Postal Rate Commission
Submitted 4/14/2003 4:24 pm
Filing ID: 37814
Accepted 4/14/2003

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

REPLY BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Nan K. McKenzie
Eric P. Koetting
Scott L. Reiter
Michael T. Tidwell

United States Postal Service
475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
April 14, 2003

TABLE OF CONTENTS

Page

I. THE COMMISSION MAY, CONSISTENTLY WITH THE POSTAL REORGANIZATION ACT, RECOMMEND RATE AND CLASSIFICATION CHANGES NEEDED TO IMPLEMENT A NEGOTIATED SERVICE AGREEMENT

In this proceeding, the Postal Service's proposals conform to both the provisions and policies of the Postal Reorganization. The Act neither specifically prohibits nor is inconsistent with rates and classifications founded on a Negotiated Service Agreement. Furthermore, by proposing changes based on an NSA and by considering them, and perhaps recommending them, the Postal Service and the Commission are performing their intended functions embodied in the statutory scheme. Prices and service conditions based on NSAs represent a widely-accepted practice in many regulated and unregulated industries, and especially in the provision of private postal services. In the Postal Service's exercise of its responsibility and its efforts to develop and improve approaches to providing mail services to the nation, NSAs are no more than another step in the evolution of economic and business theory and practice applied to postal ratemaking. Nothing in the language of the Act or its legislative history clearly evinces an intent to impede that evolution or that improvement.

Of the thirteen participants who filed briefs, only NAA and NNA have argued to the contrary.[1] For the reasons explained below, the Postal Service believes they are mistaken and urges the Commission to recommend the changes proposed in the Stipulation and Agreement filed on March 31, 2003.[2]

---

[1] Two other parties, Valpak and the Greeting Card Association, state that they support the concept of NSAs in principle, but oppose recommendation of the particular changes proposed here.

[2] As of today, the Stipulation and Agreement has been signed by 12 participants: American Bankers Association, AOL Time Warner, Advo, Capital One, Direct Marketing Association, Douglas F. Carlson, Dow Jones & Company, Magazine Publishers of

(continued…)

A. The Review Appropriate for Changes Needed to Implement an NSA Is Consistent with the Act and Commission Practice

NAA argues that it would be inconsistent with the Act for the Commission to "review" the proposed rate and classification changes needed to implement the NSA. To support its argument, NAA creates a blatantly false dichotomy between what it misleadingly calls "passive review" of a "deal previously negotiated" and the "active ratemaking role assigned to the Commission by Congress" including an "independent recommendation of rates and classifications." NAA Brief at 4, 6, 7.

The Act itself, however, uses no such terms and draws no such distinctions. It directs only that the Commission make recommended decisions—after an opportunity for hearing on the record under 5 U.S.C. §§ 556 and 557 and governed by its rules—in accordance with the policies of the Act and certain enumerated factors. Congress left to the Commission broad discretion on how to conduct its proceedings. The Commission's rules of practice and procedure generally determine the scope of particular proceedings. No court has held that the Commission's discretion is limited in the way NAA suggests.[3]

(…continued)
America, Office of the Consumer Advocate, Parcel Shippers Association, and the Postal Service. These participants represent users of every class of mail; they represent some of the largest mailers and some of the smallest, as well as the public interest generally.

Three parties have filed briefs supporting the changes proposed in this docket, but have not signed the Stipulation and Agreement: American Postal Workers Union, AFL-CIO; Alliance of Nonprofit Mailers; and Pitney Bowes.

[3] NAA cites the UPS case for the proposition that "there is no room under the Act for single-mailer negotiated contract rates" and that "it is no answer to say that a single-mailer NSA can be filed as a special classification limited to one mailer …. *United Parcel Service, Inc., v. United States Postal Service*, 604 F.2d 1370, 1375-76 (3d Cir. 1979), *cert. denied*, 446 U.S. 957 (1980)." NAA Brief at 8. One reads those pages,

(continued…)

For over thirty years of contemporaneous and continuous interpretation of the statutory scheme, the Postal Service has proposed specific rates, fees, and/or classifications in virtually every case that it has initiated. NAA's false dichotomy would lead one to believe that the Commission could almost never recommend what the Postal Service proposes. Nothing in the wording of the statute, its interpretation by the courts, or its legislative history, however, so restricts the exercise of the Commission's functions and authority. The *policy* of independent review embodied in the Act ensures independence of evaluation under the rate and classification criteria in the Act, and an objective recommendation based on a carefully developed evidentiary record, not a *tabula rasa* exercise where only the Commission may provide the source of ideas for change.

In an area as complex as postal ratemaking, if the Commission could not adopt proposals requested by the Postal Service, only coincidence would lead it to come up with the exact same classification language or the exact same rates. Yet, the Commission does, with some frequency, recommend either what the Postal Service proposed or what resulted as a settlement among the parties. In such cases, the Commission has reviewed what the Postal Service (and the parties, in a settlement)

(…continued)
indeed the entire decision, in vain for support for NAA's assertions. That case concerned an experiment under which the Postal Service signed contracts with a number of mailers for promised minimums of parcel post at discounted rates. The Postal Service did not seek a recommended decision from the Commission. The court held that the Postal Service could not conduct an experiment involving changes in rates or classifications without first requesting a recommended decision from the Commission. This case was the impetus for the development of the so-called experimental rules under which the Postal Service filed the request in the instant docket. The legality of contract rates or volume discounts *per se* was not before the court.

proposed, found it in accordance with the Act, and recommended it. The Commission is not required to re-invent the wheel by rewriting classification language in its own words from scratch or by recalculating all the elements that go into the development of the rate(s). It has the discretion, based on the record, simply to find that what the Postal Service proposed, or what the settlement parties agreed to, is consistent with the Act and should be recommended.

Nor would such a restrictive interpretation conform to the intentions embodied in the statutory scheme, and the Commission's rules, as well as the consistent interpretation of them over the years. Under a correct reading of the Act, Congress expected that the Postal Service would exercise leadership in the development of rates and classifications, as well as products and services. Notwithstanding the permissive language in section 3622(a), the entire Act emphasizes the Postal Service's dominant role in most dimensions of its authority. The Commission performs a vital function in the statutory scheme in evaluating and recommending changes in rates and classifications. But, only the Postal Service was given the authority to initiate rate changes. It shares with the Commission the authority to initiate classification changes. Furthermore, only the Postal Service has final ratemaking authority. This view does not detract one bit from the important functions performed by the Commission. Rather, it amplifies the absurdity of NAA's restrictive interpretation.

Indeed, the Commission has adopted rules which demonstrate that it understands its ability to exercise its authority to augment and enhance both its and the Postal Service's responsibilities. For example, the rules for market tests and provisional services allow the Postal Service to specify those features of its request that it does not

wish to subject to modification by the Commission. 39 C.F.R. § 3001.162(g), 3001.172(a)(3). These features, therefore, are subject to either a "yes" or "no" by the Commission.

These provisions are not a limitation on the Commission's authority; rather, they are an expression of it. They are an aid to the efficient conduct of the Commission's proceedings in that they narrow the inquiry before the Commission. They demonstrate that the Commission has the innate authority to choose to limit its review to "yes" or "no" and to refrain from recommending a modified version of what the Postal Service requested. Presumably, the Postal Service would use this provision only when it is willing to assume the risk of getting nothing if the Commission finds that it cannot, consistently with its view of the Act, recommend exactly what the Postal Service proposed.[4] The Commission would, of course, remain free to discuss alternatives in its Opinion even when its recommendation is voluntarily limited to approval or rejection.

Furthermore, under these rules, there is no limit on how many features could be designated as non-modifiable and, presumably, the Postal Service could designate all features of its request. The Commission would then either recommend the entire proposal or decline to recommend it. More simply put, the Postal Service could request, for example, a provisional change in a single rate and ask the Commission to either approve or reject it, but not to modify it.

[4] In such a case, the Postal Service would presumably be as sure as it could be that the Commission could find the feature acceptable. Similarly, the Postal Service and its NSA partner would presumably take great pains to negotiate an agreement needing changes that they believe the Commission would find appropriate, under the Act, to recommend.

Despite the existence of a provision in these instances, a special rule is not generally required for the Commission to refrain from modifying requested rates or classifications. In fact, it often does so in cases in which a Stipulation and Agreement among the parties is presented for its review. Even in as complicated a matter as the last rate case, Docket No. R2001-1, the Commission accepted the settlement, rather than conduct its own independent rate development. This type of review, which is apparently the "passive review" NAA decries, violates no legal standard. In any proceeding before it, the Commission certainly may, in the normal exercise of its discretion—following an opportunity for a hearing on the record and its own independent review of the record—refrain from modifying requested rates and classification.

In this docket, the Commission has the same options it has in any most other cases: to recommend what the Postal Service proposed, to formulate a different or modified approach, or to decline to make any recommendations. The Postal Service would, of course, prefer that the Commission not modify the requested classification and rates in this proceeding, since a modified recommendation would detract from the flexibility afforded by the NSA approach to pricing, and might lead to cancellation of the NSA and the need for further negotiations between the Postal Service and Capital One.

In this case, the Postal Service does not expect the Commission to be any more "passive," whatever that may mean, than in any other proceeding it conducts. Indeed, the Commission took the active, and somewhat unusual, step of obtaining *sua sponte* the expert economic testimony of Dr. John Panzar. Dr. Panzar's testimony has been extremely helpful in airing and suggesting resolution of significant issues raised in this case. Ultimately, Dr. Panzar expressed his pleasure "to see the issues of NSAs in

general being considered by the Commission and evaluated." Tr. 8/1772. Dr. Eakin filed testimony showing that "the Capital One NSA terms are consistent with Professor Panzar's suggestion that NSAs should be an opportunity to improve the Postal Service's economic efficiency (Tr. 8/1645)" and he explained his conclusion that "the Capital One NSA is in the public interest." USPS-RT-2, at 1. Whatever the outcome of this case, the Postal Service has every reason to expect that it will be clear that the Commission took an active role in making an independent recommendation based on its own analysis of the full record before it.

B. Setting Rates for a Single Mailer is Consistent with the Natural Evolution of Postal Ratemaking Under the Act

NAA also argues that it violates the Act for the Commission to set rates for a single mailer, rather than by class and subclass. NAA Brief at 7-8. According to NAA, "[b]y its express terms, the Act contemplates that postal rates are set by class and subclass; not by mailer." NAA Brief at 7. In support of this claim, NAA cites sections 3622 and 3623. *Id*. at 7-8. Ironically, although both of those sections refer to "class" of mail, neither section includes any reference to "subclass." While the omission of the word "subclass" from the Act is not necessarily of great significance, the apparently reflexive inclusion of that term by NAA in the above statement shows how pervasively the core concepts of postal ratemaking and classification have been extended to encompass elements of a framework beyond that "expressly" stated in the Act. The Act refers only to each "class" of mail, but Commission proceedings under the Act have evolved to include consideration of proposals for mail classes, subclasses, rate categories, and rate elements. Surely, however, this would come as no surprise to the drafters of the ratemaking provisions of the Act, who crafted section 3623 in only very

broad terms, and who obviously intended to grant the new postal entities great flexibility in considering the most beneficial structures for mail classification. NAA's overly literal interpretation of the Act would erase years of beneficial evolution in postal ratemaking. Given that history, moreover, it would be dangerous to the future health of the Postal Service to believe that the era of rate evolution had ended, rather than to continue to innovate in ways that meet the needs of mailers. *See* Testimony of Anita Bizzotto, USPS-T-1, at 4-5.

The drafters' broad intention is amplified by the very structure of the classification provisions in the Act. Under 39 U.S.C. § 3623(a), the Postal Service was directed to initiate a proceeding to establish the classification of mail, in accordance with the Commission's exercise of its functions in the statutory scheme. That process led over several years to the development of the Domestic Mail Classification Schedule (DMCS), which itself was the product of a non-unanimous settlement agreement among the Postal Service and the many participating intervenors. The Commission adopted that settlement as the foundation of modern postal rates and classifications. Furthermore, while the DMCS incorporated many features of classifications existing prior to postal reorganization, it also introduced new or modified approaches that evolved out of the Commission's proceedings. Contrary to the NAA's apparent presumption that the Act inflexibly dictates the structure of rates and classifications, the statutory scheme and its contemporaneous and continuous interpretation show that Congress intended rates and classifications to grow out of the interactions between the two primary postal agencies, and to evolve to meet new circumstances and new challenges.

To the extent that one nonetheless wishes to focus excessively on the express terminology of sections 3622 and 3623, NAA is overstating its case with the further claim that "not one ratemaking criterion by its terms suggests that rates would be set for a single mailer." NAA Brief at 7. In fact, there is one such provision in section 3622, and one in section 3623. Specifically, subsection 3622(b)(6) refers to "the degree of preparation of mail for delivery into the postal system performed by the mailer and its effects upon reducing costs to the Postal Service." Similarly, subsection 3623(c)(5) speaks of "the desirability of special classifications from the point of view of both the user and of the Postal Service."[5] The Postal Service is not suggesting that the drafters of these provisions, by referring to "the mailer" and "the user" in the singular rather than the plural, necessarily contemplated rates for individual mailers of the type included within the current proposal. On the other hand, NAA is clearly in error to suggest that the terminology and the structure of sections 3622 and 3623 "lead to the conclusion that there simply is no room under the Act for single-mailer negotiated contract rates." NAA Brief at 8. The reality is that any attempt to buttress arguments in favor of or in opposition to single-mailer classification and rates within the bare language of chapter 36 of the Act is essentially a pursuit of that which is not there.

Contrary, however, to at least one possible misinterpretation of NAA's statement that "[b]y its express terms, the Act contemplates that postal rates are set by class and subclass; not by mailer," NAA Brief at 7, the proposed NSA is not a global attempt to move all of the mail tendered by Capital One out of the mail classification schedule and

[5] When insisting on page 8 of its brief that subsection 3623(c)(5) is intended to address the needs of "a particular group of mailers" rather than "a single mailer," NAA perhaps neglected to actually examine the wording of that provision.

into its own separate little universe. Rather, the proposal is one firmly embedded within the existing classification schedule. The agreement only pertains to Capital One's First-Class Mail, and mail covered by the agreement remains within First-Class Mail. Thus, the applicable discounts are discounts off of the otherwise applicable First-Class Mail rates. NAA's attempts (NAA Brief at 8) to distinguish a First-Class rate proposal applicable to only one mailer from one applicable to a small group of mailers under a "niche" classification scheme are unavailing. There is no reason in either law or logic why a rate proposal acceptable if applicable to a small group of mailers or even two mailers would automatically become unacceptable if the number of potential users is diminished to one mailer. The Act provides no minimum acceptable number of potential users of a mail classification.

C. Agreements with Individual Mailers Are Not Unduly or Unreasonably Discriminatory under 39 U.S.C. § 403(c)

A number of the arguments by those opposing the Stipulation and Agreement in this case are based on an assertion that it is unlawfully discriminatory for the Postal Service to conclude an NSA with its largest First-Class Mail user. The question of whether it is unduly or unreasonably discriminatory for the Postal Service to negotiate individual service agreements with large-volume mailers has already been settled judicially. With regard to the International Customized Mail (ICM) program, the Third Circuit, considering 39 U.S.C. § 403(c), held that because "reasonable discrimination and preferences among users of the mail are permitted, … [a]llowing a limited class—the relatively small percentage of large-volume mailers eligible to participate in the ICM program—to negotiate individual service plans at individual rates does not appear on its face to be 'undue or unreasonable.'" *UPS Worldwide Forwarding, Inc., v. United States*

Postal Service, 66 F.3d 621, 634 (3d Cir. 1995). The court noted that these agreements were permissible, even in the absence of a requirement that the mailer "actually mail or pay any specified amount." *Id.* at 633.[6]

Accordingly, the rate and classification changes needed to implement the Capital One NSA are not unduly or unreasonably discriminatory. Although they apply to only one large mailer, the uniqueness of that mailer has been clearly established on the record. In addition, the Stipulation and Agreement includes draft regulations that provide for and govern the negotiation of comparable agreements for other mailers.

NNA expresses concern that NSAs will not be available to smaller mailers. NNA Statement at 2-3. This concern may stem from the fact that this first NSA happened to be with a very large mailer. Just as large mailers were the first to take advantage of worksharing discounts, it is not surprising that large mailers provide a natural

---

[6] In holding that NSA-type agreements in the international realm constitute appropriate examples of the innovation expected of the Postal Service by Congress, and do not violate the Act, the court in *UPS Worldwide Forwarding* compared international postal services with domestic ones and suggested that, between the two, domestic postal services are more analogous to services provided by public utilities that charge uniform rates. *Id.* at 637-38. Several observations can be made in response to the court=s comments in this regard. First, as discussed in the testimony of Dr. Eakin, the traditional public utilities referred to by the court are themselves embracing NSAs to respond to evolving market conditions. Tr. 10/2085-94. Second, as likewise acknowledged by many witnesses, despite the Private Express Statutes, the Postal Service=s customers enjoy a growing number of technological alternatives to letter mail for purposes such as communication, financial transactions, and advertising. To the extent that the court envisioned a scenario in which international mail faces competition and domestic mail does not, in practical terms, the contrast may no longer be that stark. Third, while the court was focusing on uniform prices, it is important to note that, under the NSA, Capital One is no longer receiving uniform service. Unlike other First-Class Mailers, under the NSA, Capital One would not be entitled to free physical return of all of its mailpieces. In negotiating with Capital One to establish rates appropriate to its unique service needs, the Postal Service is doing nothing more in the domestic sphere than pursuing the same types of opportunity for innovation endorsed by the court in the *Worldwide Forwarding* case in the international sphere.

opportunity as NSA partners. Large mailers are not, however, the exclusive source of potential NSAs. Just as smaller mailers are able to take advantage of worksharing discounts, so will smaller mailers be able to take participate as NSA partners, to that extent that circumstances exist whereby the Postal Service and the mailer can address a unique situation and find mutual benefit.[7] Moreover, just as consolidators arose to help smaller mailers take advantage of worksharing discounts, it is certainly conceivable that an NSA could be fashioned with a consolidator that would pass on the benefits of the NSA to a large number of small mailers. In fact, the special factors necessary to bring rate benefits to smaller mailers, such as complexities in mail preparation and postage payment when mail from different mailers is combined to take advantage of worksharing discounts, seem especially appropriate for negotiations leading to NSAs.

D. Discussions and Negotiations Between the Postal Service and Mailers Should Be Encouraged, Not Derided

For years the Postal Service was criticized for developing rate and classification proposals without regard to the needs and desires of mailers. Over the last decade, the emphasis has shifted to greater responsiveness to mailers. Mailers' ideas are solicited; Postal Service proposals are aired, sometimes privately, with affected mailers and groups of mailers; broad rate and classification policy directions are discussed publicly; and settlement discussions are a routine part of almost every case filed with the

[7] At the time of the establishment of Bulk Parcel Return Service, if Cosmetique, for example, had been the only continuity mailer interested in using BPRS, would the Commission have been barred from recommending it? Would the Commission have been barred from recommending the classification and fee if it had been incorporated into a service agreement between the Postal Service and Cosmetique that also included details regarding pick up frequencies and other operational aspects of the service? Certainly not, but NAA's argument would seem to have forbidden it.

Commission. The Postal Service has filed requests that were the result of discussions and agreement with affected mailers. None of this has engendered controversy; to the contrary, it seems to have been well received by all stakeholders. Now, simply because a signed formal agreement underlies the Postal Service's request, the Postal Service is disparaged.[8]

E. The Dichotomy Between Niche Classifications and NSAs Is a False One

NAA argues that "it is important to distinguish impermissible single-mailer contracts from what have become known as 'niche' classifications." NAA Brief at 8. NAA asserts that while niche classifications are permissible, NSAs are not. The Postal Service believes that the difference has no great legal significance. If the exact same rates and classification at issue here had been proposed, but without mentioning Capital One by name and without any reference to an NSA, the criteria for evaluating the proposals would have been exactly the same as they are in this case: those specified and referenced in the ratemaking sections of the Postal Reorganization Act.

Suppose further that there was a second company that was essentially Capital One's twin, "Cap Two." The Postal Service might have signed the exact same NSA with Cap Two and filed proposed rate and classification changes to implement the NSAs that were substantively identical to the ones filed here, except that they were not labeled with Capital One's name. Or suppose that the Postal Service did not sign actual NSAs with the two companies, but simply developed the contours of the proposed classification and rates based on discussions with the companies and filed a request for the exact same rate and classification changes. There would seem to be no basis

[8] *E.g.*, NAA Brief at 4 ("cutting special deals to big mailers").

under the Act for the Commission's analysis to lead to different conclusions in these situations, simply because of the label put on the proposal. The fact of the matter here is, of course, that there is no Capital Two. The uniqueness of the situation has been established on the record.

There has been concern expressed about the so-called "Cap Half," a mailer with significant smaller volumes than Capital One, but which also uses a higher-than-average amount of First-Class Mail for solicitations. This situation is now fully addressed by the Stipulation and Agreement. Under that agreement, the Postal Service has indicated that it would propose regulations to govern the development of appropriate agreements with mailers who wish to engage in an NSA that is comparable to, but not the same as, the NSA with Capital One. Indeed, the proposed regulations address one of the Commission's recently stated interpretations about the legality of NSAs.[9]

F. The Proposed Approach Ensures Continued Commission Involvement

It should be clear by now, despite the contrary rhetoric, that the Postal Service has structured its request and the NSA itself to ensure continued involvement by the Commission in the ratemaking process at the same level as in non-NSA-generated cases. Indeed, the proposed DMCS language and rate schedules were drafted to ensure that, even if a Cap Two were to appear, the Postal Service would have to file a new request in order to extend the terms of the NSA with Capital One to Cap Two. This would allow all interested parties to participate in a proceeding focused on whether the

[9] Report to 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 1, item 3 (February 11, 2002).

same arrangement would be beneficial with respect to Cap Two. The proceeding could presumably be expedited since it would be limited to this narrow issue.

G. The New "Principles" Suggested by Valpak and GCA Are Unfounded and Unnecessary

Both Valpak and GCA present in their briefs, "principles" that they have constructed and which they argue should be applied to this case. In essence, they are strawmen that can be knock down as easily as they were erected. Valpak decrees that unless the NSA meets all of its principles, the Commission may not approve the proposal in this docket. Valpak Brief at 5. No authority is cited for this theory. Only two of the Valpak's Principles can be identified as based on policies of the Act. Principle II appears to be a restatement of § 3622(b)(3) and Principle IV appears to be a restatement of § 403(c). It is not clear whether the other five Principles came down from some unidentified mountain or were merely found in a cave. In any event, Valpak's analysis is completely misplaced.

GCA also erects two principles that it seeks to superimpose on the statutory criteria: that the Commission should not recommend rates and classifications implementing an NSA if it can construct a niche classification in its place, and that NSAs may not combine features of different services. GCA's principles are equally baseless and illogical.

1. Valpak Principle I: "NSAs cannot substitute for fixing systemwide pricing problems."

Without conceding the validity of the premise that there is a systemwide pricing problem, there is no basis for Valpak's assertion. Valpak cites no authority for this proposition. This principle, broadly applied, would require permanent, comprehensive

changes even in cases where it would clearly be more appropriate to test a potential resolution of a "problem" incrementally, such as through an experimental change of limited duration and applicability. Such a position would severely and unjustifiably restrict the Postal Service's and the Commission's mutual discretion.

2. Valpak Principle III: "NSAs must be evaluated using mailer-specific costs."

No authority is cited for this proposition. Costing cannot always be based on the ideal data, but must, by necessity, be based on the best available information. It is common in postal ratemaking to use proxies where actual data do not exist and where the proxy is shown to be a reasonable substitute. In Docket No. MC97-4, for example, witness Pham used a series of proxies to calculate the likely costs of Bulk Parcel Return Service. *Id.*, USPS-T-1. Valpak did not intervene in that case to suggest that the Commission could recommended BPRS based only on costs specific to BPRS mailers. It is simply the fact that Valpak's Principle III has no basis in postal ratemaking law. Witness Crum has explained why the average subclass costs he used are a reasonable proxy for Capital One's costs. Tr. 2/328, 331. Valpak is free to urge rejection of his explanation as an empirical matter, but there is no basis for its erecting a false principle that has no legal basis.

3. Valpak Principle V: "NSAs must not provide discounts based solely on high volume."

Valpak apparently bases this Principle on § 403(c), believing that all forms of volume discounts are unreasonably or unduly discriminatory. This issue was examined more than a decade ago by the Commission/Postal Service Joint Task Force, which suggested declining block rates as a means of encouraging additional volume without

discriminating against lower-volume mailers.[10] Most firms offering volume discounts provide a discount off every piece. Thus, large customers pay less for each unit than do small customers. The Commission has expressed the opinion that such discounts are not permissible in the absence of cost differences. Declining block rates, by contrast, provide discounts only at the high volume levels, so that the large and small customers pay the same rates for the same volume level.

4. Valpak Principle VI: "NSAs must not provide unfair rewards for high-cost mailers discontinuing high-cost behavior."

This Principle is also of Valpak's creation. If such a situation existed, there might be a question of fairness. This situation, however, is far removed from Capital One's. The relevant "behavior" Capital One is engaging in is using First-Class Mail for solicitations, instead of Standard Mail. As demonstrated by witness Plunkett in his rebuttal testimony, this is highly beneficial to the Postal Service. CITE. The NSA will serve only to increase the value of Capital One's "behavior" through its voluntary declining of service it is otherwise entitled to by virtue of using First-Class Mail. Capital One receives a "reward" under the NSA only if it increases its First-Class Mail volume, whether solicitations or other mail, which also unequivocally benefits the Postal Service and all mailers by providing contribution that it would not have received without the discounts.

[10] *Postal Ratemaking in a Time of Change, A Report by the Joint Task Force on Postal Ratemaking* at 43 (June 1, 1992.)

5. Valpak Principle VII: “NSAs must attempt to anticipate and avoid unintended consequences.”

This Principle is also of Val-Pak's creation. To the extent that one can understand the explanation of this principle as presented in Val-Pak's Brief at pages 38-40, however, it makes little sense. It appears to be premised on the notion that mailers would behave in accordance with subjective feelings of relative Afairness,@ rather than an objective analysis of costs and benefits. Specifically, Val-Pak suggests that some mailers might take such great umbrage at the agreement made with Capital One that they would Aresist adopting the more efficient and less costly electronic return service.@ Val-Pak Brief at 39. Presumably, these Aresisting@ mailers are among those for whom it otherwise makes economic sense to adopt electronic return service. (If it did not otherwise make economic sense for them to make the switch, it would be impossible to attribute their Aresistance@ to purported feelings of unfairness.) Of course, no such mailers have been identified on the record in this proceeding, and Val-Pak suggests no potential examples (while nonetheless maintaining that there are Aperhaps many@ such mailers). Why these mailers would choose to register their concerns regarding Aunfairness@ by refusing to adopt rational economic behavior is distinctly unclear. It seems far more likely that, under the circumstances hypothesized by Val-Pak, such mailers would merely seek to rectify their concerns by pursuing their own NSAs with the Postal Service in accordance with the expanded proposals incorporated into the Stipulation and Agreement. In any event, as even Val-Pak appears willing to concede on page 40 of its brief, its abstract discussion of this somewhat bizarre principle offers no legitimate impediment to the recommendation of the pending NSA proposal.

6. GCA Principle: NSAs Are Appropriate Only Where a Niche Classification Is Infeasible

GCA erects a principle that it asks the Commission to enshrine as a limitation on both its and the Postal Service's discretion to recommend rate and classification changes based on NSAs. It argues that NSAs may only be recommended "where a niche classification open to all is infeasible." GCA Brief at 8-13. It provides no basis in the specific language, structure, or interpretation of the statutory scheme to support this dictum, apart from a vague expression of a general and unfounded conclusion that NSAs in the abstract might be unfair or discriminatory. Rather, it offers three somewhat practically-oriented reasons why niche classifications should always be preferred over NSA's: (1) NSAs might exclude some mailers from sharing in the benefits of cost and service relationships that could create the basis for more favorable rates or mailing conditions; (2) NSAs might foster competitive relationships among mailers that could lead to the loss of mail volume, to the overall detriment of the mailing community; and (3) NSAs might lead to costly and inefficient practices and transaction costs needed to develop and convert them to rate and classifications.

Elsewhere in this brief, we discuss the second reason cited above, which was engendered by Professor Panzar's observations regarding the possible economic consequences arising from pricing based on NSAs. Neither of the other two reasons, however, make a compelling case against NSAs in general or the Postal Service's proposal in this proceeding. They are either beside the point or, at best, premature.

GCA seems principally concerned that the practice of negotiating NSAs will overtake the normal evolution of broader classifications and create islands of exclusivity that will favor only particular mailers. By proposing that a basic election between NSAs

and niche or broader classifications be required, GCA implies that Congress intended that NSAs be disfavored. Like NAA's argument that Congress intended only broad classes of mail, however, GCA makes an argument that is not well-founded in the statute. The fact is that Congress created a flexible mechanism for the establishment of rates and classifications that relies principally on the judgment and discretion of the Commission and the Postal Service. It did not decree, as GCA implies, either that NSAs be excluded or that niche classifications be preferred.

When the prejudice against NSAs is distilled from this argument, what remains is no more than a truism. NSAs are not niche classifications. They serve distinct purposes and provide distinct benefits. As understood by the Postal Service, the two pricing mechanisms are essentially apples and oranges. For GCA to argue that an apple should never be used when an orange is available is essentially meaningless. That choice depends on whether you are preparing a pie or a breakfast beverage.

GCA's draws the primary example to illustrate its limiting principle from Docket No. MC95-1. In that proceeding, the Commission observed that the potential overlap between two proposed classifications, Automation and Retail First-Class Mail, militated against their establishment as exclusive categories for the purpose of assigning rates. Besides arguably vindicating Congress's wisdom in entrusting classification authority to the Commission, however, that precedent does not detract one bit from NSAs as a concept, or from the Postal Service's proposal in this proceeding. The Postal Service has never proposed that any NSA exclude consideration of a sensible classification proposal, whether it serves a narrow niche of mailers or a broader range. In fact, it is possible that successful elements of NSAs could evolve into more general

classifications. That potential, however, should be no impediment to rates and classifications based on well-founded NSAs, especially where, as in this case, there are means of making similar terms available to other mailers.

The Postal Service is interested in NSAs where they make sense, namely, where they are based on distinct relationships with particular mailers and can result in benefits to both the NSA parties and all other mailers. Nothing in law or logic should prevent opportunities to exploit those relationships and those benefits on the basis of vague expectations that someday a niche classification might be formulated that would have broader appeal, albeit with a different combination of benefits. That election, if it exists, is for the Postal Service and the Commission to decide.

GCA's final argument in favor of a announcing a principle operating against NSAs is that a regime that includes particularized pricing and service arrangements would potentially be inefficient and costly. GCA's reasoning is that negotiating individual agreements would be more time consuming, compared to efforts to establish niche classifications, and that administering and monitoring individual agreements would be costly. In this regard, the Postal Service readily admits that such expenses could militate against a wide network of NSAs. That uncertainty is one of the main reasons why it has made its proposal here as an experiment. Uncertainty about costs, however, is not a reason not to embark upon the experiment. As an exercise in pricing flexibility, NSAs hold great promise for the postal industry. If successful on economic grounds, they could justify a carefully conceived classification framework and specialized Commission procedures providing thorough, expeditious review of future agreements. The Postal Service would fully support moving in that direction.

II. THE REQUESTED CHANGES NECESSARY TO IMPLEMENT THE CAPITAL ONE NSA ARE CONSISTENT WITH THE POLICIES OF THE ACT

A. The Capital One NSA Meets the Criteria of the Act

The briefs in opposition to the Capital One NSA invoke few statutory criteria other than fairness and undue or unreasonable discrimination or preference.[11] As discussed earlier, the opponents seek to have the Commission measure the Capital One NSA against "new standards and principles." With the fervor of a re-education campaign in a totalitarian regime, the opponents have offered the Seven NSA Principles (Val Pak), and the Two New Standards for NSAs (GCA).[12] This approach of holding the Capital One NSA to standards that are specifically designed to tear down this NSA should be rejected.

In sum, the changes needed to implement the Capital One NSA are fair, equitable, and non-discriminatory. The changes have been tested in the crucible of a public proceeding, open to all stakeholders. The Postal Service proposal has been the subject of robust discovery and eight days of hearings. The record demonstrates that the conservative cost analysis employed the standards of Commission proceedings, and that there will be a net contribution benefiting all mailers. Putting aside all of these hallmarks of fairness, one compelling fact remains: the stakeholders most in the position to claim undue or unreasonable discrimination are ones who have not raised

---

[11] GCA Brief at 9, 14; NAA Brief at 13, 15-16; Valpak Brief at 7-9.; As discussed *infra*, NAA does invoke the statutory criteria of simplicity to challenge the Capital One NSA.

[12] Although not invested with Roman Numerals, GCA articulates two principles: 1) NSAs Are Only Appropriate Where A Niche Is Not Feasible (GCA Brief at 8) and 2) An NSA Should Not Combine Independently Usable, Unrelated Elements. (GCA Brief at 14).

their voices in opposition or concern: the direct competitors of Capital One. Yet, even their competitive interests have been fully explored in this proceeding, and the record reflects how the Postal Service will make comparable NSAs available to similarly situated mailers.[13] Of particular note, ,trade association that represents the mailing interests of financial services companies which are the likely competitors of Capital One, the American Banker Association, has signed the Stipulation and Agreement.

Finally, what the Capital One NSA and this proceeding demonstrate is that NSAs are an excellent example of the untapped pricing flexibility available under the Postal Reorganization Act. As noted above, mailers of all classes of mail support the NSA. Competitors of Capital One wish to follow Capital One's suit and pursue non-linear pricing and innovative cost-savings. Another advantage of the Capital One NSA is that it has allowed the Postal Service to identify new ways to make the Postal Service more efficient. This is an important benefit of the exchange of information between the Postal Service and customers as they discuss NSAs.[14] All customers can then benefit from this greater understanding of how customers use the mail. The risks of doing nothing,

---

[13] *See* Stipulation and Agreement (March 31, 2003). Contrary to NAA's and GCA's contention, the Capital One NSA is in accord with the Commission's recent report to Congress.

> [NSA]s are legally permissible, provided that 1) the proposal is reviewed in a public proceeding, 2) the agreed-upon rate and service chances will work to the mutual benefit of mail users and the postal system as a whole; 3) the negotiated rate-and-service package is made available on the same terms to other potential users willing to meet the same conditions of service.

2002 Report to Congress. at 1. The report, while non-binding, provides an appropriate framework for the analysis of NSAs.

[14] Tr. 4/845.

of retreating to the routine confines of postal ratemaking are great. *See* Testimony of Anita J. Bizzotto, USPS-T-1, at 4-5.

B. Neither a Niche Classification nor De-Averaging Will Confer the Benefits of Declining Block Rates or Reduce the Cost of First-Class Mail Returns

Section I showed that the Act does not require the Commission to engage in an analysis of whether an NSA should be changed into a broader classification. As a way to underscore why combining ACS and declining block rates make sense, this section presents a discussion of practical problems with converting the elements of the Capital One NSA into broader classifications

Valpak, NAA, and GCA recommend rejecting the Capital One NSA because niche or broader classifications can confer the benefits to a larger group of mailers, yet each is vague about the details of these "better" classifications and their benefits.[15] One must at least give credit to the OCA for having the intellectual fortitude to back up its claim that classifications would be better by attempting to design them. OCA's experience has been a valuable asset to the record in this docket for it demonstrates the pitfalls of Valpak, NAA and GCA's position that generally available classifications are *per se* better.[16] Moreover, it bears repeating that a general classification would never meet one of the key goals of the Capital One NSA: to "allow the Postal Service

[15] GCA Brief at 8; NAA Brief at 8; Valpak Brief at 30

[16] OCA now acknowledges that the Capital One NSA is superior to the classifications it proposed. See Office of Consumer Advocate Notice of Withdrawal of Classification Proposal at 3-4 (March 31, 2003) (OCA Notice of Withdrawal).

and the Commission to test the effectiveness of the NSA approach, as a means of providing flexibility under the existing statutory ratemaking scheme." Request at 2-3.

1. The Opponents' Claim that Declining Block Rates Should Be Offered as a Classification in Lieu of the Capital One NSA is Without Merit.

The potential utility of declining block rates in postal ratemaking was examined in detail in the Joint Task Force Report. Declining block rates were recommended for competitive services as a way to address the potential discrimination issue raised by pure volume discounts. *Id.* at 43. As this has been amply demonstrated in this proceeding, declining block rates can be a valuable tool to increase mail volume and net contribution.[17] Declining Block rates afford an opportunity to adjust prices in accord with an individual company's perceived value of additional mail service. At least one opponent of the Capital One NSA, Valpak, does not believe that declining block rates violate the Act. Val Pak Brief at 19.

It would be difficult, however, to offer declining block rates as a broader classification, as GCA recommends. GCA Brief at 16. Once such a classification were established, the Postal Service would have the discretion to decide who qualifies.[18] Witness Callow's proposal to apply a formulaic approach would have granted the Postal

[17] Although the class of mail affected here, First-Class Mail, was not at that time considered among the "competitive classes," this case concerns the use of First-Class Mail to send advertising mail, which is subject to competition. Moreover, technological changes in the last ten years, which can be expected to accelerate in coming years, has subjected all First-Class Mail, even that protected by the Private Express Statutes, to increasingly competitive alternative means of delivery.

[18] Under witness Callow's proposal, the Postal Service would have set, without further review, a threshold for each mailer in relation to a forecast of the potential user or users of the rate.

Service unprecedented latitude in making these decisions, and those decisions would not have been subject to Commission review.[19]

Commission review of comparable NSAs, as is contemplated in the regulations attached to the Stipulation and Agreement, provides an important check to ensure the viability of this pricing option. Given that this is the first foray into declining block rates, an experimental NSA provides a good incubator for the concept.

The Postal Service also has policy reasons for wanting to bind mailers through an agreement rather than a classification. Declining block rates are a very effective arrow in the quiver of negotiations with mailers. (See Tr. 4/824) As with the Capital One NSA, they could be used to convince a mailer to undertake innovative cost-saving service changes and enhancements.

2. Valpak's proposed comprehensive solution to the high cost of Undeliverable-As-Addressed mail is not tenable.

Valpak's suggested approach to a "comprehensive" solution to the situation regarding physical/electronic returns is hopelessly muddled. Valpak's suggestion is "to calculate the cost of both physical and electronic return of information relating to undeliverable First-Class bulk mail, and to remove those costs from the cost base of First-Class bulk mail." Valpak Brief at 16. What Valpak either fails to appreciate, or perhaps intentionally glosses over, is the fact that, under the current ratemaking

[19] Accord OCA Notice of Withdrawal at 3-4.

structure, there is no "cost base of First-Class bulk mail."[20] Presorted or "bulk" First-Class Mail letters is not a separate subclass, and rates for presorted or "bulk" letters are not built up from a separate cost base. Presorted First-Class Mail letter rates are, rather, set using discounts (based on avoided costs) off the single-piece First-Class Mail letter rate. Therefore, what Valpak suggests as something that would not be "unusually difficult" would, in fact, require nothing less than a complete reclassification of the First-Class Mail Letters and Sealed Parcels subclass. While Valpak indeed may prefer that rates be built from the bottom up rather than from the top down, its unstated preference in this regard should not be allowed to interfere with the much more limited objectives of this proceeding.

The Postal Service acknowledges that this case has raised issues that warrant future study. However, Valpak's proposed "solution" – do nothing unless a "comprehensive solution" can be implemented – is short-sighted and ignores the contribution-increasing benefits that can be achieved in the short-term by implementing the Capital One NSA. While a review of the current Address Correction Service offerings may result in the Postal Service proposing future changes, it is not yet clear what any such changes would be and how they might affect the Postal Service's overall financial position or what their impact might be on other customers. Meanwhile, the Commission should not ignore the opportunity to benefit all customers by addressing the specific issues raised by Capital One's mailing profile.

---

[20] Perhaps even more fundamentally, there are no "bulk" rates for First-Class Mail letters, but rather, single-piece letter rates and presorted letter rates. We use the term "bulk mail" in this discussion as a synonym for "presorted letters" simply to maintain consistency with the term used by Valpak.

3. It is not as simple as waving a wand: Waiving the electronic Address Correction Service fee would not necessarily result in a net gain of efficiency.

Setting address management policy is not, as Valpak, GCA, and NAA suggest, as simple as waiving a fee.[21] The goal of address management policy is to reduce UAA costs, a multi-faceted problem needing a multi-faceted solution. Waiving the electronic address correction service fee for First-Class Mail may save the difference between electronic and physical return, but Address Change Service is only one part of the Postal Service's policies to reduce UAA mail. Offering the service associated with the endorsement Change Service Requested (CSR) would not, as Valpak[22] argues, automatically result in net gain in efficiency.[23]

Given the complexities of address management, as explored at length in this proceeding, implementation of the Capital One NSA will yield rich data that that will likely aid in the Postal Service's re-evaluation of address correction fees.[24] The Capital One NSA will provide the Postal Service the opportunity to test the use of the CSR endorsement on very large scale. In FY 2001, the average annual rate at which notices were provided for mailpieces bearing the CSR endorsement was only about 17,000 pieces per participant, resulting 2.8 million notices in all.[25] Based on the record in this

[21] NAA at 20, Valpak Brief at 13, see GCA Brief at 14.
[22] Valpak Brief at 13.
[23] A discussion of some of the policy implications of waiving the fee can be found in the Postal Service's Response to OCA/USPS-T4-14 at Tr. 5/943.
[24] See Response to OCA/USPS-T4-11, at Tr. 5/941.
[25] In FY2001, the Postal Service sent 2.8 million ACS notices for First-Class Mail bearing the Change Service Requested endorsement to a total of 165 participants, or approximately 17,000 per participant. Tr. 3/571. At 20 cents per notice, the cost would be $3400 per participant. In FY2002, the total number of electronic notices for CSR endorsed First-Class Mail was 3.6 million. Tr. 3/573

case, it is estimated that Capital One will receive 55 million notices[26], an amount that dwarfs prior use of CSR. As a result, the NSA is ideally suited to test the effectiveness of expanding ACS from a tool that corrects addresses to one that reduces the high cost of returns.

Similarly, Valpak's suggestion that it would be better pricing policy to pay Capital One for each ACS notice,[27] would create a perverse incentive. At first, such a payment seems more in accord with our current workshare discount structure where we "share" the operational savings by offering a discount off the scheduled rate. But, once again, address management is not amenable to easy fixes. Paying for each ACS notice is actually paying for UAA mail and by sheer logic, would create the incentive for a mailer to generate more UAA mail.

Furthermore, Valpak's and NAA's claim[28] that the waiver of the fee is unfair when other mailers pay for ACS, is another misguided attempt to isolate ACS from a broader Address Management plan. Capital One, at significant cost, will continue to process its addresses through NCOA far more frequently than postal regulations require. Thus it is already paying far, far more for address corrections than the average user of ACS. [29]

---

[26] The number of notices that Capital One will receive is a function of the revised solicitation estimate found in (COS-RT-2, Exhibit 3) multiplied by return rate (9.6 percent) ACS success rate (85 percent) or 670,000,000 *.096*.85=55,000,000.
[27] Valpak Brief at 21.
[28] See GCA's Brief at 22; NAA Brief at 5.

[29] . As indicated supra, the cost per participant for electronic notices was, on average, $3400. For NCOA processing, mailers pay charges 50 cents to 2 dollars per thousand names. Tr. 3/639. Since Capital One processes hundreds of millions of names, they pay substantially more than an ACS mailer.

4. Combining the Address Correction Service and Declining Block Rates makes sense.

As stated earlier, the Act is flexible enough to permit seemingly disparate elements to be joined together in one NSA. Here the two main features, declining block rates and address correction service, present an excellent example of how declining block rates can create an incentive for mailers to adopt new practices that save the Postal Service operational costs. The Agreement is designed to induce Capital One to move as much solicitation mail as possible into the ACS program. Only solicitation mail that bears the Change Service Requested endorsement can be counted toward the thresholds. If the two features were not joined together, then use of the CSR endorsement would be optional and may succumb to marketing decisions to simplify the front of the mail piece. By tying the availability of declining block rates directly to the use of the CSR endorsement, Capital One's full participation in ACS is assured. The NSA also provides for compliance mechanisms to ensure that the agreement's objectives, to reduce UAA costs and induce new volume, are achieved.[30]

The NSA is not, as NAA and Valpak argue, a reward for "bad behavior." Valpak Brief at 37, NAA Brief at 13. Rather it is an effective short-term way to deal with a situation that is not easily susceptible to traditional price signals. It is a good vehicle for

[30] Several features of the NSA will ensure that the declining block rates encourage new First-Class Mail volume rather than cannibalization of volume already in the system, a concern expressed by APWU. APWU Brief at 7. The agreement states that the mail must be for Capital One's products and services and may not mail on behalf of other companies. See Agreement, Article III K. Also, Capital One has waived the First-Class Mail seal against inspection for pieces being returned. The Postal Service will be able to examine the contents to ensure that they pertain only Capital One services and products, even if these are offered in conjunction with strategic partners. *Id.* Article IV A.

setting a standard for high quality mailing practices with features such as Mail Preparation Total Quality Management (MPTQM) and more frequent address cleansing. *See* NSA Article II Sections H and I. These are standards that will shape comparable agreements as well. *See* Regulations, Attachment D to Stipulation and Agreement.

Finally, joining the declining block rates and ACS into an NSA reduces the risk of unintended consequences. *Contra* Valpak Principle VII; Valpak Brief at 38. The NSA is an experiment and extensive data will be collected as a result. As discussed herein, waiving the address service correction fee or offering declining block rates separately as classifications, even classifications of limited duration, carry far more risk.

C. The Commission Should Find that the Capital One NSA Complies with the Statutory Criteria of Fairness and Equity

A number of opponents invoke the unfairness to Capital One competitors as a reason to reject the Postal Service's Request. GCA Brief at 10. Citing one page from his direct testimony (JCP-T-1 at 18, Tr. 8/1593), NAA claims that Professor Panzar Asuggests that the only situation in which NSAs with postal business customers theoretically might benefit the public interest would be where the Postal Service enters into NSAs with every firm that competes in the same market.@ NAA Brief at 33.

Professor Panzar, however, made no such suggestion. On the cited page of his testimony, he merely indicates that having separate NSAs with each firm in the input market is an example of how economic efficiency might be improved through the mechanism of NSAs. Nowhere on that page, or elsewhere, does he claim that his example was intended to identify Athe only situation@ in which NSA might benefit the

public interest. In fact, two pages later in his testimony, he clearly states that an ANSA may be in the public interest even if [competitors of the firm receiving the NSA] are damaged.@ Tr. 8/1595. The thrust of his testimony is that the potential impact on competitors merits consideration, and that additional opportunities for competitors to qualify for discounts (either through separate NSAs, or through niche classifications) *may* be a pragmatic approach to deal with the issue of fairness. *Id.*

In testimony also cited on page 33 of the NAA Brief, Dr. Eakin likewise identifies the opportunity for competitors to negotiate their own NSAs as his recommended response to concerns of potential harm to them from an NSA. Tr. 10/2139-40. As Dr. Eakin indicates, these other customers need to be able to come forward and request their own NSAs, and the Postal Service needs to be prepared to handle such requests. *Id.* Yet, as is clear from Mr. Plunkett=s rebuttal testimony (Tr. 9/1870, 1889-90), credit card companies that compete with Capital One are currently being afforded, with regard to their own NSAs, the exact types of opportunities discussed by Drs. Panzar and Eakin.[31] Given the circumstances discussed by witness Plunkett, given the detailed regulations incorporated into the proposed Stipulation and Agreement, and given that none of the competitors has chosen to intervene and oppose the proposed NSA with Capital One, the portions of the testimonies of Drs. Panzar and Eakin cited on page 33 of the NAA Brief provide no valid basis to impede recommendation of the currently pending NSA proposal.

---

[31] GCA misconstrues another part of Dr. Eakin's testimony as stating that competitors may react by reducing communications or shifting to non postal media. GCA Brief at 11. At Tr. 10/2110-15, Dr. Eakin said that Capital One's competitors would likely respond to an increase in Capital One advertising. In fact, he said it would be very unusual for competitors to react by advertising less. Tr. 10/21141.

.

D. The Capital One NSA Will Benefit All Mailers Because It Makes a Positive Net Contribution to Costs

Contrary to the contention of NAA, GCA, and Valpak, the record amply supports that this agreement will benefit all mailers because it makes a positive net contribution to costs. The cost analysis meets Commission standards set forth for these proceedings. GCA, NAA and Valpak attempts to undercut the analysis fail. The record demonstrates that the Capital One cost analysis makes use of a combination of reasonable proxies and customer specific information.

1. The Use of Best Available Costs to Support the Capital One NSA is Consistent with the Act

NAA and Valpak misplace their reliance on Professor Panzar when they cite his proposition, that cost information specific to the NSA partner is preferable to average cost information, as grounds for the Commission to reject the proposal now. Valpak Brief at 22, NAA Brief at 18. While Professor Panzar indicated that specific mailer costs are preferred, he acknowledged that where such costs are unavailable, the best available data may have to suffice. Tr. 8/1633-35. Most importantly, however, his statements quoted in footnote 10 of the Valpak Brief to the effect that the success of the experiment must be judged on the basis information specific to Capital One relate to the optimal information to use in a *post hoc* evaluation of the experiment. Tr. 8/1782. Those statements are not indicative of any intent by Professor Panzar to suggest that the Commission not proceed with the proposed experiment. Professor Panzar, as even quoted in the Valpak brief, actually explained why he would expect that specific costs for the NSA partner would not be available prior to the experiment. Id.

GCA, NAA and Valpak's contention that Capital One's specific costs should have been modeled[32] does not withstand scrutiny when one compares the cost of a special study as compared to the benefits. Because Capital One is a high volume national mailer, the costs of such a study would have been prohibitive.

Capital One is a national mailer of letters which is the most homogenous type of mail. The study that opponents demand would entail a sampling of 38,000 delivery units around the country. Capital One's return mail would have to somehow be isolated and then tracked through carrier and clerk handlings at the delivery units. The mail would have to be tracked on a variety of transportation routings and through intermediate processing at a array of plants. The mail would have to tracked through destinating facility or facilities in Richmond. To be accurate, the measurements would probably need to be taken over time to account for seasonal fluctuations and ensure that the data reflect the average handling. [Need better rate case lingo here]

Once Capital One's costs are modeled they need to be measured against a national benchmark of all returned First-Class Mail, a benchmark that is not available. Consequently, an additional national study would need to be done.

Witness Kent, upon whom NAA relies for the proposition that a special study should have been done, lacks the necessary knowledge of postal operations or costing. His expertise lies in railroad costing, specifically the cost of tracking box car loads of coal by rail between relatively few origin and destination points. He cannot provide a sound basis for requiring far more complicate studies here. [SCOTTS Xexam

[32] GCA at 20; NAA at 17-19, VP Principle III at 19.

In the end, the special study would most likely not be worth the cost and effort. Capital One is a national mailer of letters, the most homogenous type of mail. There is no reason to suspect, nor does the record have any evidence, that the Capital One return costs vary materially from the class average.

The cost data supporting Capital One NSA are based on appropriate combination of reasonable proxies and customer-specific information. Alliance, MPA, PostCom and Parcel Shippers at 13 With the data that will be collected as a result of the experiment, the Postal Service will be have information that can be used to evaluate many of Capital One's specific costs.

2. The record contains no evidence that PARS will materially affect the cost savings estimated provided in this case

In yet another criticism of the cost analysis, GCA claims that the introduction of PARS might confer benefits that do not exist. GCA Brief at 21. The Postal Service recognizes that PARS is a legitimate area of inquiry in this proceeding because it is an ambitious technology program designed to reduce UAA mail costs. However, the fully developed record shows that PARS will have no effect on the test year, the relevant period, and that there is no evidence that the impact in the out years of the agreement will materially alter the net benefit. PARS's design will likely lead to a decrease in the costs of providing ACS notices as well as a decrease in the costs of physically returning mail. Consequently there is no clear indication whether the cost savings will increase or

decrease, but the effect is likely to be minor.[33]. There is no basis in the record for GCA's statement that the savings will be lower. GCA Brief at 21, fn. 46:

3. Witness Crum's estimate of the cost of providing electronic address correction service is accurate.

NAA's claim that the cost savings are understated because they inappropriately rely on the cost data for providing electronic address correction notices is meritless. NAA Brief at 23-24. The costs at issue, the 14.5 cent cost of processing at the Computerized Forwarding Service (CFS) centers, are based upon library reference J-69, Docket No.R2001-1. *See* USPS-LR-1/MC2002-2. These ACS costs have been available for review and evaluation in recent omnibus rate cases. The costs are based on data which were fully explained, for example, in Docket No. R2000-1 USPS-T-29, at 5 (witness Campbell) and in LR-I-160, section A, page 3. The underlying data collection is fully described in LR-I-82, at 1-75.

Specifically, NAA relies on witness Kent's challenge of the CFS cost in his February 21, 2003, written answer to counsel for Capital One's earlier question at hearings. He states that it inappropriately averages ACS COA notification ($0.0997/piece) and ACS nixie processing ($0.2074/piece). Kent assumes that ACS nixie processing is for letter returns and therefore is the more applicable cost. NAA Brief at 23-24.

But as witness Plunkett testified, ACS nixie processing relates to mail that is handled on non-mechanized terminals which process nonletter (i.e. flats, packages

[33] Postal Service Revised Response to APWU/USPS-7, filed February 5, 2003; see Tr. 7/1229.

etc.), and consequently, have higher costs than Capital One's mail, which are letters and therefore will be processed on mechanized terminals. Tr. 9/1958-60; *see also* Tr. 9/1872.

E. Discount Thresholds Below Expected Before-Rates Volumes May Be Part of a Meritorious Broader NSA Proposal

The OCA states in its initial brief, apparently as a general principle intended to govern the establishment of declining block rates within NSAs, that the Athreshold for the payment of incentives should be set at approximately the expected Before Rates volume.@ OCA Brief at 12. The OCA then proceeds to conclude that, given the most recent test year forecasts in the rebuttal testimony of Dr. Elliott, this standard has been met in the current proposal, and its earlier concerns on this issue have therefore been ameliorated. *Id.* While the Postal Service appreciates that the OCA no longer feels compelled to pursue the issue in this case, the Postal Service is equally convinced that the standard suggested by the OCA is not one that should be embraced, even as *dicta*. As explained below, substantial harm could result if the Postal Service and potential NSA partners cannot include the appropriate threshold as elements of the agreement to be freely negotiated on a case-by-case basis. Any potential benefits from limiting the thresholdas a general principle.

Theoretically, there are two potential benefits from excluding discount thresholds below the level of volume at which it is estimated the NSA partner would be mailing even in the absence of an agreement (termed TYBR volume for this discussion). The first is fairness – the perception that mailers should not receive rate incentives to mail volumes that they would be mailing anyway. In the testimony in this proceeding, this has been dubbed the Afree rider@ effect (Tr. 7/1241), and setting the threshold at TYBR

or above eliminates known Afree-riders.@ In practical terms, however, the fairness concern cannot be viewed in isolation. It is well-known that, with the establishment of virtually every new worksharing discount program in the past, discounts were granted to mailers who had already been performing the worksharing activity without any rate incentive (presumably for service reasons, or because the cost to them was minimal). Nonetheless, as long as there was a reasonable expectation that the overall effects of the new discount program would be beneficial, the discounts were initiated, despite the existence of these Afree riders.@ To insist under these circumstances that the discounts should not have been created, solely on the grounds of fairness, would have been the policy equivalent of cutting off your nose to spite your face. Instead, the proper focus was (and should be) on the big picture – the overall effects of the proposal.

That brings us to the second alleged benefit of setting the threshold floor at TYBR **B** the avoidance of discount leakage. Discount leakage is the financial consequence of the Afree rider@ phenomenon noted above. The concern in this instance is that excessive discount leakage would render the entire deal unprofitable (i.e., reduce the net contribution to institutional costs from this mailer, relative to the contribution that would be obtained without the deal). Thus, to guard against the possibility of *excessive* discount leakage, the rationale behind the TYBR threshold floor is to prohibit *any* expected discount leakage. Once again, however, regarding this result purely as a benefit requires an unduly narrow focus on only one portion of the bigger picture. Such a conclusion is premised on the notion that countervailing effects are either non-existent in other portions of the agreement, or insufficient to produce a net overall gain despite the expected discount leakage. In reality, the appropriate focus is on the agreement as

a whole, and the Postal Service is only pursuing NSAs which are expected to produce a net gain in contribution. While setting discount thresholds at TYBR may be one approach to ensuring net contribution, it is most certainly not a necessary element to achieve that objective. As the Postal Service's proposal in this case demonstrates, it is clearly possible to anticipate overall positive financial contribution despite discount leakage expected from a threshold set below TYBR.

While the alleged benefits of a TYBR threshold floor thus do not withstand scrutiny, the costs of such a floor would be very real, as perfectly illustrated by this case. Although the Postal Service potentially stood to benefit both from the ACS cost savings and the declining block rates, the primary benefits to Capital One were anticipated from the discounts. Tr. 4/848-50. If the parties had not been fully free to negotiate the discount threshold (because of the imposition of a TYBR threshold floor), a key opportunity for balancing the benefits of the deal would have been taken off the negotiating table. The consequence of this removal, in this case, and in potentially similar instances in the future, would be a reduction in the likelihood that the parties could reach a mutually agreeable deal. NSAs such as the instant one, with a demonstrated potential to benefit both parties and postal customers generally, might never even be presented to the Commission, because of unnecessary rigidity built into the negotiation process.

Such a result is unwarranted in this case, and would be highly detrimental to the prospect for future NSAs.[34] Among the potential parties most harmed by such a

[34] While there are potential means by which this rigidity could be circumvented, they are not particularly attractive. If a rule were imposed that the discount threshold could

(continued…)

needless restriction could be the very competitors of Capital One over whom so much concern has been pronounced. The attraction of NSAs, as Dr. Eakin testified, is to use their inherent flexibility to work out as many mutually beneficial agreements as possible with mailers in, for example, the credit card industry. Tr. 10/2095-96. Placing undue constraints on the discount threshold would work against that goal. The Commission should avoid imposing across-the-board conceptual limitations on the appropriate volume threshold for discounts, and instead endeavor to determine on a case-by-case basis whether the negotiated threshold constitutes part of a proposed agreement that would be beneficial overall. The result would be a process in which, exactly as in this proceeding, discount leakage from the lower threshold would not be ignored, but instead would be explicitly estimated and evaluated in the context of all of the other expected financial ramifications posed by Professor Panzar on this matter, who was careful not to categorically rule out a threshold below TYBR, and who preferred instead merely to place the burden of justifying such a threshold on its proponents. Tr. 8/1772.

(…continued)
not be set below the TYBR volume estimate, parties might respond by seeking to manipulate information so as to suppress what would have become the *de facto* discount threshold. In other words, instead of expecting potential NSA partners to work out a good-faith TYBR estimate and then negotiate a discount threshold around that estimate, the process could evolve into one in which parties Anegotiate@ a TYBR volume level, rather than try to maintain some objectivity in that admittedly difficult and inherently judgmental exercise. Creating incentives for such an evolution would not enhance anyone=s ability to sort out potentially beneficial NSAs from those that truly are unlikely to pass financial muster.

F. The Requested Changes to Rates and Classification Necessary to Implement the Capital One NSA Do Not Violate the Simplicity Criteria of the Act

At pages 14-15 of its Brief, NNA argues that establishment of the proposed NSA would violate subsection (b)(7) of the statutory pricing criteria.[35] NNA argues that establishment of the proposed NSA would add as many as five pages to the existing Domestic Mail Classification Schedule (DMCS), 39 C.F.R. §3001.68, and would require reference to the multi-paged NSA itself. Accordingly, NNA argues, the NSA would violate the "simplicity" criterion of the Act and, on that basis, should be rejected. NNA cites a pair of court opinions interpreting subsection (b)(7) as providing a basis for rejecting the proposed NSA. For the reasons discussed below, NNA's arguments are fatally defective.

In evaluating the meaning of subsection (7), the Commission has always taken into account the varying levels of sophistication and general technological aptitude of mailers to whom discrete portions of the DMCS are intended to apply. Thus, the Commission has been more willing to recommend the establishment of technically detailed and complex mailing specifications and requirements for bulk producers of barcoded or presorted or drop-shipped mail at one end of the spectrum than it has been willing to recommend for household mailers, with more basic postal mailing needs, at the other end of the spectrum. Accordingly, the portions of the Express Mail, First-Class Mail, Priority Mail and Package Services classification and rate schedules that are utilized by the general public are among the least complicated portions of the Domestic

[35] This criterion requires the Commission to consider the "simplicity of structure for the entire schedule and simple identifiable relationships between the rates or fees charged the various classes of mail for postal services[.]" 39 U.S.C. § 3622(b)(7).

Mail Classification Schedule. On the other hand, the portions of the DMCS utilized by the likes of Capital One and the members of the National Newspaper Association are more detailed and complex. This is as it should be, given that the purpose of the DMCS is to serve a very diverse mailing public. Were the Commission to apply the "Aunt Minnie" complexity standard to the entire DMCS, NNA members would be deprived of all opportunity to enjoy the rate benefits of worksharing, at least until Aunt Minnie was able to master all of the DMCS provisions relating to Periodicals that are completely unrelated to her mailing needs.[36] Taken to its logical extreme, this would be the nonsensical result of accepting the argument advanced by NNA.

NNA's reliance on judicial precedent is equally flawed. At page 15 of its Brief, NNA cites portions of discussions pertaining to § 3622(b)(7) in court opinions affirming the Commission's rejection of intervenor First-Class Mail drop-ship rate and classification proposals. However, when one examines the truncated passages cited by NNA in context, one reaches a conclusion other than the one that NNA intended.

The D.C. Circuit has opined that "a separate rate for every group of mailers with special cost savings, no matter how small the group, would produce a hopelessly complicated rate schedule." *See United Parcel Service* v. *United States Postal Service,* 184 F3d 827, 845 (D.C. Cir 1999)*; Mail Order Association of America* v. *United States Postal Service,* 2 F.3d 408, 437-38 (D.C. Cir 1993). However, in each opinion, the court went on to add:

> This does not mean the Commission may always reject proposed cost-based classifications in order to avoid complexity

[36] A task, no doubt, that NNA members would suddenly find themselves very financially motivated to undertake.

> in the rate schedule; in some cases the facts might be compelling enough to require a new classification.

Id. And in each instance referenced by NNA, the court affirmed the Commission's rejection of each of the proposed classifications and rates because of "the complete absence of evidence establishing the existence of a substantial category of mail systematically involving lower costs[.]" *Id.* Thus, contrary to the false impression given by the NNA Brief, the decisive factor was not that each proposal would contribute complexity to the rate schedule, but that each – unlike the NSA here – was devoid of an evidentiary foundation.

III. CONCLUSION: DON'T LET THE PERFECT BE THE ENEMY OF THE GOOD!

To a large extent, the arguments against NSAs in general, and this NSA in particular, are reminiscent of Chicken Little's cries. The sky will not fall, even if this NSA is not a success. The agreement was carefully designed to minimize possible risks. It has a limited term; it involves only one large mailer. The financial risk, especially in the context of total First-Class Mail revenues, is tiny. Yet the potential value, not just in net revenue, is enormous. Knowledge will be gained concerning the effect of waiving the address correction fee on a large First-Class Mail user. Knowledge will be gained concerning a large mailer's reaction to declining block rates. The Postal Service and the Commission will have valuable information to apply to analysis of potential future changes of wider applicability. The NSA concept will be tested in a variety of respects. At the same time, the postal system as a whole will be protected from disruption and loss from making more widespread changes.

The opponents have criticized the cost estimates, forecasts, and other data presented in support of the changes needed to implement the NSA. As explained above, these data may not perfect, yet they provide more than sufficient support for this experiment under any reasonable standard. The small financial risk and the experimental status of the changes, combined with the plan to monitor performance and collect data during the course of the experiment, will offset the real and imagined liabilities associated with data sufficiency and quality issues.

In this regard, GCA claims that the Postal Service said that it had developed "no systems … to collect data regarding the performance of an NSA …." GCA Brief at 24, citing witness Plunkett at Tr. 9/1891-94. Witness Plunkett, however, was talking about

systems to monitor witness Callow's proposal, if it were to became a classification. He was not talking about monitoring the NSA. GCA also claims that any data collected is likely to be insubstantial and will only amount to what the NSA partner is willing to share. GCA Brief at 25 There is no basis for this argument. The data collection plan is not optional. Failure to provide the necessary data is a basis for termination of the Agreement. Because Capital One will be by far the largest mailer to use ACS, there will be significant data that will help in determining whether and in what manner to extend this arrangement to other mailers.

As with any practical business relationship, the reasons for perpetuating the Capital One NSA beyond its original term will remain valid only insofar as the economic and service relationships that gave rise to them continue into the future. In this regard, APWU justifiably asks what will happen at the end of the term. Both the Postal Service and Capital One will carefully evaluate the experience to ensure that the rewards from the agreement remain vital. In other words, there will be no automatic renewal without a detailed, objective assessment. Furthermore, the experimental status of the rate and classification changes needed to implement the NSA will ensure that the Commission will have an opportunity to evaluate the success or failure of the agreement, and the financial consequences, if the Postal Service seeks renewal. If, as we recommend, the Commission undertakes a broader exploration of the classification issues associated with NSAs in the future, a framework might be recommended that could build on the information learned from this experiment. If warranted, the Commission could develop specialized procedures that would expedite review, and make NSAs a more practical and viable option for establishing prices and service conditions.

In the immediate future, the Postal Service will continue to explore possible sources of new NSAs. The mailing community and the Commission, however, can rely on the Postal Service's commitment to undertake rigorous prior justification and review of any future arrangements that it might propose for Commission consideration. During the course of the Capital One experiment, the process outlined in the settlement agreement will ensure that mailers willing to enter into an agreement similar to the Capital One NSA will have a fair opportunity to pursue that objective.

In short, the Postal Service readily admits that its proposal raises important questions. In a perfect world, we would already know the answers. There is much to be gained, however, from embarking on a path that will lead to a greater understanding of the issues and consequences raised by the Capital One NSA. For the above reasons, the Commission should recommend it as proposed.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.
Chief Counsel, Ratemaking

Nan K. McKenzie
Eric P. Koetting
Scott L. Reiter
David H. Rubin
Michael T. Tidwell

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260-1137
April 14, 2003

CERTIFICATE OF SERVICE

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

Scott L. Reiter

475 L'Enfant Plaza West, S.W.
Washington, D.C. 20260B1137
April 14, 2003