

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

RATE AND SERVICE CHANGES TO IMPLEMENT
FUNCTIONALLY EQUIVALENT NEGOTIATED
SERVICE AGREEMENT WITH DISCOVER
FINANCIAL SERVICES, INC.

Docket No. MC2004-4

RESPONSES OF THE UNITED STATES POSTAL SERVICE WITNESS AYUB
TO INTERROGATORIES OF VALPAK DIRECT MARKETING SYSTEMS, INC.
AND VALPAK DEALERS' ASSOCIATION, INC. (VP/USPS-T1-1-11)
(August 2, 2004)

The United States Postal Service hereby provides its responses to the following interrogatories: Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. First Interrogatories and Requests For Production of Documents to United States Postal Service Witness Ali Ayub (VP/USPS-T1-1-11), filed on July 21, 2004.

Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,
UNITED STATES POSTAL SERVICE

By its attorneys:

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August 2, 2004

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TO INTERROGATORY OF VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

VP/USPS-T1-1.

a. Please refer to your Appendix A, page 2, and confirm that the incremental volume of the First-Class Marketing mail of Discover Financial Services, Inc. ("DFS") is projected to be as follows for Years 1, 2 and 3:

Year 1: 13 million pieces
Year 2: 18 million pieces
Year 3: 18 million pieces

If you do not confirm, please provide what you believe to be the correct volumes.

b. Please refer to your Appendix A, page 1, row 2, and confirm that the projected return rate forecast for DFS's Marketing mail in Years 1, 2 and 3 is 9.3 percent.

c. Please confirm that, at the assumed return rate for Marketing mail of 9.3 percent, the incremental volume of Marketing mail discussed in preceding part a will result in the following incremental volume of returns:

Year 1: 1.209 million pieces
Year 2: 1.674 million pieces
Year 3: 1.674 million pieces

If you do not confirm, please provide what you believe to be the correct volumes.

d. Please confirm that, with the assumptions used to compute the costs shown in your Appendix A, page 7, line 11, the Postal Service's total cost to handle the incremental volume of DFS's returns discussed in preceding part c will be as shown here. If you do not confirm, please provide what you believe to be the correct cost for the Postal Service to handle the incremental volume of DFS's After-NSA returns.

Year 1: \$452,650
Year 2: \$651,815
Year 3: \$677,888

e. Please confirm that the incremental return cost per piece of incremental volume shown in preceding part a will be as follows:

Year 1: \$0.0348
Year 2: \$0.0362
Year 3: \$0.0377

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If you do not confirm, please provide what you believe to be the correct unit cost for the Postal Service to handle the incremental volume of DFS's After-NSA returns shown in part a above.

RESPONSE:

- a) Confirmed.
- b) Confirmed.
- c) Confirmed.
- d) Not confirmed. Page 7 of Attachment A is used to calculate and present the cost savings on existing First-Class mail pieces. The model does not calculate the savings on the incremental return pieces as a cost saving benefit to the Postal Service. The incremental costs that are incurred in handling the higher return volumes are addressed on page 5 of Appendix A in column 13 (Current Returns Adjustment Unit Cost) and column 15 (After Rates Returns Adjustment Unit Cost). For further explanation please refer to OCA/USPS-T1-16. However if you wanted to develop a general point estimate of the return cost for a population of pieces you could use the costs calculated in Appendix A page 7, line 11. Such an analysis would generate costs for return handling as presented.
- e) I can confirm, if you assume the general point estimate as explained in part (d) above. The incremental costs are addressed in the higher "Total Unit Cost Estimates including contingency" for marketing mail (page 5) compared to statement mail (page 4).

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VP/USPS-T1-2.

a. Your Appendix A, page 10, line 6, indicates that (i) the First-Class Marketing letter cost per piece before rates in Year 3 will be \$0.164, and (ii) on line 8 the First-Class Marketing letter contribution per piece before rates will be \$0.129. Your testimony at page 6, line 18, indicates that when DFS's annual volume exceeds 515,000,000, the applicable discount will be at the maximum level, \$0.045 per piece. Please refer to VP/USPS-T1-1, part e, and confirm that, at volumes above 515,000,000, the **marginal** contribution derived from each piece of Marketing mail in Year 3 will be as follows:

First-Class Marketing Letter Contribution Before Rates \$0.1290
Less: Incremental return cost per piece \$0.0377
Marginal contribution per piece After Rates \$0.0913

If you do not confirm, please explain what you believe will be the marginal contribution per piece of Marketing mail in Year 3, after taking into account the incremental return cost and assuming the maximum discount is applicable.

b. Please confirm that the **marginal** contribution per piece of First-Class Marketing mail After Rates in Year 3 is somewhat less than the **average** First-Class Marketing Letter Contribution Before Rates of \$0.129 shown on line 8 of Appendix A, page 10. If you do not confirm, please explain fully.

c. Please confirm that the **marginal** contribution per piece of First-Class Marketing mail After Rates, as computed in preceding part b above, slightly exceeds, by \$0.0073, the Standard Letter Contribution per piece of \$0.0840 shown on line 12 of Appendix A, page 10. If you do not confirm, please explain fully.

RESPONSE:

a) Not Confirmed. First-Class Marketing Letter Contribution After Rates should be used to calculate the incremental contribution on marketing First-Class pieces, because the adjustment to the after rates cost estimate includes the higher return rates and electronic handling of return pieces.

First-Class Marketing Letter Contribution After Rates	\$0.147
Less Discount	\$0.045
Incremental Contribution	\$0.102

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- b) Confirmed, although the marginal contribution of First-Class marketing mail is \$0.102, and average First-Class Mail Contribution Before Rates is \$0.129.
- c) Not Confirmed. The marginal contribution per-piece of First-Class Marketing mail After Rates including the highest price incentive of \$0.045, as computed above, exceeds Standard Contribution of \$0.084 in TY 3 by \$0.018.

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VP/USPS-T1-3.

a. Please confirm that the Postal Service's systemwide average Undeliverable as Addressed ("UAA") return rate for First-Class Mail is 1.23 percent. If you do not confirm, please provide what you believe to be the correct rate, indicate the year or years to which that return rate applies, and the source of any datum you provide.

b. Please confirm that the Postal Service's systemwide average rate for forwarding UAA mail that is forwardable is 1.96 percent. If you do not confirm, please provide what you believe to be the correct forwarding rate, indicate the year or years to which that rate applies, and the source of any datum you provide.

c. Please confirm that if the systemwide forwarding rate for First-Class Mail is 1.96 percent, and the systemwide return rate First-Class Mail is 1.23 percent, then the ratio of pieces forwarded to pieces returned is 1.5935; *i.e.*, for every 10,000 pieces returned, 15,935 pieces need to be forwarded. If you do not confirm, please provide what you believe to be the correct systemwide ratio for First-Class Mail, and indicate the source and derivation of any different ratio(s) you provide, and the year or years on which the underlying data are based.

d. Please confirm that for Standard Mail the ratio of pieces forwarded to pieces returned is 2.472 (see Domestic Mail Classification Schedule ("DMCS"), Sec. 353 and Domestic Mail Manual ("DMM") F010.5.3; see *also* Docket No. MC2002-2, response of Postal Service witness Charles L. Crum to OCA/USPS-T3-25, Tr. 2/337); *i.e.*, for each 10,000 pieces of Standard Mail that is returned, 24,720 pieces need to be forwarded. If you do not confirm, please provide what you believe to be the correct ratio for Standard Mail, and indicate the source and derivation of any different ratio(s) you provide, the year or years on which the underlying data are based, and their source.

RESPONSE:

- a) Confirmed.
- b) Confirmed.
- c) Confirmed.
- d) Not confirmed. Your question indicates a misunderstanding regarding the numbers in the ratio. The ratio cited is used to obtain compensation for

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both the average number of 1.472 pieces forwarded per Standard Mail
piece returned, plus the piece that was returned.

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VP/USPS-T1-4.

a. Please confirm that if the Postal Service has to forward 15,935 pieces of mail for each 10,000 pieces that are returned, then the incremental volume of DFS Marketing mail and the incremental volume of returns that such mail will generate, as shown in preceding interrogatory VP/USPS-T1-1, will result in the Postal Service having to forward the following additional volumes of mail:

Year 1: 1.927 million pieces

Year 2: 2.668 million pieces

Year 3: 2.668 million pieces

If you do not confirm, please provide what you believe to be the correct volumes of forwarded mail that will be result from DFS's incremental Marketing mail generated by the proposed Negotiated Service Agreement ("NSA"), based on the systemwide averages and ratio for First-Class Mail, and explain the derivation.

b. To your knowledge, do the Postal Service or DFS have any data on the number of pieces of DFS's First-Class Marketing mail that were forwarded in 2003 (or any prior period)?

RESPONSE:

a) Not confirmed. The Postal Service does not believe that the ratio forwarded for the system wide average of forwarding and return rates will accurately reflect Discover's First Class marketing mail forwarding rate. The Postal Service believes that the forwarding rate for Discover reflects more of the system-wide average as explained specifically in Witness Crum's response to POIR2-7 in MC2002-2. Furthermore, unaudited results from the Capital One NSA indicate a forwarding rate that closely mirrors the system average for forwards.

b) To my knowledge neither the Postal Service nor Discover have any specific information on the number of Discover First-Class marketing pieces that have been forwarded.

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VP/USPS-T1-5.

Please confirm that if the Postal Service has to forward 24,720 pieces of mail for each 10,000 pieces that are returned, then the incremental volume of DFS Marketing mail and the incremental volume of returns that such mail will generate, as shown in VP/USPS-T1-1, will result in the Postal Service having to forward the following additional volumes of mail:

Year 1: 2.989 million pieces

Year 2: 4.138 million pieces

Year 3: 4.138 million pieces

If you do not confirm, please provide what you believe to be the correct volumes of forwarded mail that will be result from DFS's incremental Marketing mail generated by the proposed NSA, based on the best data available for the Standard Mail ratio, and explain how you derive your results, give the source of whatever ratio you use, and explain fully why it is more appropriate than 2.472.

RESPONSE:

See VP/USPS-T1-3(d). The Postal Service believes that the First-Class system-average for forwarding is a more accurate estimate of the forwarding rate for Discover's First Class marketing volume that shifts from Standard. Assuming the system-wide average the expected forward volumes are:

YEAR 1: 13,000,000 Incremental First Class pieces 254,800 forwards

YEAR 2: 18,000,000 Incremental First Class pieces 352.800 forwards

YEAR 3: 18,000,000 Incremental First Class pieces 352.800 forwards

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VP/USPS-T1-6.

- a. Please confirm that the Postal Service's cost to forward a piece of First-Class Mail in FY 2000 was 30.7 cents. If you do not confirm, please provide what you believe to be the correct cost.
- b. Please confirm that with a 4.0 percent inflation rate since FY 2000, the cost of forwarding a piece of First-Class Mail in FY 2004 would be approximately 35.9 cents.
- c. Please provide the best and most recent estimate of the unit cost for the Postal Service to forward a First-Class letter, indicate the year to which the datum is applicable and the source.

RESPONSE:

- a) Confirmed.
- b) Confirmed.
- c) The only available estimate of the unit cost to forward a First-Class letter is the 30.7 cents as presented in MC2002-2.

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VP/USPS-T1-7.

a. Please confirm that at a unit cost of 30.7 cents per piece to forward a piece of First-Class Mail, the total incremental cost to forward the additional volume of DFS First-Class Marketing mail shown in preceding VP/USPS-T1-4 would be as follows:

Year 1: \$591,448
Year 2: \$818,928
Year 3: \$818,928

If you do not confirm, please provide what you believe to be the correct incremental costs of forwarding, using FY 2000 data, and explain the derivation.

b. Please confirm that at unit cost of 35.9 cents per piece to forward a piece of First-Class Mail (which reflects a 4 percent annual inflation since FY 2000), the total cost to forward the additional volume of DFS First-Class Marketing mail shown in preceding VP/USPS-T1-4, would be as follows:

Year 1: \$691,911
Year 2: \$958,030
Year 3: \$958,030

If you do not confirm, please provide what you believe to be the correct incremental costs of forwarding, using FY 2004 data, and explain the derivation.

c. Please confirm that the incremental costs of forwarding, shown in preceding parts a and b, when divided by the total incremental volume of DFS Marketing mail shown in VP/USPS-T1-1, part a, results in the following incremental costs per piece:

	@30.7 Cents	@35.9 Cents
Year 1:	\$0.0455	\$0.0532
Year 2:	\$0.0455	\$0.0532
Year 3:	\$0.0455	\$0.0532

If you do not confirm, please provide what you believe to be the correct incremental unit cost of forwarding the above-referenced volume of mail, and explain the derivation.

RESPONSE:

- a) Not Confirmed. If the forwarding rate for Discover's Standard marketing pieces is higher than the system-wide average for First-Class mail

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forwarding, only then could any incremental costs for forwarding be counted as a cost of the NSA. The incremental cost for the system wide average of 1.96% is already calculated within the total cost for First-Class Mail which is used to calculate First-Class Marketing letter contribution.

- b) Not confirmed. Please see above.
- c) Not confirmed. Please see above.

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VP/USPS-T1-8.

a. Please confirm that at a unit cost of 30.7 cents per piece to forward a piece of First-Class Mail, the total incremental cost to forward the additional volume of DFS First-Class Marketing mail shown in preceding VP/USPS-T1-5 would be as follows:

Year 1: \$ 917,515
Year 2: \$1,270,405
Year 3: \$1,270,405

If you do not confirm, please provide what you believe to be the correct incremental costs of forwarding, using FY 2000 data, and explain the derivation.

b. Please confirm that at a unit cost of 35.9 cents per piece to forward a piece of First-Class Mail (which reflects a 4 percent annual inflation since FY 2000), the total cost to forward the additional volume of DFS First-Class Marketing mail shown in preceding VP/USPS-T1-5, would be as follows:

Year 1: \$1,073,363
Year 2: \$1,486,195
Year 3: \$1,486,195

If you do not confirm, please provide what you believe to be the correct incremental costs of forwarding, using FY 2004 data, and explain the derivation.

c. Please confirm that the incremental costs of forwarding, shown in preceding parts a and b, when divided by the total incremental volume of DFS Marketing mail shown in VP/USPS-T1-1, part a, results in the following incremental costs per piece:

	@30.7	@35.9
	Cents	Cents
Year 1:	\$0.0706	\$0.0826
Year 2:	\$0.0706	\$0.0826
Year 3:	\$0.0706	\$0.0826

If you do not confirm, please provide what you believe to be the correct incremental unit cost of forwarding the above-referenced volume of mail, and explain the derivation.

RESPONSE:

- a) Not confirmed. The cost for forwarding with a 1.96% forwarding rate is a component of the First-Class letter cost structure. If Discover's forwarding

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rate were to exceed 1.96%, the incremental difference would incur new costs at \$0.359. However, because there no indication to suggest that Discover's forwarding volume exceeds the national average, there are no incremental costs associated with forwarding.

- b) Not confirmed. Please see above.
- c) Not confirmed. Please see above.

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VP/USPS-T1-9.

a. Please confirm that the projected source of DFS's incremental Marketing mail volume shown in response to VP/USPS-T1-1, part a, will be from the lists that would have been entered as Standard Mail, but instead will be converted to First-Class Mail as a result of the inducements contained in the proposed NSA. If you do not confirm, please explain your understanding of the source of DFS's incremental First-Class Marketing mail volumes.

b. VP/USPS-T1-3, parts c and d, discussed two different ratios for the number of UAA pieces forwarded per piece of UAA mail returned — one based on systemwide averages for First-Class Mail, and the other based on data for Standard Mail. In your opinion, as between these two averages, which would be the more appropriate one to use with respect to the volume of forwarded pieces likely to arise from DFS's incremental volume of Marketing mail? Please explain fully.

RESPONSE:

- a) Confirmed.
- b) Please see answers to VP-USPS-T1-6, 7, and 8.

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VP/USPS-T1-10.

a. Please confirm that at the present time, whenever the Postal Service forwards a piece of DFS's First-Class Marketing mail that is UAA but forwardable, DFS does not receive any kind of notice or other information that the piece has been forwarded. If you do not confirm, please explain fully all information and feedback that the Postal Service currently supplies to DFS when its First-Class Marketing mail is forwarded.

b. Please confirm that under the proposed NSA the Postal Service will provide DFS with electronic address corrections for (i) all of its UAA Marketing mail that is forwarded, as well as for (ii) all Marketing mail that is UAA and non-forwardable and entitled to free physical return; *i.e.*, the volume of electronic returns to be provided under the proposed NSA will exceed (by some unstated number) the volume of non-forwardable UAA mail. If you do not confirm, please explain fully what DFS can expect to receive from the Postal Service regarding its First-Class UAA mail.

c. Please refer to your Appendix A, page 7, and confirm that the Return Forecast for the volume of Marketing mail shown on line 6 (i) reflects only the Before Rates volumes shown on line 4 multiplied by the 9.3 percent Return Rate on line 2, and excludes the incremental volume of returns that will arise by virtue of the incremental volume of Marketing mail; and (ii) does not include any returns for DFS's UAA Marketing mail that is being or will be forwarded and for which the Postal Service also will generate an electronic address correction under the proposed NSA. If you do not confirm, please explain fully what the data on line 6 include, and what they exclude.

d. Please confirm that the After Rates Return Costs for Marketing mail, shown on line 11, is only for the return volumes shown on line 6, and does not reflect the total cost of returns that the Postal Service will be required to provide under the proposed NSA. If you do not confirm, please explain.

RESPONSE:

a) Confirmed.

b) Confirmed.

c) Confirmed.

d) Not confirmed. The incremental costs for handling the higher return rates and system wide forwarding rate are calculated in the First-Class After Rates marketing mail contributions. Please refer to USPS-T1-1 and 2.

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VP/USPS-T1-11.

a. Please confirm that the cost and revenue model in USPS-T-1, Appendix A, does **not** include (i) any cost for forwarding of DFS First-Class Marketing mail, or (ii) any cost for providing DFS with electronic address corrections for DFS First-Class Marketing mail that will be forwarded after the proposed NSA becomes effective. If you did include costs for either or both of the preceding two items, please indicate where in your Appendix A such figures appear.

b. Please refer to preceding interrogatory VP/USPS-T1-2, which computed the marginal contribution to the Postal Service's overhead After Rates in Year 3 as \$0.0913, and preceding interrogatory VP/USPS-T1-7(c), which computed incremental forwarding costs in Year 3 of \$0.0455 with no inflation, and \$0.0532 with a 4 percent inflation. Since these incremental forwarding costs are a direct result of implementing the proposed NSA, would you agree that it would be appropriate to deduct such costs when estimating the net marginal contribution? Please explain fully any disagreement.

c. Assuming that you consider it appropriate for the final analysis to include Postal Service costs that predictably and directly arise from the proposed NSA, would you agree that the following reflects a reasonable estimate for Year 3 of the marginal contribution to overhead for pieces that exceed the 515,000,000 volume threshold?

Marginal contribution per piece After Rates \$0.0913
Incremental cost of forwarding \$0.0532
Net marginal contribution per piece \$0.0381

If you do not agree, please provide what you consider to be the most appropriate marginal contribution, and explain fully why it is more appropriate than \$0.0378.

d. Would you agree that if your cost-revenue model in Appendix A were to include any adjustment in excess of \$0.0075 for the incremental cost of forwarding arising from the proposed NSA, then the marginal contribution in Year 3 at volumes in excess of 515,000,000 will be less than the contribution from Standard Mail (\$0.0840) as shown in your Appendix A, page 10, line 12? If you do not agree, please provide the maximum adjustment that you could make for the cost of forwarding without falling below the \$0.0840 threshold, and explain how you arrive at your answer.

RESPONSE:

- a) Not confirmed. As explained previously the cost of forwarding is included in the cost calculation for First-Class Mail. However, the \$0.066 cost of

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providing the electronic notice for forwards is not included nor is any benefits from eliminating repeat forwards.

- b) The costs of forwarding for rates above the system average may be considered a cost. However there are no reasons to suspect that Discover forwarding rates are higher than the system wide average.
- c) The Postal Service believes the marginal contribution after rates of \$0.147 best reflects any incremental costs associated with the NSA. At the highest price incentive of \$0.045 this contribution is \$0.102.
- d) Assuming the cost of \$0.359 per forwarded piece the forwarding rate, as presented in VP/USPS-T1-8, Discover's forwarding rate would have to be 6.97% or 35.9 million forwards for there to be no difference between the First Class marketing mail contribution of \$0.102 (after \$0.045 price incentive) and the Standard letter contribution of \$0.084. The return rate would have to be higher if Discover did not reach the highest price incentive levels. However, Standard letter contribution assumes the system average UAA in calculating costs. If Discover's forwarding rate of shifted mail reflected a 6.97% forwarding rate, the costs for the UAA costs for Standard would be higher, and the average contribution lower.

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.

Brian M. Reimer

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August 2, 2004