

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 THE
NEWSPAPER ASSOCIATION OF AMERICA**

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The Newspaper Association of America (“NAA”), by its attorneys, hereby respectfully submits its initial brief in this proceeding.

I. INTRODUCTION AND SUMMARY

The Commission should reject the Postal Service’s unprecedented proposal to establish a unique, specially negotiated contract rate for a single large mailer, and specifically the proposed non-cost based volume discounts. Carving out contract deals with single mailers has no place in the nation’s postal system. Doing so violates both the letter and spirit of the Postal Reorganization Act.

Accordingly, the Commission should exercise its responsibilities under the Act by rejecting the proposed amendments to the Domestic Mail Classification Schedule and Rate Schedule that would implement the Negotiated Service Agreement (“NSA”) with Capital One Services, Inc. (“COS”). For much the same reasons, the Commission should reject the last-minute partial “settlement agreement” filed on March 31, 2003 – which is apparently the Postal Service’s currently proposed DMCS language.¹

¹ Although styled a “settlement agreement,” that document reflects merely a compromise among the three moving parties. The Postal Service did not discuss this potential “settlement” with NAA before it was filed. While the so-called “settlement” may have induced the OCA to abandon its own proposal, it does not address the issues of concern to NAA.

However, NAA commends the Postal Service for recognizing that its current pricing signals for undeliverable as addressed (“UAA”) First-Class Mail are fundamentally flawed, and that correcting those pricing signals offers promise for reducing unnecessary postal costs. In particular, the current bundling of “free” (but high cost) physical returns of UAA mail as a service feature of First-Class Mail, while a charge of 20 cents is imposed for the less costly and more efficient electronic returns, is not efficient pricing and raises costs pointlessly. NAA encourages the Postal Service and the Commission to look for ways to correct the “important issue” of the pricing of UAA returns (see Tr. 9/1868 (Plunkett)) that are nondiscriminatory and generally available. Indeed, NAA notes that Mr. Plunkett stated on rebuttal that the Postal Service is already reviewing the matter internally.

But rather than fix the problem directly by adjusting the generally available price signals for physical returns and electronic address correction to reflect the relative costs, the Postal Service offers this complicated, eight single-spaced pages, scheme in which it would contract with one selected high cost, national mailer substantial volume discounts and fee waivers – totaling perhaps as much as \$20 million – to induce it to engage in more desirable mailing behavior to “net” about \$8.2 million according to now-outdated estimates. The Commission should reject this approach completely.

Indeed, the particular proposal in this case illustrates some of the legal, economic, and policy shortcomings of negotiating postal rate and service deals. It improperly would shift the primary ratemaking responsibility from this Commission, to which Congress assigned it, to postal management, relegating this Commission to a passive reviewing role, and would violate numerous substantive provisions of the Postal Reorganization Act.

Any private carrier entering into such an arrangement would do so only after carefully and thoroughly analyzing the costs of serving the particular customer over the entire period of the agreement. The Postal Service, however, has premised its case upon estimates of asserted cost savings that do not purport to model the actual costs of handling Capital One's UAA mail and consider only one year's activities, and the record casts considerable doubt as to the numbers that the Postal Service did rely upon.

As a policy matter, the NSA would give a very large national mailer – one that imposes disproportionately high returns costs – volume discounted rates (and possibly more valuable free electronic address correction notices) for doing little more than engaging in desirable hygiene practices while other mailers who can and do engage in such practices, and presumably impose fewer costs on the USPS, pay full price. This odd approach will send very counterproductive signals to other mailers.

Finally, the NSA would also place the Postal Service squarely in the position of favoring one competitor in a downstream market over all of its rivals. This could lead to many undesirable consequences, none of which appear to have been considered in the Postal Service's direct case.

The belated "settlement agreement" filed on Monday of this week does nothing to cure these defects. A close reading indicates that the Postal Service has conceded very little, as it is still reserving full discretion regarding with whom it will negotiate, and on what terms. There is absolutely no commitment or assurance that any future NSA based on that footnote would confer the same discounted volume rates and fee waivers as Capital One would receive.² That is not "generally available," and the alternative now set out in the settlement should be rejected as well.

² NAA understands that the Office of the Consumer Advocate has conditionally withdrawn its alternative proposal of witness Callow, but only if the Commission accepts the "settlement."

II. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE'S PROPOSED NSA WITH CAPITAL ONE AS CONTRARY TO LAW

The Postal Service is a public service³ dedicated to serving all mailers on a nondiscriminatory basis, not cutting special deals to big mailers. The Postal Reorganization Act charges this Commission with recommending rates and classifications to ensure that the Postal Service offers services as a public service. The Commission supplies the only check for the Postal Service's stakeholders, and the only process of public review and participation, on what would otherwise be the unbridled discretion of postal management to set rates and fees however they may wish.

Congress charged this Commission with applying the Act's ratemaking and classification provisions to effectuate this congressional determination that postal services should be provided on a nondiscriminatory, public service basis. The contract with Capital One violates the Act in numerous ways.

First, the NSA is inconsistent with the structure of the Act, which presupposes that the Commission issues an independent recommendation of rates and classifications, not a review of a deal previously negotiated between the Postal Service and a large customer. That structure leaves no room for negotiated agreements with single mailers.

Second, the NSA's volume discounts and fee waivers unreasonably discriminate in favor of Capital One to the detriment of other mailers, in violation of Section 403(c). Nothing in the purported "settlement" rectifies this problem.

Third, the NSA improperly would substitute negotiating skill for the substantive criteria of the Act. Doing so would bring back into postal ratemaking precisely the type of politics and lobbying that Congress intended to eliminate by the Act.

³ 39 U.S.C. §101.

Fourth, NSAs in general would violate the “simplicity of rate structure” requirement of Section 3622(b)(7), including the requirement for “simple, identifiable relationships” between different rates and fees.

Fifth, the NSA’s volume discounts and fee waivers are unfair and inequitable in violation of Section 3622(b)(1), because rewarding one large mailer in that manner for taking mail hygiene steps for which other mailers pay is unfair to those other mailers who have thus far shouldered the cost of COS’s physical returns.

In addition to these factors, because this NSA applies to First-Class Mail, yet another barrier to its implementation is Section 3623(d) of the Act, which requires that the rate for First-Class Mail (the class for letter mail sealed against inspection) to “be uniform” throughout the United States. This NSA raises new and untested questions of the application of this provision, although by an arrangement by which Capital One pays a volume discount unavailable to any other First-Class mailer appears to violate this uniformity requirement on its face.

A. Single-Customer NSAs Are Not Permissible Under The Postal Reorganization Act

NAA respectfully submits that single-mailer NSA contracts, and specifically the one proposed in this proceeding, violate the Postal Reorganization Act in a number of respects.

1. The structure of the Act precludes single-customer NSAs

The Postal Reorganization Act does not allow for single-customer negotiated contract rates for domestic services. This is evident from the structure of the Act, the primacy of the Commission’s ratemaking role, and past decisions of this Commission.

First, the essentially passive review of a negotiated service contract is contrary to the active ratemaking role assigned to the Commission by Congress. It has been well established since the outset that postal “ratemaking authority [was] vested primarily” in this Commission. *National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810, 820 (1983) (citing S. Rep. No. 91-912 at 4 (1970)); see also *Time, Inc. v. United States Postal Service*, 685 F.2d 760, 772 (2d Cir. 1982). The role of the Governors is to set the revenue requirement and, within circumscribed limits, to act on the Commission’s recommendations, which are, in turn, based on extensive on-the-record adjudicatory proceedings.

The Commission’s ratemaking primacy is evident from the statute. It, and not the Service, conducts the on-the-record adjudication required by the Act. 39 U.S.C. § 3624. It makes independent recommendations on the basis of evidence compiled in an on-the-record proceeding. *Experimental Periodicals Co-Palletization Dropship Discounts*, Docket No. MC2002-3, Opinion & Recommended Decision Approving Stipulation and Agreement at 16 (Dec. 20, 2002). This careful statutory review supplies the only independent check on ill-advised USPS rate proposals. Where, as here, the USPS privately negotiates a special deal with a selected mailer, this independent review becomes more important.

The Commission must actively make a rate recommendation, and can initiate mail classifications. In contrast, the Postal Service’s more limited role is evident from the absence of a statutory requirement that the Service propose *any* particular rate changes at all. 39 U.S.C. § 3622(a). The Commission itself has also noted that the Act, unlike other regulatory statutes, does not have a mechanism whereby rate changes could, in the normal course, take effect without issuance of a formal recommendation. *Procedures for Consideration of Contract Rates*, 54 Fed. Reg. 47,223, 47,225 (Nov. 13,

1989) (rejecting petition by Advo for adoption of rules for consideration of contract rates). In short, it is the Commission, not the Postal Service that sets rates with the concurrence of the Governors.

The Commission itself has previously recognized that these considerations establish that the very structure of the Act makes it an active participant in the ratesetting process, and not a “mere reviewer of Postal Service proposals.” *Id.* at 47,224. The Commission noted “[t]he natural inference is that the ch. 36 process itself generates the rate change, and is not provided simply to review an otherwise independently effective rate change by the Postal Service.” *Id.* After careful consideration of contract rates in that 1989 proceeding, the Commission declined to establish rules for the consideration of contract rates, citing these statutory issues. Similarly, in 1995, the Commission again declined to create rules that would allow for review of contract rates, citing doubt as to their legality. 60 *Fed. Reg.* 54,981 (Oct. 27, 1995).

In short, under the Act the Commission affirmatively recommends rates. The Act does not contemplate that it engage in a *post-hoc* review of negotiated agreement with single mailer.

Second, not only does the Act assign the Commission an active ratesetting role, but also its structure does not contemplate setting customer-specific contract rates. By its express terms, the Act contemplates that postal rates are set by class and subclass; not by mailer. In particular, four of the ratemaking criteria established by Section 3622(b) expressly refer to the Commission recommending rates for classes of mail or types of mail service. In contrast, not one ratemaking criterion by its terms suggests that rates would be set for a single mailer.⁴ Similarly, Section 3623 refers specifically to

⁴ See also 39 U.S.C. § 3621 (referring to “classes of mail”).

“classifications” of mail, and nowhere contemplates a single-customer rate.⁵ This Commission has previously recognized the fact that “the Act speaks in terms of institutional cost contributions by classes of mail and types of mail service” – and not by mailer -- is of “great significance.”⁶

These statutory provisions lead to the conclusion that there is simply no room under the Act for single-mailer negotiated contract rates.⁷ It is no answer to say that a single-mailer NSA can be filed as a special classification limited to one mailer – as the proposed DMCS language in this proceeding does. The courts have already properly rejected such classification sleight-of-hand. *United Parcel Service, Inc. v. United States Postal Service*, 604 F.2d 1370, 1375-76 (3d Cir. 1979), *cert. denied*, 446 U.S. 957 (1980).

It is worthwhile, in this vein, to distinguish impermissible single-mailer contracts from what have become known as “niche” classifications. The latter, of which the Commission has approved several, are distinguishable. First, they are not limited to a single mailer. Instead, they address unusual needs of a particular grouping of mailers – precisely as contemplated by 39 U.S.C. § 3623(c)(5). Second, the niche classification is not based on a contract between the USPS and a mailer, and the Commission’s power to reject or amend the implementing proposal is unfettered. This contrasts with the NSA before the Commission now, as the underlying contract in this case specifically allows either Capital One or the Postal Service to terminate the contract if the

⁵ A “class” is a “grouping” of mail matter for the purpose of assigning it a specific rate. *National Retired Teachers Ass’n v. United States Postal Service*, 439 F. Supp 141, 147 (D.D.C. 1977), *affirmed*, 593 F.2d 1360 (D.C. Cir. 1979) (emphasis added).

⁶ 54 *Fed. Reg.* at 47,228.

⁷ In addition, the declining block rate structure for Capital One’s First-Class Mail on its face appears to violate the statutory requirement that the rates for sealed First-Class letters “shall be uniform throughout the United States.”

Commission does not approve the particular rates and classifications contained in the Request. See Request, Attachment G at 9.

2. The Commission has long rejected as contrary to law volume discounts based on market considerations rather than cost savings

This Commission has long rejected volume discounts that are not justified by solid evidence of cost savings as unreasonably discriminatory in violation of Section 403(c). The volume discounts in the proposed NSA are similarly not justified by cost savings, and are coupled with fee waivers that may be larger in amount. They should be rejected as unsound as matter of law and policy.

In Docket No. R87-1, the Commission rejected a Postal Service proposal for volume discounts in Express Mail. *Rate and Fee Changes*, Docket No. R87-1, Opinion and Recommended Decision, 747, ¶ 6020 (Mar. 4, 1988). Noting that the Postal Service had offered no evidence of cost differences that would justify a volume discount, the Commission noted that the USPS would “have to show how the rates comply with the prohibition, found in section 403(c), of undue or unreasonable discrimination among mailers and undue or unreasonable preferences to a mailer.”

Similarly, in Docket No. R90-1, the Commission again rejected a similar USPS proposal for a non-cost-based volume discount in Express Mail. *Rate and Fee Changes*, Docket No. R90-1, Opinion and Recommended Decision, V-387, ¶ 6533 (Jan. 4, 1991). The Commission again faulted the Postal Service for offering a discount based on marketing considerations rather than cost differences related to the volume levels. Responding directly to the USPS’s contention that volume discounts were necessary in order to meet volume discounts offered by private Express Mail competitors, the Commission stated: “The truism that large-volume customers have more options than smaller-volume customers is insufficient to show compliance with the

statute's requirement that the Postal Service, a part of the government, treat all its customers fairly." *Id.*⁸

In this proceeding, the Postal Service concedes that the declining block discounts offered to Capital One would, if allowed to take effect as proposed, result in an estimated \$6.7 million in discount leakage (loss) in the first year alone. Tr. 2/290 (Crum). This includes a "leakage" of \$4.9 million on volumes that the USPS's direct case assumed that COS would mail without an NSA. The USPS did not develop a projection of the negative contribution from the discounts in the second and third years of the NSA. See Tr. 4/763 (Plunkett).⁹ The total loss to the Postal Service in the first year, after taking the eACS fee waiver into account, approaches some \$20 million.

The Postal Service does not contend that these volume discounts are based on any cost savings associated with those particular volumes of mail. The USPS concedes that there is "no quantifiable rate relationship between the address element cost savings of the Capital One NSA and the volume discount element." Tr. 5/935. Dressing it up with a linkage to Capital One's UAA mail does not cure this failure. The USPS does not contend that they are a promotional discount. Tr. 6/748 (Plunkett). COS has made no threats to leave First-Class Mail. Tr. 6/714 (Plunkett); Tr. 2/70 (Jean). Nor has COS made any promises regarding increasing its use of First-Class Mail. Tr. 2/71 (Jean).

⁸ Notwithstanding these defeats, the USPS continued to advocate volume discounts throughout the 1990s. The June 1, 1992, Joint Task Force on Postal Ratemaking proposed the use of declining block rates for competitive services. *Postal Ratemaking in a Time of Change: A Report by the Joint Task Force on Postal Ratemaking* (June 1, 1992) (at 43-44). However, the Commission chose not to adopt rules to implement that proposal.

⁹ Witness Crum's estimate of loss contribution due to the volume discounts also did not take into account the alternative discount structure that would take effect if COS's volumes in the first year of the NSA fell below 1.025 billion pieces. Tr. 2/276 (Crum).

Instead, the declining volume rates are just part of the deal – and apparently a vital part to Capital One¹⁰ which, like any large mailer, would like to pay less postage. Granting such a volume discount simply amounts to discrimination in favor of national mailers to the comparative disadvantage of smaller local mailers. The Commission has never before approved a volume discount of this nature, and should not do so in this case.

3. Negotiating skill is not a statutory ratemaking criterion

One of the Congress's goals in enacting the Postal Reorganization Act was to "get politics out of the Post Office." *National Association of Greeting Card Publishers v. United States Postal Service*, 607 F.2d 392, 400 (D.C. Cir. 1979). In particular, Congress sought to put an end to the "political nature of postal ratemaking [that] in general attracted lobbyists into the ratesetting process and invited the abuses that not infrequently result from their influence." *National Association of Greeting Card Publishers v. United States Postal Service*, 569 F.2d 570, 588 (D.C. Cir. 1976), *vacated on other grounds sub nom. United States Postal Service v. Associated Third Class Mail Users*, 434 U.S. 884 (1977). To that end, a "major thrust of the postal reform effort therefore was to minimize this attraction of lobbyist influence." *Id.*

We have come full circle. The hearing record in this case makes abundantly clear that the rates that were negotiated in this case – and undoubtedly would be negotiated in any subsequent NSAs – are the product of, well, lobbying in the sense that they are the result of private discussions between postal management and the interested mailer. As such, the rates are simply the result "balancing the benefits" of the deal. Tr. 4/718 (Plunkett). The contract rates would split the "gain" from the deal

¹⁰ Indeed, Mr. Shippee of COS said the volume discounts are "at the heart of this deal." Tr. 9/1801.

between the USPS and the mailer “on the basis of relative bargaining power.” See Tr. 8/1642-43 (Panzar)

What this means is that the rates in this NSA, and presumably in any future contracts, are the result of negotiating skill, not of the Commission’s ratemaking expertise as intended by Congress. Oral cross-examination of USPS witnesses Bizzotto and Plunkett made quite clear that the USPS seeks to preserve the maximum flexibility to negotiate with whomever it chooses, on whatever terms that it can get, which easily could vary in each instance. Tr. 2/460-61(Bizzotto testifying about “prioritizing customers” for NSAs); Tr. 2/462 (Bizzotto testifying that “each one of these is unique”); Tr. 2/463 (Bizzotto testifying “no menu of service features”); Tr. 4/808-809 (Plunkett). The proposed new footnote in the DMCS language attached to the “settlement” – the USPS “may” enter into “comparable” NSAs -- adds nothing to what the testimony of USPS witnesses under oath that they would be willing to “talk” with other mailers. It confers no other mailer with a right to the same rates as Capital One.

Negotiating skill, however, “is not a recognized criterion under the Act.”

Procedures for Consideration of Contract Rates, 54 *Fed. Reg.* at 47,224. The statutory criteria set forth in Section 3622(b) at no point mention “negotiating skill” or “access to postal management” as permissible ratesetting criteria. As this Commission recognized in 1989, “To permit large mailers to negotiate special contractual deals” would only merely reinforce the public impression, that the Act sought to change, that “the influence of special interests had a determining effect on the structure of postal rates.” *Id.* (quoting comments).

The Postal Service might wish it were as free as AT&T to negotiate with whomever it wishes on whatever terms it desires, but it is not. Contract rates would

impermissibly resurrect lobbying and influence as major factors in postal ratemaking – practices that the Act was enacted to stop.

4. The NSA is inequitable because it deaverages rates by rewarding a high cost mailer for changing mail practices

The Capital One NSA violates the fair and equitable requirement in Sections 3622(b)(1) and Section 3623(c)(1). The NSA unlawfully deaverages rates in favor of a mailer responsible for disproportionately high physical returns costs by granting more favorable rates.

As noted earlier, the basic problem in this case is the irrational pricing signals provided by the Postal Service fees for physical and electronic returns. The higher cost physical returns are priced at a fee of zero, because physical returns are a bundled feature of First-Class Mail. Electronic returns are charged 20 cents each, although they are much less costly to the USPS than physical returns.

“Divergence from cost tends to send users inaccurate signals—ones that may lead mailers to adopt distribution strategies that are more costly than necessary.” *Mail Order Association of America v. U.S. Postal Service*, 2 F.3d 408, 436 (D.C. Cir. 1993). Comes now Capital One, using mailing lists that generate a whopping 10.6 percent rate of physical returns (plus an unknown number of UAA forwards), which has responded rationally to the Postal Service’s irrational pricing by insisting on its prerogative to receive physical returns at no extra charge. Because its physical returns rate is well above average, Capital One is a beneficiary of rate averaging in this respect. Tr. 4/803 (Plunkett).

In the NSA, the Postal Service’s proposed solution to the problem of a customer who benefits from intra-class averaging by engaging in high cost activity is to reward that mailer with volume discounts and fee waivers for shifting to lower cost practices. In

contrast, other First-Class Mailers that opt for CSR Option 2 will receive no financial reward for doing so, although they help reduce costs for all First-Class Mailers (including Capital One) by eschewing their rights to physical returns. Indeed, they will pay 20 cents per eACS for their trouble, and enjoy no volume discount.

Singling out COS for rate and fee breaks for using CSR Option 2, while all other First-Class Mailers will pay a fee for the same service, is unfair and inequitable. It rewards a mailer that imposes disproportionate costs for engaging in more desirable mailing practices, while the many other mailers whose mailings have never caused such high costs on the USPS get no direct benefit for being good citizens.¹¹

Thus, this NSA raises very troubling implications. It signals all mailers whose mailings impose disproportionate costs on the USPS that “engaging in high cost behavior [may be] a way to get a better deal with the Postal Service.” Tr. 6/1009 (Kent). This is not to say that mailers might deliberately begin to adopt higher cost practices. But Mr. Kent’s testimony does point out the obvious fact that, if the USPS now approaches a mailer to encourage it to, for example, shift from flat to letter-shaped pieces or to begin drop-shipping, the mailer might be well-advised to decline to do so unless offered a financial inducement in the form of an NSA.

5. NSAs, including this one, would violate the “simplicity” requirement of the Act

Section 3622(b)(7) of the Act provides that, in setting rates, the Commission shall consider the:

Simplicity of rate structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services.

¹¹ A surcharge for COS's high physical return rate would be a more cost-based and direct remedy.

The COS NSA, the OCA's alternative proposal, and the "settlement" language all would violate this "rate simplicity" requirement.

The current rate schedule for First-Class letter Mail consists of one page. *E.g.*, Docket No. R2001-1, Opinion and Recommended Decision, Appendix One at page 3 (March 22, 2002). The COS NSA alone would add two more to the rate schedule. Request, Attachment B. It would also add three pages to the First-Class Mail classification schedule. Request, Attachment A. In addition, an interested person would also need to refer to the 8 single-spaced pages of substantive provisions in the NSA agreement itself. See Request, Attachment G. One can only imagine how many more pages would be generated from the 8 to 10 possible NSAs (all different) for other credit card companies alone mentioned by Mr. Plunkett (Tr. 9/1890), not to mention NSAs for other customers or in other classes as well.¹²

The Court of Appeals applied this provision in *United Parcel Service v. USPS*, 184 F.3d 827, 845 (D.C. Cir. 1999), when it affirmed the rejection of a separate rate for "local only" mail processing. The Court noted: "A separate rate for every group of mailers with special cost savings, no matter how small the group, would produce a hopelessly complicated rate schedule." See also *Mail Order Association of America v. USPS*, 2 F.3d 408, 437-38 (D.C. Cir. 1993). This multiplying of pages in the rate schedule to accommodate NSAs would be the antithesis of rate simplicity.

B. The Proposed NSA Violates The Commission's Own Recent Interpretation Of Section 403(c)

In its non-binding February 11, 2002, Report to Congress, the Commission stated that "rate and service adjustments agreed upon by the Postal Service and

¹² It is instructive that, when AT&T was still required to file its contract tariff arrangements at the Federal Communications Commission pursuant to a statute that does not contain a rate simplicity provision, the number of contract tariffs on file with FCC was well into the thousands.

mailers are legally authorized if three conditions are satisfied: (1) proposal reviewed in a public proceeding; (2) the agreed-upon rate and service changes will work to the mutual benefit of mail users and the postal system as a whole; and (3) the rate-and-service package is made available on the same terms to other potential users willing to meet the same conditions of service.¹³ Although NAA respectfully disagrees with that legal standard,¹⁴ even under that test the Capital One contract must be rejected. The Postal Service has failed to prove that the second and third criteria are satisfied by this proposal.

1. The Postal Service has failed to prove that it will benefit from the NSA

Under the Commission's test, the Postal Service must prove that it would benefit from the NSA. It has utterly failed to make that showing in this case. Indeed, the numbers upon which its direct case relied appear no longer to be valid.

The Postal Service's direct case based its "net benefit" on an analysis purporting to show that the NSA would generate a net positive contribution of \$8.2 million. USPS-T-3 (Crum).¹⁵ That analysis relied on three components:

- A "leakage" of \$6.7 million in contribution from the declining block volume discounts (this includes leakage from volumes that COS was projected to mail in the absence of the NSA);
- New contribution of \$1.8 million from "new" volume generated by the volume discounts; and

¹³ Report to the Congress: 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, Postal Rate Commission (Feb. 11, 2002).

¹⁴ NAA is pleased by the Chairman's statement at the prehearing conference that the Commission could revisit this conclusion after reviewing the legal and policy arguments. Tr. 1/9.

¹⁵ This \$8.2 million is substantially less than the surplus the Commission projected in its recommended decision in Docket No. R2001-1 for the Test Year in this case. See Opinion and Recommended Decision, Appendix G, Page 1. This means that whether the NSA is approved or not would have no material effect on the Postal Service's finances within the meaning of 39 U.S.C. §3625(d), although it could have dramatic effects on private firms.

- Estimated cost savings of \$13.09 million due to reduced physical returns.

In short, the USPS relied on estimated cost savings from reduced physical returns as the basis for claiming a net positive contribution from the NSA.

These numbers, touted with fanfare at the outset of the case, are no longer operative. Since the case was filed, the volume projections with which the case began were abandoned in rebuttal testimony. See Tr. 9/1843 (Elliott) and Tr. 9/1809 (Shippee endorsing new Elliott forecasts). Furthermore, the hearing cast substantial doubt on the estimates of cost savings upon which the proposal originally relied. In particular,

- The USPS failed to identify and model the USPS's actual costs of returning (and forwarding) COS's mail – the very cost savings on which the NSA's entire justification rests, and a fundamental predicate to any negotiated service agreement in the private sector;
- Confining the analysis of financial effects of the NSA to the first year, instead of considering the entire three-year period, including reasonably anticipated changes in the USPS's methods of processing UAA mail, prevents full consideration of the effects of the contract;
- The cost of providing electronic address correction service for returns appears understated, which means that the asserted cost savings from substituting electronic for physical returns may be overstated;
- The revenue loss is underestimated due to the complete omission of any consideration of the value of the waived fees, which are far greater than the claimed savings; and
- The omission of any consideration of the costs of provided eACS for COS's forwarded UAA mail means that costs are underestimated, while there is no reliable basis for calculating offsetting savings.

In short, not only are the volume and cost bases for the original \$8.2 million figure no longer valid, but the record does not support any substitute number.

a. The Postal Service's failure to identify and model the costs of returning Capital One's mail, and thus the cost savings that it may actually realize, makes its analysis unreliable

Both Mr. Kent and Professor Panzar testified, based on their extensive experience in advising regulated utilities, that when a regulated entity such as the Postal

Service is “basing cost savings on altering the cost behavior” of a large customer, “it is important to understand that customer’s specific costs, and not simply to base the estimated savings on averages.” Tr. 6/1010 (Kent); Tr. 8/2662-63 (Panzar). This can be a difficult analysis, but one that is essential to a serious determination of the costs that can be saved from a new service arrangement. As Professor Panzar stated, identifying the particular costs of serving a particular customer is “sometimes quite a complicated problem” and there often exists tension between the marketing department trying to make sales and the cost analysts trying to determine profitability.

This is important because, as filed, the Postal Service’s estimated net benefit leaves relatively little margin for error, in light of the billion or more pieces of First-Class Mail sent annually by Capital One. Yet the Postal Service made no attempt to model its costs of handling Capital One’s undeliverable as addressed mail. What the Postal Service offers instead is the use of First-Class average costs, with a few adjustments. Tr. 4/761 (Plunkett). This is simply not enough.

As the record stands today, the *actual costs* incurred by the Postal Service in returning COS’s mail are unknown, as are *the savings it can reasonably expect to realize* from the NSA arrangement. In particular, the Commission has been presented with no evidence of the actual cost of processing COS’s UAA mail,¹⁶ with almost no evidence as to how that mail is returned (for example, whether COS’s large volumes may be collected at some postal facilities and returned in bulk, rather than

¹⁶ The USPS does not know, for example, the proportion of COS’s returned pieces that receive more than one outgoing sort on the return trip, or that receive only one incoming sort. Tr. 5/905.

individually),¹⁷ and with hardly any evidence as to what actually occurs when the returned mail arrives in Richmond.¹⁸

Mr. Kent's testimony suggested reasons why the Postal Service's reliance on average returns costs for First-Class Mail could well be overstated. These include, for example, the fact that average costs include pieces that may be more costly to return than COS's. The Postal Service essentially assumed that COS's physical returns are handled like any single piece returns, and did not consider whether the large volumes of COS returns may generate cost efficiencies today. Mr. Kent also noted the complete omission from the USPS's cost testimony of any discussion of the planned introduction of the PARS program, which is designed to reduce the costs of handling UAA mail still further. Tr. 6/1-1010-12 (Kent); Tr. 5/889-91 (PARS will reduce manual processing of UAA mail). It is reasonable to believe that COS's barcoded and professionally prepared mail may impose lower costs, when UAA, than the average First-Class Mail piece.

The rebuttal to Mr. Kent's testimony was that there may be *other* factors that could cause COS's mail to be less costly than the average piece. *But there is no real evidence as to which is correct!* All that is known for sure is that the USPS does not know – because it has not attempted to model the costs -- either the actual costs of handling COS's UAA mail, or the costs that it would avoid if the contract were to take effect. But both of these numbers are essential to this NSA.

¹⁷ The USPS has confirmed that this may occur. Tr. 5/881. Given the volumes of COS's returns, it is reasonable to assume that this occurs in at least some postal facilities. But such bulk handlings would tend to reduce the average cost of returning a COS piece.

¹⁸ Symptomatic of this failure is the fact that only two of the USPS witnesses in this case had made the short trip to Richmond, Virginia, to review the mailing operations there, and apparently neither saw COS physical returns being handled. Note Tr. 5/904 (USPS stating "apparently" all handling now is done at the Richmond PD&C).

b. The Postal Service improperly ignored known upcoming changes to its processing of UAA mail

The Postal Service's direct case included calculations of the costs of returning COS's UAA mail. There are at least two problems with these calculations.

First, the record is unclear regarding the extent to which the FY2000 IOCS data upon which the USPS's cost averages are based reflect current and future processing of returns. Tr. 6/1012 (Kent).

Second, the Postal Service's calculations completely ignored the planned implementation of the PARS systems for returns and forwards in 2003, which should reduce the cost of returning mail throughout the proposed duration of the NSA. Tr. 6/1012 (Kent).¹⁹ Although PARS will automate manual procedures currently used to handle UAA mail, the USPS omitted these changes from its cost estimates. Tr. 4/777 (Plunkett).

In an effort to downplay this omission, the USPS has suggested that PARS will have only a limited scope and may not affect very much COS mail during the three years of the NSA. Tr. 5/889-892 (USPS). However, according to the Postal Service, PARS should process about one-third of all machinable UAA mail in FY05, and will begin in at least FY04. Tr. 5/891. Whether that position is well-founded is difficult to assess, given the state of the record on the PARS program and the USPS's own failure to model the handling of COS's returned mail.

The USPS has not provided any estimate of cost savings for FY04 and FY05. However, the important point is that the Postal Service has in effect conceded that the PARS program will change the assumptions upon which the NSA relies. The amount of those changes is unknown.

¹⁹ The USPS states that Phase I of PARS deployment will begin in July 2003. Tr. 5/891.

The omission of any accounting for a major innovation in the handling of exact type of UAA mail at the heart of this NSA should give the Commission considerable pause. The Commission would be on sound ground to believe that PARS will reduce the costs of handing COS's UAA mail to some extent. The burden is on the USPS to show by how much, which it has failed to do.

c. Consideration of the second and third years of the NSA is necessary

The Postal Service's financial justification of the NSA addresses only its first year. See USPS-T-3 (Crum) (analysis limited to FY03); Tr. 5/870 (USPS has conducted no cost roll-forward analysis for years two and three). The failure to consider fully the financial implications of a three-year deal is astonishing.²⁰ No private regulated firm would enter into such a contract without fully considering the financial consequences over its full term. As Mr. Kent testified:

“A regulated firm operating under the break-even constraint of the Postal Service should not entertain a multi-year arrangement such as this one without giving fuller consideration to the financial impacts in the second and third years. If the USPS does not realize its projected cost savings (such as if it has overstated the actual cost of handling COS's mail) and actually does lose money, other mailers will pick up the tab.”

Tr. 6/1007.

The Postal Service has advanced several rationales for these omissions. See Tr. 4/763 & Tr. 5/869 (Plunkett). These include the custom of a single-year test year, the belief that the “benefits” of the deal will be immediate, rather than gradual over time, and certain sensitivity analyses. None is persuasive.

²⁰ The Governors apparently were presented with an analysis covering only the first year (the forerunner to Mr. Crum's testimony). Tr. 4/797 (Plunkett). Postal management considered a version of the “sensitivity analysis” supplied by Mr. Crum in response to APWU/USPS-2. Tr. 4/798 (Plunkett).

The reliance on the single year test year is particularly unavailing. When customer-specific pricing and projected tailored cost savings are the issue, consideration of all years of a multiyear NSA is vitally important. The USPS's assertion that this NSA is "really no different than those present in the overwhelming majority of Commission proceedings" is simply incorrect. Tr. 5/869. On the contrary, a NSA is far different from a more conventional case. In particular, omnibus cases involve analyses of rates and costs on a systemwide basis. They do not involve costing and pricing of company-specific contracts and service arrangements where net benefits and costs may turn on very individualized facts. Indeed, although the Postal Service has not invoked the rules for multiyear test periods for new services (39 C.F.R. § 3001.181), those rules demonstrate the Commission's recognition that a "test period" of more than one year can be appropriate in particular instances.

Nor does the possibility that operational changes stemming from the NSA may reduce costs immediately dispose of the matter. It is not clear how rapidly some changes (such as Capital One's ceasing to send subsequent mailings to addresses that generate returns) will occur. Furthermore, consideration of the second and third years is necessary in order to take into account likely changes in costs that would occur in any event over the three-year duration. The implementation of the PARS system is one notable change that should reduce the costs of handling UAA below the levels that Mr. Crum used in supporting the case. Another factor to consider is that the Postal Service did not obtain from Capital One any estimate of its solicitation volume beyond the first year of the NSA.

The Postal Service's "sensitivity analysis" – which is no substitute for actually studying the costs -- does not cure these ills. Its fundamental flaw is that the costs upon which it depends are simply the average First-Class costs upon which it relies

throughout the case, rather than the actual costs of serving COS that it should have been modeled, but never were.

Regulated firms do not enter into a multiyear contract without a very clear understanding of its costs over the entire period. A “business-like” Postal Service should be no different. The fact that other mailers, not shareholders, bear the brunt of any losses only heightens the need for a more definitive assessment of the net effect of the contract over the entire period.

d. The Postal Service’s estimate of the cost of providing eACS in lieu of physical returns is unreliable

The Postal Service estimates that the cost of an electronic return is \$0.1450. USPS-LR-1/MC2002-2, page 2 (Crum) (cost of eACS). The source for that figure is Tab 3 of USPS Library Reference J-69 from Docket No. R2001-1.

In response to a question asked during the hearing, Mr. Kent pointed out that the \$0.1450 figure appears to understate the cost of providing an electronic return. That is because the \$0.1450 figure is a weighted average of two cost components of ACS notifications: ACS COA notification (\$0.0997/piece) and ACS nixie processing (\$0.2074/piece). Mr. Kent noted that although the (higher) ACS nixie processing costs are solely associated with returns (a fact that Mr. Plunkett confirmed on rebuttal at Tr. 1896), the ACS COA notification cost is for forwards. Using that lower cost for forwards in computing the cost of electronic returns would understate the cost of electronic returns, meaning that the cost of electronic returns is higher than the \$0.1450 figure used by Mr. Crum. Consequently, the Postal Service’s estimate of cost savings arising from substituting eACS for physical returns is too high.

On rebuttal, USPS witness Plunkett testified that the \$0.1450 cost is correct for the eACS portion of COS electronic returns for a variety of reasons. Tr. 9/1872. First,

he contended that the ACS COA notification portion of the weighted average includes not only forwards, but also some returns such as due to an expired forwarding order. Tr. 9/1872. However, Mr. Plunkett did not know what proportions of eACS COA notifications were for forwards and or for returns. Tr. 9/1896. However, he conceded that when the ACS COA notifications were weighted to arrive at the \$0.1450 figure, the costs of forwards were included in that weighting. Tr. 9/1897.

During oral cross-examination by counsel for COS, Mr. Plunkett offered another justification, asserting that the COA portion of the weighted average really pertains to the cost of mechanized terminals and the nixie portion really pertains to the cost of non-mechanized terminals. He went on to say that because COS mail is primarily comprised of letters which can be processed on mechanized terminals, using the weighted average of \$0.145 is conservative. Tr. 9/1959-1960.

Mr. Plunkett's attempted justification of the \$0.145 cost depends on several assumptions. First, to accept his testimony, one must assume that Tab 3 of LR-J-69 is improperly labeled and that the COA cost does not apply to the ACS cost for change of addresses, but for processing mail on mechanized terminals. Second, one must assume that the nixie-processing cost in Tab 3 really applies only to mail handled on non-mechanized terminals. If these two assumptions are correct, this must mean that 58% of ACS mail currently is processed on mechanized terminals and 42% must be processed on non-mechanized terminals. This last assumption seems unrealistic. It seems highly unlikely that the percentage of ACS mail that can be handled only on non-mechanized terminals is as high as 42%. That, in turn, supports Mr. Kent's contention that the \$0.1450 cost for eACS providing in lieu of physical returns is in error, and that the true cost is greater.

e. The value of the fee waivers should be included in the “net benefit” analysis

One element of the NSA that received comparatively little attention is the Postal Service’s waiver of the 20 cent fee for each electronic address correction. The Postal Service did not include the value of that waiver in its financial “net benefit” analysis.

The fee waivers should be included in the cost of this NSA to the Postal Service. They are hardly insubstantial. The value of these fee waivers could range between \$15 and \$26 million – above and beyond the volume discounts. Tr. 6/1009 (Kent).²¹ These sums dwarf both the value of the volume discounts and the Postal Service’s claimed net benefits.

Capital One supports the USPS, insisting that these waived fees should not be considered in the financial calculations because it never would pay them, preferring instead to insist of its right to physical returns rather than pay 20 cents per eACS. Capital One and the Postal Service are incorrect.

First, the waived fees are lost revenue from the arrangement in the contract. The Postal Service would provide a service – eACS – to Capital One that it does not now provide. When the USPS provides that eACS for any other mailer, it would receive the fee. It is appropriate to include their value in the analysis.

Second, the Commission could well not accept COS’s representations. This issue presents a classic example of what Dr. Eakin called “asymmetric information” regarding the comparative “baseline.” Tr. 10/2092 & 2117. No one outside of Capital One really knows whether it might choose to pay eACS fees in the future, and it has every reason to assert in this case that it would not.

²¹ Footnote 10 to Mr. Kent’s testimony supplied the calculations supporting these estimates.

But there are several reasons why it might. First, substituting eACS for physical returns should reduce COS's own costs in dealing with the physical returns in Richmond by some amount. Second, and more importantly, Capital One rebuttal witness Shippee conceded that the receipt of electronic address correction would be "of great value" to COS. Tr. 9/1833. Mr. Shippee said, in response to a question from Vice Chairman Covington:

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 don't get to the intended recipient.

Tr. 9/1832; *accord* Tr. 2195 (Jean). This "great value" is evident, and would come from the eACS. Capital One's position apparently means that the great value it would obtain from eACS is not worth its paying 20 cents (less than the rate for a single letter). The Commission would be well justified in treating Capital One's insistence with skepticism.

f. The Postal Service's failure to consider forwarding costs and savings casts further doubt on the NSA's soundness

The Postal Service's direct case did not consider the effects of the NSA on the costs and savings associated with COS's forwarded mail. Tr. 5/862. That is because the Postal Service does not have a sufficiently good grasp of those costs for the filing.

The Postal Service's lack of data about COS's forwards should be a cause for concern. This is because the NSA would require the USPS to incur costs to provide eACS for COS mail that is being forwarded today and would continue to be forwarded if the NSA were implemented. Tr. 3/560 (Wilson). This will require the Postal Service to incur additional costs, and the amount of these costs is simply not known.

To know the cost of providing eACS for COS's forwarded mail, one must know: (1) the percentage of COS solicitation mail forwarded; (2) the percentage of COS

solicitation mail forwarded through the Computerized Forwarding System; and (3) the cost of providing eACS for forwards. Tr. 6/1014 (Kent). Unfortunately, this proceeding has made apparent that neither the Postal Service nor COS knows either (1) or (2), and it is slightly in error as to (3). Tr. 3/575 (Wilson).

In this case, the Postal Service has assumed that COS's forwarding rate is equal to the average forwarding rate for First-Class Mail. Tr. 5/859-61 (Crum); *accord* Tr. 3/552 (Wilson). For its part, Capital One has no information that would support or undermine that assumption that Capital One's First-Class Mail is forwarded at or below the average rate. Tr. 2/107 (Jean). While this may be a correct assumption, it is not intuitively obvious due to the fact that Capital One's return rate is far above the average for First-Class Mail.²²

As for the second factor, all CSR, Option 2, forwarded mail should go through CFS. Tr. 6/1016 (Kent). Thus, a conservative estimate for the percentage of COS mail forwarded through CFS would be 95%. The USPS offered no rebuttal to this point.

As for the cost of eACS, Mr. Crum used a cost of \$0.066 for providing eACS for forwarding mail (a different figure from the \$0.1450 cost used – incorrectly – as the cost of an electronic *return*). He admitted, however, that the true figure would be slightly higher. Tr. 6/1016.

Offsetting these costs to some degree should be some reduction in the amount of forwarded COS mail, since providing eACS for forwarded mail should reduce the number of repeat forwards.²³ The record contains considerable speculation as to

²² An alternative calculation would apply the ratio of returned COS mail to the system average to estimate Cap One's forwarded mail. This calculation produces an estimate that some 15.3 % of Cap One's mail is forwarded. Tr. 6/1015 (Kent).

²³ Using the USPS's non-modeled average costs, the cost difference between a forwarded piece and a regularly delivered piece is 30.6 cents. Tr. 6/1018 (Kent). The true cost, of course, is unknown.

whether this would be a large or small number, but does not provide a sound basis for identifying this number. However, this is an important number, and the existence of this unknown should caution against approving the NSA.

If the USPS is correct that COS's forwarding rate is close to the system average, the cost savings from avoided forwards would be less than if the percentage of forwards is higher. If COS's has only an average (or less) number of forwards, then there would be fewer repeat forwards and, accordingly, a smaller amount of cost savings.

g. The Postal Service has ignored the possible loss of institutional cost contributions from Capital One mail that might shift from Standard Mail

The Postal Service's analysis does not consider any possible losses of contribution if COS were to shift mail from Standard to First-Class Mail in order to reach the discount threshold. Although this omission is problematic in its own right, Dr. Elliott's rebuttal testimony indicating that Capital One's volumes may fall below the 1.225 billion piece threshold increases its significance. See Tr. 9/1844-45.

The Postal Service assumed that there will be no migration of Standard Mail solicitations to First-Class Mail in order to satisfy the volume thresholds for the discounts. Tr. 2/280 (Crum). Capital One's testimony is less clear. Although Dr. Elliott does not forecast any shift, Mr. Jean – the Capital One business witness – says merely that he expects no "significant" shift. However, he leaves open the possibility of some, although he does not attempt to quantify the volume. Tr. 2/66.

Nonetheless, there are several reasons to believe that some migration may occur. First, the Postal Service assumption of no migration conflicts with its own volume forecasting models, which show a price-elasticity effect between First-Class Mail and the Standard Regular mail used by Capital One.

Second, it is readily conceivable that Capital One could be tempted to shift some Standard Mail solicitations to First-Class in order to reach the discount threshold if it otherwise might fall just shy of a discount threshold. This would not be difficult to do, as Capital One, on occasion, has used both Standard and First-Class Mail for the *same* solicitation campaign with the *same content*. Tr. 2/67 & 93 (Jean). This must mean that, for at least some marketing campaigns – the two classes are substitutes for one another. And Capital One uses sealed envelopes for its Standard Mail solicitations as well as for its First-Class Mail solicitations. See Tr. 2/65 (Jean).

As noted, the Postal Service assumes no loss of contribution from migration away from Standard Mail. Any such migration would reduce the alleged net gain in contribution by about 7 cents per piece (see Tr. 9/1865 (Plunkett)), an amount not included in the Postal Service’s calculations.

2. The NSA is not available on the same terms to other potential users

By its very terms, the proposed DMCS language is limited to Capital One. See Request, Appendix G; Tr. 5/897.²⁴ For three years, only Capital One would receive the non-cost based benefits it negotiated for itself. Confining the NSA to a single mailer in this way violates well-established principles of non-discrimination in regulatory law, and Section 403(c) of the Act specifically. And this defect is not cured by the Postal Service’s last-minute offer to modify its proposed DMCS language as part of a “settlement” with the OCA.

²⁴ The Postal Service suggests that the Capital One NSA might, after three years, be considered for permanent status. Then again, it might not. Cross-examination of Mr. Plunkett elicited the admission that the Postal Service apparently has given no thought to, in time, making the NSA a permanent classification. Tr. 9/1894.

The USPS is “a public utility,” a common carrier of postal mail. *UPS Worldwide Forwarding, Inc. v. United States Postal Service*, 66 F.3d 621, 637 (3rd Cir. 1995); *Sea-Land Service Inc. v. Interstate Commerce Commission*, 738 F.2d 1311, 1317 (D.C. Cir. 1984). In *Sea-Land Service Inc.*, the U.S. Court of Appeals unequivocally held that even where common carriers are permitted to offer individual contract rates, they may do so consistently with the principle of nondiscrimination only if carriers “make [the contract rates] available to *any* shipper willing and able to meet the contract’s terms.”²⁵ Courts and federal agencies have analogized this principle to multiple common carrier contexts, including mail carriage.²⁶

This, however, the Postal Service has refused to do.

On the contrary, the Postal Service has consistently maintained that other mailers would go through the same process of negotiations and Commission hearing. It stated this most clearly in its institutional response to NAA/USPS-4. Tr. 5/897-99. The so-called “settlement agreement” between the Postal Service, OCA, and Capital One *does nothing* to change this position. There is no assurance either under the USPS proposal as filed or as recast by the “settlement” that a similarly situated mailer could obtain the same contracted discounts and waivers as Capital One.²⁷ To say that another mailer perhaps could mail at the same contracted rates, but only after negotiating a separate deal and a Section 3624 case, is as far from a generally

²⁵ *Sea-Land Service Inc. v. Interstate Commerce Commission*, at 1317 (emphasis added). See also *MCI Telecommunications Corp. v. FCC*, 917 F.2d at 34 and 7 CFR § 69.727(a)(2)(i) (allowing certain local telephone carriers to enter into contracts if “services are made generally available to all similarly situated customers”)

²⁶ This principle was applied in the postal context in *UPS Worldwide Forwarding, Inc. v. United States Postal Service*, 66 F.3d 621, 635 (3rd Cir. 1995) (every international service agreement must be available to similarly situated customers under similar circumstances and conditions).

²⁷ The USPS may also contend that there is no other mailer “similarly situated” to COS. This is immaterial. The fact of the matter is that the plain terms of the NSA precludes any other mailer from claiming the same rates and obligations as of right, and that is in itself improperly discriminatory.

available offering as could be imagined. Consequently, the NSA is unjustly discriminatory and must be rejected by the Commission.

Instead, the USPS consistently seeks to reserve maximum discretion to negotiate with whom it pleases for whatever terms it pleases. Under both versions of the DMCS language, the Postal Service would reserve full discretion to determine whether “there [are] other mailers” that fit Capitol One’s profile of “usage and growth potential” and whether “it could be beneficial to enter into a similar arrangement with those mailers.”²⁸

The Office of the Consumer Advocate filed testimony that attempted to correct this flaw by proposing an alternative discount structure that would be more open to other mailers. This was intended to advance the Postal Service’s initiative to reduce UAA costs, but in a less discriminatory manner. That proposal, whatever its other flaws, did have the virtue of addressing the inherently discriminatory aspect of the COS NSA. Unfortunately, the OCA has apparently settled for an inferior option that, in effect, requires the USPS to do nothing other than what it had already said it is willing to do – that is, talk to mailers about other NSAs – but does not obligate the Postal Service to correct the inefficient UAA pricing signals for other mailers generally.

III. THE TESTIMONY OF PROFESSOR PANZAR REGARDING DOWNSTREAM EFFECTS PROVIDES ADDITIONAL REASON FOR REJECTING THE NSA

The economic testimony of Professor Panzar demonstrates that the proposed NSA is far more complex, as a matter of economics, than as presented in the Postal Service’s case. These complexities provide an additional reason why it should be rejected.

²⁸ USPS-T-2 at 8 (Plunkett).

First, Professor Panzar observes that the conventional assumption that an optional tariff is beneficial to the vendor – an assumption underlying the testimony of USPS witnesses Bizzotto and Plunkett – “relies heavily on the assumption that the vendor [here, the Postal Service] is a profit seeker.” Tr. 8/1581 (Panzar). But the Postal Service is not a profit seeker. By law, it is forbidden to act as a profit maximizer; rather, it must operate on a break-even constraint.²⁹ Accordingly, the assumption is unfounded.

Professor Panzar’s testimony also refutes the contention that the volume discount aspect of the NSA is in the public interest. As he observes, the basic analysis of optional tariff offerings – that advanced, for example, by the Postal Service – is that, in economic jargon, the demand of the different mailers are independent. But Professor Panzar correctly notes that this assumption does not hold where the service being purchased – here, the postal handling and delivery of solicitation and account mail – is itself an input into a different final product market – here, credit cards. Tr. 8/1582. That analysis becomes far more complex.

As Professor Panzar states, the selective offering of a discount to a large mailer “allows final consumers’ purchases and associated mail volumes to shift from mailers purchasing according to the standard tariff toward mailers availing themselves of the discounts incorporated in the optional tariff offering.” Tr. 8/1582. The same effect was acknowledged by Dr. Eakin. Tr. 10/2139 (noting that competitors of the NSA recipient are worse off). And that concern, expressed by witnesses Panzar and Eakin in economic terms, is precisely the concern expressed, in practical business terms, by

²⁹ It is not entirely clear what the USPS seeks to maximize. Apparently its focus is on maximizing volume – thus its anxiety about the possible loss of First-Class Mail to electronic alternatives. What is clear is that by law it cannot be seeking to maximize profit. Redefining “profit” to mean “contribution” – as the USPS seeks to do, does not salvage the point, because the Postal Service institutionally does not have the incentives of a private, profit-maximizing, shareholder-owned firm.

National Newspaper Association witness David, who eloquently described the consequences to a small community when the large business takes advantage of volume discounts to harm the small, local businesses. Tr. 6/974-87. Whether the companies concerned are WalMart or the banking industry, the phenomenon is much the same. Tr. 8/1668 (Panzar).

But more importantly, Professor Panzar further points out that a different analysis is necessary for a postal services to business users, which are an input to a final product. He points out that the demand curves of competing firms, such as Capital One and other credit card issuers, “are necessarily interdependent.” Tr. 8/1589. The consequence of that is to destroy any presumption that optional rates, such as the NSA, are efficient. Tr. 8/1591. Instead, a welfare shift occurs in favor of the favored firm. *Id.*

On this issue, the cross-examination of witness Posch speaks volumes. Mr. Posch’s testimony endorsed NSAs generally. This is no surprise, as his company is negotiating one with the USPS and its outcome depends on this case. Tr. 10/1994-95. But when Mr. Posch was asked what he would do if his company’s competitor negotiated a lower postal rate than did his, he responded that he would want to consult with his legal counsel to see if it were open to him and others. Tr. 10/2001.

Indeed, Professor Panzar’s testimony suggests that the only situation in which NSAs with postal business customers theoretically might benefit the public interest would be where the Postal Service enters into NSAs with every firm that competes in the same market. Tr. 8/1593. Dr. Eakin seemed to agree with Professor Panzar. Tr. 10/2139. This would tend to make the offering less discriminatory.

The testimony from the standpoint of economic theory is clear that an NSA can, and usually will, have effects in “downstream” or “secondary” markets – the markets in which the favored mailer competes. That is confirmed by the practical testimony of

National Newspaper Association witness David and the cross-examination of PostCom *et al.* witness Posch. These effects greatly complicate the consideration of an NSA offered by the federal government, such as this one.

IV. THE COMMISSION SHOULD REJECT THE PROPOSED NSA BUT ENCOURAGE REFORM OF THE PRICING OF ADDRESS CORRECTION SERVICES TO REDUCE COSTS FOR UAA MAIL

Although the proposed NSA must be rejected for numerous reasons, the record in this proceeding compels the conclusion that substituting eACS for physical returns offers considerable promise for reducing costs. NAA encourages the Commission and Postal Service to correct the irrational pricing of physical returns and electronic ACS services. This should enable the Postal Service to reduce costs.

Today, the Postal Service provides for free physical returns of UAA First-Class Mail as a bundled service feature of the class, at no marginal cost to the mailer. In contrast, the Postal Service charges 20 cents for electronic address correction, despite the fact that eACS is less costly than physical returns. In short, the current pricing of physical and marginal returns perversely encourages mailers to choose the option that imposes the greatest costs on the Postal Service, and that costs them nothing.

This case magnifies the problem, because it involves the largest First-Class mailer, which has chosen the higher cost (to the Postal Service) option. However, the problem affects all First-Class mailers. The Postal Service should fix the problem directly in a generally applicable manner.

In Mr. Plunkett's rebuttal testimony, he conceded that "This case has brought to light important issues relating to the pricing of address correction services, and the associated operational impacts." Tr. 9/1868. He further testified that the Postal Service is now reviewing the issue internally. Tr. 9/1876; see *also* Tr. 5/941 (USPS

institutional). If this leads to a generally available solution without the unnecessary discounts in the proposal, it would be a welcome development.

NAA urges the Commission and Postal Service to correct the irrational pricing of address correction services in a more comprehensive manner.

V. CONCLUSION

For the foregoing reasons, the Newspaper Association of America respectfully urges the Commission to recommend rejection of the changes to the Domestic Mail Classification Schedule that would implement the negotiated service agreement with Capital One. NAA does encourage the Commission and Postal Service to explore further the possible savings to the Postal Service from correcting the pricing irrationality of electronic and physical returns in First-Class Mail.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the instant document on all participants requesting such service in this proceeding in accordance with section 12 of the Rules of Practice and the Presiding Officer's Rulings.

April 3, 2003

William B. Baker