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

Rate and Services Changes to Implement Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Inc.	)))))	Docket No. MC 2004-4

RESPONSE OF DFS WITNESS KARIN GIFFNEY TO OCA INTERROGATORIES OCA/DFS T1-1 through T1-5

July 9, 2004

DFS hereby provides the responses of witness Giffney to Office of the Consumer Advocate interrogatories OCA/DFS T1-1 through T1-5 filed June 25, 2004.

Each interrogatory is stated verbatim and followed by the response.

Respectfully submitted,

/S/

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Responses of Witness Giffney to OCA/DFS-T1-1

OCA/DFS-T1-1. In your testimony at page 2, lines 18-20, you state that you are providing insights into the economic factors, industry trends, and company practices that influence the selection of marketing channels and mail forecasts.

(a) To what degree does the state of the economy (whether we are in a recession, whether better times are ahead, whether consumers are confident, trends in interest rates, etc.) affect the marketing of credit cards? Please address specific, relevant factors.

(b) What are the primary drivers affecting the selection of specific marketing channels?

DFS RESPONSE:

(a) The state of the economy affects the credit card industry in several ways, usually with a lag time of approximately six months. Consumer confidence in an improving economy initially prompts increased spending on credit cards, but not necessarily revolving behavior. As consumers feel secure in their employment and future prospects they are more willing to finance new consumption with unsecured, revolving debt, which improves company profitability. Improved profitability may have a positive effect on funding for marketing programs in general.

Consumer confidence in a worsening economy results in two diverse actions on the part of consumers. Consumers with the means to do so pay off their accounts in full, causing activation rates to decrease and attrition rates to increase across the credit card industry. Others negatively affected by the economy are unable to pay on their accounts and end up defaulting. Both of these actions directly reduce the profitability of the company and may have a negative effect on the funding of marketing programs.

However, there are other factors to consider which may change the dynamics of consumer confidence. Low interest rates during the recent recession made home equity loans very attractive for debt consolidation. Many homeowners without the means to pay off their credit cards used home equity loans to pay off credit card balances. However, as interest rates rise, home equity loans will become less attractive, and consumers will be willing to borrow more on their credit cards.

Consumer confidence will also impact response rates to marketing programs. If consumers are in the mode of having too much debt or are paying off their debt, response rates become depressed because consumers are not in the market for new credit cards or new debt. Consequently, more marketing dollars are required to obtain a certain level of performance from the business.

Finally, increasing interest rates also affect the cost of funds upon which credit card loans are made. Should the cost of funds rise too sharply, this may increase the expense line of the business, cutting into profitability, and may result in reduced funding for marketing programs.

(b) Strategic goals determine the general funding levels of the three main marketing business units: Acquisition, Cardmember Marketing, and Advertising. Advertising does not mail. The program budgets in these other arenas are independent of each other, with program effectiveness driving channel choice. Within Acquisition and Cardmember Marketing, a program's effectiveness is measured by the potential profitability of an account based on the net present value of funds. Potential profitability is determined by several key drivers inclusive of the cost per account, expected response rate, expected activation rate, expected account spend, expected balance carried, and potential write-off rate. These drivers are analyzed by channel to arrive at the best outcome to achieve strategic goals.

For example, in acquiring new accounts, direct mail has a higher cost per account, a higher activation rate, higher carried balances, and average write-off rates. Telemarketing delivers a better cost per account and low write-off rates but, unfortunately, delivers lower activation rates and lower carried balances. The Internet has a low cost per account, with an average activation rate and average carried balances but, unfortunately, delivers a much higher write-off rate. Proprietary analytical tools are used to analyze these drivers and determine the optimal mix of channels to achieve the most profitable new accounts, as well as the number of new accounts, to meet the company's strategic goals.

Responses of Witness Giffney to OCA/DFS-T1-2

OCA/DFS-T1-2. In your testimony at page 8, line 14, through page 9 line 7 you provide Before-NSA and After-NSA forecasts of mail volume.

(a) Please provide the models, statistical analyses, estimating procedures, and/or other relevant quantitative documentation substantiating the forecasts.

(b) Please provide your understanding of the underlying factors that would cause Discover to switch between Standard Mail and First-Class Mail, as referenced at page 5, line 19.

DFS RESPONSE:

(a) The quantitative basis for the forecast is the DFS budget. In formulating its budget, DFS does use various models and quantitative procedures. These models are highly sophisticated and proprietary, and consequently, we cannot disclose them.

These models compare various marketing channels, and we use them to determine the most efficient use of our marketing funds. In doing this analysis, we consider recent campaign performance, cost per account, response rates, approval rates, and activation rates. When mail is chosen as the appropriate marketing channel, a total mail volume number is generated.

Moreover, once the budget is set and marketing has determined which channels to utilize to achieve specific business goals, DFS then uses both statistical analyses and modeling to enhance the effectiveness of each channel. These are also highly proprietary.

As for the After-NSA forecast, we arrived at the figure for the increase in volume as a result of the NSA through a straightforward calculation of how many pieces could be upgraded from Standard to First Class by reinvesting postage savings realized through the NSA.

Responses of Witness Giffney to OCA/DFS-T1-2 (cont)

(b) Response rate and cost per piece are the two main factors driving DFS's determination of which direct mail campaigns to send First Class and which to send Standard. We look at performance data for recent mailings to determine the appropriate mix of First Class and Standard. Factors we look at in this process include the expected lift in response rate due to forwarding inherent in First-Class Mail, the quicker in-home delivery of First-Class Mail, and the relative cost difference between First Class and Standard. With the lower First-Class costs that this NSA would generate, DFS would be able to send more mail First Class.

Since the prospect of a discount on First Class, which would narrow the rate difference, is new to us, it is possible that the amount actually upgraded from Standard to First Class will be larger than forecasted. However, the forecast provided is as accurate as possible at this time. Also, as noted in my testimony, there surely will be some "new" First-Class volume, but we cannot predict how much.

Responses of Witness Giffney to OCA/DFS-T1-3

OCA/DFS-T1-3. In your testimony at page 5, lines 1-2, you indicate that direct mail is a part of Discover's core strategy. In Appendix 1, you provide Discover's mailing data from December of 1999 onwards for First-Class Mail. Please provide similar data from December 1995 through November of 1999, thereby providing some verification of Discover's mailing trends as related to actual and forecasted volumes over an extended period of macroeconomic variability.

DFS RESPONSE:

Solicitation Mail. We do not have marketing mail data prior to December 1999. This applies to both First-Class Mail and Standard Mail.

The reason we do not have any pre-December 1999 marketing mail data is because before 1999 each separate Marketing unit within DFS independently purchased print and mail, generally utilizing third-party brokers. The mailings were sent out on others' permits and few if any postage records were kept by DFS.

During 1999, a centralized Production Services unit was created to purchase print and lettershop services for all Marketing areas. Also, a postal expert was put on staff to deal with the Postal Service and to handle postal matters. Throughout the year postal permits were opened and linked to a centralized CAPS account. By December 1999 (our fiscal year starts on December 1), this process was completed and a structure was in place to accurately record mail volumes and postage expenses. Therefore, DFS's mail records for solicitation mail (First and Standard) start in December 1999.

Operations Mail. First-Class Mail volumes are only available for Operations Mail (statement mail) beginning with December 1997. Prior to this, DFS volume was processed through several outside mailing vendors. During that time, mail volume reporting was inconsistent and incomplete. Beginning in December 1997, DFS was able to fully capture and record all First-Class Operations Mail volume. Below is a table containing First-Class Mail volumes for Operations Mail from December 1997 through November 1999.

Discover Financial Services, Inc.
Operations First-Class Mail Volumes
December 1997 – November 1999

	FY 1998	**FY 1999**
Dec	29,620,448	28,170,285
Jan	28,940,610	28,348,055
Feb	28,188,164	28,480,194
Mar	27,637,052	30,163,890
Apr	28,607,506	29,207,320
May	28,071,994	29,415,100
June	28,245,506	29,508,732
July	28,117,687	29,144,140
Aug	27,153,245	29,347,975
Sept	28,539,826	28,649,982
Oct	28,624,119	29,332,321
Nov	27,444,938	30,138,609
Annual Totals	**339,191,095**	**349,906,603**

Responses of Witness Giffney to OCA/DFS-T1-4

OCA/DFS-T1-4. In your testimony at page 8, lines 18-19, you indicate that your First-Class Mail projections for the next three years are essentially flat, notwithstanding a recent reported industry trend toward lower First-Class Mail volumes. Please explain why the projections are flat, as related to your use of First-Class Mail, Standard Mail, and the drivers that affect marketing programs.

DFS RESPONSE:

Attached is the article I cited in my testimony that noted the industry trend toward lower solicitation mail volumes. This report of lower industry solicitation mail volume is not just limited to First-Class Mailings.

While the overall Before-NSA forecast remains essentially flat, there are separate business factors contributing to the forecasts for Marketing and Operations Mail.

In Marketing, a business goal is to maintain the current level of cardmembers while improving quality. The current level of direct mail marketing is sufficient to maintain our current cardmember level and DFS does not foresee a reason to change it at this time. Another Marketing business goal is to focus on the portfolio side of the business in order to build cardmember balances. Direct mail marketing for this portion is normally sent via Standard Mail. Therefore, although this is a major business goal, it does not impact the volume of First-Class Mail and the Marketing forecast remains constant during years one, two, and three of the NSA.

The main two drivers considered for Marketing programs are response rates and cost per account. Together, the two drivers form the basis for Marketing's business decisions. Given the current cost structure of First-Class

Mail and our budget limitations, we believe the current level of spending for direct mail marketing most economically accomplishes our goals.

The Operations forecast decreases slightly in years two and three of the NSA as a result of two main factors. First, the business goal to maintain the current level of cardmembers directly relates to the volume of statements. Since the number of cardmembers is expected to remain constant, the number of statements should remain fairly stable. Second, there is an increased utilization of electronic statements. This would decrease the number of statements mailed per month. As a result, the Operations Mail volume forecasts decrease slightly.

Responses of Witness Giffney to OCA/DFS-T1-4 (cont)

DM NEWS

The Online Newspaper of Record for Direct Marketers

May 10, 2004

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Survey: Fewer Credit Card Offers Mailed for 2nd Consecutive Year

April 01, 2004

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Annual credit card mail volume for 2003 decreased 12 percent compared with volume in 2002, market researcher Synovate announced this week.

The findings, compiled using Synovate's Mail Monitor, a service of Synovate's financial services practice, showed that 4.29 billion credit card offers were received by U.S. households in 2003, down from 4.89 billion in 2002. Consumer response was 0.6 percent.

The drop follows a record 5.01 billion mailed offers in 2001.

Synovate, Arlington Heights, IL, said 69 percent of U.S. households received 4.8 offers on average monthly in 2003 versus 75 percent of households getting 5.1 offers in 2002.

"During 2003, typical seasonal mailing patterns went out of the window," said Andrew Davidson, vice president of competitive tracking services for Synovate's financial services practice.

Davidson said that 90 percent of credit card direct mail comes from the 10 largest card issuers, and half of those issuers cut back in 2003, causing the overall decline in mail volume. The company also noted that personal bankruptcies reached an all-time high in 2003, and despite recent improvements to the economy, unemployment remains high.

"Card issuers have reacted to this environment by mailing fewer low-introductory-rate offers and decreasing the frequency of mailings to lower-income households," Davidson said.

Meanwhile, he said, "we have seen a significant increase in offers promoting rewards and cash rebates as issuers seek new ways to stand out from the clutter and acquire customers that are less likely to switch."

According to Synovate, U.S. households got 1.27 billion reward offers in 2003, up from 810 million in 2002. Rebate card mail volume increased to 900 million from 680 million over the same period.

"Although volumes were down for the year, I was encouraged by our December 2003 findings," Davidson said. "Many issuers who had cut back overall in 2003 finished with a strong December, and I would not be surprised if the year begins with strong mailing volumes overall."

Responses of Witness Giffney to OCA/DFS-T1-5

OCA/DFS-T1-5. In your testimony at page 9, lines 13-15 you indicate that your projection for the After-NSA forecast is based upon an upgrade from Standard Mail to First-Class Mail for existing marketing campaigns. In order to understand potential Postal Service losses in Standard Mail revenues, and potential gains in First-Class Mail revenues, and the overall level of mailings under previous and projected economic conditions, please provide Discover's monthly data for Standard Mail for the time period December 1995 to December 2003.

RESPONSE

Discover Financial Services, Inc.
Standard Mail Volumes
December 1999 through November 2003

Month	FY 2000	FY 2001	FY 2002	FY 2003
Dec	46,185,374	62,836,837	26,124,243	37,622,732
Jan	21,201,659	35,036,900	70,399,581	61,877,181
Feb	55,253,673	64,221,153	40,303,066	60,621,690
Mar	42,455,983	46,507,548	27,402,433	48,819,532
Apr	65,933,173	52,261,978	33,946,497	49,460,915
May	54,360,690	46,032,444	30,870,973	44,447,020
June	67,842,744	57,508,640	64,328,566	33,634,169
July	62,997,819	45,641,195	23,206,401	31,166,613
Aug	85,110,470	66,524,211	41,955,362	33,295,819
Sept	71,542,368	51,107,780	45,904,975	33,409,274
Oct	68,523,453	28,632,214	52,597,759	34,490,170
Nov	56,233,554	34,829,111	42,724,616	14,921,093
Annual Total	**697,640,960**	**591,140,011**	**499,764,472**	**483,766,208**

We have no record of Standard Mail volumes (or of any marketing volumes) for November 1999 and earlier, for the reasons explained in our response to OCA/DFS-T1-3.

Certificate of Service

I hereby certify that I have this date caused to be served the foregoing document in accordance with Section 12 of the Commission's Rules of Practice.

_______/S/________________
Robert J. Brinkmann
July 9, 2004