

1 **Direct Testimony of**
2 **Karin Giffney, Discover Financial Services, Inc.**

3 **Introduction**

4 My name is Karin Giffney. I am Vice President of Marketing for Discover
5 Financial Services, Inc. (DFS). DFS is a business unit of Morgan Stanley and is
6 responsible for the operation of the Discover® Card brand. DFS offers a variety
7 of Discover branded credit cards and other financial services to meet the needs
8 of our customers. As one of the largest issuers of general purpose credit cards
9 in the U.S., we are a direct competitor of Capital One.

10 As provided in the Commission's new Negotiated Service Agreement
11 (NSA) rules, DFS is appearing before the Commission as a co-proponent with
12 the Postal Service of a Functionally Equivalent NSA. Our NSA generally
13 encompasses the same or analogous terms and conditions of the Capitol One
14 NSA and is consistent with DMM §911. This NSA does not encompass the mail
15 of the brokerage business of our parent company, Morgan Stanley. We look
16 forward to a thorough and prompt review, pursuant to the time limits of the
17 Commission's rules, and pledge our full cooperation with the Commission in this
18 process.

19 I have worked in direct marketing for 24 years, primarily in financial
20 services. I was part of the original marketing team that launched the Discover
21 Card in 1986 and have held a variety of marketing positions. My previous areas
22 of responsibility include fee products, cash advance and investment product
23 marketing, card activation and retention, and credit card promotion and

1 sponsorships. In my current role I manage four departments: Production
2 Services, Creative Services, Telemarketing, and Contact Management Strategy.
3 I procure the majority of external marketing services for DFS.

4 I am an active member of the Direct Marketing Association (DMA) and
5 serve as a judge in DMA's Echo Award direct mail competition. I also recently
6 received the "Woman of the Year" award from Women in Direct Marketing
7 International, Inc. I am also a member of the Chicago Association of Direct
8 Marketing, and have lectured on direct marketing principles at several
9 universities in Illinois.

10 **Purpose of My Testimony**

11 The purpose of my testimony is to provide the Commission with
12 background about DFS and to discuss in general terms our marketing practices
13 as they relate to mail operations. In addition, I will give our "before-NSA" and
14 "after-NSA" First-Class Mail volume projections. In discussing our marketing
15 practices, I trust the Commission accepts that I cannot reveal proprietary
16 information. The credit card industry is highly competitive, and too much insight
17 into the specifics of our marketing strategies would give our competitors a
18 significant and unfair advantage. With that in mind, this testimony provides
19 insights into economic factors, industry trends, and company practices that
20 influence the selection of marketing channels and our mail forecasts.

21 **Discover Financial Services**

22 DFS is one of the largest issuers of general purpose credit cards in the
23 U.S., with more than 50 million Cardmembers. We offer a variety of credit cards

1 to meet the needs of our customers, including the Discover Classic Card, the
2 Discover Gold Card, the Discover Platinum Card, The Miles Card from Discover
3 Card, and an array of affinity cards. When the Discover Card was launched in
4 1986, DFS pioneered many card features that since have spread throughout the
5 credit card industry—no annual fee, 24/7 customer service, and the Cashback
6 Bonus® award.

7 DFS also offers additional services such as Discover CDs and Money
8 Market Accounts, auto insurance, and home loans. DFS owns and operates its
9 own merchant network (the Discover/NOVUS® Network), which processes credit
10 card transactions, much in the same way that the Visa, MasterCard, and
11 American Express networks do.

12 DFS is also proud to support a wide variety of philanthropic programs and
13 organizations. These include Juvenile Diabetes Research Foundation
14 International, Boost, Make a Wish Foundation, Communities in School, and the
15 Discover Card Tribute Award Scholarships.

16 Over the years, the industry has recognized Discover Card many times
17 and we have received numerous awards. In 2003, we won the Brand Keys
18 Customer Loyalty Award in the credit card category for the sixth consecutive
19 year. Further, the Discover 2GOSM Card, the first key chain credit card in the
20 industry, was recognized as "One of the Best Products of 2002" by *Business*
21 *Week* and *USA Today*. DFS is also a leading credit card company on the
22 Internet, with more than 12 million Cardmembers registered at the Discover Card
23 Account Center, accessible at www.discovercard.com.

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Functionally Equivalent NSAs

DFS is pleased to see that the Postal Service and the Commission have opened up the area of NSAs and we anticipate that this new pricing mechanism will provide mutual benefits to both the Postal Service and the mailing community. For this pricing mechanism to be a success, the Commission must ensure that competitors of a company benefiting from an NSA, competitors both large and small, can straightforwardly receive a Functionally Equivalent NSA. In this regard, both the speed and flexibility of the process will be critical to the success of the process.

Since no two companies are alike, the Commission and the mailing community should expect that Functionally Equivalent NSAs will not be mirror images of a baseline NSA. Inevitably they will reflect differences between companies' operations, practices, structures, goals, and marketing philosophies, as our NSA demonstrates.

DFS's Approach to Marketing and the Mail

DFS assesses the viability of its marketing strategies on an ongoing basis. We do so by evaluating the efficiency of various marketing channels, and strive to use those that are most productive. While mail provides many benefits, this channel does face increasing competition. DFS utilizes a variety of marketing channels: telemarketing, event marketing, and merchant marketing, as well as print, television, radio, and outdoor advertising. We also use email and the Internet.

1 Still, direct mail remains a part of our core strategy and we expect to
2 continue using this channel in our marketing efforts. Direct mail is a proven and
3 highly viable channel for reaching both customers and prospects. Mail provides
4 DFS with the ability to quickly and cost-efficiently reach large numbers of
5 households, yet gives us the flexibility to target specific consumers with
6 appropriate offers. With the personalization that mail technology provides, mail
7 allows us to test many offers at one time and create multiple versions of each
8 offer. In sum, mail is a robust marketing vehicle in which we can test myriad
9 offers and products simultaneously.

10 **DFS's Use of the Mail**

11 DFS uses both First-Class Mail and Standard Mail. Our total mail volume
12 is comprised of two types: Operations and Marketing Mail. Our Operations Mail,
13 which is always sent First Class, includes all business-related correspondence
14 directed to both our Cardmembers and the merchants that participate in the
15 Discover/NOVUS Network, e.g., Cardmember and merchant statements.

16 While some of our Marketing mail is currently sent First Class, the bulk is
17 sent Standard Mail. We have concluded that under this NSA there would be an
18 advantage, depending upon certain characteristics of the addressees, to shift a
19 portion of our monthly campaign mail from Standard Mail to First-Class Mail. The
20 speed and likelihood of delivery, as well as the forwarding capability inherent in
21 First-Class Mail, are valuable components of our marketing program.

22 Each month DFS creates acquisition marketing campaigns, which mail on
23 a weekly basis, to acquire new Cardmembers. Each campaign consists of

1 various offers mailed from contracted lettershops and presort suppliers located
2 primarily in the Midwest. The mailings in each campaign range in size from very
3 small volumes (generally marketing tests) to very large volumes. The campaigns
4 are typically planned well in advance and often incorporate new features,
5 promotions, and creative tests. Our respective marketing areas analyze the
6 results of each campaign.

7 On a monthly basis, DFS procures over 40 mailing lists that make up the
8 entire acquisition campaign mailing. We mail from these lists and not from an
9 internal prospect database. Once lists are obtained, we use statistical analysis to
10 select the best offers and pricing that would be of value to new Cardmembers.
11 We balance response modeling and risk analyses in an effort to obtain profitable
12 new accounts. DFS markets on a monthly basis to its portfolio through a contact
13 management and segmentation strategy in an effort to provide additional
14 services and meet its Cardmembers' needs.

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DFS's Historic Mail Volumes

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While the volume of our Operations Mail tends to be stable, our Marketing

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Mail volumes fluctuate, although that fluctuation has recently moderated. The

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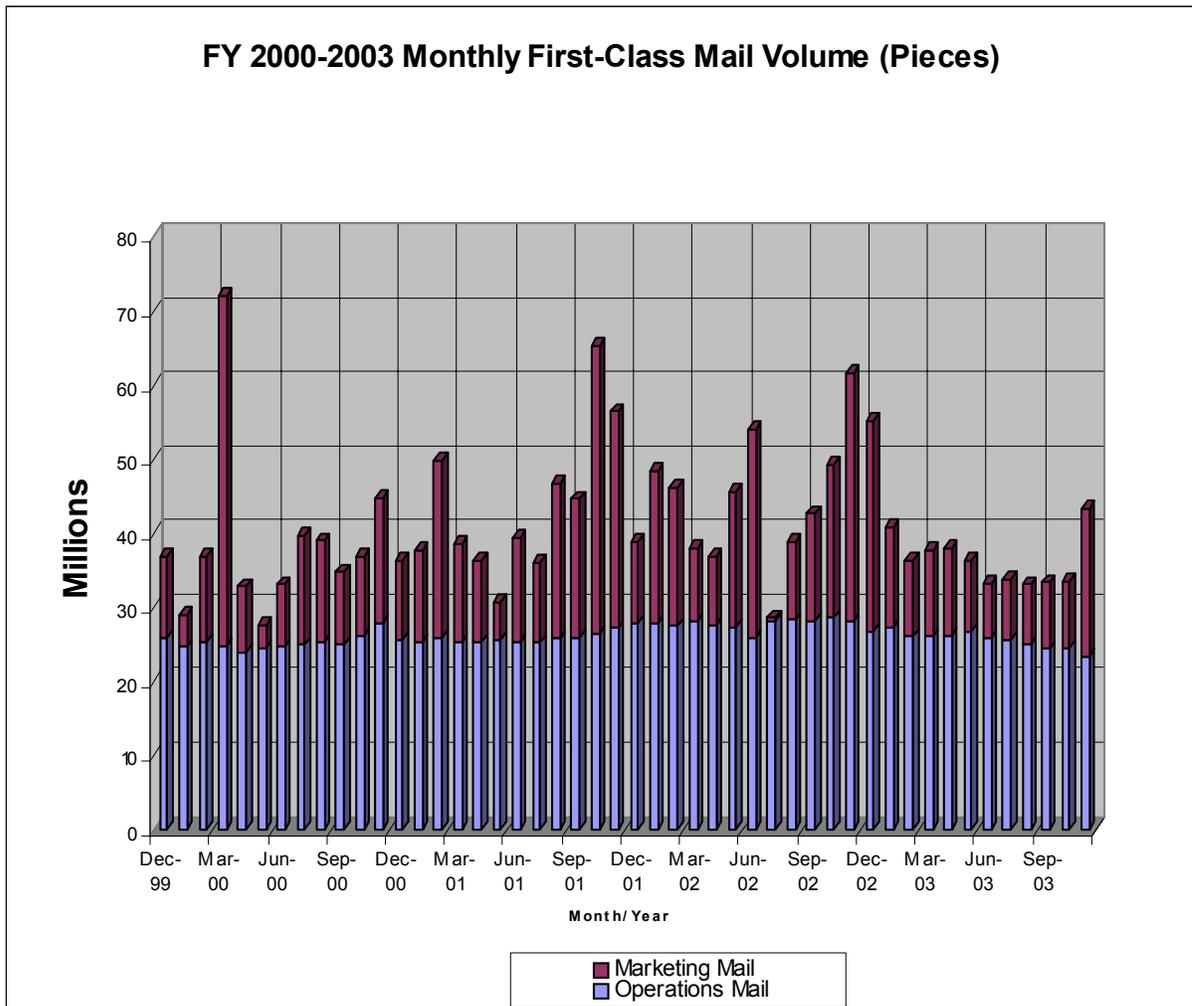
following graph shows our First-Class Mail volumes for both Marketing and

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Operations Mail for December 1999 through our FY 2003 fiscal year. The data

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upon which this graph is plotted are found in Appendix I.



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DFS's Budgeting Process

Our annual budget process begins with a strategic plan that provides direction and key drivers, including a new account goal for the period. Economic factors, current market conditions, and other business developments are considered as the plan is developed. As we develop a budget pursuant to the plan, we use recent performance data and we identify common industry trends such as declining response and approval rates, consumer's debt capacity, debt consolidation, and consumer usage. Once drafted, the budget is approved by DFS's Senior Management and then by Morgan Stanley. It is the Marketing Department's responsibility to manage its budget within a one percent variance each month. Consequently, we manage the marketing budget extremely tightly, and this discipline is critical to the success of our business.

Three-Year Forecast, Before- and After-NSA

DFS's current three-year forecast, which reflects our use of other channels including electronic communications, for First-Class Mail is:

Before-NSA Forecast (millions)

	Year One	Year Two	Year Three
Marketing	156	156	156
Operations	295	290	285
Total	451	446	441

As these numbers show, our First-Class Marketing Mail projections for the next three years are essentially flat, notwithstanding a recent reported industry trend towards lower First-Class Marketing Mail volumes. See DM News "Fewer

1 Credit Card Offers Mailed for 2nd Consecutive Year,” April 1, 2004 at www.dmnews.com/cgi-bin/artprevbot.cgi?article_id=20720&dest=article. See also
2
3 www.postalwatch.org/news_2004_01.htm.

4 We have projected our after-NSA First-Class Mail volumes, which still
5 reflect our use of other channels including electronic communications, to be:

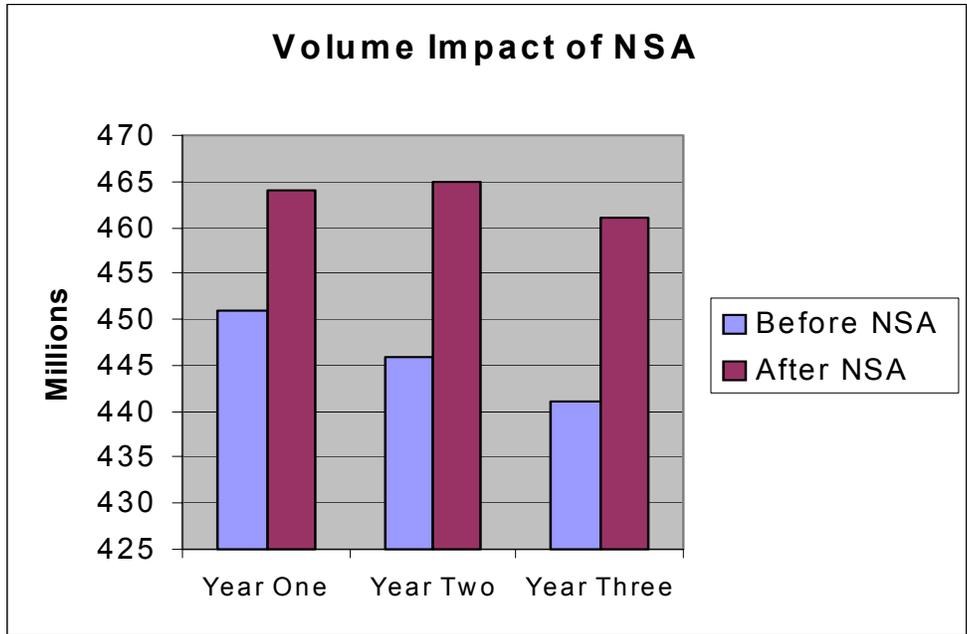
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	Year One	Year Two	Year Three
Marketing	169	174	174
Operations	295	291	287
Total	464	465	461

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8 As explained below, we view this projection as a minimum for it is based
9 upon an upgrade from Standard to First-Class Mail for existing marketing
10 campaigns, and does not project any “new” marketing campaigns that would use
11 First-Class Mail. While we are confident that the lower rates will incent us to use
12 mail when we create new marketing campaigns, we believe that we cannot
13 accurately project the level of such new volume at this time. Hence, our
14 projection is a minimum projection that encompasses only the Standard to First-
15 Class Mail upgrade.

16 Even with this minimum projection, the Postal Service should profit from
17 this NSA. An additional 8.33% in First-Class Marketing Mail volume will be
18 generated in the first year, and an additional 11.54% in First-Class Marketing
19 Mail volume will occur in years two and three, as shown in the following graph.



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2 Explanation of Marketing and Operations Mail Forecasts

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3 **Marketing Mail Before-NSA Volumes.** DFS’s before-NSA volume
 4 projection is 156 million for each of the next three years.

5 As explained earlier, DFS uses a variety of marketing channels in its
 6 marketing mix and our First-Class Marketing Mail volume, which recently has
 7 been relatively flat, reflects that. This trend continues in our first year’s forecast,
 8 which is an actual budgeted figure. Moreover, unless the cost structure for mail
 9 becomes more attractive, this trend will continue in years two and three, as
 10 alternate channels increasingly are considered by DFS. Therefore, absent the
 11 NSA, we expect that our First-Class Marketing Mail volume will remain at 156
 12 million in years two and three.

13 **Marketing Mail After-NSA Volumes.** DFS’s after-NSA volume projection
 14 is that First-Class Marketing Mail will increase by 13 million in the first year, to
 15 yield a year-one volume projection of 169 million. DFS expects that its Marketing

1 Mail will increase by an additional 5 million the second year and remain at that
2 level the third year. This yields volume projections of 174 million for both years
3 two and three. As noted above, these are minimum projections for they are
4 based solely upon upgrading Standard-Mail volumes to First Class. The discount
5 provided under the NSA increases the attractiveness of First-Class Mail for
6 certain acquisition segments, particularly in view of the forwarding, speed,
7 likelihood of delivery, and perceived value of First-Class Mail.

8 In addition, DFS recognizes that lower NSA rates will improve mail's edge
9 in our decision-making process when we consider which channels to use in new
10 marketing campaigns, and inevitably yield greater First-Class Mail volumes from
11 these new campaigns. However, DFS at this time cannot accurately project the
12 First-Class Mail growth for such new mail campaigns in years two and three.
13 Thus, we believe these First-Class Marketing Mail projections are minimums.

14 **Operations Mail Before-NSA Volumes.** DFS's before-NSA volume
15 projection for Operations Mail for year one is 295 million pieces. This is based
16 on the number of Cardmember and merchant accounts, as well as the number of
17 mailings to each. As set forth in Morgan Stanley's Form 10-K for fiscal year
18 2003, DFS intensified its focus on the quality of its credit card loan portfolio. We
19 expect this focus to continue in 2004 and thereafter. It is designed to eliminate
20 some lower quality accounts and increase higher quality accounts. We expect
21 this intensified focus on quality, along with an increased number of merchants
22 and Cardmembers receiving electronic statements, will likely result in a decline in
23 Operations Mail volume of approximately 5 million for each of years two and

1 three. This yields an Operation Mail volume projection of 290 million in year two
2 and 285 million in year three.

3 **Operations Mail After-NSA Volumes.** DFS's after-NSA volume
4 projection for Operations Mail for year one remains at 295 million. This
5 projection is the same as our before-NSA projection because any impact on
6 Operations Mail volume from increased marketing will not likely be seen until
7 year two.

8 DFS expects that increased marketing under the NSA will grow high
9 quality accounts at a faster rate for years two and three. This increase in high
10 quality accounts will produce an additional 1 million pieces of Operations Mail per
11 year for each of the years, thus reducing the net decline for both years from 5
12 million to 4 million. These figures produce a net total volume projection for
13 Operations Mail of 291 million in year two and 287 million in year three.

14 **The Competitive Cap and Address Quality Issues.**

15 **Competitive Cap.** The DFS NSA includes a three-year cap of \$13
16 million. This is a competitive cap, proportionate to that set forth in the Capital
17 One NSA. In principle, DFS does not see the need for any cap since the Postal
18 Service will generate additional profit from the increased volume and since we
19 have agreed to an adjustable threshold.¹ DFS does realize, however, that the
20 Commission made a decision to cap the total possible benefit that Capital One
21 could earn under its NSA. DFS also realizes that it would not be completely
22 unreasonable for the Commission to insist that a Functionally Equivalent NSA

¹ Our NSA includes a provision under which our threshold will be adjusted by the percentage change in our “domestic gross active accounts” as reported in our SEC filings. See Paragraph III F.

1 also include a cap. Thus, Discover and the Postal Service negotiated a
2 competitive cap of \$13 million. This recognizes the fact that DFS should have
3 the potential to enjoy a benefit proportionate to the one received by Capital One.

4 While DFS is as large a credit card company as Capital One, it is not as
5 large a mailer. Thus the \$13 million was set to reflect the difference between the
6 overall sizes of the two companies as First-Class mailers, using total First-Class
7 Mail volume projections. In very straightforward terms, DFS's projected First-
8 Class Mail volume is 32% of Capital One's and thus our cap is 32% of theirs. As
9 a direct competitor, we believe that this is the most equitable result.

10 **Address Quality Issues.** While DFS is a very efficient mailer, we do not
11 use an internal prospect database. Thus, our return rate is largely predicated
12 upon the quality of the data in the lists we purchase. When DFS prospects for
13 new Cardmembers, we are interested in expanding and improving the quality of
14 our credit card portfolio. Consequently, the drivers that achieve this goal relate to
15 the type of lists purchased, not to the quality of the postal addresses in the lists.
16 Moreover, when we buy a list, we do not mail to the entire list, but analyze the list
17 based on a variety of proprietary factors. As a result, some of the addresses are
18 purged from the original list and we mail to the remaining addresses. Also, we
19 process those addresses against the NCOA/CASS database within 60 days
20 before mailing, which exceeds current Addressing Requirements.

21 Despite these efforts, some of our mail is returned. For Operations Mail
22 (which is mailed from our Cardmember and Merchant databases and not from a
23 list), the return rate is low, approximately one-quarter of one percent (0.25%).

1 For Marketing Mail, which is mailed from purchased lists, the weighted average
2 return rate is 9.3%. We anticipate that our return rate for future mailings will
3 remain consistent with this figure.

4 As in our baseline NSA, DFS has agreed to receive return data
5 electronically, which will save the Postal Service a considerable amount of
6 money, and to use the information to benefit the quality of its mailing lists. Since
7 we do not have an internal prospect database, we have agreed to work with the
8 Postal Service and our list processor to analyze the return data we receive from
9 the Postal Service and use it in an efficient manner to improve our mail quality.
10 We have also agreed, should we ever develop and use an internal prospect
11 database, that we would regularly update that database within 30 days of our
12 receipt of return data.

13 **Conclusion**

14 DFS, a direct competitor of Capital One, has negotiated a Functionally
15 Equivalent NSA with the Postal Service. DFS prides itself on managing its
16 business closely and with a sophisticated budgeting process. We have provided
17 the Commission with straightforward volume projections, based on our budget,
18 that represent minimums and are as accurate as possible. We trust that the
19 Commission will approve our NSA as soon as reasonably possible pursuant to its
20 rules for Functionally Equivalent NSAs.

21 On behalf of DFS, I would like to thank the Commission for the time and
22 effort that it is devoting to this matter.

Appendix I.

The graph on page seven of this testimony is based upon the following data:

Month	Operations Mail	Marketing Mail	Total Mail
Dec-99	26,019,712	10,983,803	37,003,515
Jan-00	24,656,256	4,442,905	29,099,161
Feb-00	25,283,389	11,560,124	36,843,513
Mar-00	24,889,656	47,080,329	71,969,985
Apr-00	23,954,905	8,880,749	32,835,654
May-00	24,590,695	2,971,024	27,561,719
Jun-00	24,662,650	8,463,686	33,126,336
Jul-00	24,938,017	14,718,654	39,656,671
Aug-00	25,409,691	13,616,328	39,026,019
Sep-00	24,947,667	9,875,462	34,823,129
Oct-00	26,131,086	10,689,321	36,820,407
Nov-00	27,833,898	16,934,257	44,768,155
Dec-00	25,620,543	10,656,050	36,276,593
Jan-01	25,360,153	12,392,639	37,752,792
Feb-01	25,875,912	24,068,360	49,944,272
Mar-01	25,368,388	13,240,232	38,608,620
Apr-01	25,409,041	10,895,366	36,304,407
May-01	25,649,428	5,054,920	30,704,348
Jun-01	25,297,673	14,101,784	39,399,457
Jul-01	25,252,916	10,907,850	36,160,766
Aug-01	25,787,691	21,055,416	46,843,107
Sep-01	25,844,965	18,782,428	44,627,393
Oct-01	26,495,123	38,849,619	65,344,742
Nov-01	27,236,967	29,225,728	56,462,695
Dec-01	27,821,835	11,036,124	38,857,959
Jan-02	27,831,948	20,579,413	48,411,361
Feb-02	27,512,108	18,734,310	46,246,418
Mar-02	28,125,220	9,918,058	38,043,278
Apr-02	27,671,148	9,295,077	36,966,225
May-02	27,316,428	18,309,872	45,626,300
Jun-02	25,995,405	28,061,863	54,057,268
Jul-02	28,180,136	431,865	28,612,001
Aug-02	28,316,130	10,662,159	38,978,289
Sep-02	28,238,399	14,463,979	42,702,378
Oct-02	28,637,176	20,727,322	49,364,498
Nov-02	28,127,623	33,618,431	61,746,054
Dec-02	26,774,983	28,357,215	55,132,198
Jan-03	27,367,651	13,427,613	40,795,264
Feb-03	26,098,149	10,163,281	36,261,430
Mar-03	26,103,841	11,568,258	37,672,099
Apr-03	26,281,431	11,724,500	38,005,931
May-03	26,833,247	9,426,696	36,259,943
Jun-03	25,862,033	7,291,696	33,153,729
Jul-03	25,654,287	8,208,638	33,862,925
Aug-03	25,052,196	8,049,412	33,101,608
Sep-03	24,383,001	8,993,174	33,376,175
Oct-03	24,626,432	8,877,887	33,504,319
Nov-03	23,355,150	20,124,732	43,479,882
Dec-03	24,805,590	11,131,530	35,937,120