

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

EXPERIMENTAL CHANGES TO)
IMPLEMENT CAPITAL ONE NSA)

Docket No. MC2002-2

REPLY BRIEF

OF

VALPAK DIRECT MARKETING SYSTEMS, INC., AND
VALPAK DEALERS' ASSOCIATION, INC.

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INTRODUCTION

For a docket limited to one mailer, this case has generated significant interest. Six initial briefs were filed in support of the requested Negotiated Service Agreement (“NSA”) (Postal Service, Capital One, Office of the Consumer Advocate (“OCA”), Alliance of Nonprofit Mailers, *et al.*, American Postal Workers Union (“APWU”),¹ and Pitney Bowes), while four initial briefs were filed in opposition (Greeting Card Association, Newspaper Association of America, National Newspaper Association,² and Valpak). All of these parties understand that although this case involves only Capital One, its effect will be widespread. Indeed, the Commission’s opinion and

¹ APWU expressed “serious reservations” with the proposed agreement, but it nevertheless supports it based on its belief that the “first NSA will provide information and experience about the workings of such agreements that will be valuable in structuring future agreements.” APWU Initial Brief, p. 1.

² The National Newspaper Association denominated its filing “Statement in Lieu of Brief.”

recommended decision in this docket, and the principles which it will establish, could potentially affect every mailer.

ARGUMENT

I. A SINGLE-COMPANY NSA IS THE WORST POSSIBLE WAY TO ADDRESS A PROBLEM THAT AFFECTS THOUSANDS OF MAILERS

In its initial brief, Valpak explained why NSAs are not an appropriate way to deal with a general problem in the Postal Service's pricing scheme which affects many mailers — here the free provision of high-cost physical return of non-forwardable First-Class Undeliverable as Addressed (“UAA”) mail (hereafter referred to as “UAA mail”), while charging a fee of 20 cents per return for the less costly electronic service. The Postal Service should be seeking to induce as many First-Class bulk mailers as possible to use electronic Address Correction Service (“ACS”) rather than physical return of their UAA mail, by proposing appropriate changes to the general rate structure. Valpak Initial Brief, at 9. Other parties thus far have generally ignored the fact that the Postal Service needs to fix this aspect of First-Class pricing across the board.

Of course, it also would be possible to achieve a more limited fix through a more comprehensive manner, such as a niche classification, as also discussed by other intervenors. *See, e.g.*, Greeting Card Association Initial Brief, at 8-14; Newspaper Association of American Initial Brief, at 34-35. Valpak continues to assert that because of its inherently exclusive nature, an NSA is the least suitable tool on the Postal

Service's workbench to make this repair. NSAs are appropriate for situations that are unique, or at least highly distinct, and limited to a very small number of mailers.

Although this was alleged to be the case at the outset of this docket, it clearly is known not to be so now. Neither the interests of the Postal Service nor those of the mailing community are well served by a narrow and exclusive mailer-specific partial or micro-fix that clearly is inadequate to a major systemwide problem. NSAs should be reserved for those truly unique situations where a broader classification change or niche classification would be unnecessary. The attempts by Capital One and the Postal Service to justify the use of an NSA, rather than a niche classification, in the circumstances of this case are not persuasive.

A. To Recommend the Proposed NSA, the Commission Must Explain Why the NSA Would Be Preferable to a Niche Classification

Valpak agrees with the Commission (as stated in its Report to Congress, February 11, 2002), the Postal Service, and those Intervenors who take the position that NSAs are permissible under the Postal Reorganization Act. The Postal Service and several intervenors argue that NSAs satisfy the second criterion of 39 U.S.C. section 3623(c), "the desirability of special classifications and services of mail" — as well as the fifth criterion — "the desirability of special classifications from the point of view of both the user and of the Postal Service."

Nevertheless, in their zeal to encourage the Commission's recommendation of NSAs in the instant proceeding, the initial briefs of the Postal Service and several intervenors fail to explain adequately why the proposed NSA is preferable to a broader

solution, such as a niche classification. If NSAs are legally permissible, then in certain instances NSAs and niche classifications represent competing approaches. The above-referenced statutory criteria provide little guidance here, but the prohibition on undue and unreasonable preferences would seem to require that broad solutions available to all affected mailers be preferred to single mailer solutions. *See* 39 U.S.C. § 403(c). The consequences that flow from choosing one alternative over the other must be carefully considered by the Commission.

The choice between a niche classification and an NSA involves tradeoffs. Niche classifications are available on a non-discriminatory and non-preferential basis to all qualified mailings that can meet the established terms. An NSA, on the other hand, can have individualized terms, and by definition is an exclusive arrangement between the Postal Service and a particular mailer. To the extent that a similar contract may be available to other mailers, the timing and terms are wholly at the discretion of the Postal Service. Further, an exclusive NSA with one mailer would be more likely to have adverse effects on other mailers than would a niche classification.

The underlying rationale of the NSA in this docket, as explained below, has been shown to be broadly applicable to many mailers rather than narrowly focused on one mailer. In such a circumstance, the Commission should not approve the NSA unless it can explain, from the viewpoint of all potentially affected mailers and the Postal Service, why an **exclusive** NSA is **more** appropriate and **more** desirable than a **non-exclusive** niche classification.

B. The Underlying Rationale for the Proposed NSA Is the Efficiency Gains From Substituting Electronic ACS for Physical Return of UAA Mail

Identifying and understanding the rationale that underlies the NSA is necessary to evaluate whether an NSA may be used at all. The Capital One NSA consists of two separate parts which have been joined in a single NSA contract:

Part A. Substitution of electronic ACS for physical return of UAA mail;

and

Part B. Declining block discounts.

Part A is alleged to produce efficiency gains for the Postal Service (and the nation) that will result in an increased contribution to overhead (among other things). It appears to be uncontested that part B, the declining block discount, by itself will reduce the contribution to overhead (referred to as “leakage”). From the perspective of the Postal Service and mailers not party to the contract, the driving rationale clearly is the efficiency gains from part A. By itself, part A could be considered by some a viable NSA, but part B alone would never be considered viable. With this understanding, the economic rationale for entering into similar NSAs with “similarly-situated” mailers — if such mailers exist — would be to realize further efficiency gains from greater levels of substitution of electronic ACS for physical return of UAA mail. So a critical question that should be addressed is whether the more effective way to realize these further “efficiency gains” is with one, or even a series of, NSAs, or rather with a broader approach, such as a niche classification.

C. The Issue of Capital One's Alternatives Is a Red Herring

Capital One's Initial Brief cites witness Plunkett (USPS-T-2) as concluding "that, absent the current NSA, the only way to address the high return percentage on Capital One's First-Class solicitations would be for Capital One to shift all of its First-Class solicitations to Standard Mail." Capital One Initial Brief, at 26; *see also, id.* at 4. Capital One actually asks for a Commission **finding** "that, except for the NSA, there is no practical alternative for Capital One to reduce the high percentage of returns of its First-Class Mail solicitations other than to convert from First-Class to Standard Mail where there is no requirement to physically return UAA mail." *Id.*, at 45.

These pleas about the paucity of Capital One's alternatives, even if they had been established by record evidence, would not provide a reason for the NSA, because (i) many other mailers appear to be in the same position, and (ii) Capital One could use (when available) the new Option No. 2 under the Change Service Requested endorsement. In any event, the current record does not permit any Commission findings concerning the extent of, or the attractiveness of, Capital One's alternatives, for several reasons, including the following:

1. No testimony focused on Capital One's alternatives.
2. It was not established on the record that Capital One has a compelling need or desire to address its "high return percentage."
3. Capital One has indicated that its use of First-Class Mail for solicitations is based on a range of commercial considerations, not just on an interest in receiving returns of non-deliverable UAA mail..

4. Capital One has a contractor key in the return addresses so that its mailing lists can be improved, but the record does not establish the cost of this process.
5. It was not demonstrated on the record whether the Postal Service's Address Center has the capability to review an address and tell the mailer before mailing whether the address is a good one. If only good addresses were used and normal forwarding was performed, returns would seem to be limited.
6. If it takes a week or two for Capital One's contractor to key in the returns, it is not clear from the record how many more pieces would be sent to that same address during that period.
7. Capital One has not provided record evidence that would allow a meaningful assessment of the attractiveness of Standard Mail and the endorsements that can be used on Standard Mail.

In fact, if record evidence had been available to allow a valid assessment of Capital One's alternatives, it might be discovered that Capital One does not consider its high level of physical returns to be a problem, but that they simply provided a handy available vehicle to obtain declining block discounts and free information on forwarded pieces.

Capital One's argument also overlooks the fact that the Postal Service could have solved any problem that exists without an NSA. The limitation on Capital One's alternatives in looking at the current Postal Service product offerings is totally irrelevant when viewed from the perspective of the Postal Service (and the Commission), which have alternatives to NSAs.

D. The Original Rationale for an NSA, as Opposed to a Niche Classification, No Longer Exists

The Capital One Initial Brief explains the original rationale for rejecting a niche classification in favor of an NSA as follows:

Witness Bizzotto pointed out that the Postal Service did not consider a niche classification because of the uniqueness of the Capital One return situation. According to her, the Postal Service simply **did not have enough information** at the time to know whether to do a **niche classification** for a larger group of other mailers who would trade their physical returns for free electronic address correction service (eACS). Tr. 3/487, 489. **Capital One was, as far as they knew, unique.** *Id.* at 415-16. [Capital One Initial Brief, at 24 (emphasis added).]

The Postal Service's early lack of information about mailers other than Capital One clearly has been remedied. This presumed uniqueness of Capital One's return situation has been revealed to be incorrect. In an apparent effort to deflect any thought that Capital One is being given some impermissible preference, Capital One's Initial Brief also states that "the Postal Service has had discussions with roughly 8 to 10 financial services companies, all but one of the significant credit card companies, about doing an NSA." *Id.*, at 31. Thus, even before this case is concluded, numerous other deserving mailers appear to be queuing up for NSAs predicated on the same (or a similar) underlying rationale. Upon approval of this NSA, the Postal Service is said to be prepared to negotiate and submit to the Commission a number of similar NSAs. Should this NSA be recommended for approval and implemented and a plethora of subsequent filings eventuate, it might, after the fact, help put to rest issues of undue and

unreasonable preferences. At the same time, however, in considering whether to recommend approval of this NSA, the Commission must recognize that the Postal Service's original rationale for an NSA has evaporated into thin air.³ Inertia now drives this NSA forward, even in the absence of its initial rationale, creating other problems which deserve serious consideration.

E. Use of NSAs in the Context of a Systemwide Pricing Problem Can Open a Pandora's Box

The Postal Service seeks to have it both ways, but cannot. If Capital One's situation is truly unique, or at least highly distinct, then an NSA might be the more appropriate and desirable alternative. But if its situation is indeed so rare, there should be no, or at most few, future NSAs whose underlying rationale is the same as or similar to the one with Capital One — *e.g.*, to reduce the volume of UAA mail that is physically returned. Contrariwise, if there exist many similarly-situated mailers that merit an NSA whose underlying rationale is the efficiency gain from reducing the physical return of UAA mail, then a broader approach such as a niche classification would be the correct way to address the issue. Even if the Postal Service refuses to address this issue in its zeal to win the case that it has filed, the Commission must ask: how many NSAs should be permitted to address the same basic issue (*e.g.*, reducing the volume of UAA mail that is physically returned), before acknowledging that NSAs

³ The situation is reminiscent of the encounter between Alice (in Wonderland) and the Cheshire Cat, where the cat slowly disappeared, but the grin remained.

were the wrong classification tool to employ?⁴ Using NSAs to substitute for niche classifications is like using a hand scythe instead of a combine to harvest a huge wheat field. Once the Postal Service and the Commission have recommended the approval of the first dozen or so NSAs enabling mailers to avoid the per-piece address correction fee of 20 cents, how could any other mailers be left out without violating the principle of undue discrimination?

II. NSAs SHOULD NOT BE BASED ON INAPPROPRIATE AND INACCURATE COSTS

Exclusive reliance on systemwide average cost to estimate the cost of physically returning Capital One's non-forwardable UAA mail is expressly endorsed in the initial briefs of the following three parties: Alliance of Nonprofit Mailers, *et al.* ("ANM, *et al.*"), Capital One, and the Postal Service. Each is discussed below.

A. ANM, *et al.* Acknowledge that the Commission Must Assess the Reasonableness of Proxies, but Would Have the Commission Ignore Deficiencies in the Record

In their Initial Brief, ANM, *et al.* state that:

Given the practical limitation in Postal Service systems discussed by Bizzotto, analyzing the financial impact of NSAs will almost always (if not always) require

⁴ If subsequent NSAs that deal with substituting electronic Address Correction Service for physical return of mail are virtually identical, the Commission might be able to review and approve them with relative ease. But if the Postal Service incorporates various features into each NSA that somehow make each one materially distinct (*e.g.*, different thresholds for declining block discounts), then each NSA must be subject to a careful review by the Commission, and substantial resources will be spent dealing with a long string of separate dockets.

the use of a combination of **reasonable proxies** from Postal Service systems and customer-specific information. In instances where use of a proxy is required, we suggest the **Commission should assess whether the proxy is reasonable, not whether the Postal Service could or should have performed an additional (and potentially very costly) study** to develop a better estimate. [Alliance of Nonprofit Mailers, *et al.*, Initial Brief, at 13 (emphasis added).]

ANM, *et al.* ask the Commission to use reasonable proxies, but the record does not permit the Commission to make such an informed decision on this issue. Simply put, the record contains no evidence of either (i) the appropriateness of the proxy used (systemwide average costs), or (ii) the relative ease or expense of a study designed to develop a cost estimate relating to the way the huge volume of Capital One’s non-forwardable UAA mail is handled. As a general principle, the Commission cannot take ANM, *et al.*’s advice that it should “not [assess] whether the Postal Service ... should have performed an additional ... study,” because doing this is part of its effort to “assess whether the proxy is reasonable.”

To their credit, ANM, *et al.* **do** acknowledge that when a proxy is used, the Commission should assess whether the proxy is reasonable. However, ANM, *et al.* suggest no meaningful standard for evaluating reasonableness. *See generally* Valpak Initial Brief, p. 27. In their enthusiasm to have this NSA approved, ANM, *et al.* overlook — and would have the Commission overlook — the weaknesses in the current record and what could reasonably have been expected to be shown without exerting any great effort. For example, it would have been neither difficult nor expensive for a Postal Service operations witness to explain the probable flow paths for Capital One’s

returns, including the (strong) possibility that they receive only one incoming sort.

Similarly, it would have been neither difficult nor expensive for such a witness:

- (i) to examine operations in the Richmond Area Distribution Center (“ADC”);
- (ii) to discuss differences between mail destinating at an ADC instead of at an average office;
- (iii) to learn how many incoming sorts Capital One’s mail gets;
- (iv) to explain whether the return 5-digit code for Capital One is unique;
- (v) to learn if Capital One has dedicated sorting bins on the sorting equipment in the Richmond ADC; and
- (vi) to itemize and discuss the “several factors” alluded to in the response to NAA/USPS-10 (Tr. 5/904).

It would not be difficult to compare these Capital One operational facts with the way returns are generally handled. Not only should these issues have been considered by the Postal Service, as they are not complex or expensive, but they also should have been put on the record. In this way, the Commission could have learned whether the costs for Capital One’s mail are in any way similar to average costs, and thereby have been enabled to draw conclusions about the reasonableness of the proxy of average costs.

ANM, *et al.* are actually recommending that the Commission set the bar for determining the reasonableness of a proxy so low as to constitute no bar at all. Such a decision could sanction the Postal Service’s filing of all NSA and niche classification cases based on average costs, with no attempt to develop any specific cost data whatsoever. *See, e.g.*, Postal Service Request in Docket No. MC2003-1.

Finally, ANM, *et al.* cite witness Bizzotto's statement that the Postal Service's data systems are designed to measure costs for entire classifications, and that it is not reasonable to expect that they can be used to measure costs for selected customers. *See* Tr. 3/423. This is indeed the case. *See generally* Valpak Initial Brief, at 26. But whether the existing data systems are designed to obtain a mailer-specific cost figure is irrelevant to the question of whether specific costs are needed. This is not rocket science. The solution is to do a special cost study, of a kind that has been done many times before.⁵

B. Capital One Espouses an Additional Red Herring

The desire of Capital One to have this NSA approved is understandable. Like ANM, *et al.*, it too would have the Commission overlook the many infirmities in the critical cost estimate of physically returning Capital One's non-forwardable UAA mail. Capital One's Initial Brief states that:

Witness Crum's method for estimating the cost of Capital One's physical and electronic returns ... is appropriate for two reasons....

First ... the Postal Service has developed costing systems to accurately estimate average costs for classifications of mail, **not for individual customers**.... Witness Crum's method leveraged these existing systems to estimate the cost of returns. [Capital One Initial Brief, at 14-15 (emphasis added).]

⁵ If NSAs are to become commonplace, the Postal Service will need to develop a better cost accounting system, one that is capable of developing estimates that take account of individual mailer characteristics. The existing cost accounting system, which is acknowledged to be totally inadequate for the job, would need to be changed.

Capital One urges that, for purposes of this case, there is no significant drawback to this methodology since Capital One's returns are similar to First-Class Mail returns as a whole, because "Capital One's First-Class Mail is comprised primarily of letters." Capital One Initial Brief, at. 15. In a further effort to justify the Postal Service's failure to do its homework, Capital One states that:

The alternative to using adjusted subclass averages would have been to perform a special study to estimate the costs of Capital One's returns.... [I]t is **hard to believe that the Postal Service could design a study** (at any cost) that would produce as reliable a cost as produced by its established systems.

Second, as stated by **witness Posch**, requiring a company-specific analysis is often **unrealistic and impractical** since "many **mailers** do not collect or retain the data that the Postal Service would need to perform modeling and forecasting at the level of specificity expected in omnibus rate cases." [Capital One Initial Brief, at 15 (emphasis added).]

The volume of Capital One's UAA mail that is returned is huge, and in other contexts of espousing this particular NSA such huge volume is said to be an important defining characteristic that makes Capital One's situation unique. It is revealing, then, that when discussing the appropriateness of the estimated cost of handling Capital One's returns, the only similarity between First-Class Mail as a whole and Capital One's First-Class Mail to which Capital One can cite is the fact that Capital One's "First-Class Mail is comprised primarily of letters."

The alleged improbability of being able to "design a study (at any cost)" has been discussed above in conjunction with ANM, *et al.*, and will not be repeated here, but Capital One's disbelief "that the Postal Service "could design a [suitable] study"

intentionally disregards the numerous Postal Service cost studies presented previously to the Commission.

Capital One also relies on witness Posch's testimony about mailers not collecting or retaining cost data. Capital One appears to evidence the same confusion that witness Posch had while on the stand — being unable to distinguish between the costs Capital One incurs, and the costs that the Postal Service incurs in handling Capital One's mail. *See* Tr. 10/2026-29. The costs at issue here are those of the Postal Service — not Capital One's. They do not involve reliance on cost data provided by any mailer. Looking back over numerous prior dockets, both rate cases and mail classification cases, the Postal Service has presented a multitude of cost studies. Almost without exception, these cost studies were conducted with little or no reliance on mailer-furnished cost data.⁶

C. The Postal Service Makes No Effort to Justify the Reasonableness of its Proposed Proxy for the Estimated Cost of Physically Returning Capital One's Non-forwardable UAA Mail

The portion of the Postal Service's Initial Brief devoted to the estimated cost of physically returning Capital One's non-forwardable UAA mail is rather succinct.

Witness Crum's costing methodology appropriately used adjusted **aggregate cost data** to reflect **customer specific information**.... These types of costs, adjusted when possible to reflect Capital One's costs, are **appropriate** since they are the **best data available**.
[USPS Initial Brief, at 30.]

⁶ The Postal Service Initial Brief does not appear to rely in any way on witness Posch's testimony. *See* USPS Initial Brief, at pp. 10 and 24.

The Postal Service has chosen to describe witness Crum's use of aggregate cost data as appropriate, solely because they are the only data available. It cites no record evidence to support the reasonableness of the proxy, because the record is totally devoid of such evidence. Succinctness in the brief correlates to the void in the record. Interestingly, the Postal Service Initial Brief makes no claim that the Postal Service could not have done a special study of the cost to return Capital One's UAA mail.

The Postal Service's Initial Brief notes that NSAs have been actively discussed “[f]or most of the some thirty years of ratemaking under the statutory scheme of the Postal Reorganization Act....” USPS Initial Brief, at 1. It recognizes that important precedents will be set in the Commission's opinion and recommended decision in this docket. And for all of the 30-some years since the Postal Reorganization Act, the Postal Service has been fully aware that its cost system was not designed to provide mailer-specific costs, and would never be able to do so. Under the circumstances, it is difficult to understand why the Postal Service itself would not acknowledge the reasonableness — and even the necessity — for developing either (i) an estimate of the cost of returning Capital One's non-forwardable UAA mail, or (ii) a strong case for using systemwide average costs as a proxy.

The Postal Service's Initial Brief (as well as that of Capital One) cites Presiding Officer's witness Panzar to the effect that average cost, if justified, might be used as a proxy for mailer-specific cost. However, it conveniently fails to include witness Panzar's further statement on this issue — namely, that “as a means of evaluating the experiment more precisely, [cost data] closely tied to Capital One would be desirable, if

feasible, because, remember, one of the reasons driving this thing is the particular characteristics of Capital One's mailstream ... [a]nd so **the success and impact of the experiment has ultimately got to be judged on the basis of Capital One's specific numbers.**" Tr. 8/1782, ll. 17-24 (emphasis added). "[T]he Postal Service regards its proposal under the Capital One NSA as fundamentally experimental." USPS Initial Brief, at 6. Once Capital One begins receiving electronic information in lieu of physical returns, it will be impossible to ascertain the current cost of returning Capital One's UAA mail. Since an appropriate baseline cost has not been established, whether this particular experiment is a financial success or failure will be incapable of being known.

D. Inadequacy of Record to Support Use of Proxy

The Postal Service does not claim to have made any effort to develop the specific cost of physically returning Capital One's non-forwardable UAA mail. Instead, it has used systemwide average cost as a proxy — not because it is a good proxy, but just because the data were available. Moreover, the record is devoid of any evidence intended to justify the proxy. Given the huge volume of UAA returned to Capital One via the Richmond ADC, it is reasonable to posit that the unit cost of handling this mail is substantially lower than the systemwide average. A lower unit cost would reduce the savings from switching to Electronic Address Correction service penny for penny.

The Postal Service, Capital One, and their supporters ask the Commission to accept cost data that potentially are highly inappropriate, totally non-representative of

the actual cost, and subject to a margin of error so wide as to make even a money-losing situation appear profitable. Clearly, these are actions the Commission should not take.

The purpose of an NSA is to customize a contract to a specific major's characteristics. It makes no sense whatsoever to develop customized pricing without basing that pricing on customized cost data. For the reasons stated here, as well as in Valpak's Initial Brief, the Commission should insist upon mailer-specific costs when considering NSAs, and accept average costs only when (1) it can be firmly established that development of mailer-specific cost is not a feasible alternative, and (2) a proffered proxy is demonstrated on the record to be a suitable substitute. Only then can the Postal Service be reasonably confident that the NSA will not result in a loss. This has not been done in this docket, and the NSA must be rejected.

CONCLUSION

For the reasons set forth above, Valpak believes that this NSA request as well as the proposed Stipulation and Agreement filed by certain parties should be rejected.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served this document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.

John S. Miles

April 14, 2003