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WASHINGTON, D.C. 20268-0001

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

OFFICE OF THE CONSUMER ADVOCATE COMMENTS CONCERNING PROCEDURES FOR FUTURE NSAs

(April 3, 2003)

The Office of Consumer Advocate (OCA) hereby submits suggestions for the adoption of Commission rules to be applied to future requests of the United States Postal Service for negotiated service agreements.

Respectfully submitted,

SHELLEY S. DREIFUSS
Director
Office of the Consumer Advocate

EMMETT RAND COSTICH
Attorney

1333 H Street, N.W.
Washington, D.C. 20268-0001
(202) 789-6830; Fax (202) 789-6819

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The OCA respectfully requests that the Commission view these Comments as *prospective* in their application. OCA readily admits that, over the course of this proceeding, its views have evolved concerning the importance of certain issues and how best to resolve them. It is to be expected that a NSA proceeding of first impression will not be supported by as complete an evidentiary record as future filings ought to be. The standard for future NSA cases can justifiably be set higher than the first. Therefore, OCA asks the Commission not to cite or rely upon any of the discussion contained in these Comments for the purpose of criticizing the Stipulation and Agreement. OCA's Initial Brief, also filed today, constitutes OCA's position on the recommended decision it seeks in the instant Request. However, OCA also thought it efficient to open a dialogue on the course to be followed in future NSA proceedings.

I. THE OCA PROPOSES FILING AND DATA COLLECTION REQUIREMENTS FOR CAPITAL-ONE-TYPE NSAs

The Stipulation and Agreement filed on March 31 revises the Domestic Mail Classification Schedule (DMCS) from the version originally proposed by the Postal Service to implement the Capital One negotiated service agreement (NSA).[1] That revision consists of an added footnote indicating "the process for proposal, consideration, and negotiation of NSAs comparable to the Capital One NSA." Stipulation and Agreement at 2. As part of the Stipulation and Agreement, and pursuant to the added footnote, the Postal Service proposes regulations to be issued in

[1] *See* Stipulation and Agreement, Attachment A, March 31, 2003.

the Domestic Mail Manual (DMM) concerning comparable (or Capital-One-type) NSAs.[2] Those regulations set forth the process for negotiations, and the requirements that will be incorporated into Capital-One-type NSAs.

The Stipulation and Agreement does not address how the Commission should deal with future Capital-One-type NSAs. However, much has been learned in the course of the current proceeding. The Commission can now establish filing requirements for Postal Service requests for NSAs negotiated under the proposed DMM regulations contained in Attachment D of the Stipulation and Agreement.

A. Filing Requirements for Future Capital-One-Type NSAs Should Elaborate on Proposed Regulations to the Domestic Mail Manual Accompanying the Stipulation and Agreement

The proposed DMM regulations describe the "general requirements of comparability, factors to be considered in entering into a comparable agreement, data and documentation requirements, as well as other matters." Stipulation and Agreement, Attachment D, at 1-2. The OCA believes that the proposed regulations contain essential requirements for any comparable NSA. However, in many respects, how the Postal Service satisfies these requirements, and the information it relies upon, is critically important to Commission understanding. Three deserve special attention in any filing requirements established by the Commission.

1. The Postal Service should demonstrate that Capital-One-type NSAs will demonstrate a material additional contribution to institutional costs

Additional contribution to institutional costs should be the *sine qua non* for any Capital-One-type NSA. Toward that end, the Postal Service's proposed regulations

2 *See* Stipulation and Agreement, Attachment D, March 31, 2003.

require that there be an "overall positive financial impact" on the Postal Service. Stipulation and Agreement, Attachment D, at 5. Demonstration of this result should be an essential part of any future Postal Service filing associated with a comparable NSA.

The current proceeding illustrates the need for a Commission filing requirement. At the time of its request, Postal Service witness Charles L. Crum (USPS-T-3) estimated the additional contribution from the Capital One NSA to the Postal Service from two sources. The first was increased contribution from new mail volume prompted by the volume discounts.[3] The second source was cost reductions associated with electronic notices in lieu of the physical return of First-Class Mail that is undeliverable-as-addressed (UAA). USPS-T-3 (Crum), Attachment B, Page 2. During the course of this proceeding, however, it became apparent there was a third source of additional contribution: cost reductions from Capital One's avoided mail forwarding. Tr. 2/318-22. Witness Crum decided not to include these cost reductions in his testimony because of too many "unknowns" to justify a supportable estimate. Tr. 2/303. However, he maintains it is "highly likely" that electronic address correction notices for forwarded mailpieces will further reduce costs to the Postal Service. Id.

The absence of information on costs associated with avoided mail forwarding argues strongly for a Commission filing requirement consisting of two parts. First, the Postal Service should be directed to provide with the filing of its request an estimate of additional contribution for each major element of a Capital-One-type NSA. Second, the Postal Service should demonstrate that each element is individually making a material

[3] USPS-T-3 (Crum), Attachment B, Page 1. The increased contribution from new mail volume was more than offset by "discount leakage" or lost revenue from mail volume that Capital One would have mailed even in the absence of the NSA. USPS-T-3 (Crum), at 6. In total, the declining block rate feature

additional contribution to institutional costs. This part would preclude the establishment of a volume-based rate schedule that knowingly resulted in a negative contribution to institutional costs, as proposed with respect to Capital One.[4] Moreover, this part would preclude contribution neutral Capital-One-type NSAs (or elements thereof), as contemplated by the Postal Service. Tr. 3/508. Where there are numerous assumptions or "unknowns," the Postal Service should give its best effort in developing estimates for each element and, and express its degree of confidence (or lack thereof) with the estimates, as it did with avoided mail forwarding for Capital One.

2. With respect to volume-based rates, the Postal Service should explicitly justify the size of incremental volume blocks and the rates for each block

Under the proposed regulations, Capital-One-type NSAs will feature computation of postage using "declining block rates [ ] based on particular volume requirements that define incremental discount thresholds." Stipulation and Agreement, Attachment D, at 4. For any Capital-One-type NSA, it can be expected that the amount of discount and the size of incremental volume blocks for each discount will have been the subject of intense negotiations. However, the outcome of such negotiations should not be the sole basis for judging the appropriateness of the discounts and size of incremental volume blocks.

In this proceeding, the declining block rates available to Capital One are presented in the testimony of Postal Service witness Michael K. Plunkett. USPS-T-2 at 4, 14. This "discount structure" was simply the outcome of negotiations that both the

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of the Capital One NSA results in a negative test year contribution to institutional costs of $4.9 million. Tr. 2/309.

4 This was described by witness Crum as discount leakage. USPS-T-3 (Crum), Attachment B at 3.

Postal Service and Capital One believed to be fair. Id. at 5. No attempt was made to objectively analyze the declining block rate structure in terms of its economic efficiency. Tr. 4/723. Such an analysis was deemed to be "inappropriate." Id.

Consequently, Capital One Services witness Stuart Elliott (COS-T-2) estimated additional test year volume of 15.5 million mailpieces in response to the declining block rates. Tr. 2/211. This entire additional volume would receive one discounted rate. Thus, whether the increasingly larger discounts in the declining block rate schedule available to Capital One will induce even greater additional volume at the margin is irrelevant *in this docket.*

However, greater analytical rigor and justification will be appropriate and necessary in the case of future Capital-One-type NSAs. The testimony of witness Panzar indicates the economic basis and type of analysis that should accompany any Capital-One-type NSA.

Witness Panzar discusses the economic considerations involved in second-degree price discrimination or "nonlinear pricing" related to the establishment of optional tariff schedules. Tr. 8/1583. Nonlinear pricing refers to "the use of a price schedule under which the total outlay is not the simple product of a constant price times the quantity purchased."[5] This form of pricing has been commonly used in both competitive and monopoly markets where, for example, public utilities offer quantity discounts for bulk purchases.

In the case of nonlinear pricing, a vendor offers two tariffs: the established price available to anyone, and a discounted or optional price for bulk purchases. Customers

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[5] Tr. 8/1583. Stated alternatively, the price per unit of output is not constant but depends on how much is purchased.

may make purchases at the established price, or take advantage of the optional price for larger purchases. For any customer, therefore, a graph of its total outlays is not a straight line through origin, but some nonlinear function that exhibits a “kink” beginning at the optional price point. Tr. 8/1586.

Through the use of an optional tariff schedule, the vendor has constructed two price-quantity offerings, one targeted at customers with higher demand and the other for lower-demand customers. Since both the established price and optional price are available to all, any customer is free to select the price-quantity offering that suits its needs. Tr. 8/1586-87. This incentive to self-select can maximize the vendor’s profits without the need to know the demands of individual customers.

The Postal Service’s volume-based rate schedule, featuring increasingly larger discounts for additional volume, appears inconsistent with second-degree price discrimination. The volume-based rate schedule consists of multiple price points designed to induce incremental volume, rather than a single optional price for bulk purchase.

The existence of these multiple price points suggests *first-degree price discrimination*, or “perfect price discrimination.” Under perfect price discrimination, each unit of output is sold to the customer with the highest demand at the maximum price that the customer is willing to pay for it.[6] In more general terms, it means a monopolist sells different units of output for different prices and these prices may differ from customer to customer. Id. To perfectly price discriminate, however, requires vendor knowledge of each customer’s demand, or reservation price. Id.

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[6] See Varian, Hal R., “Intermediate Microeconomics: A modern Approach.” W.W. Norton & Company (1999), at 434.

The Postal Service's volume-based rate schedule for Capital One suggests an attempt at perfect price discrimination. The Postal Service reduces rates through increasingly larger discounts to induce new incremental volume by Capital One. But the Postal Service can make no showing that it has modeled Capital One's demand or that the larger discount at each incremental volume block will actually induce new incremental volume. In the absence of knowing Capital One's demand, all other declining block rates are irrelevant, and the Postal Service has engaged in typical second-degree price discrimination, which could be made available to all mailers.

As part of any filing, the Postal Service should be directed to show an objective connection between the discounts and size of incremental volume blocks, and how they will stimulate volume all along the mailer's demand curve. Alternatively, the Postal Service should restrict itself to second-degree price discrimination models.

3. An accurate forecast of the before-rates mail volume should be used in determining the threshold for the payment of discounts

As noted in the OCA's Initial Brief, the accuracy of the forecasted level of mail is important. If the estimated threshold of expected business is set too high, the optional tariff will not be used. Alternatively, if the threshold is set lower than the level of mail which would have occurred absent the NSA, then the mailer will avail itself of the lower price for mailings that it had previously purchased at the established rate. Clearly, the threshold for the payment of incentives in future NSAs should be set at approximately the expected Before Rates volume.

4. The baseline forecast of before rates mailings should be developed using a verifiable quantitative analysis and publicly available data

The procedures appropriate in forecasting mail volume are well known. Forecasting procedures include the definition of the exogenous variables (the drivers of the forecast), the use of econometric and statistical forecasting and modeling procedures, and the analysis of trends in the exogenous variables for their future impact. A company-specific demand study is needed for a full understanding of future mailing levels. It is important that an analysis be verifiable and reproducible, which is why it should be based on publicly available data.

The Postal Service will need to have available a unique volume threshold for each proposed NSA participant based upon the mailer's known, historical mail volume. Such historic volume data, if publicly available and verifiable, provide an objective basis for estimating future volume. In the event that the mailer itself develops the estimated threshold, the Postal Service will need to verify the suitability of the estimation procedures. The Commission should require the Postal Service to provide such verification with its initial filing in future cases.

5. The oligopolistic nature of some postal markets may diminish total revenue to the postal service resulting from a single-firm NSA.

The economic theory of oligopoly hypothesizes a wide variety of potential outcomes, including one in which a firm obtaining access to a NSA could become the dominant firm in an industry. Under such a circumstance, market dominance by a single firm could cause other previously competitive firms to exit the industry, thereby decreasing overall postal revenues. However, recognizing that other outcomes are possible depending on the economic circumstances and assumptions, Professor

Panzar also noted that implementation of an NSA could also result in a larger increase in First-Class mail by the firm receiving the discount, an amount larger than the size of the decrease in First-Class Mail by the firms not receiving the discount. Tr. 8/1704.

Oligopoly theory is complex, attempting to describe the market outcomes when firms base their pricing and production decisions on the behavior of their competitors. The specific circumstances of a market will determine the market outcome. Witness Eakin confirmed that there can be a variety or range of possible equilibria. Tr. 10/2112. It is possible that implementation of a future NSA could lead to increased or decreased mail usage, depending on market circumstances.

If a NSA results in a substantial market share improvement by a leading oligopolist, then other firms may exit the market; this could result in reduced mail advertising and solicitation. Alternatively, if an NSA results in a market share improvement by the leading firm and the firm’s competitors respond with additional advertising (i.e., an “advertising war”), then one could hypothesize an increase in overall postal revenues.

The actual outcome is indeterminate, depending on the market structure. In future NSA cases, the Commission should require a more rigorous analysis of market structure and behavior, both by NSA participants and by their competitors. Even if harm to postal finances is unlikely, basic fairness suggests that the terms of a NSA should be available on an equal basis to all competitors.

B. Filing Requirements for Future Capital-One-Type NSAs Should Include A Comprehensive Data Collection Plan

In addition to the requirements for Capital-One-type NSAs, the Postal Service’s proposed DMM regulations establish a process for negotiating NSAs with mailers. Stipulation and Agreement, Attachment D, at 7-8. The successful outcome of negotiations would involve a Postal Service request with the Commission for an experimental mail classification pursuant to Chapter 36 of Title 39 of the Untied States Code.

The proposed regulations do not specify the filing (or content) of a data collection plan with any Postal Service request for an experimental mail classification relating to a comparable NSA.[7] The Commission should establish a filing requirement for such plans, and specify the types of data it wishes to see in order to evaluate the effects of any comparable NSAs.

1. The data collection plan accompanying the Stipulation and Agreement is the minimum required for comparable NSAs

The Stipulation and Agreement provides for a more comprehensive data collection plan than originally proposed by the Postal Service in this proceeding. A number of requirements of the plan are drawn from the Postal Service's original filing. USPS-T-2 (Plunkett), at 12. Additional requirements proposed by the OCA in the testimony of witness Callow are also included. Tr. 7/1368-69, 1377-78. Still other requirements were incorporated as part of negotiating the Stipulation and Agreement. This more comprehensive data collection plan, contained in Attachment C of the Stipulation and Agreement, should be considered the minimum required data collection plan for any Capital-One-type NSAs presented to the Commission.

The data collection plan now requires the Postal Service to report the number of electronic address correction notices provided to Capital One for forwarded mailpieces

[7] The proposed regulations do require the Postal Service to report on mailer interest in negotiating comparable NSAs. Under the proposed regulations, the Postal Service agrees to report "annually on the number of requests made for comparable NSAs, the industry of each requestor, and the status of negotiations, or if negotiations were terminated, the reason therefore." Stipulation and Agreement at 2.

and separately for mailpieces that would otherwise be physically returned, not only by CFS units, but also by PARS when fully operational. The plan also requires a monthly estimate of the amount of time spent on compliance activities conducted by the Postal Service, and a description of the activities performed. The Postal Service will provide an evaluation of the impact of the Capital One NSA on the contribution.

The plan further specifies that the Postal Service will provide data on the number of times that a particular move address record is accessed for a Capital One solicitation mailing, including the dates the record is accessed and the effective date of the change of address order. These data are intended to be used to assess the number of forwards that may have been avoided by Capital One's prompt corrections to its address databases.

In addition, Capital One will provide certain data. It will provide NCOA contractor reports concerning the number of address records checked and the number of corrections made when First-Class solicitation mailing list are run against the NCOA database. These reports will permit estimation of the percent of address changes that NCOA is able to correct, and should facilitate an understanding of how many additional address corrections for forwarded mailpieces CFS units are able to generate.

2. The Postal Service and mailers party to comparable NSAs should develop plans to estimate the number of repeat forwards

The development of cost estimates associated with avoided mail forwarding is hampered by an absence of essential data about forwarded mail. In this proceeding, the Postal Service initially decided not to include an estimate cost reductions for Capital One's avoided mail forwarding because of "too many unknowns." Tr. 2/303. Such unknowns include "the forwarding ratio of Capital One and the average number of solicitations per address that Capital One mails to in a given year." Id. Nevertheless, at the request of the Commission, the Postal Service provided cost savings from avoided mail forwarding using "a number of simplifying assumptions." Tr. 2/318.

It is clear that data concerning avoided mail forwarding is one of the least available, and most difficult to obtain, types of information related to the Capital One NSA. In future Capital-One-type NSAs, such data may be essential to support cost reductions from avoided mail forwarding that are the principal justification for the NSA.

The data collection plan of the Stipulation and Agreement specifies one way to estimate avoided mail forwarding. Under the data collection plan, both the Postal Service and Capital One will separately collect data that, when combined, will facilitate evaluation of the number of mailpieces that avoid forwarding.[8] However, the Postal Service should explore with mailers party to future Capital-One-type NSAs additional methods to estimate the number of repeat forwards.

3. The Postal Service should clearly demonstrate that cost reductions included in comparable NSAs have been realized

The reduction in costs from the elimination of Capital One's physical returns is the principal justification of the NSA. The Postal Service dedicates substantial resources to the processing of Capital One's returns. In this proceeding, the Postal service estimates the reduction in costs for eliminating Capital One's physical returns at $13.08 million. Tr. 2/307.

In its data collection plan, the OCA proposed collection of data to determine the effect on Postal Service operations from eliminating the physical returns of mailers under its experimental classification. The data collection plan directed that the Postal service estimate "cost savings to the Postal Service of providing electronic notifications in terms of facilities closed (if any), craft positions eliminated, other labor cost savings, etc." Tr. 7/1369.

The existence of cost savings estimates should be translated into real changes in Postal Service operations. Consequently, the Postal service should be able to demonstrate how the estimated cost savings have affected Postal Service operations. These estimates should include savings related to the number of facilities closed and the number of craft positions eliminated, as well as changes in workhours at different pay levels as compared to physical returns, and other workhour reductions, etc.

II. THE OCA PROPOSES GENERAL PRINCIPLES FOR FUTURE NEGOTIATED SERVICE AGREEMENTS

There are both benefits and costs to the Postal Service from seeking negotiated service agreements. On the one hand, the availability of an NSA provides an incentive to large mailers to provide information about potential opportunities for the Postal Service. On the other hand, each NSA proposal requires the Postal Service to devote resources to verifying that a significant potential to increase contribution actually exists. The Postal Rate Commission can assist both mailers and the Postal Service by establishing guidelines for NSAs.

In its Trial Brief in this proceeding, the OCA identified four basic issues presented by the Capital One NSA. The Stipulation and Agreement resolves these issues to the OCA's satisfaction. However, these same issues, or their analogs, are likely to arise in other NSA proceedings. These issues involved (1) the accuracy of volume estimation, (2) the level of financial risk assumed by the Postal Service, (3)

[8] *See* Stipulation and Agreement, Attachment C, Items 8 and 9, March 31, 2003.

whether the NSA was fair to competitors of Capital One, and (4) whether procedures for future NSAs could be streamlined.

A. Each Future NSA Should Represent A Unique Win/Win Opportunity For the Mailer and the Postal Service, Including All Its Stakeholders

Perhaps *the* defining characteristic of a legitimate NSA is the uniqueness of the business relationship between a mailer and the Postal Service. This follows from the simple fact that section 3623 of title 39 and the Commission's rules already address situations where several mailers present mail having similar characteristics that should be recognized in the DMCS or rate schedules. Thus, if more than one mailer exhibits characteristics worthy of rate recognition, then these characteristics can be addressed through a traditional rate category or other classification mechanism. Resort to an NSA should come only after traditional classification approaches have been exhausted.

The existence of statutory and regulatory classification principles also seems to require that other ratepayers not incur higher rates or other burdens as a result of an NSA. That is, the Postal Service must always benefit directly from an NSA, and there must be no hidden costs that will eventually lead to raising rates for other mailers. If the net present value to the Postal Service of an NSA is negative, then the rates for all subclasses of mail are potentially affected, and the appropriate mechanism for effecting the proposed changes should be a general rate case. This situation would arise, for example, if a NSA participant were to obtain a lower rate based on *existing* low-cost behavior. This would raise a "free-rider" problem in a different context. Instead of giving a discount for volume that would exist anyway, the Postal Service would be giving a discount for behavior that would have occurred anyway. Tr. 7/1285. Future NSAs should not be based on deaveraging.

B. Each Future NSA Should Embody Simple Features

One lesson that can be learned from this proceeding is that complexity breeds opposition. In this case the OCA was initially concerned about the bundling of apparently unrelated services. There was suspicion that the Postal Service was using bundling to create an artificial appearance of uniqueness. The OCA went so far as to propose separate classifications for the different elements of the NSA. The OCA suggests that the Commission require the Postal Service to identify separately the service elements of a proposed NSA, to demonstrate the profitability of *each* service element, and to explain precisely why it is advantageous to the Postal Service to bundle service elements.

C. Each Future NSA Should Minimize Speculation And Hedge Uncertainty

1. Forecasting behavior of an individual customer is inherently speculative

One of the most contentious issues during hearings on the Capital One NSA was how to determine the appropriate volume above which to offer discounts. There is great uncertainty involved with forecasting the mail volumes of an individual customer. Many factors other than price affect a customer's demand for mail services. OCA witness Smith identified several of these factors. Tr. 7/1240-41, 1279-80. When such factors change—as they almost certainly would over the course of three years—the volume that a customer would demand at a given price also changes.

Capital One witness Elliott initially estimated that the discounts contained in the NSA would induce an additional 15.5 million pieces from Capital One. Tr. 2/211. This estimate was for only the test year and assumed all factors other than price remained constant. If, over the course of the NSA, some factor other than price—*e.g.,* marketing strategy—were to change, the volume demanded *at the undiscounted price* could increase substantially. When such a change occurs, the free-rider effect identified by witness Smith reappears. That is, the Postal Service ends up paying discounts for volume it would have received anyway.

Because witness Elliott estimated such a small volume response to discounts, the OCA reasoned that significantly larger new volumes would be the result of changes in nonprice factors. In order to mitigate the free-rider problem in such a situation, OCA witness Callow proposed a limit on the volume that could be eligible for discounts.

2. The net present value to the Postal Service of an NSA needs to be estimated

A second source of uncertainty identified in this case is the effect of an NSA on Postal finances in years beyond the test year. One service element of the Capital One NSA is the Postal Service's provision of free electronic notice of returns and forwards to Capital One. Capital One is required to use this information to improve the quality of its address lists. This quality improvement should reduce costs for the Postal Service. For the test year, Witness Crum estimated $13.8 million in cost reductions. USPS-T-3, Attachment B at 2. However, these cost reductions should decline over the life of the experiment, as Capital One's improved address lists generate fewer returns and forwards. Ideally, this decline would be explicitly modeled and a more realistic reduction in costs over the life of the experiment estimated.

The concept of a test period equal to one year is unsuitable when the test period used is not typical of conditions expected over the life of an NSA. In the case of the Capital One NSA, one would expect the proportion of returns (and electronic notices) to decline from the initial rate of 0.098 to some much smaller number. Future NSAs may present similar situations, but it may not be so obvious that benefits exceed costs over the life of the NSA. Therefore, the OCA suggests that the Commission adopt a rule that equates the test period for an NSA case to the length of time the NSA will be in effect.

3. Mechanisms for hedging uncertainty should be identified and utilized

Given the high level of uncertainty associated with predicting the behavior of an individual customer, the Postal Service should take steps to mitigate financial risk in future NSAs. In this case, the Postal Service tied volume-based discounts to new cost-saving behavior by Capital One in order to ensure that the NSA would be profitable. In future cases such an approach may be insufficient. The Commission should adopt a rule for future NSA cases requiring the Postal Service to include mechanisms in the NSA that place an absolute cap on its possible losses. There are no doubt many mechanisms other than the one proposed by witness Callow that can effectively hedge the risks associated with NSAs. The Postal Service should identify and use them in future cases.