Postal Rate Commission
Submitted 9/30/2004 2:32 pm
Filing ID: 41896
Accepted 9/30/2004

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION
WASHINGTON, DC 20268–0001

Before:

Chairman Omas,
Vice Chairman Hammond,
Commissioner Covington,
and Commissioner Goldway

Rate And Service Changes To Implement Functionally Equivalent Negotiated Service Agreement With Discover Financial Services, Inc.

Docket No. MC2004–4

OPINION AND RECOMMENDED DECISION

APPROVING

NEGOTIATED SERVICE AGREEMENT

Washington, DC 20268–0001
September 30, 2004

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I. INTRODUCTION AND SUMMARY

The Postal Rate Commission recommends that the United States Postal Service enter into a three-year Negotiated Service Agreement with Discover Financial Services, Inc., a business unit of Morgan Stanley (DFS or Discover). The DFS Negotiated Service Agreement is based on the same two substantive functional elements that are central to the recently recommended Capital One Services, Inc. (Capital One) Negotiated Service Agreement — an address correction element and a declining block rate volume discount element.

The DFS Negotiated Service Agreement address correction element provides DFS, at certain levels of volume, electronic address corrections without fee for properly endorsed First-Class Mail solicitations. DFS will receive the services associated with Change Service Requested, Option 2, which include forwarding. In return, DFS agrees to forgo physical return of undeliverable mail, which otherwise is provided under the existing service features of First-Class Mail for mail that cannot be forwarded.

The DFS Negotiated Service Agreement declining block rate volume discount element provides DFS with per-piece discounts on those portions of its First-Class Mail that reach specified volume thresholds. The initial volume threshold, which must be reached to receive any discount, is 405 million pieces yearly. The discounts range from 2.5 cents to 4.5 cents depending on the block volume.

The Postal Service will benefit by $7.0 million over the life of the DFS Negotiated Service Agreement. This is based on estimates of $8.1 million in savings due to the address correction feature, $2.1 million in increased contribution due to increased First-Class Mail volume, and a net leakage of minus $3.2 million due to the discount feature of the agreement. The agreement establishes a negotiated $13 million discount cap over the life of the agreement. The agreement further provides an annual adjustment mechanism to the volume threshold.

The Capital One Negotiated Service Agreement recommended by the Commission in Docket No. MC2002-2 and approved by the Governors on June 2, 2003 rests on the Postal Service's express undertaking to make the essential features of that agreement available to similarly situated mailers. This was viewed as essential to complying with the statutory requirement that the Postal Service not “make any undue or unreasonable discrimination among users of the mails, nor shall it grant any undue preferences to any such user.” The DFS Negotiated Service Agreement is significant in that it demonstrates the Postal Service’s commitment and ability to offer the essential features of a previously recommended Negotiated Service Agreement to other mailers willing to accept similar terms and conditions.

While the DFS Negotiated Service Agreement is functionally equivalent to the Capital One Negotiated Service Agreement, it is not, nor is it required to be, identical. The DFS Negotiated Service Agreement is tailored to DFS’s unique situation. For example, the DFS Negotiated Service Agreement includes discounts and volume levels applicable exclusively to DFS’s mailing characteristics. It also includes contract terms and conditions, such as a yearly threshold adjustment, which were negotiated specifically to address DFS’s interactions with the Postal Service. The necessity to tailor specific rates and classifications to a particular mailer is a characteristic of a Negotiated Service Agreement classification, which might not be present with a more inclusive type of classification.

Just as the functional elements of the Capital One and DFS Negotiated Service Agreements are similar, but not identical, the benefits or effects of each agreement on the Postal Service are comparable, but not identical. For example, the DFS Negotiated Service Agreement does not rely on the generation of new First-Class Mail volume, but instead relies on a shift of mail volume from Standard Mail to First-Class Mail. Also, because of the operational differences between Capital One and DFS, the Postal Service may experience different effects from each mailer’s utilization of electronic return data.

The Postal Service will pursue a data collection plan with the DFS Negotiated Service Agreement that is similar to the plan recommended for the Capital One Negotiated Service Agreement. Information from both data collection plans should prove useful for evaluating the benefits of pursuing this style of agreement with other mailers.

This docket has been conducted using the Commission's new rules for functionally equivalent Negotiated Service Agreements. The rules provide the opportunity for expediting Postal Service requests considering functionally equivalent Negotiated Service Agreements by allowing participants to rely on relevant record testimony from a previous docket and avoiding the need to re-litigate issues that were recently litigated and resolved. Shortly after the conclusion of this docket, the Commission will solicit comments on the first use of the new rules.

On brief, one participant discusses the problem of high-volume First-Class undeliverable as addressed mail, and the apparent anomalies in the pricing of electronic Address Correction Service versus manual return service. The Commission recommends that the Postal Service focus on developing solutions to these problems.

The Commission acknowledges the participants' efforts that have gone into rapidly resolving issues in this docket and bringing this docket to a conclusion. The Postal Service's settlement coordinator and all of the participants that were involved in the settlement negotiations diligently worked to narrow and resolve issues without Commission involvement. This effort led to the development of the substantial record upon which this decision is based.

II. PROCEDURAL HISTORY

On June 21, 2004, the United States Postal Service filed a formal request with the Postal Rate Commission seeking a recommended decision approving a mail classification and related rates and fees predicated on a Negotiated Service Agreement with Discover Financial Services, Inc.[1] The Postal Service contends that the proffered Negotiated Service Agreement is functionally equivalent to the Capital One Financial Services, Inc. Negotiated Service Agreement recently recommended by the Commission[2] and approved for implementation by the Governors.[3] See Docket No. MC2002-2.

The Postal Service has identified DFS, along with itself, as parties to the Negotiated Service Agreement. This identification served as DFS's notice of intervention, and indicated that DFS will be considered a co-proponent, procedurally and substantively, of the Postal Service's Request during the Commission's review of the Negotiated Service Agreement.

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[1] Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Inc., June 21, 2004 (Request); Notice of the United States Postal Service of Filing Erratum to Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Inc. June 24, 2004 (Erratum).

[2] Opinion and Recommended Decision, Docket No. MC2002-2, May 15, 2003 (Capital One Opinion).

[3] The Governors' decision announces that the Negotiated Service Agreement classification and related rates and fees shall be in effect from September 1, 2003, through September 1, 2006. Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission Recommending Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One, Docket No. MC2002-2, June 2, 2003.

The Request, which includes six attachments, was filed pursuant to Chapter 36 of the Postal Reorganization Act, 39 U.S.C. § 3601 *et seq*.[4] In support of the Request, the Postal Service filed Direct Testimony of Ali Ayub on Behalf of United States Postal Service, June 21, 2004 (USPS-T-1).[5] DFS separately filed Direct Testimony of Karin Giffney on Behalf of Discover Financial Services, Inc., June 21, 2004 (DFS-T-1). The Request relies substantially on record evidence entered in the baseline docket, Docket No. MC2002-2. The Postal Service's Compliance Statement, Request Attachment E, identifies the baseline docket material on which it proposes to rely.

In contemporaneous filings, the Postal Service submitted a proposal for limitation of issues in this docket,[6] a request to establish settlement procedures,[7] and a motion requesting that if the Commission concludes that the submitted materials and incorporations are not sufficient, that those requirements be waived.[8]

The Commission issued Order No. 1410 to announce the filing of the Request; address the request for waiver of certain filing requirements; authorize settlement negotiations; appoint the Postal Service as settlement coordinator; designate the director of the Commission's Office of the Consumer Advocate (OCA) as the

[4] Attachments A and B to the Request contain proposed changes to the Domestic Mail Classification Schedule and the associated rate schedules; Attachment C is a certification required by Commission rule 193(i) specifying that the cost statements and supporting data submitted by the Postal Service, which purport to reflect the books of the Postal Service, accurately set forth the results shown by such books; Attachment D is an index of testimony and exhibits; Attachment E is a compliance statement addressing satisfaction of various filing requirements; and Attachment F is a copy of the Negotiated Service Agreement.

[5] See also, errata filed on September 2, 2004, and September 3, 2004.

[6] United States Postal Service Proposal for Limitation of Issues, June 21, 2004; See also, Statement of Support of Discover Financial Services, Inc. (DFS) for the Postal Service's Request to Establish Settlement Procedures and for the Postal Service's Proposal for Limitation of Issues, June 21, 2004 (DFS Statement of Support).

[7] Request of the United States Postal Service for Establishment of Settlement Procedures, June 21, 2004; see also, DFS Statement of Support.

[8] Statement of the United States Postal Service Concerning Compliance with Filing Requirements and Conditional Motion for Waiver, June 21, 2004. This motion was denied in PRC Order No. 1410 at 6-7.

representative of the interests of the general public; establish the deadline for intervention; and set the date and agenda for a prehearing conference. [9]

The prehearing conference was held on July 15, 2004. The Postal Service, acting as settlement coordinator, reported on the first settlement conference, held on July 14, 2004. Settlement discussions focused on functional equivalency and the appropriateness of proceeding under rule 196, the Postal Service's proposal for limitation of issues, the need for a hearing, and the timing of discovery. The settlement coordinator requested and was granted an additional week to further explore whether any participant wished to request a hearing. Additional time also was provided to allow participants to explore what issues were contested in this docket.

Because of the emphasis on expedition of requests predicated on functionally equivalent Negotiated Service Agreements, the Presiding Officer issued a scheduling ruling to provide direction to the proceeding.[10] The ruling established that this docket would proceed under rule 196 for functionally equivalent Negotiated Service Agreements. It also tentatively scheduled a hearing for September 8 or 9, 2004 on the proponents' direct case. The Presiding Officer indicated that to issue a decision in as little as 60 days, it generally would be necessary for all participants to be prepared to discuss limitation of issues and the need for a hearing at the prehearing conference. He also indicated that if it is clear from the settlement coordinator's next report that no participant seeks a hearing, a decision within 60 days remains feasible.

The settlement coordinator's report of July 22, 2004, indicated that two participants requested a hearing, although the settlement coordinator stated that it is unclear whether a hearing is warranted, or what issues would be covered in a hearing.

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[9] Notice and Order on Filing of Request Seeking Recommendation of Functionally Equivalent Negotiated Service Agreement, June 24, 2004 (Order).

[10] Presiding Officer's Ruling Establishing Procedural Schedule, POR No. MC2004-4/1, July 20, 2004.

The settlement coordinator kept the Commission informed of settlement discussions by filing periodic reports over the next several weeks.[11] During this time the Commission also received extensive pleadings discussing the limitation of issues, and whether or not a hearing would be warranted in this docket. Upon review of the pleadings, the Presiding Officer issued a ruling limiting the issues in this docket to those specified in rule 196(a)(6).[12] He also allowed discussion on brief of a system-wide fix to the problem of undeliverable as addressed First-Class Mail and consideration of a niche classification to help the Commission deal with future similar requests, but he announced that this discussion would not form the basis of the recommendation in this docket.

By August 20, 2004, settlement negotiations and discovery progressed to where there was no need to orally cross-examine a witness in a hearing on the proponents' direct case. This allowed the Presiding Officer to cancel the tentative hearing and to establish a procedural schedule and mechanisms to enter testimony, designated written cross-examination, and POIRs into the record without a hearing.[13] A schedule for filing initial and reply briefs also was established.

On September 3, 2004, the proponents filed motions requesting that the direct testimonies of Postal Service witness Ayub and DFS witness Giffney; the written cross-examination designated by the American Postal Workers Union, AFL-CIO, the OCA, and Valpak; and POIR Nos. 1 and 2 be entered into the record.[14] DFS's motion was

[11] Settlement negotiations, both formal and informal, appear to have had the desired effect of allowing the parties to resolve, and narrow, issues without the need for Commission intervention. The parties to the negotiations, and especially the settlement coordinator, deserve credit for facilitating the expedition of this docket.

[12] Presiding Officer's Ruling in Regard to Limitation of Issues, POR No. MC2004-4/2, August 11, 2004.

[13] Presiding Officer's Ruling Establishing Procedural Schedule, POR No. MC2004-4/3, August 25, 2004.

[14] United States Postal Service Motion for Inclusion of Direct Testimony, Designated Written Cross-Examination, and Responses to POIRs into the Record, September 3, 2004; Motion of Discover Financial Services, Inc. (DFS) to Enter Testimony, Designated Written Cross-Examination, and POIR Responses and Answers into the Record, September 3, 2004.

accompanied by the supporting declaration of witness Giffney. The Postal Service separately filed the supporting declaration of witness Ayub.[15] The testimonies, designated written cross-examination, and POIRs were entered into the record on September 9, 2004, and the record was closed.[16]

Briefs were filed September 8, 2004, by American Bankers Association, DFS, Valpak, OCA, and the Postal Service.[17] Reply briefs were filed September 15, 2004, by DFS, J. P. Morgan Chase, Magazine Publishers of America, Valpak, OCA, and the Postal Service.[18]

[15] Notice of the United States Postal Service Regarding Filing of Original Declarations of Authenticity of Witness Ali Ayub, September 3, 2004.

[16] Presiding Office's Ruling Placing Testimony into Evidence and Closing the Record, POR No. MC2004-4/4, September 9, 2004.

[17] Initial Brief of American Bankers Association (ABA Brief); Initial Brief of Discover Financial Services, Inc. (DFS Brief); Initial Brief of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak Brief); Initial Brief of the Office of Consumer Advocate (OCA Brief); and Initial Brief of the United States Postal Service (USPS Brief), all filed September 8, 2004.

[18] Reply Brief of Discover Financial Services, Inc. (DFS Reply Brief); Reply Brief of J. P. Morgan Chase and Co. (J. P. Morgan Chase Reply Brief); Reply Brief of the Magazine Publishers of America, Inc. (MPA Reply Brief); Reply Brief of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak Reply Brief); Reply Brief of the Office of the Consumer Advocate (OCA Reply Brief); and Reply Brief of United States Postal Service (USPS Reply Brief), all filed September 15, 2004.

III. BASELINE AGREEMENT

The Postal Service submits that the DFS Negotiated Service Agreement, on which this Request is predicated, is functionally equivalent to the Capital One Negotiated Service Agreement (the baseline agreement) recommended by the Commission in Docket No. MC2002-2 and currently in effect. The Postal Service Board of Governors determined that the rate and service changes associated with the Capital One Negotiated Service Agreement will remain in effect from September 1, 2003 through September 1, 2006.

The Capital One Negotiated Service Agreement includes two significant mail service features that form the bases of the agreement — an address correction service feature, and a declining block rate volume discount feature.

The address correction service feature provides Capital One, at certain levels of volume, electronic address corrections without fee for First-Class Mail solicitations that are undeliverable as addressed (UAA). In return for receipt of electronic address correction, Capital One will no longer receive physical return of its UAA First-Class solicitation mail that cannot be forwarded. Capital One will also be required to maintain and improve the address quality for its First-Class Mail. PRC Op. MC2002-2, para. 2004.

Use of the address correction service feature is a prerequisite to use of the second feature of the NSA, a declining block rate volume discount. This feature provides Capital One with a per-piece discount for bulk First-Class Mail volume above an annual threshold volume. The per-piece discount varies from 3 to 6 cents under a "declining-block" rate structure. Should first-year mail volume decline under a predetermined quantity, a reduced threshold and lower initial discounts take effect. Id., para. 2005.

The Commission's analysis of the Capital One Negotiated Service Agreement focused on assuring that the agreement would not make mailers, other than Capital One, worse off. Id., para. 8006. To meet this condition, the Commission's recommendation of the Capital One Negotiated Service Agreement included the addition of a provision establishing a cumulative three-year stop-loss limit of $40.637 million. Id., para. 8011. The Commission found that the estimates of before rates volumes for Capital One were so unreliable that without a stop-loss provision there would be no reasonable assurance that the Postal Service would not lose money on the Capital One Negotiated Service Agreement. Id., para. 8013.

IV. SUMMARY OF PROPOSAL

A. Witness Giffney's Testimony

Discover Financial Services witness Giffney describes DFS's business, reviews its marketing practices as they relate to mail operations, presents the before and after Negotiated Service Agreement First-Class Mail volume projections, and addresses the competitive cap and address quality issues. Tr. 2/29–44.

DFS Background and Marketing Practices. Giffney explains that DFS is a business unit of Morgan Stanley, and is responsible for the operation of the Discover® Card brand.[19] Tr. 2/30. She asserts that DFS is one of the largest issuers of general purpose credit cards in the U.S. with more than 50 million card members, and is a direct competitor of Capital One. Id. at 30–31. She states that DFS offers additional services such as Discover CDs and Money Market Accounts, auto insurance, and home loans. Id. at 32. DFS also owns and operates its own merchant network, which processes credit card transactions. Ibid.

Giffney states that DFS's total mail volume is composed of operations mail which is sent as First-Class Mail, and marketing mail which is sent both by First-Class Mail and Standard Mail. Its operations mail includes all business-related correspondence directed to both card members and merchants (e.g., statements). Giffney explains that some marketing mail is sent as First-Class Mail, but the bulk is sent as Standard Mail. She asserts that DFS has "concluded that under this NSA there would be an advantage, depending upon certain characteristics of the addressees, to shift a portion of our monthly campaign mail from Standard Mail to First-Class Mail." Id. at 34.

Giffney states that each month DFS creates acquisition marketing campaigns to acquire new card members, which mail on a weekly basis. DFS does not mail from an internal prospect database. Each month it procures over 40 mailing lists for use in its acquisition campaign mailings. Id. at 34–35. DFS does not mail to each address on

[19] The Negotiated Service Agreement does not encompass the mail of Morgan Stanley's brokerage business.

each list, but applies a variety of proprietary factors to determine the composition of the mailings.

DFS's Before and After First-Class Mail Volume Projections. Giffney presents DFS's monthly historical mail volumes from December 1999 through December 2003. She describes monthly operations mail volume as stable, varying between 23.4 million and 28.6 million pieces. She notes that there is a historical fluctuation in monthly marketing mail volume, which she claims has recently moderated. Monthly marketing mail has varied from 0.4 million to 47.1 million pieces over the December 1999 through December 2003 period. Id. at 36; 44.

Giffney asserts that DFS imposes extremely tight management over its marketing budget, and that its projected marketing volumes are essentially flat. Given these factors, and the fairly stable operations mail volumes, DFS's three year forecast for "before" Negotiated Service Agreement First-Class Mail volume is shown in Table 1. Id. at 37.

Table 1. DFS "Before" First-Class Mail Volume (Millions of Pieces)

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

The three year forecast for "after" Negotiated Service Agreement First-Class Mail volume is shown in Table 2. Giffney explains that the "after" volumes are viewed as minimum volumes. The projections are based on an upgrade from Standard Mail to First-Class Mail for existing marketing campaigns, and do not project the use of First-Class Mail for new marketing campaigns. Id. at 38.

Table 2. DFS "After" First-Class Mail Volume (Millions of Pieces)

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

Competitive Cap. Giffney explains that DFS and the Postal Service have negotiated a "competitive" cap of $13 million, which is based on the ratio of total First-Class Mail volume between DFS and Capital One. In principle, she does not see the need for a cap because she asserts that the Postal Service will realize additional profit from increased mail volume, and because of the adjustable threshold specified in the DFS Negotiated Service Agreement. However, she notes that as the Commission has established a cap in the Capital One decision to limit the total possible benefit to Capital One; therefore it would not be unreasonable for the Commission to do the same in this decision. Id. at 41–42.

Address Quality. DFS processes addresses against the NCOA/CASS database within 60 days of mailing. Despite this and other efforts, some mail is returned. Giffney estimates that operations mail, which is not mailed from purchased lists, has a return rate of approximately 0.25 percent, and marketing mail, which is mailed from purchased lists, has a weighted average return rate of 9.3 percent.

Under the Negotiated Service Agreement, DFS will receive return data electronically, and no longer receive physical return of its undeliverable mail. Since DFS does not use an internal prospect database, Giffney states that DFS and the Postal Service have agreed to work with its list processor to analyze return data and use the data in an efficient manner to improve mail quality. Furthermore, if DFS ever develops and uses an internal prospect database, Giffney asserts that DFS has agreed to update that database within 30 days of receipt of return data. Id. at 42–43.

B. Witness Ayub's Testimony

Postal Service witness Ayub, USPS-T-1, reviews the importance of Negotiated Service Agreements, and functionally equivalent agreements, to the Postal Service. He states that Negotiated Service Agreements "represent one tool that can help mitigate the risk that continued erosion of existing First-Class Mail volume will lead to higher-than-necessary rate and fee increases in the future." Tr. 2/89. "Functionally equivalent NSAs are important to the Postal Service because they extend the benefits of favorable baseline agreements to similar relationships with other customers." Ibid.

Ayub's testimony discusses the relationship of the baseline Capital One Negotiated Service Agreement to the DFS Negotiated Service Agreement. He then presents the Postal Service's financial impact analysis and competitive impact analysis, discusses the discount cap, and reviews the factors of the Act.

Functionally Equivalent. Ayub asserts that the DFS Negotiated Service Agreement fully meets the guidelines outlined in Commission Order No. 1391 for functionally equivalent Negotiated Service Agreements. He contends that the DFS Negotiated Service Agreement contains the same functional elements as the baseline Negotiated Service Agreement, i.e., declining block rates and address correction elements. Id. at 92–93.

Ayub explains that the declining block rate discounts are applied only to the incremental volumes above a volume threshold of 405 million pieces. The incremental discounts versus the applicable volume blocks are shown in Table 3.

Table 3. Incremental Discounts Versus Volume Block

Volume Block	Incremental Discounts
405,000,000 — 435,000,000	2.5¢
435,000,001 — 465,000,000	3.0¢
465,000,001 — 495,000,000	3.5¢
490,000,001 — 515,000,000	4.0¢
515,000,001 — above	4.5¢

Request, Attachment F at 4.

Ayub refers to the description of the ACS system described by witness Wilson in the baseline docket. See Docket No. MC2002-2, USPS-T-4 at 2-7. The address correction element allows the Postal Service to convert physical return of DFS's undeliverable-as-addressed (UAA) marketing mailpieces into electronic address correction information through the computerized ACS system.

He contends that the functional elements in the DFS Negotiated Service Agreement provide a benefit comparable to what the Postal Service expects to obtain with the baseline Negotiated Service Agreement. Tr. 2/93.

Ayub lists other notable terms and conditions of the DFS Negotiated Service Agreement. The agreement:

waives the seal against postal inspection of the mail;

requires DFS to prepare mail under applicable standards;

requires DFS to enhance its address management practices;

includes a transaction penalty;

contains a provision for DFS to make necessary records and data available to facilitate and monitor compliance; and

> enables the Postal Service to cancel for failure by the mailer to provide accurate data, to present properly prepared and paid mailings, to comply with a material term of the agreement, or to use the Negotiated Service Agreement.

Id. at 93–94.

In describing terms and conditions unique to the DFS Negotiated Service Agreement, Ayub notes that although the discount structure remains the same as in the Capital One Negotiated Service Agreement, the thresholds, incremental blocks, and starting discounts are unique to the DFS Negotiated Service Agreement. Also, the DFS Negotiated Service Agreement includes an annual threshold adjustment. Finally, the Capital One Negotiated Service Agreement stop-loss provision has been replaced with a "negotiated" discount cap of $13 million over the life of the agreement. Id. at 94–96.

Financial Impact Analysis. Ayub explains that there are three factors affecting the financial estimates: ACS cost savings, new volume contribution, and discount exposure (leakage). An ACS cost savings of $8.2 million accrues from elimination of the physical return of First-Class Mail marketing pieces, and substituting electronic return notice in its place. A new volume contribution of $2.1 million accrues from the conversion of a percentage of marketing mail from Standard Mail to First-Class Mail. A discount exposure of $3.2 million is created as the result of price incentives applied to any volume that would have occurred without a price incentive. Ayub estimates that this results in a net benefit to the Postal Service of $7.1 million over the life of the Negotiated Service Agreement. Id. at 96–99.

Ayub's financial analysis model, with certain modifications, follows witness Crum's methodology from Docket No. MC2002-2. Modifications are made to present a financial analysis over the life of the agreement, versus the test year approach taken in the Capital One docket. In addition, Ayub applies a 4 percent annual inflationary cost adjustment factor to estimate unit costs in each year of the agreement, and to account for cost increases since litigation of the Capital One Negotiated Service Agreement. Id. at 98–99.

Competitive Impact Analysis. Ayub relies on the competitive impact analysis presented in the baseline docket. He states that the Commission concluded that the impact on competition would be minor, and that it was significant that no competitors of Capital One opposed that Negotiated Service Agreement. Ayub estimates that the impact on competition due to the DFS Negotiated Service Agreement should be even less than the effect from the Capital One Negotiated Service Agreement. Id. at 100-101.

Discount Cap. Ayub discusses the possible negative ramifications of applying a stop-loss provision. He argues that basing a stop-loss provision "solely on cost savings would tend to limit participation in the NSA process to only large volume mailers who can offer significant cost savings opportunities." Id. at 101. Also, stop-loss provisions (based on the Capital One 95 percent pass-through methodology) could foreclose potential contribution from increased volume. Id. at 102.

Ayub argues that the conditions cited to support the Capital One stop-loss provisions do not apply to DFS. He contends that the concern in the Capital One docket was that mail volume would have grown in the absence of discounts so that discounts would exceed cost savings. In the case of DFS, he argues that DFS's volume history is stable, and even with an increase in volume, the agreement will be contribution-positive. Id. at 102-103.

Criteria of the Act. In Ayub's discussion of the factors of the Act, he contends that the arguments made by Postal Service witness Plunkett in the baseline docket are also applicable in this docket. He incorporates Plunkett's testimony into his own, and argues that the Commission's findings and conclusions in the baseline docket also justify recommending the instant Request. See witness Plunkett's testimony at MC2002-2, USPS-T-2, page 9, line 36 through page 10, line 15. Ayub further argues that the customer-specific rates offered DFS cover all Postal Service costs (criterion 3), and that this is fair and equitable (criterion 1). Tr. 2/103-105.

C. Incorporated Record Evidence

The Request relies upon the record evidence from previous dockets shown in Table 4.

Table 4. Record Evidence From Previous Dockets

Witness	**Reference**	**Docket**	**Transcript (Volume/Page)**
Anita J. Bizzotto	USPS-T-1	MC2002-2	3/411*; 3/410-530
Michael K. Plunkett	USPS-T-2 USPS-RT-1	MC2002-2	4/674*; 4/673-851 5/865-66; 9/1857-1961
Charles R. Crum	USPS-T-3	MC2002-2	2/254*; 2/252-400; 5/858-864
James D. Wilson	USPS-T-4	MC2002-2	3/532*; 3/531-666
B. Kelly Eakin	USPS-RT-2	MC2002-2	10/2060-2140
Institutional Responses	USPS	MC2002-2	5/867-966
John C. Panzar	JCP-T-1	MC2002-2	8/1572-1790
Donald Jean	COF-T-1	MC2002-2	2/34-198
Stuart Elliott	COF-T-2 COF-RT-2	MC2002-2	2/198-251 9/1836-1872
Robert Shippee	COF-RT-1	MC2002-2	9/1797-1835
Other Sources	**Reference**	**Docket**	**Source**
Library Reference	USPS	R2001-1	J-58; J-60 (as revised 11/15/2001); J-69 (as revised 11/5/2001)
Library Reference	PRC	R2001-1	PRC-LR-2; PRC-LR-4; PRC-LR-7

* Location where accepted into the record (Postal Service written direct testimony is referenced but not transcribed into the record.)

Request, Attachment E-17.

D. DMCS Provisions

The Postal Service proposes to add a new Domestic Mail Classification Schedule (DMCS) section 611, to specify the general parameters of the DFS Negotiated Service Agreement. See Request at Attachment A. The Postal Service also proposes the addition of two new rate schedules to the DMCS: 611A and 611B. Rate Schedule 611A specifies the initial volume block incremental discounts. Rate Schedule 611B specifies the adjusted threshold volume block incremental discounts. See Request at Attachment B.

V. FINDINGS AND CONCLUSIONS

A. Functional Equivalency

The finding that a request predicated on a Negotiated Service Agreement is functionally equivalent to a Negotiated Service Agreement previously recommended by the Commission and currently in effect (a baseline agreement) affords the new request the opportunity for expedited review by allowing proponents of the agreement to rely on relevant record testimony from a previous docket. This potentially could expedite the proceeding by avoiding the need to re-litigate issues that were recently litigated and resolved. The Commission finds that the DFS Negotiated Service Agreement is sufficiently functionally equivalent to the Capital One Negotiated Service Agreement, which is currently in effect, such that record evidence specified from Docket Nos. MC2002-2 and R2001-1 may be relied upon in this docket, MC2004-4.[20]

The criteria for determining whether a proposed Negotiated Service Agreement is functionally equivalent to a previously recommended Negotiated Service Agreement are developed in Docket No. RM2003-5.

> "Functional Equivalency" focuses on (1) a comparison of the literal terms and conditions of one Negotiated Service Agreement with the literal terms and conditions of a second Negotiated Service Agreement, and (2) a comparison of the effect that each agreement has upon the Postal Service.

PRC Order No. 1391 at 50.

"The first part of the analysis is an examination of the literal terms and conditions of each Negotiated Service Agreement." Ibid. From a macro perspective, the Capital One Negotiated Service Agreement and the DFS Negotiated Service Agreement are based on the same two functional elements. Each agreement provides a declining block rate volume discount on those portions of First-Class Mail that reach specified volume thresholds. Each agreement provides, as the major cost savings element,

[20] A corollary to this finding is that the Commission shall rely on relevant portions of its analysis and many of its conclusions formulated in the previous dockets.

electronic address corrections without fee for properly endorsed First-Class Mail solicitations in place of physical return of undeliverable First-Class solicitations mail for mail that cannot be forwarded. Additionally, each agreement provides mechanisms to limit the risk to the Postal Service and protect the interests of mailers not party to the agreement.

The declining block rate volume discount element in each agreement share the same structure, but they are not identical. Each agreement establishes a volume threshold, block levels, and discounts which are unique to each mailer. This does not imply that the agreements are not functionally equivalent. It does imply that further examination of each agreement is necessary to determine whether the declining block rate volume discount elements have a comparable effect upon the Postal Service.

The electronic address correction element in each agreement similarly provides, at certain levels of volume, electronic address corrections without fee for properly endorsed First-Class Mail solicitations in place of physical return of undeliverable First-Class solicitations mail that cannot be forwarded. Even though the literal terms and conditions in each agreement are similar, there are differences in related requirements that have an effect on the Postal Service. For example, DFS uses only addresses that have been processed against National Change of Address / Coding Accuracy Support System databases within 60 days prior to mailing. Capital One processing takes place within 30 days prior to mailing for customer mail and within 60 days prior to mailing for solicitations mail.

The mechanisms to limit the risk to the Postal Service and protect the interests of mailers not party to each agreement are essential provisions in each agreement. The notable requirements establish stop-loss mechanisms, and acquisition and merger adjustments. The DFS agreement adds an annual threshold adjustment. Each agreement tailors the specific requirements of each mechanism to the unique relationship between the mailer and the Postal Service.

The Capital One Negotiated Service Agreement initially did not contain a stop-loss mechanism. However, the Commission found the estimates of “before rate” volumes so unreliable that without the addition of a stop-loss mechanism there would be no reasonable assurance that the Postal Service would not lose money on the agreement. The addition of this provision, which was central to the recommendation of the agreement, effectively eliminated the uncertainty of before rate volumes from the analysis of the Postal Service's risk of entering the agreement. The Commission believes that some level of uncertainty will always be present when mailers are asked to predict mail volumes into the future. Furthermore, the best of estimates will always be subject to exogenous factors.[21] The DFS Negotiated Service Agreement contains a stop-loss mechanism with literal terms identical to those recommended with the Capital One Negotiated Service Agreement. The stop-loss values in each agreement are unique to each mailer and are determined using different methodologies as discussed below.

The DFS Negotiated Service Agreement also includes an annual threshold adjustment based on the percentage change in domestic gross active accounts. This element does not appear in the Capital One Negotiated Service Agreement. The threshold adjustment functions as an additional method of reducing risk in the DFS Negotiated Service Agreement.

The comparison of the literal terms and conditions of the DFS Negotiated Service Agreement with the literal terms and conditions of the Capital One Negotiated Service Agreement reveals two substantially similar, but not identical, agreements. The differences generally focus on tailoring the specific agreement to the specific mailer. Allowing such differences is contemplated as a general characteristic of Negotiated Service Agreement type classifications. The differences do not change the overall functionality of the agreements.

"For the second part of the analysis, the Commission will go beyond the literal terms and conditions of the agreements and compare the effect that the baseline and

[21] For example, see proposed rule clarifying the circumstances in which mail containing "personal" information may be eligible for Standard Mail rather than First-Class Mail rates. 69 Fed. Reg. 20,841 (April 19, 2004).

proffered functionally equivalent agreements have on the Postal Service." Id. at 51. This requires the Commission to evaluate whether both Negotiated Service Agreements provide a comparable benefit to the Postal Service. "A comparable benefit does not mean an identical benefit, but instead will be placed into context by the terms and conditions of each agreement, and the characteristics of each participant." Ibid.

Each agreement establishes different volume thresholds, block levels, and discounts for the declining block rate volume discount element. Each mailer also anticipates different before and after rates mail volumes. Also important to the analysis, each mailer's mail characteristics has an effect on the comparable benefit to the Postal Service.

In regard to mail characteristics, Valpak notes that the Capital One Negotiated Service Agreement generates an increase in First-Class Mail volume through new First-Class Mail pieces, which creates all new contribution. The DFS Negotiated Service Agreement generates an increase in First-Class Mail volume through a migration of Standard Mail pieces to First-Class Mail pieces. Thus, the additional contribution attributable to the DFS agreement in part is due to the difference between the higher First-Class Mail contribution and the lower Standard Mail contribution. See Valpak Brief at 6-7.

Also, DFS's anticipated year one before rates volume is above the level of the initial threshold. This allows a discount to be received for mail that would have been mailed anyway absent the discount. The Capital One Negotiated Service Agreement did not exhibit this characteristic because the initial threshold was set below the anticipated year one volume.

The differences in new versus migrated mail and the setting of the threshold levels influence the value of the DFS Negotiated Service Agreement to the Postal Service. New First-Class Mail pieces generate higher additional contribution than mailpieces migrating from Standard Mail. Setting the initial threshold below the initial volume estimates reduces the amount of contribution that would have otherwise been received. The detailed effect of these factors is represented in the financial analysis presented below. However, the Commission believes that even with these differences, the declining block rate volume discount element present in each agreement has a comparable benefit of increasing net contribution to the Postal Service.

The address correction element present in each Negotiated Service Agreement acts as the main cost savings element for the respective agreement. The cost savings is realized by substituting lower cost electronic return service for high cost manual return service. To this extent, the address correction element present in each agreement produces a comparable net benefit for the Postal Service.

However, Valpak argues that because of each mailer's mailing list practices and how each mailer will utilize electronic address correction information, the Postal Service will experience a different effect from each agreement's electronic address correction element. For example, the Capital One Negotiated Service Agreement is based on a mailer that maintains its own internal solicitations lists. The DFS Negotiated Service Agreement is based on a mailer that predominately relies on rented lists. This difference, combined with how each mailer utilizes the electronic address correction information, could influence each mailer's return and forwarding rates, and the resulting effect on the Postal Service. See id. at 7-8.

The Postal Service counters this argument by stating that both OCA and Valpak fail to appreciate the impact that National Change of Address processing has on keeping forwarding rates at or below the systemwide average. USPS Reply Brief at 11.

The Commission has considered the different characteristics of each mailer's mailing practices, and believes that the electronic address collection element in each agreement provides a comparable benefit to the Postal Service. This, in part, is based on the Commission's assessment, discussed below, of the effect that forwarding rates have on the agreement.

The stop-loss mechanisms, merger and acquisition clauses, and other protective provisions all produce a comparable effect and provide a comparable benefit to the postal service by limiting the risk to the Postal Service, and assuring that mailers not party to each agreement are not made worse off.

There is, however, a conceptual difference between the stop-loss mechanism employed in the Capital One Negotiated Service Agreement and the one proposed in the DFS Negotiated Service Agreement. This difference does not affect the outcome of the recommendation, but it could have an effect on future proposals.

The Capital One Negotiated Service Agreement stop-loss mechanism was developed from the perspective of limiting potential Postal Service losses, and thereby protecting the interests of mailers not party to the agreement. The methodology employed to calculate the stop-loss mechanism effectively associates the cost savings element of the agreement to the discount element. Associating the two elements is an important aspect of the agreement.

The DFS Negotiated Service Agreement stop-loss mechanism (described as a “competitive” cap) is proposed as a method of providing DFS with a benefit proportional to the one received by Capital One. Tr. 2/41-42. From the DFS perspective, the stop-loss mechanism functions as a limit on the benefit that it may receive and not primarily as a protective mechanism for the Postal Service or other mailers. Because of this, the methodology employed to calculate the value of the DFS stop-loss mechanism does not effectively associate the cost savings element of the agreement to the discount element.

The association of the cost savings element with its discount element is one factor the Commission must weigh when examining whether a proposed agreement (and its stop-loss mechanism) is functionally equivalent to the Capital One Negotiated Service Agreement. Two agreements might not be considered functionally equivalent if comparable associations did not exist. A comparison of stop-loss mechanisms also is important from the perspective of fairness and equity between two mailers. For example, a more advantageous stop-loss mechanism from the perspective of the recipient of a functionally equivalent Negotiated Service Agreement may discriminate against the recipient of the baseline agreement and leave that mailer competitively worse off. As will be discussed in the stop-loss section appearing below, the conceptual differences between the proposed and the baseline stop-loss mechanisms do not affect the outcome of this recommendation.

The comparison of the literal terms and conditions of each Negotiated Service Agreement, and the comparison of the effect that each agreement has upon the Postal Service, demonstrates that the DFS Negotiated Service Agreement is functionally equivalent, but not identical, to the Capital One Negotiated Service Agreement. The Capital One Negotiated Service Agreement is currently in effect, which implies that the record evidence developed in Docket No. MC2002-2 is not dated and may be relied upon. Docket No. MC2002-2 in turn relies upon material from the most recent omnibus rate case, Docket No. R2001-1. Therefore, the Commission finds that record evidence specified from Docket Nos. MC2002-2 and R2001-1 may be relied upon in this docket, MC2004-4.

B. Financial Analysis

Address Correction Element. Postal Service witness Ayub estimates that providing electronic Address Correction Service (eACS) in lieu of physically returning DFS's undeliverable-as-addressed (UAA) First-Class marketing letters that cannot be forwarded will save a total of $8.2 million in Postal Service costs over the term of the agreement. This estimate essentially is developed using the same technique recommended in Docket No. MC2002-2. As in the baseline recommendation, the inputs include the Before Rates volume of First-Class marketing letters, the return rate for the marketing mail, the ACS success rate, and the average costs of a physical return and an "electronic return." In contrast to the method adopted by the Commission in MC2002-2, Ayub applies a contingency factor to the costs that form the basis of the savings estimate. The proxies for DFS's ACS success rate and return costs are taken directly from MC2002-2 with one modification — the return costs are projected to increase at an assumed 4 percent annual rate of inflation. The return rate and volume forecasts are provided by DFS witness Giffney. Giffney bases her estimates of Before Rates marketing volume on DFS's budget for the first year of the agreement and the assumption that absent the Negotiated Service Agreement, marketing volume will remain flat for years two and three. Id. at 39. Her return rate estimate is based on a compilation of data from 1999 to 2002. Id. at 80 (Response to POIR 1, Question 1).

The Commission applies the same methodology for estimating the financial effects of the ACS provisions as it used in the baseline agreement, modified to incorporate the Postal Service's 4 percent inflation assumption. The Commission's estimate differs from the Postal Service's estimate because the Postal Service rounds some inputs and adds a 3 percent contingency to the underlying cost estimates. The exclusion of contingency from the estimation of cost savings is consistent with Commission precedent for the calculation of worksharing cost avoidances and with the method employed in the baseline agreement. The resulting savings estimates are \$2.6 million, \$2.7 million, and \$2.8 million in years one, two, and three of the agreement, for a total savings of \$8.1 million over the term of the agreement.

Participant's Argument in Regard to the Address Correction Element. DFS's UAA First-Class marketing mail that would have been forwarded in the absence of the Negotiated Service Agreement will continue to be forwarded, and in addition, an electronic notification will be sent to DFS. Each such notification will cause the Postal Service to incur costs that it would not have incurred otherwise. As in Docket No. MC2002-2, the Postal Service excludes the cost of ACS notices for forwarded mail from its analysis on the grounds that such costs are likely to be offset by savings from reducing the number of "repeat forwards."

On Brief, Valpak and OCA express concern about the Postal Service's treatment of costs related to forwarding. Both analyze the potential impact of above average forwarding rates on the expected increase in contribution from the shift of Standard Mail to First-Class Mail. Valpak Brief at 21-26; OCA Brief at 11-14.

OCA's analysis indicates that a forwarding rate slightly above the average for First-Class Mail would sharply reduce the net contribution to the Postal Service at any given volume level. See OCA Brief, Table 4-1 and Figure 4-1. For example, the analysis suggests that a forwarding rate for DFS's First-Class marketing letters of between 3 and 4 percent (compared to a 1.98 percent average) could result in a negative net contribution at the forecast before rates volume. Id. at 31-35 and 39-42. OCA calculates an estimated forwarding rate of 8.82 percent for First-Class Mail other than bills, statements and bill payments (including marketing mail) and concludes that the potential for above average forwarding rates to threaten the profitability of the agreement is significant. Id. at 13-14. Valpak calculates a potential forwarding rate of 13.7 percent by applying a ratio of forwards to returns (1.472) from Standard Mail to the 9.3 percent return rate of DFS. Valpak Brief at 21-25.

OCA also presents analysis of the net contribution from the ACS provisions under a variety of assumption about the ACS success rate and return rate. See OCA Brief, Tables 4-2 and 4-3, Figures 4-2 and 4-3. While less dramatic than the analysis of forwarding rates, these illustrate the sensitivity of net ACS savings to these input variables. For example, the tables show that an ACS success rate of roughly 55 percent (compared to the 85 percent assumed by the Postal Service) or a return rate of slightly less than 6 percent (versus the historical 9.3 percent) would result in a net loss of contribution from the agreement. Id. at 35-42. To support the assertion that the ACS success rate may fall short of the Postal Service's forecast, OCA cites an extra-record publication indicating that, prior to the Capital One Negotiated Service Agreement, the actual ACS success rate was only 47 percent. Id. at 10-11.

The Postal Service contends that the record supports the assumption that the forwarding rate of DFS's marketing letters will be equal to the average for First-Class Mail. In support of its position, the Postal Service cites evidence disputing a link between forwarding and return rates, DFS's use of the NCOA database, and the 2.0 percent forwarding rate indicated by the unaudited results of the Capital One Negotiated Service Agreement. It further asserts that the estimated forwarding rates presented by OCA and Valpak are not supported on the record. USPS Reply Brief at 7-11.

The Postal Service also argues that OCA's concern about the ACS success rate is not based on record evidence. It points out that the article cited by OCA reports that the success rate has climbed to 86.7 percent, indicating that an 85 percent success rate is a reasonable assumption. Id. at 11-12.

DFS claims that because the ratio of forwards to returns that Valpak relies on in its analysis is based on mail with an ACS endorsement, it is affected by an adverse selection problem and thus is not representative of all Standard Mail. DFS also disputes the claim of a necessary link between forwarding and return rates, and emphasizes the extent of address cleansing performed on its mailings to reduce its forwarding rate. DFS Reply Brief at 13-18.

The Commission concludes that the significance of the questions raised by OCA and Valpak in regard to the ACS success rate, return rate, and forwarding rate hinge on two considerations: the likelihood that the actual values will vary significantly from the values used in the Postal Service's models, and the sensitivity of results to changes in these variables. The return rate used in the Postal Service's model is the actual return rate for DFS's marketing mail over a recent history. Tr. 2/80. The record does not indicate that there is reason to expect this to change to a degree that would have a significant impact on the net savings. Furthermore, this assumption is consistent with the baseline docket. No argument has been presented in this docket that convinces the Commission to vary from this precedent. Similarly, the Commission finds unconvincing arguments that the ACS success rate will vary from the estimate used by the Postal Service enough to significantly affect the savings. The 85 percent rate used in the baseline docket has not been discredited to justify deviating from the precedent.

OCA's analysis of the sensitivity of net ACS savings to variations in the forwarding rate of DFS's marketing mail suggests that an actual forwarding rate even slightly above average would result in substantially less savings than estimated by the Postal Service. However, close examination of the calculations underlying OCA's analysis reveals an implicit assumption that is unsupported and unrealistic.

OCA estimates the year one net savings of the ACS provisions by multiplying the before rates volume of First-Class marketing letters by the change in average unit cost that results from the ACS provisions. The calculation of the change in the average unit cost of DFS's marketing letters begins with a straightforward estimate of the average unit savings from returns: (cost of a physical return — cost of an electronic return) x

ACS success rate x return rate. From this, OCA subtracts the costs of excess forwarding (i.e., forwarding costs in excess of average forwarding costs). However, the formula includes physical forwarding costs in addition to the cost of providing an electronic notice of forwarding. The implication is that, as a result of the agreement, DFS's "anyhow" First-Class marketing mail incurs additional physical forwarding costs above what it would have in the absence of the agreement. In other words, the OCA estimate assumes that the forwarding rate of "anyhow" volume increases as a result of the agreement. There is no support on the record for such an assumption.[22]

While physical forwarding costs are relevant to the evaluation of the contribution effects of Standard Mail migrating to First-Class, the record provides no reason to suspect that the physical forwarding costs incurred by "anyhow" marketing letters will be adversely affected by the Negotiated Service Agreement. On the contrary, physical forwarding costs are likely to decrease due to reduced repeat forwards (as in the baseline agreement).

The only additional costs related to forwarding incurred by "anyhow" volume as a result of the Negotiated Service Agreement are the costs of providing DFS with electronic ACS notices of mail that is forwarded. The cost of an electronic notice is small enough that even a relatively high forwarding rate does not have a significant effect on the net savings resulting from the agreement. Given the low sensitivity of the results, the empirical evidence from the experience with Capital One, and the potential for savings from the avoidance of repeat forwards, the Commission follows the

[22] The formula used by the Commission to estimate the net savings of the ACS provisions per piece of First-Class "anyhow" marketing volume (including costs related to forwarding), assuming that the forwarding and return rates are the same before and after rates is:

$$\begin{aligned}&\left[(CostPhy.Rtrn.-\ CostElec.Rtrn.)\times Rtrn.Rate\times ACSSucc.Rate\right]\\&+\left[(CostPhy.Fwd.-(CostPhy.Fwd.+CostACSNotice))\times Fwd.Rate\right]\end{aligned}$$

wherein the physical forwarding costs cancel out. This is in contrast to the formula used by OCA, see OCA Brief, file IBrief_Tables-Charts.xls:

$$\begin{aligned}&\left[(CostPhy.Rtrn.-\ CostElec.Rtrn.)\times Rtrn.Rate\times ACSSucc.Rate\right]\\&-\left[(CostPhy.Fwd.+CostACSNotice)\times(Fwd.Rate-Avg.FC.Fwd.Rate)\right]\end{aligned}$$

precedent of the baseline agreement and assumes the agreement will have a neutral effect on the costs related to forwarding.

Declining Block Rate Volume Discount Element. The declining block rate discount element provides per-piece discounts for those portions of First-Class Mail that reach specified volume thresholds. The rate structure is described by witness Ayub. See Table 3 above. The initial volume threshold, which must be reached before any discounts are provided, is set at 405 million pieces yearly and reviewed annually. The discounts increase in one-half cent increments with increasing volume, ranging from 2.5 cents to 4.5 cents depending on the block volume. Each year, the thresholds are adjusted in proportion to the change in the number of DFS's domestic gross active accounts. The annual adjustments are designed to ensure that additional discounts are provided only for increases in First-Class marketing mail volume.

There are two components to the financial analysis of the declining block rate discount element — the additional contribution generated by solicitations mail converting from Standard Mail to First-Class Mail, and the loss of contribution from discounts awarded to First-Class Mail that would have been sent even absent the discounts. Ayub estimates the Postal Service will sustain a loss of $3.2 in contribution due to discounts on First-Class Mail that would have been sent anyway absent the discount. This is based on witness Giffney's estimates of First-Class Mail volumes in the absence of the Negotiated Service Agreement.

Ayub estimates that the conversion of a percentage of DFS's marketing mail from Standard Mail to First-Class Mail will generate an additional $2.1 million in contribution for the Postal Service. The increase in per piece contribution for new First-Class Mail is less in the DFS Negotiated Service Agreement than in the Capital One Negotiated Service Agreement. The DFS Negotiated Service Agreement assumes that all new First-Class Mail volume is converted from Standard Mail. For pieces receiving the highest discount, Ayub estimates an increase in contribution of 2.2 cents per piece in the first year of the agreement, shrinking to 1.8 cents by the third year of the agreement. In the Capital One Negotiated Service Agreement, the new volume was composed entirely of new mailings, which generated an estimated 10.4 cents of contribution per piece at the highest discount level. Since in the DFS Negotiated Service Agreement the new First-Class Mail volume is migrating from Standard Mail, the increase in contribution per piece reflects the loss of the Standard Mail per piece contribution that otherwise would have been generated.

On brief, OCA and Valpak argue that there is a high risk the actual contribution generated by the agreement will be much lower than estimated by the Postal Service. For pieces receiving the top discount of 4.5 cents, Valpak notes that the “small projected marginal contribution easily could evaporate, causing a marginal loss.” Valpak Brief at 25. Their concern is with the sensitivity of the increase in per piece contribution to changes in return and forwarding rates. Actual return or forwarding rates for new First-Class Mail higher than those assumed by Ayub would generate higher costs and thereby reduce contribution.

OCA presents scenarios whereby the contribution of a piece converting to First-Class Mail would be less than that originally obtained in Standard Mail. Because of this, OCA proposes that a requirement be added to adjust the discount levels if the increase in contribution at any discount level falls below two cents per piece.

Valpak argues that within Standard Mail, the mix of Regular and ECR that converts affects the increase in contribution since ECR has a much larger per piece contribution than Standard Regular. Should ECR make up a larger share of the converted mail than projected, the resulting increase in contribution would be less than projected by the Postal Service. On brief, Valpak also presents an alternative calculation of contribution benefits that incorporates forwarding costs.

As discussed in the analysis of the address correction element, the Commission finds the OCA’s estimate of the total impact of forwarding rates exaggerated. OCA is correct that above average forwarding rates for converted mail would reduce the increase in contribution for each converted piece. While the Commission recognizes that the increase in contribution from new First-Class Mail volume may be less than calculated it does not believe it is likely that the total new contribution will be negative.

Moreover, the Commission does not require that the increase in contribution be positive for every piece, and the basis of the Commission's recommendation is not dependent on contribution resulting from increased First-Class Mail volumes.

The Commission's acceptance of this agreement is predicted on a stop-loss value that effectively does not depend on new contribution generated by pieces converting from Standard Mail to First-Class Mail. Therefore, a reduced estimate of contribution from new First-Class Mail volume generated by the Negotiated Service Agreement is not sufficient reason to not recommend the Negotiated Service Agreement. The stop-loss value calculated using the method employed in the Capital One case (which is approximately the same as the negotiated value) depends only on the savings from the ACS provision being less than the revenue leakage even when all the discounted pieces are anyhow volume.

The Commission estimates that the conversion of a percentage of DFS's marketing mail from Standard Mail to First-Class Mail will generate an additional $2.1 million in contribution for the Postal Service. See Table 5, Section C. The discounts provide a means for DFS to participate in the savings realized by the Service from the ACS portion of the Negotiated Service Agreement. They also provide DFS with an incentive to generate additional First-Class Mail volume. The Commission estimates the Postal Service will sustain a loss of $3.2 in contribution from discounts on First-Class Mail that would have been mailed anyway absent the discount. See Table 5, Section B.

Overall Financial Impact. The Commission estimates that the net financial effect of the DFS Negotiated Service Agreement will benefit the Postal Service by an increase in contribution of $6,985,400 over the three year life of the agreement. The net effect of the address correction service element is a Postal Service cost savings of $8,109,798 — with $2,597,962 occurring in year one, $2,701,880 occurring in year two, and $2,809,956 occurring in year three. There will be a net loss of $(3,240,000) to the Postal Service because of discounts paid on before rates volumes, i.e., leakage — with $(1,230,000) occurring in year one, $(1,080,000) occurring in year two, and $(930,000) occurring in year three. The Postal Service will realize a net increase of $2,115,601 in contribution from new mail volume — with $449,702 occurring in year one, $766,352 occurring in year two, and $899,547 occurring in year three. These results are summarized in Table 5 below:

Table 5. Estimated Financial Effects of Negotiated Service Agreement at Forecast Volumes

	Year 1	Year 2	Year 3	Total NSA
A. Effects of ACS (Savings Estimate)				
First-Class Mail Marketing Letters:				
Avg. Savings from Returns	0.0167	0.0173	0.0180	
Avg. Savings (Cost) from Forwards	0.0000	0.0000	0.0000	
Total Avg. Savings from ACS	0.0167	0.0173	0.0180	
DFS Estimate of Before Rates Volume	156,000,000	156,000,000	156,000,000	
Net Contribution Gain from ACS (Savings)	**2,597,962**	**2,701,880**	**2,809,956**	**8,109,798**
B. Effects of Lost Contribution (Rev. Leakage)				
Before Rates First-Class Volume	451,000,000	446,000,000	441,000,000	
Volume Threshold for Discounts	405,000,000	405,000,000	405,000,000	
Before Rates Volume Eligible for Discounts	46,000,000	41,000,000	36,000,000	
Average Discount on "Exposed" Volume	0.0267	0.0263	0.0258	
Total Discounts on Before Rates Vol. (Leakage)	**1,230,000**	**1,080,000**	**930,000**	**3,240,000**
Net Increase in Contribution Before New Volume	**1,367,962**	**1,621,880**	**1,879,956**	**4,869,798**
C. Effects of New Volume				
DFS Estimate of Upgraded Mail:				
Volume Upgraded from Standard	13,000,000	18,000,000	18,000,000	
New Statement (Operations) Mail Volume	-	1,000,000	2,000,000	
Standard Mail (Before Rates)				
Average Revenue	0.1755	0.1755	0.1755	
Average Cost	0.0870	0.0905	0.0941	
Average Contribution	0.0885	0.0850	0.0814	
First-Class Mail Marketing Letters (After Rates)				
Average Revenue (Undiscounted)	0.2885	0.2885	0.2885	
After Rates Avg. Cost (incl. contingency)	0.1354	0.1408	0.1465	
Average Contribution (Undiscounted)	0.1531	0.1476	0.1420	
Increase in Avg. Contribution (Undiscounted)	0.0646	0.0627	0.0606	
Total Increase in Contribution (Undiscounted)	839,702	1,127,825	1,091,591	
Marginal Discount	0.0300	0.0300	0.0300	
Marginal Increase in Contribution (Discounted)	0.0346	0.0327	0.0306	
Average Discount	0.0300	0.0300	0.0300	
Average Contribution (Discounted)	0.1231	0.1176	0.1120	
Average Increase in Contribution (Discounted)	0.0346	0.0327	0.0306	
Increase in Contribution from Marketing Mail	449,702	587,825	551,591	
Increase in Contribution from Operations Mail	-	178,527	347,956	
Increase in Contribution from New Volume	449,702	766,352	899,547	**2,115,601**
Net Increase in Contribution (DFS Volume Est.)	**1,817,664**	**2,388,233**	**2,779,503**	**6,985,400**
Total Discounts Awarded	(1,620,000)	(1,650,000)	(1,530,000)	**(4,800,000)**

C. Stop-Loss Mechanisms

Stop-loss mechanisms are employed to reduce or eliminate financial risk associated with uncertainties, which can be due to either the inability to accurately forecast into the future, or due to other exogenous factors beyond the control of the participants. The Capital One Negotiated Service Agreement stop-loss cap was recommended to reduce or eliminate the risk that the Postal Service would lose money under the agreement given the uncertainty of forecasted mail volumes. To some extent, uncertainty of forecasts will exist with any functionally equivalent agreement.

The DFS Negotiated Service Agreement includes a “negotiated” cap. It also provides other mechanisms such as annual threshold adjustments and contingencies for dealing with mergers and acquisitions which are designed to deal with other risks associated with the agreement. Every agreement could exhibit more than one form of risk, and for each risk there might be more than one acceptable form of stop-loss mechanism. For an example of possible approaches, after OCA calculates two Capital One Negotiated Agreement style stop-loss mechanisms for the DFS Negotiated Service Agreement, it proposes a third alternative mechanism which focuses on profitability at the margin by adjusting discount levels.

After examining the alternative proposals, the Commission finds the mechanisms employed in the DFS Negotiated Service Agreement sufficient to adequately protect the interests of the Postal Service and to assure that other mailers will not be made worse off due to the agreement.

Calculation of Stop-Loss Cap in Baseline Agreement. The Capital One Negotiated Service Agreement calculates the stop-loss cap dollar value by finding the point where the ACS savings (added contribution) equals the volume discount leakage (lost contribution) during the test year. At this point, the net contribution as a result of the Negotiated Service Agreement is zero. PRC Op. MC2002-2, paras. 8024–31. The dollar value represented by this point is then multiplied by three to provide for a cumulative limit over the three years of the agreement. Finally, the Commission applies a 95 percent pass-through which results in a cumulative three-year stop-loss limit of $40.637 million.

Calculation of Competitive Cap in Request. In the Request, the DFS Negotiated Service Agreement sets a "competitive" cap of $13 million. This dollar value is set by agreement reached through the negotiation process. It is proportional to the Capital One stop-loss provision based on the ratio of the first-year volume projections of Capital One to the first-year volume projections of DFS. The Presiding Officer inquired whether the co-proponents view the negotiated "competitive cap" as a satisfactory equivalent substitute for the stop-loss provision recommended by the Commission and approved by the Governors in the Capital One Negotiated Service Agreement. POIR No.1, question 5. Both the Postal Service and DFS indicated that they view the competitive cap as a satisfactory equivalent substitute.[23]

C*ommission's Calculation of Stop-Loss Cap Using the Baseline Agreement Methodology.* The stop-loss cap recommended by the Commission in the Capital One Negotiated Service Agreement provides a means of protecting mailers from potential adverse effects of lost contribution without the need to rely on volume forecasts. The same methodology, with one modification, could be applied to the DFS Negotiated Service Agreement using inputs specific to DFS. After making this modification, as explained below, the Commission calculates a stop-loss value of $11.8 million. See Table 6.

The DFS Negotiated Service Agreement mechanism to adjust the discount thresholds in response to changes in the number of customer accounts virtually eliminates any uncertainty with respect to the estimated volume of statement mail. Assuming that changes in customer account volume are highly correlated with changes in statement mail volume, it can be assumed that increases in before rates statement volume will not result in additional leakage, because the increases will be offset by the

[23] Tr. 2/237 (Response of United States Postal Service to Presiding Officer's Information Request No. 1, Question 5); Tr. 2/81-82 (Response of DFS to Presiding Officer's Information Request No. 1, Question 5).

upward adjustment of the discount thresholds. Thus, where the stop-loss cap in the baseline agreement was calculated assuming a constant mix of customer and solicitation mail, the stop-loss cap for the DFS Negotiated Service Agreement is calculated by holding statement mail volume at the forecasted levels.

Table 6. Calculation of Stop-Loss Cap

	Year 1	Year 2	Year 3	Total NSA
A. Effects of ACS (Savings Estimate)				
First-Class Mail Marketing Letters:				
Avg. Savings from Returns	0.0167	0.0173	0.0180	
Avg. Savings (Cost) from Forwards	0.0000	0.0000	0.0000	
Total Avg. Savings from ACS	0.0167	0.0173	0.0180	
Break-Even Before Rates Volume	224,896,304	238,437,125	252,895,202	
Net Contribution Gain from ACS (Savings)	**3,745,334**	**4,129,671**	**4,555,284**	**12,430,288**
B. Effects of Lost Contribution (Revenue Leakage)				
Break-Even Before Rates First-Class Volume	519,896,304	528,437,125	537,895,202	
Volume Threshold for Discounts	405,000,000	405,000,000	405,000,000	
Before Rates Volume Eligible for Discounts	114,896,304	123,437,125	132,895,202	
Average Discount on "Exposed" Volume	0.0326	0.0335	0.0343	
Total Discounts on Before Rates Volume (Leakage)	**3,745,334**	**4,129,671**	**4,555,284**	**12,430,288**
Net Increase in Contribution	**(0)**	**(0)**	**(0)**	**(0)**
Savings From ACS at Break-Even Volume	12,430,288			
Passthough Percentage	95%			
Stop-Loss Cap Amount	**$ 11,808,774**			

OCA Argument. On brief, OCA presents three stop-loss mechanisms. The first two are based on the methodology the Commission recommended for the Capital One Negotiated Service Agreement. To the extent that anyhow volume poses a risk, OCA contends that this risk can be eliminated through these types of stop-loss mechanisms.[24] However, OCA does not consider the “anyhow” volume to be the most likely cause of financial risk to the Postal Service. It considers the narrow contribution

[24] Anyhow volume or free rider mail can be described as mail that is receiving benefit from the Negotiated Service Agreement, but would have been sent anyway absent the agreement.

margins as more significant to financial risk in combination with DFS's unknown forwarding rate. Thus, OCA proposes a third alternative mechanism, which annually adjusts discount levels based on contribution at the marginal rates. OCA Brief at 18-30.

OCA asserts that the competitive cap proposed in the DFS Negotiated Service Agreement is unsatisfactory, because the competitive cap bears no relationship to the cost savings generated from participation in the electronic address correction service program for undeliverable as addressed mail, and it is larger in amount than would be calculated using the Commission's Capital One Negotiated Service Agreement methodology. OCA estimates that using the Commission's Capital One Negotiated Service Agreement methodology results in a DFS Negotiated Service Agreement stop-loss cap of $8.57 million (95 percent of the estimated ACS related cost savings), which is a lower value than the proposed negotiated cap. This methodology assumes that the before and after rates ratio of solicitation mail to total First-Class Mail volume remains constant.

OCA calculates a second modified stop-loss cap to reflect its view that the DFS volume projections are more reliable than those presented for Capital One. The Commission's methodology is again employed, however any extra before rates volume is assumed to be entirely marketing mail. This results in a stop-loss cap of $11.6 million (95 percent of the estimated ACS related cost savings).

OCA also proposes a third alternative stop-loss mechanism which adjusts discounts (if necessary) in years two and three so as to maintain the minimum estimated year one unit contribution (i.e., two cents). Id. at 31-47. The Commission's version of witness Ayub's model would be rerun at the end of years one and two using actual data from the data collection plan and inputs such as return rates, billing determinants, subclass attributable costs, etc., adjusted to reflect actual experience during the previous year of the Negotiated Service Agreement. If the minimum year one unit contribution is determined to be less than two cents, the discounts would be adjusted downward. OCA contends that this proposed stop-loss mechanism has the advantage of not setting a limit on the volume of mail that DFS could shift from Standard

Mail to First-Class Mail, so long as the new volume makes a meaningful contribution to institutional costs.

Postal Service Argument. The Postal Service is fundamentally opposed to Capital One Negotiated Service Agreement style stop-loss mechanisms because it believes that they hinder the ultimate objective of utilizing Negotiated Service Agreements as a tool to increase net contribution, and they tend to limit participation to only large volume mailers. Moreover, the Postal Service contends that stop-loss mechanisms merely operate to have the Postal Service share cost savings with a mailer, and they fail to acknowledge any contribution from new induced volume. USPS Brief at 14-16. Furthermore, the Postal Service argues that DFS's volume history and projections, as compared to Capital One's, do not justify the imposition of a cap. Id. at 16-18.

The Postal Service also opposes the OCA alternative proposal to adjust the discount levels to attain a minimum contribution. It argues that the proposal represents a significant, unacceptable restructuring of the bargain, and that there is no evidence on whether a net contribution of 2.0 cents at the margin is sufficient, or that a contribution of less than 2.0 cents is insufficient. USPS Reply Brief at 15-16.

The Postal Service agrees with OCA that it is more accurate to assume that the mix of marketing mail versus operations mail will not remain constant, and that most if not all new volume above forecasts will be marketing mail. These assumptions would effect the calculation of a stop-loss cap. Id. at 14-15. Nonetheless, the Postal Service urges the Commission to recommend the competitive cap negotiated by the parties. USPS Brief at 18-20.

J. P. Morgan Chase Argument. J. P. Morgan Chase also opposes the OCA alternative proposal to adjust the discount levels to attain a minimum contribution. It argues that the Commission's focus should be on the agreement's overall profitability, and not on the marginal or incremental contribution. It suggests that an after the fact adjustment mechanism would amount to an unlawful delegation of the Commission's ratemaking authority to the Postal Service. It also believes that such mechanism's will reduce a mailer's willingness to enter into Negotiated Service Agreements because they could alter the allocation of risks initially bargained for and alter the expected economic value of the contract. J. P. Morgan Chase Reply Brief at 11-20.

Valpak Argument. Valpak contends that the Commission should seek to develop methods to protect the Postal Service and mailers against any adverse financial impact from the DFS Negotiated Service Agreement. It argues that it is important to consider profitability at the margin, which it contends must be positive. Valpak notes that the negotiated cap will "limit the extent to which any possible marginal losses could offset more certain marginal profitability at lower discount levels." Valpak also considers the OCA's alternative stop-loss mechanism meritorious. As another option to protect the Postal Service and mailers, Valpak proposes to require DFS to pay the cost of all forwards in excess of the assumed level. Valpak Brief at 39-41.

Stop-Loss Cap Recommendation. The analysis of the financial impact of the proposal is based on assumptions about the future volumes of DFS's First-Class marketing mail, both in the absence and presence of the Negotiated Service Agreement. The volume estimates presented by DFS provide a point of reference for evaluating the expected financial effects of the agreement. However, the estimates implicitly incorporate assumptions for myriad non-price factors that affect mailing behavior far into the future and the record provides no means of evaluating the sensitivity of the estimates to changes in exogenous factors. Therefore, it is prudent for the Commission to consider the possible effects of deviations from the volume estimates, and ultimately to evaluate the proposal independent from them. The Commission believes that some form of stop-loss mechanism is necessary to account for these possibilities.

The Commission does not endorse the methodology used to determine the "negotiated" cap. The methodology implies that a mailer has a right to obtain a Negotiated Service Agreement and receive a (proportional) benefit from the Postal Service, whether or not the agreement is beneficial to the Postal Service. For the methodology to be acceptable, the functionally equivalent mailer would have to be similarly situated to the baseline mailer. Without attempting a complete definition of similarly situated, this would have to include similar mailing practices and characteristics, and in this instance similar forwarding and return rates. These characteristics also would have to induce a comparable benefit to the Postal Service. It is only by happenstance in this instance that the mailers are sufficiently similarly situated that the methodology resulted in a reasonable estimation of a stop-loss value.

The Commission does not recommend the OCA's third alternative stop-loss mechanism. It appears highly complex and difficult to apply when compared with the proposed relatively simple alternatives. There also are potential procedural, due process and statutory concerns with the proposal. The OCA's proposal, first introduced on brief, has not been subjected to a vetting through discovery or other forms of examination. There has been no discussion of whether this proposal rises to the level of an unlawful delegation of Commission authority under the Act as suggested by J. P. Morgan Chase. The data needed to make adjustments would not be subject to a full review, which effectively could put the Postal Service in the position of setting its own rates. Furthermore, the Commission has not been persuaded that the effect of forwarding rates on marginal profitability is as dire as supposed by OCA. Finally, the OCA alternative does not protect mailers from revenue leakage resulting from inaccurate volume estimates.

The $13 million competitive cap value is reasonable in comparison to the $11.8 stop-loss cap calculated by the Commission. The competitive cap has the advantage of being acceptable to the parties to the contract as it was determined by agreement through arms-length negotiations. The higher value lessens the concern that potential new volume will be cut off because of an overly restrictive cap. The Commission accepts the proposition that there is more than one reasonable value for a cap, as long as the cap serves its intended purpose. The Commission finds that the competitive cap serves the intended purpose of protecting the Postal Service (and other mailers not party to the contract) from undue financial risk or harm due to uncertainties in mail volume forecasts, and other exogenous factors.

D. Competitive Issues

Every request predicated on a functionally equivalent Negotiated Service Agreement is required to consider the fairness and equity of the agreement in regard to other users of the mail, and the fairness and equity of the agreement in regard to the competitors of the parties to the agreement. See Rule 196(a)(i) and (ii). In this docket, witness Ayub relies substantially on the competitive impact analysis presented in Docket No. MC2002-2. He argues that any competitive impact on competitors should be less in this docket than in Docket No. MC2002-2.

The Postal Service notes that no participant in this proceeding asserts that the DFS Negotiated Service Agreement will have a negative competitive impact on competitors of DFS, or any other users of the mail. USPS Reply Brief at 3.

On brief, Valpak comments that the Negotiated Service Agreement could increase the undeliverable as addressed cost burden on all First-Class Mail, but only if DFS converts substantially more Standard Mail to First-Class Mail than projected. Valpak Brief at 16-19. Valpak also discusses alleged pricing anomalies between electronic address correction service and manual return service. Id. at 28-39.

The Commission closely examined competitive issues in baseline Docket No. MC2002-2. It considered competitive issues of such import that the Commission's focus in Docket No. MC2002-2 was "on assuring that the NSA will not make mailers other than Capital One worse off." PRC Op. MC2002-2, para. 8006. The Commission independently sponsored Professor John C. Panzar as a witness to examine the economic aspects of the agreement. The Postal Service sponsored rebuttal witness B. Kelly Eakin to address and further develop many of the issues raised in Panzar's testimony. After the addition of one modification to the agreement, the Commission found that there was not a sufficient indication of competitive harm to prevent recommendation of the Capital One Negotiated Service Agreement. The Commission has not been presented with record evidence in this docket, MC2004-4, to conclude that the competitive effects of this agreement will be different from the competitive effects of the Capital One agreement.

The Commission's Docket No. MC2002-2 recommendation also rests, in part, on the Postal Service's express intent "to make the essential features of the Capital One agreement available to other similarly situated mailers." Id., para. 7021. Preventing similarly situated mailers from obtaining functionally equivalent agreements is potentially discriminatory. By making a functionally equivalent agreement available to DFS, the Postal Service has taken an important step in reducing the potential for competitive harm caused by this style of agreement.

The Valpak comments on the potential for increasing the undeliverable as addressed cost burden on other mailers relies on assumptions for mail volumes not supported on the record. It is also dependent on the assumption that DFS's forwarding and return rates will be above the systemwide average. The Commission considers Valpak's pricing anomaly comments to be most applicable to specific special services, and not a reflection on the fairness and equity of the DFS Negotiated Service Agreement. The anomaly issue is discussed further below.

The Commission provided notice in the *Federal Register* of Docket No. MC2004-4 on June 30, 2004. 69 Fed. Reg. 39522 (2004). Two parties intervened that appear to have interests in the same industry segment as DFS — American Bankers Association and J. P. Morgan Chase. American Bankers Association asserts that its membership is composed of banks located in each of the 50 states and the District of Columbia. Neither intervenor commented on negative competitive aspects of the proposed agreement. Capital One Services, Inc., a competitor of DFS and a proponent of the baseline Negotiated Service Agreement did not intervene.

With adequate notice provided, and the portion of the industry represented providing no negative comment, the Commission has no basis for finding any adverse competitive effect due to the DFS Negotiated Service Agreement, other than what is already discussed in Docket No. MC2002-2. A negative competitive effect could still exist, but there is no record evidence to support this conclusion. The Commission would welcome comments related to the competitive nature of Negotiated Service Agreements in future proceedings.

E. Statutory Criteria

In every rate and classification decision the Commission is required to evaluate how the criteria of sections 3622 and 3623 apply to the pending proposal. The Commission has review each of the applicable factors and determined that on balance, its recommended decision is consistent with those policies.

The Commission's conclusion relies heavily on the Commission's findings and conclusions in Docket No. MC2002-2. See PRC Op. MC2002-2, paras. 8032-8047. This reliance is justified because the proposed DFS Negotiated Service Agreement is functionally equivalent, although not identical, to the Capital One Negotiated Service Agreement. General considerations, such as the legality and desirability of the Negotiated Service Agreement classification, also were comprehensively examined in Docket No. MC2002-2. Id. paras. 3001-3063.

Every request predicated on a functionally equivalent Negotiated Service Agreement is required to consider the financial impact of the agreement on the Postal Service, the fairness and equity of the agreement in regard to other users of the mail, and the fairness and equity of the agreement in regard to the competitors of the parties to the agreement. These items directly relate to the fairness and equity requirements of § 3622(b)(1) and § 3623(c)(1).

The Commission's analysis of competitive issues discussed above concluded that there is no indication that the DFS Negotiated Service Agreement is either not fair or not equitable in regard to other users of the mail, or in regard to the competitors of the parties to the agreement. Significantly, the Commission also found the baseline Capital One Negotiated Service Agreement fair and equitable. Therefore, the Commission finds that the DFS Negotiated Service Agreement complies with the fair and equitable standards of the Act.

The Commission has considered the effect of the proposed rates on the general public, business mail users, and enterprises in the private sector in accordance with § 3622(b)(4). The agreement benefits other users of the mail by increasing contribution to the Postal Service while having no adverse effect on the rates of other mailers.

Furthermore, no participant has indication that the DFS Negotiated Service Agreement rates will cause any competitive harm to other users of the mail.

The DFS Negotiated Service Agreement should reduce Postal Service costs by not requiring the manual return of undeliverable as addressed solicitations mail that can not be forwarded. The electronic return information received by DFS can be used to better prepare its mailings and reduce the introduction of undeliverable as addressed solicitations into the Postal System. Both of these benefits address the § 3622(b)(6) requirement to consider the degree of preparation of mail by the mailer and its effect upon reducing Postal Service costs.

The Postal Service would not be receiving these benefits unless it was able to tailor rates and classifications to the specific characteristics of its relationship with DFS. The Negotiated Service Agreement classification allows the Postal Service to do this. Thus, the Negotiated Service Agreement classification is highly desirable from the point of view of both the user and the Postal Service, § 3623(c)(5).

A substantial portion of the Docket No. MC2004-4 record is devoted to the financial analysis of the DFS Negotiated Service Agreement. The Commission's independent financial analysis concludes that the DFS Negotiated Service Agreement covers its direct and indirect attributable costs, and provides a reasonable contribution to other Postal Service costs in compliance with the § 3622(b)(3) requirement of the Act.

F. DMCS Language

The Commission recommends the addition of § 611 to the Domestic Mail Classification Schedule. The language recommended by the Commission differs from the language proposed by the Postal Service only in that it specifies the termination date of the Negotiated Service Agreement without having to refer to additional documents. Also, minor technical corrections were incorporated that should have no effect on the intended meaning.

The Commission also recommends the addition of Rate Schedules 611A and 611B, as proposed by the Postal Service. Minor technical changes were incorporated to improve the presentation of the data.

G. Data Collection Plan

The Commission recommends the data collection plan as proposed by the Postal Service with the addition of two provisions. See Tr. 2/124–25. Rule 193(g) requires the data collection plan to compare the "planned" or estimated mailer-specific costs, volumes, and revenues with the "actual" mailer-specific costs, volumes, and revenues. The Postal Service shall report this comparison as a provision of its data collection plan. Presenting this information as a comparison should provide a succinct indication of the Negotiated Service Agreement's progress toward reaching its goals.

On brief, OCA notes that the Postal Service has omitted without explanation a provision that the Commission added to the Capital One data collection plan. OCA Brief at 15. That provision requires the Postal Service to report on the "[v]olume of Standard Mail solicitations by rate category in eligible Capital One permit accounts." See PRC Op. MC2002-2, para. 9028-29 (footnote omitted). OCA deletes the word "eligible" from its proposed DFS version because "eligible" applies to First-Class marketing mail whose permit numbers can be identified, however, any of DFS's Standard Mail credit card solicitations appear to be candidates for conversion to First-Class Mail. The Postal Service and DFS agree to this change. USPS Reply Brief at 12-13; DFS Reply Brief at 2. The Commission recommends the addition of this provision to the DFS data collection plan to require the Postal Service to report on the volume of Standard Mail solicitations by rate category in DFS permit accounts.

OCA also requests the addition of a provision which would require DFS to describe its procedures for receiving and utilizing eACS information on First-Class Mail solicitation pieces that have been forwarded or returned. OCA Brief at 15-17. The Postal Service and DFS object to the addition of this provision. USPS Reply Brief at 13-14; DFS Reply Brief at 2.

Understanding the procedures for utilizing eACS information might be relevant to the Commission's consideration of a request because this could have a bearing on the comparable benefit that the Postal Service may or may not receive from an agreement. However, reporting on these procedures as part of a data collection plan after the request has been recommended does not further inform the Commission. The focus of a Negotiated Service Agreement data collection plan should be on reviewing the progress of the agreement and its effects on the Postal Service. The existing data elements reported by the data collection plan should make it apparent whether or not DFS effectively utilizes eACS information. The actual data will better inform the Commission than a description of the procedures for utilizing eACS information. The Commission does not recommend the addition of this element.

The data collection and reporting required during the Negotiated Service Agreement are set out below.

1. The volume of First-Class Mail solicitations by rate category in eligible DFS permit accounts.

2. The volume of First-Class Mail customer mail by rate category in eligible DFS permit accounts.

3. The amount of discounts paid to DFS for First-Class Mail by incremental volume block.

4. The volume of First-Class Mail solicitations bearing the ACS endorsement that are physically returned to DFS.

5. The number of electronic address correction notices provided to DFS for forwarded solicitation mailpieces, including the number of notices processed by CFS units and separately for PARS (when fully operational).

6. The number of electronic address correction notices provided to DFS for solicitation mailpieces that would otherwise be physically returned, including the number of notices processed by CFS units and separately for PARS (when fully operational).

7. Monthly estimate of the amount of time spent on compliance activity and a description of the activities performed.

8. For each First-Class Mail solicitation mailing list run against NCOA, DFS will provide NCOA contractor reports that separately identify the number of address records checked and the number of corrections made.

9. For each Change of Address record that is used to forward a piece of DFS solicitation mail through ACS under the Agreement, the Postal Service will provide the date the record was created, its move effective date, whether it was for a family or individual move, and each date that the record was used to forward a mailpiece. No other information from the record would be provided.

10. As part of each data collection plan report, the Postal Service will provide an evaluation of the impact of the agreement on contribution. It will also provide an assessment of trends of DFS's First-Class Mail volume as compared to overall First-Class Mail volume.

11. Volume of Standard Mail solicitations by rate category in DFS permit accounts.

12. A comparison of the estimated mailer-specific costs, volumes, and revenues with the actual mailer-specific costs, volumes, and revenues.

Data collected under the plan shall be reported annually following the end of the fiscal year, with the first report being made available at the end of FY 2004. The Postal Service shall provide the data in a PC-available format.

H. Miscellaneous Items

Pricing Anomalies of First-Class Mail Return Service. Valpak discusses what it describes as the highly illogical cost-price relationship between manual return service and electronic Address Correction Service. Valpak Brief at 28-39. It explains that the higher cost manual return service is provided free of charge, whereas the Postal Service imposes a 20 cents fee for the lower cost electronic Address Correction Service. Valpak contends that there are mailer advantages to using the electronic Address Correction Service, but those advantages are not outweighed by the fee. It argues that mailers appear to place a low value on return information. Valpak notes that the market is rationally reacting to the current pricing signals by limiting its use of electronic Address Correction Service.

Valpak asserts that the Negotiated Service Agreement corrects the pricing anomaly for DFS, but does nothing for other mailers. It urges the Commission to consider the fairness of this pricing structure to other mailers. Valpak proffers that this problem could be resolved by a niche classification to eliminate the electronic Address Correction Service fee for First-Class mailers. It also notes that the savings associated with the address correction element has functioned as a justification for recommending Negotiated Service Agreements, and ponders whether this fact will delay or preclude the Postal Service from taking action on this issue.

The Commission is in general agreement with Valpak's argument that the current design of rates and fees in First-Class Mail sends an inefficient signal to mailers about the relative (Postal Service) costs of processing UAA mail. The Commission discussed this same issue in PRC Op. MC2002-2, para. 6005. The Commission strongly encourages the Postal Service to consider and develop solutions to resolve this issue, and is eager to assist the Postal Service in implementing a solution. Hopefully, either a niche classification or a broader solution can be developed in time for consideration in the next omnibus rate case.

Elimination of Free Riders in Years Two and Three. On brief, OCA voices its opposition to the payment of discounts for free rider mail pieces unless there are particularly extenuating circumstances. OCA Brief at 48-53. Free rider mail pieces can be described as mail pieces that are receiving some benefit from the Negotiated Service Agreement, but would have been sent anyway even absent the agreement. The DFS Negotiated Service Agreement allows free rider mail pieces for all three years of the agreement.

However, OCA does not oppose the payment of discounts on free rider mail pieces during the first year of the DFS Negotiated Service Agreement because discount payments could serve as an offset to the regulatory expenses, associated risks and management costs associated with the implementation of the agreement. It does believe that in the second and third years of the agreement, the discount threshold should be adjusted upward to avoid free-riders.

J. P. Morgan Chase opposes OCA's proposal to increase the threshold levels in years two and three. It agues that OCA's focus is misplaced, looking at individual components of the agreement instead of looking at the profitability of the agreement as a whole. J. P. Morgan Chase Reply Brief at 20-21. The Postal Service also opposes the OCA proposal. It argues that this is an "attempt to restructure the deal, ignore the ACS savings, and view the functional elements of the NSA in isolation." USPS Reply Brief at 17.

The Commission is concerned with paying discounts to mail pieces that would have been mailed anyway absent a discount. To account for this concern, the Commission scrutinizes the overall agreement to determine whether the Postal Service (and thus other mailers) is made better off by any particular Negotiated Service Agreement. It does not view the free rider mail piece issue in isolation. The Commission's scrutiny extends to reviewing counterbalancing elements of the agreement and any stop-loss mechanisms to assure that the Postal Service limits the risk to other mailers. The Commission is satisfied that the overall DFS Negotiated Service Agreement can be beneficial to the Postal Service even though free rider mail is allowed during all three years of the agreement.

The Commission does not agree with the rationale that discounted free rider mail pieces are only justified for the specific purpose of allowing DFS to recover its regulatory and other specific internal costs. The Commission strives to make the regulatory process efficient, and thus as low cost as possible for all participants. However, the Commission generally does not consider internal participant costs (costs not incurred by the Postal Service) in its recommendations. These are costs that are part of the cost of doing business and are under the control of the participant. They would be difficult for the Commission to review without voluntary disclosure, and would be difficult to verify. They are costs which may influence a participant's decision on whether or not to participate in an agreement with the Postal Service, but they do not have a direct impact on the finances of the Postal Service.

Marginal Profitability. OCA and Valpak urge the Commission to focus its financial analysis not only on average profitability, but also on marginal profitability. Valpak argues such analysis is mandated by § 3622(b)(3). Valpak Brief at 15. OCA argues that at the highest discount, converted mail pieces will actually loss money. OCA contends that this is a violation of § 3622(b)(3). OCA Brief at 45-46.

Section 3622(b)(3) requires "each class of mail or type of mail service bear the direct and indirect postal service costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonable assigned to such class or type." The Commission consistently has interpreted this requirement as not applicable to an individual rate cell of a multi-cell rate schedule. Noncompliance with § 3622(b)(3) could indicate that other mailers were being made worse off by the agreement. This potentially could indicate that the agreement is not fair or equitable. Noncompliance with of § 3622(b)(3) pertinent to an agreement also could indicate that the applicable subclass as a whole is in noncompliance with § 3622(b)(3). In that case, the overall subclass would have to be examined.

The marginal profitability analysis urged by OCA and Valpak in relation to § 3622(b)(3) is misplaced in one other important aspect. Both participants focus on profitability, or the difference in contribution of a mailpiece sent at the marginal after Negotiated Service Agreement First-Class rate minus a mailpiece sent at the before Negotiated Service Agreement Standard Mail Rate. Both participants argue the potential for this difference in contribution could be negative at the margins. When performing a § 3622(b)(3) analysis, the Commission does not look at the "difference in contribution," but at the "actual" after rates contribution provided by the mailpiece. Under what the Commission believes are plausible scenarios, the actual contribution of all rate cells under the DFS Negotiated Service Agreement remain positive.

I. Conclusion

Having made the above determinations, the Commission has reviewed the evidentiary record pursuant to its statutory obligation under chapter 36 of title 39 of the U.S. Code. This includes an independent review of the testimony of Postal Service witness Ayub, the testimony of Discover Financial Services witness Giffney, the designated written cross-examination, the designated responses to Presiding Officer Information Requests, and the designated testimony from previously concluded dockets MC2002-2 and R2001-1. This review leads to the conclusion that the record supports the proposed classification changes and the related discounts set out in the June 21, 2004 Request, and that these changes are consistent with the policies of the Postal Reorganization Act. The Commission therefore recommends to the Governors of the Postal Service that the DMCS be amended as set forth in Appendices One and Two of the accompanying Recommended Decision.

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners:	George Omas, Chairman; Tony Hammond, Vice Chairman; Dana B. Covington, Sr.; and Ruth Y. Goldway

Rate And Service Changes To Implement Functionally Equivalent Negotiated Service Agreement With Discover Financial Services	Docket No. MC2004-4

RECOMMENDED DECISION

(Issued September 30, 2004)

The Commission, having considered the Postal Service Request has issued its Opinion thereon. Based on that Opinion, which is attached hereto and made a part hereof,

IT IS ORDERED:

1. The Commission's Opinion and Recommended Decision shall be transmitted to the Governors of the Postal Service and the Governors shall thereby be advised that the proposed discounts (set forth in Appendix One) and the proposed amendments to the Domestic Mail Classification Schedule (set forth in Appendix Two) are in accordance with the policies of title 39, United States Code, and the factors set forth in §§ 3622(b) and 3623(c) thereof; and they are hereby recommended to the Governors for approval.

2. Except to the extent granted or otherwise disposed of herein, all motions, exceptions, and other outstanding requests filed in Docket No. MC2004-4 hereby are denied.

By the Commission.

(S E A L)

Steven W. Williams
Secretary

RECOMMENDED CHANGES IN RATE SCHEDULES

The following changes represent the rate schedule recommendations of the Postal Rate Commission in response to the Postal Service's Docket No. MC2004-4 Request. The changes require the addition of two new rate schedules — 611A and 611B. The underlined text signifies that the text is new, and shall appear in addition to all other rate schedule text.

DISCOVER FINANCIAL SERVICES NSA
RATE SCHEDULE 611A

Volume Block	Incremental Discounts
405,000,000 to 435,000,000	2.5¢
435,000,001 to 465,000,000	3.0¢
465,000,001 to 490,000,000	3.5¢
490,000,001 to 515,000,000	4.0¢
515,000,001 and above	4.5¢

DISCOVER FINANCIAL SERVICES NSA
RATE SCHEDULE 611B
FOR ADJUSTED THRESHOLD (A.T.)

Volume Block		Incremental Discounts
A.T.	to A.T. + 30,000,000	2.5¢
A.T. + 30,000,001	to A.T. + 60,000,000	3.0¢
A.T. + 60,000,001	to A.T. + 85,000,000	3.5¢
A.T. + 85,000,001	to A.T. + 110,000,000	4.0¢
A.T. + 110,000,001 and above		4.5¢

RECOMMENDED CHANGE IN DOMESTIC MAIL CLASSIFICATION SCHEDULE

The following material represents changes to the Domestic Mail Classification Schedule recommended by the Postal Rate Commission in response to the Postal Service's Docket No. MC2004-4 Request. The underlined text signifies that the text is new, and shall appear in addition to all other Domestic Mail Classification Schedule text. Information to be added upon approval by the Board of Governors appears in brackets and is underlined.

NEGOTIATED SERVICE AGREEMENTS
CLASSIFICATION SCHEDULE

611 DISCOVER FINANCIAL SERVICES NEGOTIATED SERVICE AGREEMENT

611.1 Eligible First-Class Mail

Eligible First-Class Mail under this section is defined as: (1) Discover Financial Services' First-Class Mail customer correspondence related to credit and banking products and services account holders; and (2) First-Class Mail solicitations for credit and banking products that bear the endorsement specified by the Postal Service. Eligible First-Class Mail does not include Business Reply Mail, Qualified Business Reply Mail, Cards, or Priority Mail.

611.2 Waiver of Address Correction Fees

The fees for address correction in Fee Schedule 911 are waived for those First-Class Mail solicitations on which Discover Financial Services uses the endorsement specified by the Postal Service, if:

a. Discover Financial Services mails more than 350 million pieces of eligible First-Class Mail within the first year after implementation of this section, and

b. Discover Financial Services updates any databases it uses for solicitation mail, other than First-Class Mail customer correspondence related to account holders, as specified by the Postal Service.

If, during the first year after implementation, Discover Financial Services mails fewer than 350 million pieces of eligible First-Class Mail, Discover Financial Services agrees to pay the greater of either (1) all address correction service fees under Fee Schedule 911, as specified by the Postal Service, for pieces receiving address correction service, or (2) $250,000.

611.3 First-Class Mail Discounts

611.31 Discount Threshold. The Discount Threshold is set at 405 million pieces of eligible First-Class Mail for the first year of the agreement.

611.32 Discounts. Discover Financial Services' eligible First-Class Mail is subject to the otherwise applicable First-Class Mail postage in Rate Schedule 221 less the discounts shown in Rate Schedule 611A, for the first year of the agreement if Discover Financial Services meets the Discount Threshold. The discounts apply only to volume above the Discount Threshold. Each incremental discount applies only to the incremental volume within each volume block.

611.33 Annual Threshold Adjustment. The Postal Service shall annually adjust the Discount Threshold based on the percentage change, from year to year, of Discover Financial Services' domestic gross active accounts, as that figure is reported quarterly in SEC filings. The beginning and ending points for each volume block in Rate Schedule 611A will increase or decrease by the same number as the increase or decrease in the Discount Threshold. Rate Schedule 611B will be applicable in lieu of Rate Schedule 611A if there is such an adjustment.

611.34 Threshold Adjustment for Acquisition or Merger. In the event that Discover Financial Services merges with or acquires an entity with annual First-Class Mail volume in excess of 10 million pieces in the year preceding the acquisition or merger, or in the event that, in any Postal Service fiscal year, Discover Financial Services merges with or acquires multiple entities with combined annual First-Class Mail volume in excess of 25 million pieces, the Discount Threshold will be adjusted upward by the volume of First-Class Mail sent by the other entity (or entities) during the 12 months preceding the merger or acquisition. Rate Schedule 611B will be applicable in lieu of Rate Schedule 611A if there is such an adjustment.

611.35 Discount Limit. The maximum cumulative discount available to Discover Financial Services over the duration of this NSA shall not exceed $13 million.

611.4 Rates

The rates applicable to this Agreement are set forth in Rate Schedules 611A and 611B.

611.5 Expiration

The provisions of section 611 expire on [insert date three years from implementation date set by the Board of Governors].

611.6 Precedence

To the extent any provision of section 611 is inconsistent with any other provision of the Domestic Mail Classification Schedule, the former shall control.

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