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

EXPERIMENTAL RATE AND SERVICE CHANGES
TO IMPLEMENT NEGOTIATED SERVICE AGREEMENT
WITH CAPITAL ONE SERVICES, INC.

Docket No. MC2002-2

INITIAL BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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I. INTRODUCTION

A. One Small Step

The Postal Service's Request in this proceeding takes a small step in the direction of an elusive goal. For most of the some thirty years of ratemaking under the statutory scheme of the Postal Reorganization Act (PRA), some mailers and the Postal Service have held the view that narrowing the focus of rate design to encompass small subsets of customers would be compatible with the statutory scheme and could, in certain circumstances, make sound economic and business sense. For many years, we have discussed this approach under the topic of "contract rates." More recently, in the postal economic regulatory context and in other industries, we and other observers have broadened our consideration of the approach to refer more generally to "Negotiated Service Agreements," or NSAs. The change in terminology reflects a refined understanding of particularized pricing arrangements that are not rooted exclusively in a narrow cost relationship between the Postal Service, as the supplier, and its customers. Rather, NSAs can represent narrow or unique service relationships in which prices and terms of mailing may be tailored to benefit, not only the parties to the NSA, but all mailers and the public in general.

B. Tariffs and Tensions

At one analytical extreme, the NSA approach represents the ultimate in classification reform. Mail classification in general strives to establish discrete groupings of mail for pricing and operational purposes based in part on the averaged costs of operations required to provide a particular type of service. Historically, the development of mail classes and subclasses has resulted in relatively broad categories encompassing many mailers as customers for particular services. This "tariff" approach is characteristic of most traditional public utility pricing where simplicity and equitable considerations inherent in broad classifications have made more political and practical sense than attempting to view each customer individually, or in smaller groups, based only on cost of service. Just as every mailer is in some respects different, however, some mailers are capable of practices that make provision of particular services less costly than others. Consequently, there has always been an interest by some mailers to advocate narrower classifications, and even individual contractual arrangements with the Postal Service, that would result in lower individual rates.

The tendency of lower-cost mail to be produced by larger mailers capable of realizing efficiencies associated with size and more sophisticated operations and practices has been a major source of tension in the debate over NSAs. The mailers contributing "above-average" costs to classifications have resisted arguments in favor of more discrete classifications and contract rates for obvious reasons. Many of these are smaller, lower-volume mailers. This dichotomy between smaller and larger mailers has polarized the discussion of NSAs in many respects, and amplified the concerns over equity that must be considered together with economic issues. Indeed, this opposition is reflected prominently in the record of the instant proceeding.

C. Commission Concerns

The Postal Rate Commission, furthermore, has tended to view the advocacy of contract rates and NSAs with deliberate caution. Notwithstanding the economic logic of tailoring rates narrowly to costs and providing incentives associated with size and efficiency, the Commission's responsibilities range beyond narrow economic issues and span a variety of considerations embodied in the policies and statutory ratemaking criteria of the PRA. In the past, the Commission has reacted skeptically to the notion of contract rates, and has expressed serious reservations that the contractual approach to postal rates and classifications was either economically sound or practical.[1] Nevertheless, a trend toward more particularized pricing and service arrangements has progressed steadily in scholarly literature, business practice, and economic regulation, and has come to represent a dominant practice in some industries. Even in postal ratemaking, narrower, or "niche," classifications have been recognized as workable solutions in some circumstances.

D. Joint Task Force Recommendation and Postal Service Proposal

In 1992, the Joint Task Force on Postal Ratemaking, consisting of representatives from both the Commission and the Postal Service, conducted a comprehensive review of the need for change and innovation in postal rate regulation. Among other topics, the Task Force considered the practice of contract rates as a source of pricing flexibility.[2] The Task Force embraced the broader view of the concept in the form of service agreements. It stated:

> The Task Force believes that the rate and classification process should have a means to accommodate service agreements with postal customers, *varying from the general rate and classification schedules in ways which add value both for the customer and for the postal system as*

[1] *See* Notice, Docket No. RM89-5 (Procedures for the Consideration of Contract Rates) (Nov. 6, 1989).

[2] The Joint Task Force Report, at 43-44, also recommended the concept of declining block rates as a form of volume discounts that would avoid the problem of undue discrimination in the absence of cost differences, an issue that the Commission had raised in considering the Postal Service's previous proposal for Express Mail volume discounts. PRC Op. R90-1, Vol. 1, at V-388.

> *a whole.* In specific situations involving one customer or a limited group of customers, negotiated agreements tailored to the particular circumstances might be more effective than the broad schedules in meeting what the particular facts require, so that the benefits can be shared between the participating customer and the postal system.[3]

The Task Force recommended that the Postal Service and the Commission begin by establishing procedures and a classification framework for consideration of proposals based on service agreements. *Id.* The opportunity to pursue this approach arose in 1995, when the Postal Service proposed several procedural amendments to the Commission's rules designed to follow up Task Force recommendations. While the Commission addressed several of the proposed reforms, and created useful specialized procedures providing additional ratemaking flexibility, it deferred consideration of NSAs as proposed by the Postal Service. The Commission reiterated its general reservation about the contract rate concept, and pointed to the need for a general classification proceeding as a temporary impediment to establishing procedures that would accommodate an NSA approach to pricing.[4]

E. The Right Time

Throughout this history of considering approaches to individual rate and service agreements, the Postal Service remained convinced that, in the right circumstances and under the right conditions, particularized agreements with mailers could contribute to its financial needs and benefit the entire postal community. Beyond advocating that procedural and classification reform be explored, the only thing the Postal Service had

[3] Joint Task Force on Postal Ratemaking, *Postal Ratemaking in a Time of Change*, at 54 (June 1992) (emphasis added).

[4] Notice and Order Concerning Proposed Rules of Practice, Order No. 1084, at 17-19 (Oct 13, 1995).

yet to do was present the Commission with a specific proposal for rate and classification change based on an NSA. As the Commission has agreed, nothing in the review procedures established in the PRA and the Commission's rules would prevent consideration of such a proposal. The Request in this proceeding, based on the NSA with Capital One Financial Servic[5]es, represents the first attempt to test the NSA concept in the context of conventional ratemaking procedures.

Consistent with all of the beneficial features of the NSA approach, the agreement with Capital One embodies a customization of postal products, services, and pricing that meets the needs of single customer, while benefiting all other postal customers by providing a positive net contribution to the institutional costs of the Postal Service. The agreement was made possible, and makes sound business and practical sense, because of the distinct relationship between the Postal Service and Capital One, an unusually situated mailer.

The NSA combines several elements of mutual benefit in an agreement negotiated between the two parties. On one hand, it enables the Postal Service to significantly reduce costs by providing electronic notice in lieu of the physical return of Capital One's undeliverable-as-addressed (UAA) First-Class Mail. On the other hand, the agreement couples this benefit with an incentive for Capital One to retain and increase its First-Class Mail volume. This feature takes the form of declining block rates that are available for increasing volumes of First-Class Mail above stated thresholds.

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[5] Postal Rate Commission, 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 at 10-13 (February 11, 2002).

The NSA also commits Capital One to maintain and enhance address and mail preparation quality, and to pay a minimum transaction penalty if minimum thresholds are not met. To implement the NSA a number of changes to the established rates and fees are needed. Specifically, the normal fee for electronic address correction would be waived. Moreover, the First-Class Mail rates would be adjusted to offer Capital One per-piece discounts for certain of its First-Class Mail solicitation volume. These changes would only be available if Capital One met certain conditions prescribed in the agreement.

F. Experiment First

The Postal Service believes that the record fully supports the merits of the proposed classification and rate changes and the logic and benefits of the Capital One NSA. Nevertheless, the Postal Service fully appreciates the reservations regarding the concept of particularized pricing that have been expressed in the past by the Commission and others. For that reason, and out of its own sense of prudence, the Postal Service regards its proposal under the Capital One NSA as fundamentally experimental. Under the terms of the NSA and the proposed classification language, the NSA expires 3 years after the date of its implementation. Furthermore, through the settlement agreement negotiated with the Office of the Consumer Advocate (OCA) and others, the Postal Service has committed itself to monitor the operation of the NSA closely, and to collect and report financial and other data and information that will permit careful assessment of the success or failure of the proposed changes and the NSA.

In this regard, we note that, as explained below, the Commission declined to apply its specialized procedural rules governing proposals for experimental classifications in the litigation of this case. The Commission's determination was based primarily on its assessment of the suitability of those streamlined procedures, given the nature and scope of the issues raised by the Postal Service's proposal. While we believe that the Commission would have been justified in applying the experimental procedures, we understand its reasoning. Its conclusion, however, does not alter the intent of the Postal Service's Request that the Capital One NSA is proposed, and would likely be approved, as a trial, not only of the specific arrangement with Capital One, but in a general sense of the NSA concept.

G. Equitable Access

The Postal Service is acutely aware of the concerns for equity that have been expressed in the past in connection with the general debate over the NSA approach to pricing, and on the record of this proceeding. In this regard, the Postal Service is firm in its view that NSAs should never be permitted to discriminate unlawfully among mailers. Moreover, while certain general characteristics of large-volume mailers might lend themselves more readily to NSAs based on distinct relationships with the Postal Service – particularly with regard to declining block rates – the NSA concept is not logically bound to size or volume. In fact, there are many smaller mailers that might exhibit or could cultivate unique service and operational relationships with the Postal Service that could serve as the bases for NSAs. The Postal Service is not reluctant to enter into such agreements where they would mutually benefit the parties and other mailers.

As discussed below, the settlement agreement concluded with the OCA incorporates an approach to ensuring equitable access to the terms of the Capital One NSA experiment. The Postal Service has formulated standards and procedures designed to ensure that mailers can enter into NSAs that are comparable to the Capital One NSA for the duration of the experiment. The Postal Service believes that these standards and procedures are fair and will provide an effective mechanism for access to rates and conditions that might benefit other individual mailers and the mailing public.

H. Evaluation Discretion

Finally, in light of the experimental status of the Capital One NSA, the Postal Service urges the Commission to view its proposal as a whole in evaluating what should be recommended to the Governors. Beyond the specific terms of the Capital One NSA, the Postal Service is proposing a test of the NSA concept, which is predicated on an individual bargain with a particular mailer. While the Commission cannot suspend its responsibilities to recommend rates and classifications based on the criteria and policies in the statutory scheme, it can exercise considerable discretion in recommending prices. The true test of the NSA concept, and the most realistic opportunity to evaluate the merits or problems of the process leading to NSAs, will lie in the ability to assess the bargain on the basis of the terms it embodies. In this regard, as demonstrated below, the Postal Service firmly believes that the record will adequately support its proposals.

II. PROCEDURAL HISTORY

On September 19, 2002, the Postal Service filed a request with the Postal Rate Commission for a recommended decision on changes in rates and fees necessary to implement the Capital One NSA.[6] The Request also sought to limit these changes in rates and fees to three years from the implementation date set by the Board of Governors. In support of the Request, the Postal Service filed four pieces of testimony from the following witnesses: witnesses Anita J. Bizzotto; Michael K. Plunkett; Charles L. Crum; and James D. Wilson. The request also relied on the support of two pieces of testimony filed by Capital One Services, Inc witnesses Donald Jean and Stuart Elliott, PhD.

The Request sought to have the Commission review and recommend the operative rate and classification elements of the NSA as an experimental classification, under Rule 67 of the Commission's Rules of Practice. The reasons included that the case was novel; the relative impact, duration, and scope of the proposed changes were minor and would be limited to three years; and data would be collected to provide more complete information about the Capital One NSA's effect on postal costs and revenues.

On October 29, 2002, the Presiding Officer declined the Postal Service's request to consider its NSA-based proposal as an experimental classification, under the streamlined and expedited rules codified in sections 67 through 67d.[7] Instead, the proceeding has been conducted in accordance with the rules governing general mail classification requests, with a schedule designed to balance the desirability for expedition with the need for a fair opportunity to explore relevant issues.

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[6] See Request of the United States Postal Service for a Recommended Decision on Experimental Changes to Implement Capital One NSA which was docketed as Docket No. MC2002-2. The Request was filed pursuant to Chapter 36 of Title 39, United States Code.

[7] See Presiding Officer's Ruling No. 3, October 29, 2002.

On December 3 through 5, 2002, the Postal Service's and Capital One's witnesses appeared for hearings on the direct case. On December 20, 2003, the following intervenors submitted cases in opposition to the Postal Service's request: the National Newspaper Association, the Newspaper Association of America, and the Office of Consumer Advocate (OCA). The OCA's case in opposition proposed substituting the Capital One NSA with two separate classifications, one that offered free electronic address correction service and one that offered declining block rates.[8]

The hearings on the cases filed in opposition were held on February 5 and 6, 2003. NAA witness Kent and OCA witnesses Smith and Callow appeared. NNA witness David's did not appear but his written testimony was accepted on the record.

On February 7, 2003, the Commission presented the testimony of John C Panzar to discuss the Capital One NSA's effect on competition. The testimony was offered as an independent analysis to assist in developing the record on the economic issues.

In rebuttal, the Postal Service provided the testimonies of witness Plunkett and witness of B. Kelly Eakin and Capital One provided rebuttal testimonies of Robert Shippee and witness Elliott. Three intervenors, Association for Postal Commerce, The Direct Marketing Association, and the Parcel Shippers Association, provided the rebuttal testimony of Robert Posch. Hearings on the rebuttal testimony occurred on March 6 and 7, 2003.

On March 31, 2003, the Postal Service, Capital One, and the OCA filed a Stipulation and Agreement in which the OCA withdrew its alternate classification

[8] This proposal has subsequently been withdrawn. Office of the Consumer Advocate Notice of Withdrawal of Classification Proposal, (OCA Notice of Withdrawal) (March 31, 2003).

proposal and now fully supports the Postal Service's request for the changes in rates and fees necessary to implement the Capital One NSA.[9]

III. THE NSA BENEFITS THE POSTAL SERVICE AND ALL POSTAL RATEPAYERS

The Capital One NSA would benefit the Postal Service and all postal ratepayers. The Postal Service and Capital One have adequately established this on the record of this case. As the Stipulation and Agreement demonstrates, the Office of the Consumer Advocate, which initially opposed the changes needed to implement the NSA, decided, after future consideration, to support the Postal Service's request, as amended. Stipulation and Agreement ¶ 4 (March 31, 2003); Office of the Consumer Advocate Notice of Withdrawal of Classification Proposal (March 31, 2003). The OCA stated that the proposed DMCS and rate changes incorporated into the Stipulation and Agreement "are superior to the classification proposed by the OCA." *Id.* At 1. The OCA would not have taken this position unless it believed that the NSA, taken together with the provisions of the settlement, benefits postal ratepayers and the general public, whose interests it is empowered to represent. 39 U.S.C. § 3624(a).

A. Capital One's Use of First-Class Mail for Solicitations Is Beneficial to the Postal Service and Is Properly Encouraged by this NSA

Capital One, unlike other mailers, makes extensive use of First-Class Mail for solicitations, mail that also qualifies for less expensive Standard Mail rates. Tr. 2/39. While other mailers may use First-Class Mail for solicitations, they do not do so to the same extent. Tr. 9/1863-64. Capital One has developed models which help it choose between mail services to market products to potential customers or groups of

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[9] *See* OCA Notice of Withdrawal.

customers. Its efforts have been successful and the company has grown over the past few years. Tr. 2/38-39.

The Postal Service has benefited from Capital One's use of First-Class Mail for solicitations. The current First-Class Mail rates have a higher per-piece contribution to the overall costs of the Postal Service than do the Standard Mail rates. PRC. Op., R2001-1, App. G, Sched. 1. So each solicitation that is sent First-Class Mail instead of Standard Mail incrementally benefits all users of the Postal Service. Tr. 9/1863-66.

Solicitation mail, by its nature, has a much higher return rate than other First-Class Mail, which is primarily bills, statements, and other correspondence between people and entities with established relationships who inform each other of changes in their addresses. Direct mail lists, on the other hand, are less accurate, even with the frequent use of postal hygiene products. A proportion is likely be undeliverable as addressed (UAA). *See* Tr. 2/42; 9/1802.

In any event, Capital One's and other mailers' use of First-Class Mail for solicitations is unequivocally good for the Postal Service's bottom line. The difference in contribution between First-Class Mail and Standard Mail is significant enough that the additional costs of return of UAA mail is covered by the contribution difference and the Postal Service is better off than if the solicitations were sent as Standard Mail. Tr. 9/1863-66.

B. Capital One Must Make an Investment to Qualify for No-Fee Electronic ACS in Lieu of Physical Returns and thus Create Savings for the Postal Service

By agreeing to forgo physical returns, Capital One will need to change the way it processes returns, something that will require a more than trivial investment. It will have to do everything from change its data processing to reprint its envelopes to revise its mail preparation practices. Tr. 9/1931. This is not something it had the incentive to do in the absence of the declining block rates which form the other main part of the NSA.

This incentive will then allow the Postal Service to reap additional benefits, beyond those which ensue from Capital One's discretionary use of First-Class Mail for solicitations. Reducing significantly the cost of physical returns of solicitations will further increase the contribution from Capital One's mail and the increased contribution will benefit all mailers. The Capital One NSA will enable the Postal Service to substantially reduce the costs of Capital One's solicitation returns, costs that are borne by all First-Class Mailers. Currently, when a mail piece is undeliverable as addressed and cannot be forwarded, the carrier endorses the reason on the mail piece and places the piece back into the mailstream. These pieces are more expensive to handle than the automated letter mailstream because of the greater extent of manual handling. Response of United States Postal Service to Oral Request of Chairman Omas at Tr. 2/342, filed on December 9, 2002, at 3-6. In all the Postal Service estimates that Capital One's return mail pieces cost 53.5 cents per piece. USPS-LR-1/MC2002.

The agreement provides that Capital One will receive an alternate handling of its UAA solicitation pieces. Capital One has agreed to participate in the Address Change Service program. It will be assigned an ACS participant code which it will imprint on First-Class Mail solicitation pieces along with a keyline that Capital One will use to identify a specific record in its address file. Capital One will also endorse this mail with the term "Change Service Requested." Delivery units send UAA mail bearing this endorsement to a Computerized Forwarding Service (CFS) unit. The CFS unit will lift information from the mail piece necessary to inform Capital One electronically of the keyline, the reason the piece was UAA and, for move-related mail, the new address. Pieces that should be forwarded, are labeled with the new address placed in the mailstream. All other pieces are discarded at the CFS unit. The cost of handling pieces that would otherwise be returned is 33.5 cents.[10] Thus for each piece of Capital One's mail that will be handled through the ACS program, the Postal Service saves approximately 20 cents.[11]

The NSA will provide value beyond the estimated savings. Capital One is obligated to update its address records within two days of receipt of the ACS information. *See* NSA ¶ II.C, Attachment G to the Request; Tr. 2/102. Capital One anticipates that this agreement will result in a decline in the return rate for Capital One First-Class Mail solicitations. Tr. 2/92-92. Moreover, for pieces that have been forwarded, Capital One will be able to update its databases with the new address, thus obviating the need for the Postal Service to forward a subsequent piece sent to the addressee.[12] Although the complexities involved in trying to estimate these savings

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[10] For a detailed description of the handling of UAA pieces please see USPS-T-4.

[11] The Postal Service estimates that approximately 15% of Capital One's solicitations bearing the Change Service Requested endorsement will still be returned to Capital One rather than handled through the ACS program. T-4 at 6. This reduces the effective per piece savings to 17 cents.

[12] Forwarding was the subject of extensive discovery. In sum, witness Crum testified that the cost of providing Capital One with ACS notice of pieces that are forwarded will be more than offset by the reduction of forwarded Capital One mail. Tr. 2/318-22.

militated against including them as support for the Postal Service's request, they still should be considered as benefits of the deal.[13]

C. Declining Block Rates Will Encourage Additional Volume and Increase Overall Contribution

The Postal Service has proposed that these savings be used to help fund declining block rates for incremental First-Class Mail volumes above the threshold of 1.225 billion pieces. USPS-T-2, at 4. Witness Crum estimated that this would result in a net gain to the Postal Service of $8.2 million, based on witness Elliott's original forecast. USPS-T-3, at 6. Using witness Elliott's latest forecast (COS-RT-2), this figures becomes $11.4 million. Tr. 9/1845. Although this is not a large sum of money in the context of the overall postal budget, it is over 2 percent of postal revenue from Capital One, makes a positive contribution to the bottom line, and represents a significant additional contribution from Capital One. USPS-T-2 at 5; Tr. 2/288.

It should be noted that the contribution based on witness Elliott's original forecast was reduced because the volume forecast was higher than the discount threshold of 1.225 million pieces. This resulted in some revenue leakage, the so-called "free rider" problem. This is the term used by OCA witness Smith to refer to the "payment of an incentive where none is necessary, i.e., for pieces which would have been sent absent an incentive." Tr. 7/1241. Because witness Elliott's later forecast (COS-RT-2) of 1.210 million is just under the threshold, this concern has been alleviated. Nevertheless, the Postal Service does not believe that "zero leakage" should be established as a

[13] The stipulated data collection plan, Attachment C to the Stipulation and Agreement, is designed to develop further information to assess the impact of the NSA on Capital One's forwarding and return rates.

requirement for declining block rates. Forecasts are only forecasts and the future cannot be predicted with certainty. Even if an agreed-upon threshold is based on the latest and best volume forecast available, there is likely to be some divergence, in either direction, from actual volumes, and the potential for leakage cannot be eliminated. More fundamentally, it is impossible to determine with any degree of certainty which "pieces which would have been sent absent an incentive." As long as there is good reason to expect that the overall financial contribution from the declining block rates or, as here, from the declining block rates in combination with cost savings will be positive, the existence of leakage should not be seen as an impediment to recommending declining block rates. Similarly, a reasonable degree of revenue leakage has been the norm in fashioning worksharing discounts in the past. *See, e.g.,* PRC Op. R90-1, Vol. 1, at V-181-83; PRC Op., R97-1, Vol. 1, at 534.

Declining block rates will clearly provide an incentive for Capital One to maintain and increase its use of First-Class Mail for solicitations. Witness Shippee testified that "the existence of the incentives are very likely to prompt us to try to meet and exceed the 1.225 billion [threshold for volume discounts], especially since we're so close in the before rates [forecast of test year volume of 1.210 million]." Tr. 9/1835. It is logical that having the discounts within reach will provide an incentive for Capital One to use First-Class Mail, thus increasing the volume that otherwise would have been mailed, and providing additional benefit to the Postal Service and to all mailers. There is clear indication of a trend toward using Standard Mail for Capital One's solicitations. Tr. 2/39. As noted above, witness Plunkett has demonstrated that a shift from First-Class Mail to Standard Mail by Capital One, even given the savings from not returning UAA pieces, is financially detrimental to the Postal Service. Tr. 9/1863-66. The potential to stem that tide is a significant benefit of the agreement. This is especially true in light of the overall trend, and Capital One's specific goals, of moving statement mail to electronic means over the next few years. Tr. 2/40

D. It Makes Sense to Combine the Two "Parts" of the Agreement

The question has been raised of why the two "parts" of the NSA—electronic no-fee address correction service in lieu of physical returns, and declining block rates—need to be combined in one agreement and classification. *See* Tr. 9/1935-38. This question is linked to the question of whether the two main features of the agreement should be more generally made available to other mailers. The latter question was the issue the OCA attempted to address with witness Callow's proposal to create two generally available experimental classifications. Tr. 7/1353-96. But the OCA ultimately abandoned that proposal in the settlement agreement because it understood that there were practical difficulties in doing so. *See* Tr. 9/1866-69. As the settlement demonstrates, the OCA eventually agreed with the Postal Service's view that it is sensible to test out these two features in the limited context of the Capital One NSA and use that experience to evaluate their value and potential future availability to other mailers.

The main reason the two features are linked together in the NSA is simply the result of negotiation. They are, obviously, not inherent linked by subject matter, which is perhaps part of the source of the question of why they are paired in the agreement. Although the two features emerged together from negotiations, they do not form a *quid pro quo*. Tr. 9/1877-79. Capital One is not conditioning its volume growth on the availability of no-fee ACS and the Postal Service will have the benefit of return savings even if no discounts are achieved. These two features simply emerged in the course of discussions as areas of potential mutual benefit to the Postal Service and Capital One.

In this NSA, although the cost savings were not directly related to the volume discounts, the Postal Service felt that the existence of cost savings as part of the deal would alleviate the issue of potential revenue leakage from the declining block rates. The “unrelated” cost savings from the use of electronic ACS provided a convenient counterpoint to Capital One’s desire for discounts,

The fact that the latest forecast of Capital One’s volumes is below the threshold at which discounts begin does not mean there is no longer any relationship between the two parts. Indeed, witness Shippee testified that for Capital One, simply knowing that they are so close to earning discounts would provide an incentive for the company to increase the volume of First-Class Mail that it otherwise would have sent without the incentive of earning discounts. Tr. 9/1835.

The availability of discounts is one of the keys to Capital One’s willingness to make the investment it needs to meet the requirements for no-fee electronic address corrections. The Postal Service is certain that Capital One would not be interested in an agreement or a niche classification that offered only no-fee address correction service, because of the investment required for Capital One to change its operations to meet the requirements to receive the no-fee service. And the Postal Service is not ready at this time to propose declining block rates outside the context of this agreement. So without this agreement, there would be neither declining block rates and nor “free” electronic address corrections.

Combining seemingly unrelated features to fashion a special arrangement that recognizes a mailer's unique characteristics in a way that is mutually beneficial, while novel, is expected to be a recurring theme in future NSAs. The Postal Service sincerely hopes that the Commission will recognize this technique as a logical evolution in the customization of postal services, which first began with worksharing discounts in 1976. As witness Bizzotto testified, postal customers "support creative, cost-effective rates and classifications meeting their needs" and "[c]ustomized pricing and classifications will give the Postal Service a valuable tool to meet its customers' needs in an increasingly complex marketplace." USPS-T-1, at 4.

IV. THE RECORD SUPPORTS THE REQUESTED CLASSIFICATION AND RATE CHANGES NECESSARY TO IMPLEMENT THE CAPITAL ONE NSA

A. Review of the Record.

The Postal Service's direct case rests on six pieces of testimony; four from Postal Service witnesses Bizzotto, Plunkett, Crum, and Wilson and two from Capital One witnesses Jean and Elliott. The direct testimony of witness Bizzotto, USPS-T-1, provides an overview of how NSAs fit into the Postal Service's overall pricing strategy, which seeks flexibility and customization within the current statutory framework.

Witness Plunkett, USPS-T-2, discusses the features of the Capital One NSA and the policy and business considerations that support the NSA. He relies on the testimony of Capital One witness Jean to describe Capital One's innovative use of First-Class Mail and how this gives rise to the opportunity for significant cost savings upon implementation of the NSA. He explains how the declining block rates structure operates, how it is a fair basis for sharing the benefits of the agreement, and how it provides incentive at the margin to retain and increase First-Class Mail volume. Witness Plunkett describes how the NSA serves the interest of Postal Service and its customers and how the requested changes in rates, fees, and classifications are consistent with the criteria of the Postal Reorganization Act. Finally, witness Plunkett supports the Postal Service's requests that these changes be established as an experimental classification and provides a plan for the collection and reporting of data during the experiment.

Witness Crum, USPS-T-3, presents the financial impact of the NSA on the Postal Service by estimating the cost savings, the loss of revenue from the discounts, and the contribution from new mail volume that result from the discounts. To do so, he relies upon the forecasts of First-Class Mail volume made by Capital One witnesses Jean and Elliott in their direct testimonies. He also relies on aggregate data from Docket No. R2001-1, which he adjusts to reflect Capital One specific cost information. Finally, he relies upon the testimony of witness Wilson, an address management expert, for an adjustment to the cost-savings based upon the percentage of pieces that will receive electronic notices in lieu of the physical returns. Witness Crum estimates that the Capital One NSA would have a net positive contribution to institutional costs of $8.2 million.

Witness Wilson, USPS-T-4, provides background on the handling and processing of UAA First-Class Mail. He focuses on the Address Change Service (ACS) program, describing the particular option that, as part of the NSA, Capital One would use to receive electronic notices in lieu of physical return of the mail. He also provides witness

Crum an estimate of the proportion of mail that would still be physically returned despite Capital One's use of the ACS program.

Capital One witness Jean, USPS-T-1, provides a detailed description of Capital One's innovative use of First-Class Mail for credit card solicitations. Unlike most direct marketers who rely primarily on Standard Mail, Capital One uses a combination of First-Class Mail and Standard Mail to better reach credit worthy consumers. He explains that Capital One uses First-Class Mail when it needs a higher level of service, such as speed of delivery, forwarding, and return of undeliverable mail. Witness Jean provides the test year forecast for First-Class Mail in the absence of the agreement (1.4 billion pieces of mail), and the expected rate of return on solicitations. He also describes how receiving the information electronically, along with Capital One's compliance with other terms of the agreement, will improve the mail's address quality.

Capital One witness Elliott, COS-T-2, reviews witness Jean's projections of before-rates volumes and places those projections in context. He also derives Test Year After Rates volumes projections under two separate methods, one which uses the First-Class Mail elasticities, and another which uses the Standard Mail elasticities. Witness Crum uses the most conservative forecast, under the former method, to estimate the amount of new volume that would result from the discounts.

The Postal Service's direct case was subject to extensive written and oral cross-examination on a variety of issues. Many of these issues were reflected in the testimony filed in opposition by three intervenors and will be discussed in detail below.

The National Newspaper Association presented the testimony of witness David, NNA-T-1, who opposes volume-base rates because he fears that they will provide advantages for large national businesses only. The Newspaper Association of America presented the testimony of witness Kent, NAA-T-1, who was concerned that the Postal Service had not appropriately assessed the financial impact and, in particular, had not calculated the cost savings correctly. The OCA presented the testimony of witness Smith, OCA-T-1, who takes issue with Capital One's volume forecasts and offers a substitute methodology for forecasting. OCA witness Callow, OCA-T-2, proposed two new experimental mail classifications in First-Class Mail based upon the principal features of the Capital One NSA: electronic address correction and declining block rates. The proposals accept the Postal Service's costing methods but were offered to supplant the Capital One NSA. Under the Stipulation and Agreement, the OCA has withdrawn its classification proposals but continues to rely on the parts of its testimony that support the Capital One NSA.[14]

The Commission submitted the testimony of John C. Panzar, JCP-T-1, to assist in developing the record on the theoretical economic issues raised in the proceeding. Professor Panzar discusses the desirability of optional tariffs such as declining block rates, but expresses concern for the potential impacts on profitability, and on competitors of the firm receiving the NSA.

In rebuttal to the cases filed in opposition, Capital One presented the testimony of witness Robert Shippee, COS-RT-1, who underscores the value that the declining block rates will hold for Capital One through the three years of the deal, even if its volumes in the test year are below the discount threshold. He explains how the NSA

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[14] See the Office of the Consumer Advocate Notice of Withdrawal of Classification Proposal, filed March 31, 2003.

was the result of long negotiations. He also discusses the benefit to the Postal Service and Capital One from receiving information about UAA mail electronically. Lastly, he discusses marketing practices in the credit card industry to question the suggestion that increased solicitation mail volume at one company might reduce the mail volume at another.

Capital One also submitted the testimony of witness Elliott, COS-RT-2 who presents a revised forecast of test year volume based upon Capital One's actual volumes through December, 2002. Then, using the new forecast of 1.210 billion and witness Crum's methodology, he provides a revised estimated contribution of $11.4 million. Since the revised forecast is below the discount threshold, the revised contribution estimate results solely from the anticipated costs savings of Capital One's use of ACS.

Postal Service witness Plunkett, USPS-RT-1, submitted rebuttal testimony that shows that Capital One's mailing practices do not harm the Postal Service. Its extensive use of First-Class Mail, rather than Standard Mail, for solicitations generates far greater net benefit to the Postal Service, even accounting for the costs owing to a greater proportion of UAA mail. He also addresses the operational and policy issues and problems that arise from witness Callow's proposal. He discusses that the best way to address the competitive concerns raised by Professor Panzar is to enter into agreements with Capital One's competitors, many of whom are already in discussion with Mr. Plunkett about obtaining their own NSAs. Tr. 9/1870 and 1998.

Postal Service witness B. Kelly Eakin, USPS-RT-2, addresses the competitive issues raised in Professor Panzar's testimony. Dr. Eakin concurs with Professor Panzar that the interdependence of demand for postal services amongst credit card firms could cause both positive and negative secondary effects from the NSA. Empirically, he estimates these indirect effects, and concludes that they are likely to be sufficiently offsetting to justify the NSA proponents' implicit assumption of no material impact. Dr. Eakin's testimony also discusses the benefits of NSA in general, and identifies other industries in which NSA-type arrangements have been successfully implemented, even for services used as production inputs by large commercial customers.

Rebuttal testimony of Robert Posch, PostCom, et al.,-RT-1, supporting the NSA was presented on behalf on three intervenors, PostCom, DMA and the Parcel Shippers.

B. The NSA Has a Net Positive Contribution under the Original and Revised Forecasts

1. The net contribution estimate is based on an analysis of the cost savings, the discount leakage and the contribution from any new volume that result from the discounts.

Witness Crum examines three elements when estimating that the Capital One NSA would increase contribution by $8.2 million. The first factor is an estimate of the cost savings that accrue when Capital One forgoes the physical return of its solicitation mail and receives information about its returns electronically through the ACS program. The second is a fairly straightforward calculation of the amount of discount leakage or discounts paid on pieces below the forecast of the mailer’s volume in the absence of the NSA (before rates volume). The third factor is the amount of contribution, or revenue minus costs, that will accrue from the new volume as a result of the discounts (after rates volume). In his rebuttal testimony, witness Elliott revises the before rates volume forecast and recalculates the positive contribution as $11.4 million. Both witness Crum and Elliott use the same methodology to calculate the contribution. See Tr. 9/1845.

In determining the cost savings, witness Crum relies upon the following key inputs: the estimated volume of Capital One solicitations, the expected rate of returns, the average test year costs for physical returns and for ACS notification and the anticipated rate at which ACS notices will supplant physical returns. See USPS-T3-3, at 5-6 and Attachment A, page 2. Using Capital One's original forecast of 1.4 billion First-Class Mail pieces, witness Crum estimates the returns adjusted unit cost for both the test year before rates and the test year after rates to yield a cost savings of $13.1 million. *Id.* Attachment B, page 2.

Witness Elliott, on rebuttal, provides a revised forecast of 1.21 billion pieces of mail and a revised analysis of contribution of $11.4 million. COS-RT-2, 9/1843-1845. The lower cost savings results from the reduction in solicitation mail volume which commensurately lowers the amount of UAA mail that would be returned. Compare Exhibit 3, COS-LR-4 to USPS-T-3, Attachment A, p. 2.

With respect to the second element of calculation, the discount leakage, witness Crum takes the test year before rates volume forecast less the volume in each tier of the declining block rates table times the applicable discount. The total estimated discount leakage is $6.7 million. USPS-T-3, at 6; Attachment B page 3. By comparison, the revised forecast by witness Elliott presents no discount leakage because it is below the initial discount threshold of $1.225 billion. Tr. 9/1845.

For the third element of his contribution calculation, witness Crum estimates the increased contribution from the new volume generated by the discounts. For the new volume figure, witness Crum relies on Witness Elliott's direct testimony, which estimates after rates volume numbers using two separate methods. COS-T-2, at 5. Witness Crum chooses the conservative estimate, 15.5 million pieces of new volume, based on the price response for workshare First-Class Mail letters.[15] Witness Crum multiplies the estimated unit contribution by the additional pieces. See USPS-T-3, at 2-4 and Attachment B, page 1. Witness Crum calculates the contribution on the new volume as $1.8 million. On rebuttal, witness Elliott calculates no after rates volume increase, and therefore no new volume contribution, since the test year before rates volume is below the discount threshold. Tr. 9/1845.

Thus the original forecast yields a positive contribution of $8.2 million and under the revised forecast, it yields a positive contribution of $11.4 million. In either case, the NSA has positive financial impact that will benefit all mailers.

2. Either the original or the revised forecast of Capital One's First-Class Mail volume can be used to evaluate the merits of the NSA in the test year.

Capital One developed its original forecast of its First-Class Mail volumes in the test year, 1.4 billion pieces, by asking business managers to provide estimates of their use of First-Class Mail. COS-T-1, at 5. Witness Elliott then reviews this estimate and placed it in context of the company's mail volume history, the impact of the anthrax attacks, and its change in marketing strategy it announced in the summer of 2002. COS-T-2, at 2-4. The mail volume history presented by witness Elliott provided actual volumes from October 1999 through July 2002. Witness Elliott found the estimates reasonable. COS-T-2, at 4.

In its rebuttal testimony, Capital One revised its forecast of its First-Class Mail volumes to 1.21 billion pieces, based upon actual volumes from October 1999 to

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[15] If witness Crum had used the alternate new volume estimate of 53 million, the contribution from new volume would have been substantially higher.

December 2002. Tr. 9/1883-1884; COS-LR-4, Exhibit 1. It did not rely upon the statements of business managers as did the first forecast. Still, either method yields an acceptable basis for forecasting Capital One's volumes.

3. The Test Year Is the Appropriate Basis for Evaluating the Merits of the Proposal

Witnesses Crum and Elliott have appropriately set forth the financial impact of the Capital NSA for the fiscal year 2003, the test year. Their presentation conforms to the long-established standard incorporated in the Commission's rules (39 C.F.R. § 3001.54(f)(2)) that proposals should be evaluated on the basis of costs and revenues estimated for a single fiscal year beginning not more than 24 months after filing of the Request. It has been variously suggested in this proceeding that this rule establishes an inappropriate standard for the Capital One NSA, or any NSA, which is negotiated to be in place over a time period going beyond a single year. It has been suggested that the only appropriate standard is the full term of the agreement.

The appropriate test period for assessing Postal Service requests has been a subject of debate and reconsideration for many years. On several occasions, the Commission has concluded that its current rule remains an effective standard to evaluate the financial effects of rate and classification changes. The guiding principle for the Commission's assessment has been whether the test period covers a time span "representative of the period in which the rates will be in effect."

In Docket No. RM82-3, the Commission conducted a comprehensive review of the test year rule and its implications. It not only considered whether a fiscal year was the appropriate standard for accounting purposes, but also whether a longer period of time should be used, given the tendency of rate cycles to exceed one year, and whether a different standard should be used for classification changes, or for rate changes more limited than those proposed in omnibus rate cases. After considering substantial comments, the Commission concluded that the single fiscal year remained the most appropriate standard for both rate and classification changes. The only amendment it adopted permitted more prospective test periods beginning no more than 24 months after filing of the Postal Service's Request.

The Commission revisited the test year rule in Docket No. RM95-4. In that rulemaking, it considered a finding of the Joint Task Force that recommended considering test periods longer than a single fiscal year when considering the establishment of new products or services requiring recovery of substantial capital investment. The Commission established such a rule applicable only to new services "which in the estimation of the Postal Service cannot generate sufficient volumes and revenues to recover all costs associated with the new service in the first full fiscal year of its operation." 39 C.F.R. § 3001.181. The Commission did not review or reconsider the applicability of its existing test year standard to any other type of proposal.

Opponents of the Capital One NSA offer a red-herring in suggesting that the existing test year rule establishes an inappropriate standard solely because the NSA has a fixed term. Nothing in a proposed NSA creates any greater vulnerability for the Postal Service in achieving break-even than created by proposals to change all rates and fees in an omnibus rate case, or in any other classification case or a case involving a more limited rate proposal. Yet, the Commission has consistently concluded that the single, prospective test period remains the most effective and appropriate standard on which to evaluate Postal Service rate and classification change proposals.

Although the FY2003 test year is the appropriate bases for evaluating the NSA, the Postal Service conducted sensitivity analyses to ensure that the agreement would yield a positive contribution over its entire duration. Moreover, the Postal Service examined possible variants that would affect the contribution throughout the term of the agreement, and determined that the test year was representative of subsequent years of the agreement. Tr. 4/776; and Response to APWU/USPS-2 (Nov. 25, 2002).[16] Litigants in the instant proceeding, and even the Commission itself, have inquired about costs (and factors that may affect costs) in the second and third year of the agreement. See Response to APWU/USPS-2, Tr. 5/869-78; Response to Oral Request of Commissioner Goldway, Tr. 5/958-66; and Response to APWU/USPS-8, Tr. 5/883-84. As the various requested sensitivity analyses demonstrated, even with significant changes in the costs and volumes in the out years, the net contribution remains positive. *Id*. The use of sensitivity analysis is a valid tool to evaluate the risks inherent in the forecasting process. The latest revision to the Capital One volume forecast is an example of some of the uncertainty inherent in forecasting the volume of a single company, but the updated estimates fall within the range of volume modeled in the sensitivity analyses requested in APWU/USPS-2. The sensitivity analyses provided should increase confidence that the single test year construct embedded in the Commission's rules remains appropriate for this proceeding.

[16] The text portion of the Response to APWU/USPS-2 appears in the transcript at Tr. 5/869-78. The Excel spreadsheets attached to that Response do not appear in the transcript, but are available in the Daily Listings on November 25, 2002, and are in the record as part of the response to APWU/USPS-2.

4. The use of average costs, with adjustments for known variations is appropriate.

Witness Crum's costing methodology appropriately used adjusted aggregate cost data to reflect customer-specific information. In calculating the average revenue for Capital One's First-Class Mail presort volume, witness Crum presented the detailed volume by rate category in Attachment A, page 1 of his testimony. In calculating the average per piece cost of Capital One's First-Class Mail presorted volume, he presents the FY2003 costs as allocated by volume by detailed rate category in Attachment A, page 2 of his testimony.[17] He further adjusts these costs by rate category to account for the difference between Capital One's return rate in the test year and the return rate for First-Class mail in total. Similarly, his costs for the physical returns as compared to ACS are based on FY2003 found in library reference J-69 from R2001-1 docket but have been adjusted to match Capital One's experience.[18]

These types of costs, adjusted when possible to reflect Capital One's costs, are appropriate since they are the best available data. The Commission's witness, Dr. Panzar, acknowledges the permissibility of using average data when the company specific data do not exist. Tr. 8/1633-1635.

[17] As noted in footnote 11 of the Request, the Postal Service has relied on cost estimates based on methodologies and approaches for cost attribution approved by the Commission in its recommendations in Docket No. R2001-1 for the limited purpose of this proceeding. Request at 9.

[18] Witness Crum removes "originating postage due unit", "destinating accountable mail unit", and "collection postage due unit – carrier" from the information presented in Table 5.1.2 before preparing the information presented in USPS-LR-1/MC2002-2, at 1. Witness Crum adds the costs of "Carrier Preparation" and "Clerk Handling" to the eACS cost from Tab 3 of USPS-LR-J-69 to develop the full electronic "return" costs presented in USPS-LR-1/MC2002-2, at 2.

V. THE REQUESTED CHANGES ARE CONSISTENT WITH THE ACT

Witness Plunkett demonstrates in his direct testimony that requested changes in the classification and rate schedules meet the criteria of the Act, set forth in 39 U.S.C. §§ 3623(c) and 3622(b), respectively.

Witness Plunkett testifies that negotiating directly with individual customers allows a more accurate determination of prices that represent the value that the user places on the service being provided (§ 3622(b)(2)) for mail classifications that are desirable to the mailer and the Postal Service (§ 3623(c)(5)). In this case, the Postal Service has directly negotiated with the sender of the mail to arrive at classifications and prices that the Postal Service considers to be fair and equitable (§§ 3623(c)(1); 3622(b)(1)). Witness Crum's testimony demonstrates that the prices presented in this case will cover the costs of providing the service (§ 3622(b)(3)). And Capital One's address improvement steps will serve to lower costs currently borne by other customers ((§ 3622(b)(6)). Witness Plunkett testifies that, for this reason, the classifications and prices presented in this agreement confer beneficial effects on the general public and other ratepayers (§§ 3623(c)(1); 3622(b)(1)). He also testifies that the proposed rates do not have an adverse impact on the rates paid by the general public, or other business mail users (§ 3622(b)(4)) and that the proposed declining block rate structure is relatively simple and maintains a transparent, identifiable relationship between volume levels and applicable rates and fees (§ 3622(b)(7). Witness Jean (COS-T-1, at 2, 4) testifies that Capital One has alternatives to the use of First-Class Mail, such as telemarketing for solicitations, and electronic bill presentment for statement mailings.

Therefore, witness Plunkett concluded that these facts are compelling reasons why customization of prices is appropriate in this instance (§ 3623(c)(5)).

VI. PRACTICAL APPLICATION OF THE THEORETICAL PRINCIPLES IDENTIFIED BY PROFESSOR PANZAR PROVIDES NO BASIS TO QUESTION THE PROFITABILITY OR FAIRNESS OF THE PROPOSED NSA

At the request of the Presiding Officer (Presiding Officer's Notice, Dec. 20, 2002), Professor John Panzar submitted testimony offering his suggestions regarding evaluation of the proposed NSA. JCP-T-1, Tr. 8/1574-1606. The primary focus of his testimony was to suggest that the potential existence of interdependent demand for postal services between the NSA partner (in this instance, Capital One) and its competitors complicates economic analysis of the effects of the declining block rate portion of the NSA. Tr. 8/1589-96. For example, at the extreme, if all units of expanded service consumption by the NSA partner at discounted rates were to be completely offset by decreased service consumption by its competitors of units formerly paying undiscounted rates, the service provider would actually be worse off with the declining block rate agreement than without it.[19] As Professor Panzar suggests, the foresighted service provider would need to take the potential for such "feedback effects" on profitability into account. Tr. 8/1592. Professor Panzar further suggested that, because Capital One uses First-Class Mail as an input into the process by which it provides financial services to its customers, any reduction in the cost of that input flowing to Capital One from the NSA, but unavailable to its competitors, creates a

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[19] Under this hypothetical scenario, there would be no change in the total number of units provided, but the total revenue generated by those units would decline.

relative competitive disadvantage for such entities, even if it were to have no effect on the postal services consumed by them. Tr. 8/1589-91, 1618, 1622-23.

Professor Panzar's concerns regarding potential "feedback effects" and profitability would be more clearly applicable if the product which was the subject of the NSA were a more traditional input into a more conventional production process. Imagine a firm that produced steering wheels, to be purchased by car companies as inputs to their vehicle production process. Further imagine that there was no source other than that firm from which the car companies could obtain steering wheels, that one steering wheel was required for each car manufactured, and that all vehicles used the same steering wheel. We have hypothesized, therefore, a firm which is a perfect monopolist, producing inputs which are homogenous and are used in fixed proportions. Under these assumptions, it seems fairly clear that cutting a deal to lower marginal prices for additional steering wheels sold to one car company is unlikely to be a winning strategy. To the extent that the lower cost of steering wheels allows that company to sell more cars, its competitors would presumably sell fewer cars, and therefore reduce their purchases of steering wheels. Since the additional steering wheels sold to the preferred car company would be sold at discount prices, while the reduction by the competitor car companies would involve steering wheels previously sold at full price, the need for the steering wheel manufacturer to pay close attention to these "feedback effects" is manifest.

Equally manifest, however, is the fact that the circumstances faced by the Postal Service with regard to the Capital One NSA differ substantially from those faced by our hypothetical steering wheel manufacturer. First, to the extent that financial service firms use the mail to advertise their products, the Postal Service has no monopoly on advertising. [20] Numerous competing advertising channels (e.g., telemarketing, Internet, print media, television) exist, and several are routinely employed by financial services companies like Capital One. See, for example, COF-T-1 at 2 (Jean), Tr. 8/1620-21 (Panzar), and Tr. 10/2073 (Eakin). The potential impact on the analysis of the existence of available alternatives is substantial. If the only effect of the NSA were to cause Capital One to shift advertising resources from nonpostal media to First-Class Mail, there would be no "feedback effect," because there would be no overall change in Capital One's advertising to which competitors would need to react. Tr. 8/1620-21. Even if only part of the adjustments made by Capital One to the NSA represented shifts from other media, the intensity of the effect would diminish. Tr. 8/1742-45. The presence of viable alternatives causes the dynamics to change significantly from the simplistic steering wheel monopoly hypothetical.[21]

Second, direct mail is unlikely to be an advertising input that is employed in fixed proportions across competing financial services firms. Certainly there is nothing even remotely approaching the essentially immutable technological relationship of one steering wheel per car. As noted above, several alternative advertising channels are available, and the mixes of media employed by the marketing experts at various firms

[20] To the extent that financial services firms use the mail to communicate with existing customers, for example, to deliver monthly statements, technological alternatives exist and are becoming increasingly important, but the choice of leaving the mail for such purposes is admittedly one that the firms generally cannot make unilaterally.

[21] Professor Panzar indicated that the assumption regarding the monopoly status of the service provider upon which his analysis is premised was one he took as a given as part of what he was asked to provide, rather than reflecting his own interpretation of the economic consequences of an established legal constraint. Tr. 8/1738-39.

are unlikely to be uniform.[22] More to the point, as Professor Panzar acknowledged, it is plausible that an increase in the use of advertising inputs by one firm would stimulate greater use of advertising by its competitors, rather than less use as envisioned by his analysis of more conventional inputs. Tr. 8/1751-54, 1787-89. Contemplating the effects on demand of competitors for postal services of a declining block rate structure for advertising is much more challenging than engaging in a similar exercise with regard to the effects of a similar rate structure for steering wheels.[23]

Third, direct mail as utilized by different credit cards companies does not constitute a homogeneous input. As witness Jean testified, while most firms advertise primarily with Standard Mail, Capital One relies to a significant degree on First-Class Mail as well to meet its advertising needs. COF-T-1 at 2. As witness Plunkett testified, the Postal Service has not identified any other mailers with the same set of mailing

[22] In his rebuttal testimony, Capital One witness Shippee even goes so far as to question whether the interdependence between the demand for postal services of competing credit card companies, postulated by Professor Panzar (and critical to his analysis), actually exists in reality. See Tr. 9/1803-04. Of course, as Professor Panzar observed, the crux of the matter is not what credit card company managers say, but what they do, and how significant that is (if at all) quantitatively. Tr. 8/1724-26.

[23] Moreover, even if customer mail (as opposed to advertising mail) is used by different companies in relatively fixed proportions (e.g., one statement a month), there is still an important distinction between the credit card market and our steering wheel hypothetical. In the market for cars, customers are basically only looking to buy one car (and, therefore, indirectly, one steering wheel). With credit cards, however, the out-of-pocket cost to consumers of obtaining an additional card may either be small or nonexistent. As a result, as Dr. Eakin suggests, an increase in customer mail by the NSA partner is unlikely to be accompanied by an equivalent decrease in competitors' customer mail, because some consumers may acquire an additional card rather than merely substituting one for the other. Tr. 10/2078. Overall, the phenomenon of consumers acquiring multiple credit cards rather than narrowing the choice down to one (as with car purchases) would tend to weaken the interdependence of demand for postal services among financial service companies.

attributes as Capital One. USPS-T-2 at 8. It is noteworthy, therefore, that the discounts available to Capital One under the NSA only apply, in the case of advertising pieces, to an input for which Capital One is already paying a premium relative to most of its competitors. In terms of "feedback effects," therefore, the potential negative impact of a lost piece of Standard Mail advertising from a Capital One competitor is not as large as the positive impact of an additional piece of First-Class advertising from Capital One. These circumstances are materially different from those assumed in our homogenous steering wheel example, and under such circumstances, as Professor Panzar agreed, his concerns regarding "feedback effects" on the profitability of the NSA are largely mitigated. Tr. 8/1625, 1755.

In his rebuttal testimony on behalf of the Postal Service, Dr. Eakin moves beyond abstract theory in the direction of putting some reasonable bounds around the likely magnitude of the secondary impact of the "feedback effects" identified by Professor Panzar. Tr. 10/2072-84. Dr. Eakin concludes that demand interdependence could result in both increases and decreases in competitors' mail volumes in response to the proposed NSA. Tr. 10/2072. Any decreases are likely to occur in the customer mail portion of competitors' use of the mail, and increases are likely to occur in their use of advertising mail. Tr. 10/2076-79. Constructing "worst case," "best case," and "middle case" scenarios, Dr. Eakin estimates a range of secondary impacts on net revenue (contribution) from the NSA between negative $1.1 million and positive $6.1 million. Tr. 10/2079-84. Based on his analysis, Dr. Eakin's ultimate conclusion is that it is "reasonable" and "pragmatic" to assume offsetting secondary impacts, which result in no material overall financial impact on the proposal. Tr. 10/2076, 2078-79, 2084. As he notes, the analysis of witness Crum can be interpreted to have implicitly made just such an assumption.

In addition to “feedback effects” regarding the profitability of the NSA, however, Professor Panzar expressed concern regarding potential adverse impacts of an NSA on the competitors of the NSA partner. In his view, competitors should have “economic standing” to provide input into the evaluation of the NSA, as they could be adversely affected regardless of whether the NSA is profitable or not. Tr. 8/1595. The potential harm arises because, under an NSA with discounts based on a declining block rate structure, their competitor may be able to achieve a reduction in the costs of inputs which they would not share. Moreover, as Professor Panzar emphasized, this potential for harm still exists even if the competitors themselves do not utilize the postal input for which the NSA might result in discounts. Tr. 8/1618. He was also careful to point out, however, that while the potential for harm to competitors merits consideration, it is not necessarily an adequate basis to reject the NSA. Tr. 8/1595.

A troubling feature of the “economic standing” principle advanced by Professor Panzar is that it equally applies to any rate reduction which might affect a rate paid by some mailers for postal services used as an input into their production process, if they happen to have competitors who do not use that specific postal service as an input. Such a rate reduction could be one portion of an NSA, or it could simply be the result of the creation of a new workshare discount. Tr. 8/1720-21. Moreover, the same principle would appear to apply to any ratemaking exercise involving such a postal service, whether rate *reductions* were under consideration or not. Thus, in a general rate case, if the Postal Service is proposing to raise a particular rate *x* percent, the principle would appear to suggest that competitors of those commercial mailers who use that rate would have "economic standing" to propose that the rate increase be *x*-plus-something percent, because, relative to that, a mere increase of *x* percent would have an adverse impact on their ability to compete.

In some sense, this is not a particularly startling proposition, as virtually anyone has standing to intervene in a postal rate proceeding and make arguments regarding whatever rate proposals they wish to address. The more pertinent question, however, is how much weight should their arguments be given? For example, if a credit card company were to adopt a marketing strategy in which it chose to eschew direct mail marketing and rely exclusively on Internet advertising to attract new accounts, neither the Postal Service nor the Commission should be especially sympathetic to any views it might express that particular postal rates should be set as high as possible solely to protect its competitive interests vis-a-vis credit card firms that do rely on direct mail.[24] The ratemaking criteria of section 3622(b) do not specifically include such concerns among the factors to be taken into consideration, and, in balancing the factors which are included, the Postal Service is unaware of any instances in which the Commission has ever had occasion to rely on such concerns to any material extent. Therefore, the Postal Service considers the "economic standing" principle articulated by Professor Panzar as one that must be viewed with considerable caution, particularly with respect to some of its broader implications.

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[24] The notion that a credit card company might adopt a totally mail-less marketing strategy is not just an off-the-wall hypothetical. An article ("Getting More Out of Direct Mail) in the March 2000 issue of *Credit Card Management* identified the existence at that time of at least one such company, NextCard, Inc.

At the same time, of course, the much more narrow context in which Professor Panzar has actually raised his concerns in this regard cannot be ignored. The NSA proposal in this proceeding would explicitly limit the immediate potential for First-Class Mail discounts to one among many credit card companies. Since postal services currently constitute an input utilized by most (if not all) credit card companies, the question naturally arises as to whether potential adverse effects on competitors might render such a proposal unfair.

In response, one could initially respond with many of the factors relevant to the above discussion of "feedback effects." For example, to the extent that Capital One is relatively unique in its reliance on First-Class Mail for solicitations, its competitors who pay less for Standard Mail (both currently and under the NSA) are not in the optimal position to complain about the unfairness of a decrease in the premium currently paid by Capital One for this input.[25] Similarly, if potential "feedback effects" turned out to be minimal because, as Dr. Eakin suggested, the relative cost savings conceivably may be too trivial to be significant to customers (Tr. 10/2080), then the adverse effect on

[25] Of course, it is Capital One's more extensive use of First-Class Mail which created the opportunity for negotiation on the other portion of the NSA (substitution of electronic for physical returns), and a larger overall agreement against which ultimate evaluations of fairness must be considered. For purposes of discussing Professor Panzar's testimony, it is most practical to focus on the same declining block rate portion of the agreement as he did, but one should not lose sight of the fact that the negotiated discounts have not been proposed in isolation. Moreover, as witness Plunkett noted in his rebuttal testimony, extending the terms of the NSA to all users of First-Class Mail would do little to address the competitive balance concerns raised by Professor Panzar, because the competitors tend not to use First-Class Mail to the same extent as Capital One. Tr. 9/1870.

competitors would presumably be commensurately trivial as well.[26] In addition, as Professor Panzar acknowledged, the greater the extent to which alternative inputs are available, the smaller the adverse impact on competitors of the NSA firm. Tr. 8/1745-46. All of these factors suggest that it seems reasonable to conclude that the adverse effects on competitors are not so substantial as to render the proposed discounts unfair.

There is, however, much more compelling support for the same conclusion. Professor Panzar's testimony is carefully limited to suggesting that competitors of the NSA firm should have the opportunity to participate in the evaluation of the proposed NSA. Tr. 8/1595. In fact, the competitors of Capital One have had every opportunity to intervene in this proceeding, directly express their concerns regarding the potential for adverse impact from the NSA on their ability to compete with Capital One, and state their opposition to the proposal. None has done so. Not only have they not voiced any objection to the NSA, they have not even chosen to intervene.[27] Moreover, we can be satisfied from the testimony of witness Plunkett that their absence from this proceeding is in no way a function of lack of notice, because those same companies have been involved in discussions with him regarding their own prospects for an NSA, and are aware of this proceeding. Tr. 9/1870, 1889-90. These facts lead to the ineluctable

[26] Using the 50 million account figure from witness Jean's testimony (COF-T-1 at 1), and the $6.7 million discount leakage figure from witness Crum (USPS-T-3 at 6), counsel for Capital One and Professor Panzar could agree that an approximation of the effect of the discounts would be 14 cents per account, but did not necessarily agree on whether that amount was likely to be significant to customers or not. Tr. 8/1717-20.

[27] Stated perhaps more fully, no party that intervened specifically identified itself as a competitor of Capital One. Interventions were filed by three trade associations (ABA, American Financial Services Association, and Financial Services Roundtable) that presumably include among their members firms that compete with Capital One, but the latter two of these indicated their support for the NSA in their notices of intervention.

conclusion that adverse effects on Capital One's competitors should not be presumed to constitute any material reason not to recommend the proposed NSA.

Professor Panzar's testimony has played a constructive role in this proceeding.[28] He has focused attention on the possible circumstances under which potential "feedback effects" can detrimentally affect the profitability of a declining block rate structure, if the postal service in question is used as an input by a commercial mailer with competitors who do not have access to the same declining block structure. He has raised a flag regarding the need for competitors to have the opportunity to be heard regarding potential adverse effects on them of limited rate proposals. As a result of his testimony, certain aspects of the proposal which were only dealt with implicitly in the direct case have now been addressed explicitly in rebuttal testimony. That exercise, however, only reinforces the conclusion that the proposed NSA is likely to be beneficial to the Postal Service, to Capital One, and to other mailers generally as well. Conversely, there is no evidence to suggest that the proposal will have any material adverse effects on Capital One's competitors.

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[28] In addition to other benefits, Professor Panzar's appearance also gave him the opportunity to express his general support for NSAs as "potentially powerful tools for improving economic efficiency," and his pleasure that the Commission is now considering the role they might play in postal ratemaking. See Tr. 8/1644-45, 1737-38, 1771-72.

VII. THE STIPULATION AND AGREEMENT SHOULD BE ACCEPTED

A. The Terms of the Stipulation and Agreement Provide an Additional Basis for Accepting the Postal Service's Proposal

During the latter stages of this case, the Postal Service, Capital One, and the Office of the Consumer Advocate resumed settlement negotiations. The purpose of the discussions was to attempt to address the concerns expressed in OCA's trial brief and testimony that may have remained unresolved. Witness Elliott's rebuttal testimony had addressed the so-called "free-rider" problem, whereby Capital One might have received discounts for mail it presumably would have sent otherwise. The Postal Service and the OCA fashioned a mutually acceptable approach for making NSAs comparable to the Capital One NSA available to other similarly situated mailers, including a process for consideration, review, and tracking of requests for other such NSAs. Also addressed was the plan for the collection and reporting of data concerning the Capital One NSA. Given the flaws in witness Callow's proposal that had been addressed in written and oral cross-examination, the OCA and the Postal Service developed a new approach to make the benefits of the Capital One NSA available to other mailers, while still recognizing the need to address separately the unique aspects of Capital One's, and other mailers', business and mailing practices through customized NSAs.

The approach which emerged from these discussion is embodied in the Stipulation and Agreement, particularly in Attachment D. The draft regulations contained therein set forth requirements and factors to guide mailers seeking comparable NSAs and to govern the Postal Service's consideration of such requests.[29]

The regulations set forth elements that an NSA must contain to be considered by the Postal Service to be NSAs comparable to the Capital One NSA. The NSA must , concern the use of First-Class Mail for matter that qualifies for Standard Mail rates, such as solicitations, which relates only to the mailer's products and services. The mailer would have to participate in the ACS program, forgoing return of UAA pieces, and would have to use NCOA or FastForward to meet the Postal Service's move update standards more frequently than otherwise required. Under such an NSA, declining First-Class Mail block rates would be available and would be based on volume thresholds tailored specifically for that mailer. Like the Capital One NSA, the mailer seeking a NSA for such mail would be required to waive the seal against postal inspection

Like the Capital One NSA, the proposed NSA would have to be projected to have an overall positive financial impact on the Postal Service, with a minimum payment or transactional penalty required to ensure a positive contribution. The mailer would have to agree to make records and data available to the Postal Service to facilitate and monitor compliance.

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[29] It should be noted that these regulations are intended only to cover NSAs comparable to the Capital One NSA. Subsequently, the Postal Service will address the development of regulations or procedures that would apply to NSAs for different services and classes of mail than the Capital One NSA.

As this case has demonstrated, the Commission, the Postal Service, and stakeholders in the ratemaking process need to work together to establish process and procedures tailored to NSAs. This may take the form of a classification framework for NSAs and the development of streamlined procedures for the filing and litigation of cases before the Commission to consider the changes in classifications, rates, and/or fees needed to implement NSAs.

Other factors that the Postal Service could take into account, under the draft regulations, in determining whether to negotiate and conclude a comparable NSA with another mailer include: the mailer's presentation of adequate historical data on mail volumes, systems, quality control and past mergers and acquisitions; the mailer's ability to make and present in an acceptable format accurate forecasts of future mail volumes; its ability to collect necessary data in an acceptable format; its willingness to establish an account for automated postage payment; its production of mail using automated systems to ensure proper mail preparation and postage payment; and its implementation of a quality control program to ensure the same.

The regulations further provide for procedures for presentation, consideration, and review of such requirements and factors. The mailer must file a written request, explaining how it meets the standards established for comparable NSAs. If the threshold standard is met, negotiations may begin, with the potential to develop an NSA comparable to the Capital One NSA, yet specifically tailored to the particular needs and circumstances of the mailer. If an agreement is concluded, the Postal Service would then prepare a request to the Commission for consideration of the NSA. Thus, there would be a public opportunity to ensure that further necessary changes to the DMCS, and rate and fee schedules meet the appropriate statutory requirements. Due to the comparability with the Capital One NSA, the issues would presumably be limited and the litigation could be expedited and the benefits of the Capital One NSA more quickly available to similarly situated mailers. This would help alleviate concerns about the potential for competitive advantage to only one credit card company.

The “anchor” for these regulations would be a footnote in the proposed DMCS provisions, indicating that comparable NSAs, involving adoption of electronic Address Correction Service in lieu of physical returns for First-Class Mail that qualifies for Standard Mail rates and declining block rates for First-Class Mail, may be entered into with other customers, as specified by the Postal Service in the draft regulations. The footnote also indicates that implementation of any such NSAs is first subject to proceedings before the Commission.

The Stipulation and Agreement also provides for the Postal Service to report annually on the number of requests made for comparable NSAs, the industry of each requestor, the volume of First-Class Mail mailed annually by the requestor within the following ranges – less than 100 million pieces, 100 to 250 million pieces, and more than 250 million pieces – and the status of negotiations, or if negotiations were terminated, the reason(s) therefore. No information that could identify a mailer would be provided. This would allow interested parties to monitor the progress of the development of comparable NSAs.

B. The Stipulated Data Collection Plan Will Provide Important Information to Gauge the Success of the Experiment

The settlement also provides for an amplified data collection and reporting plan. See Attachment C to the Stipulation and Agreement. The Postal Service and the OCA believe that this plan would provide all information that can practicably be collected to evaluate the affect of the Capital One NSA and to guide the development of future NSAs. An analysis of the data will show during the experiment the volume of solicitation mail that bears the ACS endorsement and the volume of customer mail. It will show the amount of discounts paid. It will show Capital One’s return rate and its change over time. It will show the "ACS Success rate," i.e. the ratio of return pieces that receive an electronic notice to pieces that are physically returned, and the change in the ratio over time. It will show the rate that the mail is forwarded through CFS or PARS, and the change in the rate over time. It will also show the frequency with which a Change of Address record is used to forward Capital One's solicitations, and changes in the frequency over time.

Moreover, the Postal Service will report about its compliance activities and provide an evaluation of the impact on contribution. It will also provide an assessment of trends of Capital One's First-Class Mail volume as compared to overall First-Class Mail volume..

Finally, the settlement provides that the Postal Service's estimated savings from Capital One's use of Address Change Service in lieu of physical returns for undeliverable-as-addressed mail are being anticipated in the preparation of the budget for FY 2004. To the extent these savings are eventually incorporated into the field budgets, there can be some assurance that the projected savings will actually be "captured."[30] Once costs are removed from next year's budget, that cost reduction would carry over into subsequent years' budgets as well.

The Postal Service, the Office of the Consumer Advocate, Capital One, and the other signatories believe that these provisions address the concerns expressed during the course of the proceeding, specifically with regard to the fairness and equity of

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[30] It should be remembered that such savings are bundled with many other estimated cost reductions and program costs, with budget amounts then negotiated between the field and headquarters, leading to a final budget number for each field location. There will not be specific line items in the field budget that can be traced to this particular cost reduction.

implementation of an NSA with one mailer. They also believe that the risk inherent in trying something new is now minimized and that there will be adequate mechanisms to evaluate the Capital One NSA, as it is implemented.

C. The Postal Service No Longer Needs to Address the Operational and Policy Issues Raised by the OCA's Proposal Since It Has Been Withdrawn

In Order No. 1359, issued on February 3, 2003 in response to Capital One's notice that it would object to the admission of witness Callow's testimony, the Commission declined to preclude the testimony and instead invited the Postal Service to address the operational and policy issues. Due to the settlement, the OCA has withdrawn its proposal for two separate experimental classifications. Accordingly, there is no need at this time for the Postal Service to address the merits of witness Callow's proposal. [31]

[31] Of course, should the Commission reject the Stipulation and Agreement, all participants should be given an opportunity to submit briefs on the merits of witness Callow's proposal.