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

Experimental Rate and Service Change to Implement Negotiated Service Agreement With Capital One Services, Inc.	Docket No. MC2002-2

INITIAL BRIEF OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO

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The American Postal Workers Union, AFL-CIO (APWU) supports the Postal Service's proposed Negotiated Service Agreement with Capital One Services, Inc. and does not object to the agency's proposed Stipulation and Agreement. It takes these positions with serious reservations because of several troublesome aspects of this agreement. However, the union's main concern is the future health and viability of the Postal Service and, in principal, NSAs may provide it with needed flexibility in meeting its goals and providing service to its customers. While we are not sure whether this sort of Agreement will actually grow the USPS' business, we recognize that any competitor must take risks and conduct experiments. This first NSA will provide information and experience about the workings of such agreements that will be valuable in structuring future agreements. On this basis, we support the Agreement and supply the Commission with the following observations:

1. THE UNION SUPPORTS THE ADDRESS HYGEINE SAVINGS GENERATED BY THIS AGREEMENT

The mix of address hygiene issues and volume discount issues has been somewhat confusing in this case. However, it is quite clear from witness Crum's original analysis that the address hygiene portion of this agreement [OCA/USPS-T3-3, Tr. 291] is what generates the savings to the Postal Service and offsets the losses that are generated from the volume discount leakage, an amount that is almost $5 million larger than the additional contribution generated by new volume under the discount plan [OCA/USPS-T3-2, Tr. 290]. It is the address hygiene savings that allow the union to support this agreement despite its reservations. While there are certainly questions about the accuracy of the estimates used in determining the savings, the tremendously large volume of Capital One's UAA mail (and the percentage of that mail that must now be physically returned to Capital One) does indicate sizable savings for the Postal Service if all aspects of the address hygiene plan, as put forward in the agreement, takes place.[1] To the extent this agreement will aid the Service in understanding the costs of forwarded mail and other UAA mail and possibly spur a reevaluation of pricing signals of various address hygiene methods, it will provide useful information to better understand and control Postal costs.

2. THE UNION IS CONCERNED ABOUT THE DISCOUNT PORTION OF THE AGREEMENT

The discount portion of this agreement is the part that causes the union's most serious concerns. There are several aspects of the discount structure that are questionable as a model for future volume discounts. In general, the union's position is not to support a discount that reduces the contribution to overhead being made by mail volume already in the Postal network or mail volume that can reasonably be expected to be in the Postal network. This cuts into the Postal Service's ability to cover its costs and

[1] There would also appear to be significant benefits to Capital One from this portion of the plan alone although those have not been fully documented in this case.

meet its universal service requirements. This is consistent with the union's views on worksharing discounts not exceeding the costs avoided by the Postal Service. For NSAs this implies:

a. Volume discount thresholds should not be set so low as to give discounts for mail the Postal Service would receive anyway. A reduced contribution to overhead is a plus to the Postal Service only if it is on newly generated mail that would not have used the Postal network otherwise. If a discount is given to mail that would have been in the system even without that discount, then the discount only serves to reduce the "full" institutional cost coverage that piece would have made. Therefore, the first point of concern is that the threshold amount for this agreement, set at 1.225 billion pieces, is not only significantly lower than Capital One's mail volume for FY2002 which totaled 1.666 billion but also would appear to be lower than the FY2001 mail volume of 1.259 billion pieces.[2] Even if, as Capital One contends, the mail volume in FY2002 was

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[2] There seems to be some confusion over the level of Capital One's mail volume in FY2001. Witness Plunkett testified that the threshold set in the agreement is above the level of Capital One's mail volume in FY2001, which he characterized as 1.152 billion pieces [Tr. 847 at 7and 8]. This estimate would seem to most closely correspond to the FY2001 volume numbers that Mr. Crum provided in his Attachment A, page 1 of his direct testimony (corrected version). However, the First class mail volumes that are shown above are calculated from Capital One's LR-4 by summing the customer mail volume and the first class solicitation mail volume for twelve-month periods from October through September (mail volume from the one-time informational mailing on arbitration procedures have been excluded from the totals.) The difference between the two levels may be partially explained in Mr. Crum's responses to an interrogatory (OCA/USPS-T3-10, Tr 299) where he states two reasons for differences in the Postal Service's and Capital One's mail volume estimates: 1) differences in timing due to use of a Postal Fiscal Year for his count compared to a Government Fiscal Year estimate from the Capital One data and 2) the fact the Postal Service's PERMIT system, from which the data are derived did not capture mailings made by Capital One using lettershops that were not using unique Capital One permit numbers. Since Mr. Crum uses Mr. Elliott's estimates of volume in his revenue estimates, and those are based on Capital One's volume estimates[which in response to POIR 2, question 4 the Postal Service states were in their opinion generated using "logical methodology, employed

unusually high due to special factors relating to the terrorist attacks and the anthrax attacks, it does not seem reasonable to set the threshold for mail volume below the levels of FY2001 mail and it would have been more reasonable to set the threshold at a value that anticipated some growth in that mail volume.

b. The concept of mail "it would otherwise receive" is not restricted to the test year. It is a concept that should give consideration to natural mail growth. Is it to the Postal Service's advantage to induce new mail volume this year (essentially borrowing ahead mail volume from coming years), by providing a discount, when it means that some portion of the future contribution to overhead costs of that mail will be lost, perhaps forever? While no one in this case has discussed what might be expected to happen at the end of the three-year experimental time frame of this plan, how an agreement such as this one could be continued into the future is of interest in making estimates of the leakage from the discounts.

Numerous estimates have been made and discussed of Capital One's mail volume. The following example is illustrative and is not meant as an estimate of Capital One's expected volume but as a reasonably conservative estimate of what could be their expected growth in First Class mail volume. If one begins with the FY2001 totals and grows Capital One's mail volume by 5 percent per year from FY2002 through

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reasonable assumptions, used reliable data and were based on accurate calculations" [Tr. 765], rather than those generated from the PERMIT system, it might be considered somewhat disingenuous of the Postal Service to make the claim that the threshold value is above the FY2001 volume levels. If Capital One does receive the volume discounts as put forward in this agreement, it is unlikely that any of its mail will be sent under non-unique permit numbers and consequently, the Postal Service's estimate of Capital One's mail volume based on its historical PERMIT system data is probably an underestimate of the actual Capital One mail volume. However, this point mostly reinforces the confusing nature of the testimony on volume that has been presented in this case.

FY2005, when this agreement might be expected to end, then Capital One's mail volume grows from about 1.388 billion in FY2003 to 1.530 billion in FY2005.[3] If this mail volume is compared to the threshold for the volume discounts, the amount of volume on which the Postal Service could expect leakage of overhead cost coverage grows from 164 million in 2003 to almost double that in 2005, 306 million. Simple arithmetic indicates that by 2008 the difference between Capital One's mail volume and the threshold for the volume discounts, set in this agreement, would reach over half a billion pieces.

There are many factors that could influence actual mail volume growth into the future. This is not meant as a forecast, but illustrates a point of concern with a volume discount structure. What happens at the end of the first three years? Will the trigger value be reset to a higher number? If it isn't, and the discounts are continued with the same threshold, the Postal Service could face ever growing losses between the normal mail volume growth and the frozen threshold in this agreement. Multiply this agreement by hundreds and the results become even more perplexing.

There is nothing in this record that addresses this issue. But despite Dr. Elliott's most recent analysis of possible negative trend rates of growth, both the Postal Service and Capital One's witness Shippee have stated that they expect Capital One's mail volume to continue to grow. However, these witnesses have been silent on what happens at the end of the three-year experimental period. If the discount is discontinued at the end of the three years, or the threshold is moved up to a higher

[3] While the FY2003 number is not meant as a rigorous estimate of Capital One's volume in 2003 it does fall within the estimates of possible mail volume for the year that Capital One and Dr. Elliott have provided. Given that Capital One's first class mail volume grew

volume level, that will be equivalent to a price increase on the mail receiving the volume discounts under this agreement. Based on the current rates, that price increase would range from about 10 percent to 20 percent. Mailers never like to see their prices increase and they certainly do not accept price increases of that magnitude quietly. Past experience indicates that once a discount is given it is hard to keep it from growing much less take it away. In thinking about the total loss of overhead coverage to the system and how NSAs will work in the future, some consideration should be given to whether the Postal Service is essentially willing to accept the potential of an ever growing leakage from its overhead cost coverage on every new piece of mail this customer mails in the future. Complicating the analysis more will be the cost structure of the Postal Service's UAA mail processing by the end of the three-years of this agreement. The Postal Service supports this agreement by using the costs it saves from the changes in handling Capital One's UAA mail to offset any leakage losses from the volume discounts. Given that the PARS system should significantly change the cost of processing the UAA mail by 2005, it is difficult to know what the cost of processing this mail will be by then and thus what sort of cost savings there will be. Presumably, if Capital One has significantly reduced the amount of its UAA mail, there will be less cost savings to offset a potentially growing leakage from the discounts. This feature makes it difficult to replicate this Agreement with other mailers and even with Capital One in the long run.

c. NSAs should not be set up so that the mailer receiving the discount could become, in essence, a competitor collecting mail from others to mail under its volume

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15 percent between 2000 and 2001 and 32 percent between 2001 and 2002, this 5 percent growth trend is conservative.

discount program and thus reducing the contribution to overhead being made by mail already in the system. Thus, the vague notion of the mail of Capital One affiliates and strategic partners being eligible for this agreement when neither Capital One nor the Postal Service [see APWU/USPS-T1-3, Tr. 690 and Tr. 155-164] can clearly define those terms as it applies to the mail that is eligible for discount, concerns us. While the Postal Service does seem to have made some efforts to account for possible acquisition by Capital One of current mailers during the time period of this agreement, that too could be a potential source of overhead leakage during this agreement that may not fully be accounted for. We are concerned that this Agreement is not tightly worded enough to restrict the potential for arbitrage that Dr. Panzar raises as a concern in his direct testimony.

d. While Mr. Plunkett denies that there has been a quid pro quo where the threshold is reduced in order to share some of the cost savings from the address correction service savings with Capital One, many of the intervenors in this case have had this perception. From Capital One's interrogatory to Mr. Smith [(OCA/COS-T1-19), Tr. 1285], it seems possible even Capital One believes this to be true. If this is, indeed, why the threshold for the volume discounts was set lower than the Capital One's expected mail volume in FY2003, then it sets a very bad precedent for future NSAs. As a first NSA, this one should not be setting a bad precedent that allows others to negotiate for discounts on mail volume already in the Postal Network, without having the offsetting cost savings to make that a good deal. Alternative tariff arrangements are designed to increase volume usage above what it would otherwise be. Using a round about method to share cost savings between the negotiating parties of the agreement does not set the right tone or give the right message to future NSA negotiators.

3. THE POSTAL SERVICE SHOULD EXAMINE THE FULL COST AND REVENUE PICTURE OF A NSA FOR THE FULL TERM OF THE AGREEMENT

In general, it is of concern that the Postal Service does not think it is necessary to look at the full cost and revenue picture of a NSA for the full term of the agreement. [See APWU/USPS-2 at Tr. 869, Bizzotto at Tr. 525-526.] Even if that is not required by the Postal Rate Commission's rules, it is a requirement of good business. And the union believes the Commission should consider making this a requirement for future NSA filings. For Postal Service witnesses to state that such an analysis was not done and is not necessary does not produce the sense that this is a well thought through business decision. While each NSA might involve relatively small amounts of money, in the usual rate-case terms, the uniqueness of each NSA makes it more important to think it through for the full-term and to have as clear an understanding as possible of the impacts on costs and revenues. The Postal Service can be sure that the mailers it is negotiating with will have done this. In his testimony before the Commission, Dr. Panzar noted his experiences when working for AT&T during the negotiations of custom tariffs included knowing the specific cost and revenue aspects of that agreement on AT&T. That was the only way AT&T could determine if it was negotiating a deal with the positive business aspects it desired. [Tr. 1662-1663]. The data collection plan set forth in this agreement provides a basis for the Postal Service to better understand the relative costs and benefits of NSAs. That experience is the strongest point to recommend this NSA even with its many flaws. But, the Postal Service needs to appreciate the benefits of a full period analysis of such agreements as well.

4. THE APWU OPPOSES ALTERNATIVE CLASSIFICATIONS

The OCA's office has stated it will withdraw its proposed classifications from consideration in these proceedings provided the Stipulation and Agreement is approved. [Office of the Consumer Advocate Motion to Remove Pages Tr. 7/1390-96 from the Record, March 31, 2003.] We agree, in general, this could have been structured as two separate agreements, but we have concerns about the OCA's proposal. Since those classifications have not yet been removed from this case, we want to make clear why we cannot support this as an option to this NSA.

a. First and foremost, this NSA is the first of its kind. The revenue and cost benefits are based on estimates using aggregate data to proxy what might be the actual cost savings pertaining to Capital One, on poor information about Capital One's mail volume over the term of this agreement, and on very incomplete information about the future. For that reason alone, this should stay a single-firm experiment until there is time to learn something useful about how this NSA will work. The union is cognizant of the fact that there is a potential negative impact on Capital One's competitors if they cannot also qualify for similar discounts. That fact must be weighed by the Commission in analyzing this NSA. However, the weaknesses in this plan do not make it an ideal model for immediate replication.

b. Second, it is not at all clear that the Postal Service would not be overwhelmed if it were to try to deal with many companies trying to sign up for these alternative classifications. If not all the companies who desired them could be accommodated, would this become a lottery to determine who the winners would be? Capital One is the Postal Service's largest First Class customer, while the data put forward in this case have had many weaknesses, they have provided some boundaries on what the conceivable outcomes could be if this agreement is approved. No one has any idea what the boundaries are on the cost and revenue impacts to the Postal Service if the alternative classifications were approved. Finally, Mr. Plunkett's discussion with Chairman Omas and Commissioners Goldway and Covington during his cross-examination on March 6^{th}, discusses the resources the Postal Service currently has available to negotiate these agreements and monitor their outcomes [Tr. 1932-1934 and 1938-1946]. It is clear from that discussion that it could not accommodate a large number of potential alternative classification customers and do a credible job of determining the appropriate threshold values for their discounts, much less track the outcome of those agreements with enough focus to learn the lessons. This NSA has problems, its approval can be justified as a learning tool to determine the advantage and disadvantages of NSAs. The alternative classifications proposed by Witness Callow would not play that same role.

5. CONCLUSION

For the above-stated reasons, the APWU, with the reservations stated herein, supports the NSA and does not object to the proposed settlement.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with Section 12 of the Rules of Practice.

Arthur M. Luby

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