts will be provided for First-Class Mail volumes that would have been sent in any event; and, on the other hand, that there is a reasonable likelihood that the volume discounts will, as was their intention, create an incentive to mail additional First-Class volumes.

11. The Commission finds that, even if the Capital One First-Class Mail volumes over the three year course of the agreement are significantly larger than the Test Year forecast, the discounts earned by Capital One will not be greater than the cost savings generated by the agreement.

12. The Commission finds that the block discounts, and the amounts of the discounts, are reasonable devices to create an incentive to retard the decline in First-Class Mail usage by Capital One, and an incentive to increase their First-Class usage, thereby increasing contribution to Postal Service institutional costs.

13. The Commission finds that the use of the own-price elasticity for First-Class Mail work-shared letters by Capital One was reasonable, and leads to a conservative estimate of the NSA contribution to institutional costs because the high

concentration of Solicitation Mail in First-Class suggests an own-price elasticity higher than that estimated by Capital One.

14. The Commission finds that the Postal Service's profitability will not be lessened by diminished volume of Capital One competitors as a result of Capital One's discounts because Capital One's volume increases based on the discounts would be greater than the volume losses, if any, from Capital One's competitors.

15. The Commission finds that the Capital One NSA will produce a net contribution to postal overhead of at least $11.41 million and as much as $17 million.

16. The Commission finds that Capital One's usage of First-Class Mail is unique and, for that reason, only an NSA will be able to maximize the opportunity for cost avoidance and elimination of physical returns.

17. The Commission finds that Capital One currently engages in address hygiene management that is well in excess of USPS requirements, and will continue to do so under the NSA.

18. The Commission finds that, notwithstanding Capital One's exemplary address management, because of the unique usage of First-Class Mail for solicitation, Capital One has an exceptionally high percentage of undeliverable as addressed mail.

19. The Commission finds that, except for the NSA, there is no practical alternative for Capital One to reduce the high percentage of returns of its First-Class Mail solicitations other than to convert from First-Class to Standard Mail where there is no requirement to physically return UAA mail.

20. The Commission further finds that the conversion to Standard A Mail from First-Class Mail for solicitations would be very damaging to the Postal Service, costing it a loss of contribution of between $36 million and $52 million.

21. The Commission finds that NSAs are not, *per se*, discriminatory and unfair, and that the Capital One NSA is not unfair to Capital One's competitors.

22. The Commission finds that the Capital One NSA will promote competition, and therefore is consistent with the Act.

23. The Commission finds that the Postal Service has demonstrated that it is eager, willing, and able to negotiate NSAs with Capital One's competitors and with other similarly situated mailers, and that the revised DMCS language and proposed postal regulations for negotiating NSA's will help ensure that happens.

24. The Commission finds that, consistent with past practice, the appropriate Test Year for consideration of the Capital One NSA is a single Test Year, FY2003.

25. The Commission finds that the Capital One NSA should be judged on the basis of its own terms and not on the basis of what one could speculate was a better deal or a better term for one or the other parties; rather the test is whether the NSA benefits the Postal Service and thereby other stakeholders.

26. The Commission finds that the NSA is a complete agreement and that there is no basis to believe that an agreement could have been struck that included only some of the terms of this NSA and not all; that this NSA must be judged on all of its elements and not just parts of it.

27. The Commission finds that the Capital One NSA meets the three conditions that the Commission has spelled out for the recommendation of NSAs: there has been a full and fair hearing of all interested parties; the NSA works to the mutual

benefit of all mail users in the postal system as a whole because it increases the contribution to Postal Service institutional costs through cost avoidance and the potential of increased contribution from First-Class Mail volume increases; and the Capital One agreement is made available on the same terms to other potential users who are willing to meet the same conditions of service.

Respectfully submitted

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