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

RATE AND SERVICES CHANGES TO IMPLEMENT FUNCTIONALLY EQUIVALENT NEGOTIATED SERVICE AGREEMENT WITH BANK ONE CORPORATION

Docket No. MC2004-3

INITIAL BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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TABLE OF CONTENTS

Introduction

The Capital One Negotiated Service Agreement (NSA) represented an incremental step in the progression of refining postal rates to suit the capabilities and needs of diverse mailers. Docket No. MC2002-2. The Capital One NSA, the first experiment in negotiated pricing, set an important precedent: that negotiated prices with a single mailer are consistent with the postal statutory scheme, as long as they are fair and equitable and are designed to provide a positive financial impact. Subsequent to MC2002-2, the Postal Rate Commission issued procedural rules designed to facilitate and expedite the consideration of NSAs, in keeping with the mandates of due process and the Postal Reorganization Act (PRA). The Postal Service and the Commission took the next logical step with their consideration of two NSAs that are functionally equivalent to the Capital One NSA: the Bank One NSA, in the instant case, and the Discover NSA, in Docket No. MC2004-4.

On September 30, 2004, the Commission issued its recommended decision in MC2004-4, a decision that itself extends the NSA experiment in a evolutionary rather than a revolutionary way. The Recommended Decision on the Discover NSA affirms or reaffirms key NSA principles. In its Opinion in the Discover proceeding, the Commission expressed the view that the focus of the assessment of an NSA should be on whether the overall financial contribution, and not the contribution of individual terms, is positive. It also stated that NSAs can be functionally equivalent to baseline NSAs if their terms and benefits are comparable, but not identical and that the fairness and equity of individual NSAs are best addressed by providing notice and opportunity to be heard to competitors of the NSA co-proponent. The Commission also found that terms designed to protect the Postal Service (and the interests of other mailers) should be tailored to the circumstances presented by the co-proponent.

The Postal Service, Bank One Corporation, Valpak Direct Marketing Systems, Inc., Valpak Dealers'Association, Inc. (collectively "Valpak") and the Office of Consumer Advocate, the only active parties in this case, have resolved their differences on the issues and have entered into a Modified Stipulation and Agreement. They have joined together to seek consideration of the Bank One NSA with a modification to the Domestic Mail Classification Schedule (DMCS) originally proposed.[1] The revised terms add an extra layer of protection against a negative financial outcome, while enabling the NSA to take root and have reasonable chance of success. Specifically, the Modified Stipulation and Agreement protects the Postal Service and other ratepayers from the risk of significant financial loss caused by errors in the projections of several mailer- specific cost elements.

Under the settlement, the stipulated Bank One stop-loss mechanism follows naturally from the settlement in the Capital One case, which provided, among other things, for the collection and reporting of mailer volume and cost data that would permit careful assessment of the success or failure of the proposed changes and the NSA. The Modified Stipulation and Agreement in the instant case, which also requires the collection of the same type of mailer-specific data, goes the next step: it requires an assessment of the original projections through the use of actual data. Then, if the cumulative result at the end of the second year of the agreement is negative, it limits the

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[1] See Attachment A to the Request of the United States Postal Service For A Recommended Decision on Classification, Rates, and Fees to Implement Functionally Equivalent negotiated Service Agreement with Bank One Corporation (June 21, 2004.) ("Request").

discounts available to Bank One to only those in the Rate Schedule that make a positive contribution.

As stated in their joint motion requesting consideration of the modified Stipulation and Agreement, the parties agree that this stipulated stop-loss mechanism is an attempt to move in the direction of designing a stop loss mechanism that prevents the Postal Service from suffering losses without reducing potential gains for the Postal Service and the NSA partner. The mechanism responds to the Commission's expressed desire for measures tailored to the circumstances in this case to protect the Postal Service and others not party to the NSA.

I. Procedural History

On June 21, 2004, pursuant to 39 U.S.C. §§ 3622 *et seq.* and 39 C.F.R. §§ 3001.190 *et seq.*, the United States Postal Service and Bank One Corporation (Bank One) jointly filed with the Commission a request for a decision recommending the establishment of rate and classification changes needed to implement a NSA between the Postal Service and Bank One. See Request. The grounds for the request are stated in the direct testimony of Postal Service witness Michael Plunkett (USPS-T-1); the testimonies of Bank One witnesses Brad Rappaport (BOC-T-1) and Lawrence G. Buc (BOC-T-2); and the answers of the co-proponents and their witnesses to the Presiding Officer's Information Requests and the discovery requests of other participants, all of which have been designated as written cross-examination.

The Commission docketed the request as Docket No. MC2004-3. [2] On

2 Notice and Order on Filing of Request Seeking Recommendation of Functionally Equivalent Service Agreement, June 24, 2004

July 23, 2004, the Presiding Officer ruled that the proposed NSA would be considered under Rule 196 as functionally equivalent to the Capital One NSA, which was recommended by the Commission in Docket No. MC2002-2.[3]

The following participants intervened in the case: Alliance of Nonprofit Mailers, American Bankers Association, American Postal Workers Union, AFL-CIO, Association for Postal Commerce, Discover Financial Services, Inc., Magazine Publishers of America, Inc., National Association of Postmasters of the United States, National Newspaper Association, National Postal Policy Council, Inc., Newspaper Association of America, Parcel Shippers Association, David B. Popkin, Valpak Dealers' Association, Inc., and Valpak Direct Marketing Systems, Inc. Except for the two Valpak entities and the Office of Consumer Advocate, no participant requested a hearing. Valpak and the OCA withdrew their hearing requests on August 20 [4] and September 2, 2004,[5] respectively.

The Postal Service and Bank One actively engaged in extensive settlement negotiations with the participants, as reported to the Commission in the reports of the settlement coordinator on July 22, August 5, August 20, September 2, and September 16, 2004. These reports also served to give all interested parties notice of the settlement negotiations.

On September 15, 2004, Bank One, the Postal Service, and the OCA

3 Presiding Officer's Ruling Establishing Procedural Schedule, POR No. MC2004-3/1, July 23, 2004.
4 Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Withdrawal of Protective Request for Hearing, August 20, 2004.
5 Office of the Consumer Advocate Statement Concerning the Need for a Hearing, August 17, 2004.

filed a Stipulation and Agreement with the Commission as a proposed settlement of this case. [6] The following parties signed that Stipulation and Agreement: the Alliance of Nonprofit Mailers, American Bankers Association, American Postal Workers Union, AFL-CIO, Association for Postal Commerce, Discover Financial Services, Inc., Magazine Publishers of America, Inc., National Association of Postmasters of the United States, National Postal Policy Council, and Parcel Shippers Association. The only parties that did not sign were the Newspaper Association of America, Mr. Popkin, and Valpak.

Valpak filed an opposition to the September 15 Stipulation and Agreement on September 27, 2004. [7] After further settlement discussion, Valpak joined the Postal Service, Bank One, and the OCA in a modification of the original settlement of the case and signed a Modified Stipulation and Agreement, which was filed on October 5, 2004. Also on that date, these four parties jointly moved to have the Modified Stipulation and Agreement as a basis for the recommended decision.[8] [9]

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[6] Stipulation and Agreement, September 15, 2004; See also Joint Motion of the United States Postal Service, Bank One Corporation, and the Office of the Consumer Advocate for Consideration of Stipulation and Agreement as the Basis for Recommended Decision, September 15, 2004.

7 Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments On Commission Consideration Of Proposed Settlement, September 27, 2004

8 Modified Stipulation and Agreement, October 5, 2004; Joint Motion of the United States Postal Service, Bank One Corporation, Valpak Direct Marketing Systems, Inc., Valpak Dealers' Association Inc., and the Office of the Consumer Advocate for Consideration of Modified Stipulation and Agreement as the Basis for Recommended Decision, October 5, 2004. The Postal Service expects that most, if not all, of the original signatories will remain parties to the settlement. As of this date, expressions of intent or new signatures have not been received.

[9] The Postal Service appreciates the efficient manner in which this docket has been handled. In order for NSAs for each their full potential as innovative mechanisms for

II. The Modified Stipulation and Agreement Carefully Tailors the Stop-Loss Mechanism to Bank One's Circumstances Under the NSA.

The Modified Stipulation and Agreement adds an innovative, yet suitable stop-loss mechanism to those the Commission has already considered in the Capital One NSA and the Discover NSA cases. It protects the Postal Service (and other ratepayers) from loss by incorporating actual data into an analysis of the cumulative impact of the deal, and then limits the discounts available only to those that will yield a positive result. It also protects the Postal Service (and other ratepayers) from the adverse consequences of a loss in new volume contribution that, as this record demonstrates, would occur if the stop-loss mechanism were based solely on an association between cost-savings and the amount of discounts. In this respect, the Bank One NSA, as modified, falls well within the ambit of acceptable functionally equivalent agreements, as will be discussed below. The Bank One stop-loss mechanism, which no party opposes, should be accepted as a valid method to limit risk.

A. The Bank One stop-loss mechanism uses actual mailer-specific data to measure the impact of the NSA and protect the Postal Service from loss.

The Bank One stop-loss mechanism is described in both the Modified Stipulation and Agreement and the accompanying joint motion for its consideration, and only a few highlights will be discussed here. The stipulated stop-loss mechanism uses three cost factors actually experienced during the first two years of the agreement by Bank One's marketing letter-shaped mail: the ACS success rate, the forwarding rate, and the return

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postal ratemaking to meet the needs of individual diverse mailers, functionally equivalent cases will need to be handled expeditiously.

rate. The source of these inputs will be the data reported as part of the Data Collection Plan.[10]

At the end of the second year of implementation, the actual data for these factors will be used in the model that witness Plunkett attached to his testimony (Appendix A to USPS-T-1), which is part of the evidentiary record in this case. Docket No. MC2004-3, Tr. 2/204-217.[11] No other inputs will change. If this analysis yields a positive cumulative effect, then the agreement proceeds without change. If the cumulative effect is negative, then a second analysis is performed to determine the contribution in each discount block. Only those discounts that yield a positive contribution will continue. As part of the Modified Stipulation and Agreement, the parties have attached a model that uses Appendix A to show exactly how this analysis will be conducted.

Before the stop-loss mechanism can be triggered, the initial review of the *cumulative* impact should be determined to be negative. Only after the cumulative impact is negative, is the profitability at the margin examined. In the end, this is a better deal for the Postal Service because it has the potential of eliminating unprofitable discounts in the third year.[12]

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10 See Attachment D to the Modified Stipulation and Agreement, page 15, notes 4, 5, and 6. Bank One and the Postal Service have agreed to collect and report information about these factors as part of the Data Collection Plan. See Attachment C to the Modified Stipulation and Agreement. The same type of data was part of the Data Collection Plan in Capital One case. See PRC Op. MC2002-2. para. 9029.

11 The analysis requires the addition to Appendix A of the cost of forwarding and the cost of ACS notices for forwards. Both of these inputs are derived from the record in this case. See Attachment D to the Modified Stipulation and Agreement, Page 1, notes 15-18.

12 In adhering to the Modified Stipulation and Agreement for the purposes of settlement, the Postal Service is not conceding that future NSAs necessarily should be subject to review of the marginal profitability. In fact, the Postal Service fully supports

Throughout discovery, much of the focus of inquiry related to whether the assumptions about the forwarding, return, or ACS success rates were valid.[13] The Bank One stop-loss mechanism enables the focus to shift from unfounded concern that these rates might be aberrant to the actual impact these factors on the original value of the deal. By limiting the actual data to these three inputs, which are derived from the Data Collection Plan, the stop-loss mechanism will be simple to apply. In fact, the adjustment to the rates for this stop-loss mechanism is as easy to apply as the other adjustment mechanisms found in the proposed DMCS—the annual threshold adjustment and the merger adjustment. Compare proposed DMCS 612.35 with 612.33 and 34.

B. A Cost-Savings Based Cap On Discounts Would Choke Off The Forecasted New Volume Contribution.

In the Recommended Decision in the Capital One NSA case, the Commission capped the available discounts based upon the amount of projected cost-savings. In their decision approving the Recommended Decision, the Governors disagreed with the imposition of such a cap, but determined that it had no practical effect since it would cap discounts at a volume level that exceeded the after rates volumes that Capital One had forecasted. 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

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the Commission's findings in its recommended decision on the Discover NSA, that a marginal profitability analysis is not required. See PRC. Op. MC2004-4, at 52.

13 Despite the extensive discovery on the forwarding, return, and ACS success rates, nothing in the record indicates that witness Plunkett's assumptions about these factors were not valid.

with Capital One, Docket No. MC2002–2 (June 2, 2003) ("Governors' Decision"). at 3 n.3, 20.

In its Recommended Decision on the Discover NSA, the Commission calculated a stop-loss cap, but found that the discount cap negotiated in the NSA provided adequate protection. Once again, the stop-loss cap calculated in that case would have limited the potential for new volume growth but still would have capped discounts at a volume that exceeds the actual after rates volume forecasted by Discover.

The facts in the instant proceeding differ from those in Discover. If the Commission were to apply to the Bank One NSA a stop-loss cap as based on the Discover model and passing through 95 percent of the cost savings (PRC Op., MC2004-4 at 37-38)[14] discounts would be capped at a volume *below* the after rates forecast, thus foreclosing contribution from increased volume. Specifically, the cap would take effect in the the third year of the agreement at an approximate volume of 644 million pieces, and would eliminate the contribution from about 25 million solicitation pieces. As the testimony of witness Buc demonstrates, these Bank One forecasts are conservative, and thus any stop-loss discount cap would foreclose potential additional new volume contribution.

As a consequence, the settlement parties sought to fashion a substitute mechanism to protect against the loss of new volume contribution. The features of the Modified Stipulation and Agreement represent an acceptable alternative tor each the

[14] Without conceding the appropriateness of applying stop-loss caps to these cases, the Commission methodology for calculating its stop-loss cap in the Discover case is more suitable than the methodology used in the Capital One case. See PRC Op. MC2004-4 at pp. 37-38.

objectives embodied in the stop-loss caps recommended in the Capital One and Discover cases.

C. There Is No Requirement That The Same Mechanism Developed In The Baseline Be Applied To Its Functionally Equivalent Offspring; Nor Should One Be Imposed.

In the baseline proceeding, Docket No. MC2002-2, the Commission, *sua sponte*, imposed what it called a "stop loss cap" on the Capital One NSA. Specifically, it found that Capital One's estimates of Before Rates volume were "so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA." PRC Op. MC2002, ¶ 8013. It cited Capital One's history of rapidly increasing First-Class Mail volume. Id. at ¶ 8014. It also found that "[a]bsolutely no evidence suggests that the volume projected for the current year will be representative of experience in each of the following three years when the NSA would be in effect." Id. at ¶ 8015. The concern over "discount leakage" exceeding cost savings influenced the decision to limit the total value of discounts Capital One could earn to $40.637 million over the course of the NSA. *See* PRC Op., MC2002-2, ¶¶ 8013, 8019, 8024-26.

This docket, along with Docket No. MC2004-4, presented the Postal Service and other participants with their first opportunity to present evidence on the effects of a cap. Witness Plunkett explained, USPS-T-1 at 15-17, Tr. 2/198-200, that a cap based on either cost savings or exposure (leakage) would unnecessarily hinder the ultimate objective of utilizing NSAs as a tool to increase net contribution. Basing a "stop-loss provision" on cost savings would tend to limit participation in the NSA process to only large volume mailers who can offer significant cost savings opportunities. This would place customers who do not impose added costs on the Postal Service at a disadvantage. A smaller First-Class mailer, such as Bank One, often has potential cost savings that are not nearly as large as the potential cost savings for a larger First-Class mailer, like Capital One.

As the Commission recently pointed out in its opinion and recommended decision in MC2004-4, in circumstances where a stop-loss mechanism is warranted, "there might be more than one acceptable form of stop-loss mechanism," such as, in certain cases, a mechanism that focuses on total profitability. PRC Opinion, MC2004-4, at 36.

The mechanism embodied in the modified settlement in this proceeding, under the particular facts in this case, fully meets the objectives that led the Commission to impose a stop-loss cap on discounts in the Capital One proceeding and to evaluate the negotiated cap in the Discover proceeding.

At the same time, this mechanism avoids the concerns expressed by the Governors of the Postal Service in their decision in MC2002-2. The Governors warned that a stop loss cap could risk the loss of important opportunities, in the event that contribution which otherwise would have accrued to the Postal Service from the creation of additional First-Class Mail volume did not materialize, because of the cap. 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) ("Governors' Decision") at 18, n. 19. The mechanism in the settlement would not have that effect.

A stop-loss cap should not be imposed for other reasons as well. A stop-loss cap would merely operate to have the Postal Service share cost savings with a mailer. Focusing on this objective alone would ignore the potential benefits of contribution from new volume that might be induced by a price reduction, and thus could inhibit the potential for such contribution. If NSAs are to have a future as a means to "improve [the Postal Service's] profitability by developing innovative rate designs to meet the needs of diverse individual customers," (PRC Op. MC2002-2 at 1), then they cannot be limited to agreements that limit potential gains to sharing cost savings with a mailer.

Accordingly, a stop-loss cap could cause much harm, because it would limit the upside potential of this NSA. It could risk the loss of important opportunities, in the event that contribution which otherwise would have accrued to the Postal Service from the creation of additional First-Class Mail volume does not materialize because of the cap. *See* Governors' Decision at 18, n. 19. In this regard, it is noteworthy that the Commission has affirmed that NSAs ought to result in a net increase in contribution, such that they benefit all users of the Postal Service. Imposition of a stop-loss cap in this instance would work against this aim by arbitrarily limiting such benefits. Caps of this type could reduce potential opportunities to gain additional revenues.

D. There Is No Basis in the Instant Record For a Stop-Loss Cap.

The factual findings that led the Commission to conclude that caps were advantageous in the Capital One and Discover proceedings are not present here. First, unlike Capital One’s volume history, Bank One has a stable volume history that shows little variability from non-price factors.[15] As compared to the Capital One case, there is no evidence to suggest that the before rates forecasts are not representative of the three years during which the NSA would be in effect.

Second, the co-proponents in the instant proceeding have presented fully representative estimates of the cost and volume effects of the NSA, in all three years of the agreement. *See* Plunkett Testimony (USPS-T-1) at Appendix, pp. 2-3. The before and after rates volume forecasts are undisputed. Moreover, witness Buc's testimony provides a sound analytical basis supporting Bank One after rates forecast.

. Third, the NSA contains two protective mechanisms that limit the risk of additional leakage: the annual adjustment mechanism and the cap on flat shaped solicitations. Thus, as discussed below, the only part of Bank One's mail that could possibly be subject to non-price volume effects is letter-shaped solicitations, which represents only *five percent* of the before rates volume forecast.

Fourth, in Bank One, a substantial pool of cost-savings protects against non-price factors that may affect before rates mailing behavior.[16] Fifth, the undisputed after

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[15] In addressing the Commission's rationale for recommending a stop-loss cap on the Capital One NSA in their decision in Docket No. MC2002-2, the Governors pointed out that "[b]y the same token, however, we expect that if similar NSA proposals were negotiated in the future with mailers presenting less volatile historical mailing patterns, the Commission might view the corresponding need for a cap to be very much less compelling." Governors' Decision at 18, n. 18.

[16] In its recommended decision on the Discover NSA, the Commission stated that the record provided no means for evaluating the sensitivity of the estimates to changes in exogenous factors. MC 2004-4 PRC Op. at 41. The Postal Sevrcie respectfully submits that the economic models, in this case Attachment A to witness Plunkett's testimony, provide a clear means to evaluate the relevant sensitivities.

Moreover, exogenous factors that affect Before Rates figures should be expected to have a similar effect of After Rates figures. In this case, the annual threshold adjustment protects, from the effect of exogenous factors, the 88% of Bank One's Before Rates volume that is customer mail, and the provisions governing flat-shaped mail protect an additional 7% of the Before Rates volume. Thus, there is no basis in rates forecast yields a significant price-induced growth in contribution from new First-Class Mail volume that also hedges against before rates mailing volume non-price variability. Finally, the Bank One stop-loss mechanism embodied in the settlement will not restrict the growth of new volume.

The Modified Stipulation and Agreement resolves the issues litigated by the only active parties in this docket. It should be adopted as the basis of the recommended decision in this case.

III. The Structure and Effects of the Bank One NSA, as Supported by the Record, Meet the Standards for Approval as a Functionally Equivalent NSA.

A. The Bank One NSA Is Functionally Equivalent to the Capital One NSA.

In its Opinion and Recommended Decision Approving the Discover NSA, the Commission recognized that a functionally equivalent NSA is not required to be identical to the baseline agreement: "[t]he 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." [17] Similar to the Discover NSA, the Bank One NSA contains terms, benefits, and protective mechanisms which are not identical to those found in the Capital One NSA or in the Discover NSA. However, any variations in the mechanisms, which are tailored to the specific

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this record for the Commission to conclude that the type of stop-loss mechanisms employed in Docket Nos. MC2002-2 and MC2004-4 are necessary in this case. The mechanism proposed by the participants is more than adequate to serve its intended purpose.

[17] Opinion and Recommended Decision Approving Negotiated Service Agreement, September 30, 2004, at 2.

circumstances of Bank One, do not take the NSA outside the permissible ambit of "functional equivalency."

The NSA precedents[18] and the record in this case support the issuance of the rates and service changes necessary to implement the Bank One NSA as amended by the Modified Stipulation and Agreement filed on October 5, 2004. Under the standards expressed in the Commission's rules and precedents, the Bank One NSA is functionally equivalent to the Capital One NSA. As explained below, the terms and benefits are comparable, and the NSA, as modified, has several stop-loss mechanisms that protect the Postal Service (and other ratepayers) from the risk of a negative financial impact. It is also worth noting that Bank One is a direct competitor of Capital One, and, in pertinent respects, is similarly situated. *See* Rappaport Testimony (BOC-T-1) at 3; *See also* Order 1391 at 52.[19] Accordingly, it is appropriate that Bank One should have an opportunity to participate in a functionally equivalent NSA.

1. Comparable Elements

The Commission pointed out in Docket No. RM2003-5, Order 1391 at 50, that the analysis that determines whether an NSA is functionally equivalent to a baseline NSA involves a comparison of the literal terms and conditions of the NSAs and a comparison of the financial effect that each NSA has on the Postal Service. The comparison of literal terms and conditions focuses on whether each agreement rests on the same substantive functional elements. Docket No. RM2003-5, Order 1391 at 50. As

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[18] The Commission's Recommended Decision and the Governor's Decision in the Capital One NSA case, MC2002-2 and the Commission's Recommended Decision in the Discover NSA, MC2004-4.

[19] The Postal Service reviewed the testimony of Bank One witness Brad Rappaport and, in accordance with Rule 192 (b), 38 C.F.R. § 3001.192(b), stated that such testimony may be relied upon in presentation of the Postal Service's direct case. See Direct Testimony Of Michael K. Plunkett On Behalf Of United States Postal Service (USPS-T-1) at 1-2.

explained in the testimony of Postal Service witness Plunkett (USPS-T-1) at 5-6, the Bank One NSA is based on the same two key substantive functional elements that are central to the Capital One NSA and recommended changes -- an address correction element and a declining block element.

As to the first element, if the DMCS is amended as proposed, the Postal Service would provide to Bank One, at certain levels of volume, electronic address corrections without fee for solicitations sent by First-Class Mail that are undeliverable-as-addressed and cannot be forwarded under existing regulations. *See* Request, Attachment F (Bank One NSA) at ¶¶ I.B and II.B-E. In return, Bank One would agree to forgo requiring the Postal Service to return such undeliverable mail, under the existing service features of First-Class Mail. Id. at ¶ II.A. The Postal Service estimates that this feature of the NSA will result in $7.8 million in savings, over the life of the NSA, because of the address correction feature. Plunkett Testimony (USPS-T-1) at 12.

As to the second element, if the foregoing conditions are met, to encourage increased First-Class Mail volume, Bank One would be eligible for per-piece discounts on those portions of its First-Class Mail solicitation volume that exceed specified volume thresholds. Attachment F at ¶¶ III.A and C. The discounts, set forth below, are applied only to incremental volume above the negotiated threshold. In other words, no discount would be applied to the first 535 million pieces; a discount of 2.5 cents would be applied to the next 25 million pieces, etc.:

Volume Block	Incremental Discounts
535,000,001 – 560,000,000	2.5¢
560,000,001 – 585,000,000	3.0¢
585,000,001 – 610,000,000	3.5¢
610,000,001 – 645,000,000	4.0¢

645,000,001 – 680,000,000	4.5¢
680,000,001 and above	5.0¢

Considering these discounts, and the testimony of witness Rappaport (BOC-T-1) regarding the volume response of Bank One to the proposed discount structure (BOC-T-1 at 6-8), the Postal Service expects Bank One's use of First-Class Mail to increase, resulting in additional net contribution to the Postal Service. The Postal Service estimates it will receive $6.8 million in increased contribution, over the life of the NSA, due to increased First-Class Mail volume, as well as a net exposure (leakage) of minus $2.9 million due to the discount feature of the agreement. Plunkett Testimony (USPS-T-1) at 11-12. In all, the NSA is expected to result in 217 million new pieces of First-Class Mail, at a time when Bank One's volume of First-Class Mail is declining. Rappaport Testimony (BOC-T-1) at 5-8.

2. Protective Mechanisms

In its Opinion in Docket No. MC2004-4, the Commission discussed the relationship between the two caps on cumulative discounts applied respectively to the Discover NSA, in that proceeding, and to the Capital One NSA in the Commission's recommendations in Docket No. MC2002-2. *See* PRC Op. MC2004-4, at 24-25. It might be inferred from that discussion that the Commission viewed the application of a cap to be a structural element necessary to approve functionally equivalent status, in relation to Capital One. As explained above, however, the Postal Service and the settlement parties believe that the stop loss mechanism embodied in the modified settlement agreement , as well as the other protective mechanisms in the NSA itself, serve as superior alternatives to a cap to protect the Postal Service and other mailers against adverse financial consequences, within the context of the Bank One NSA.

Accordingly, the presence of a cap should not be viewed as an essential structural element in evaluating functionally equivalent status. This conclusion follows from an analysis of the factual foundations supporting each NSA, and the individual characteristics of the NSA partners. In this regard, we describe above the circumstances that distinguish the Bank One NSA from the Capital One and Discover NSAs.

Rather than focus on the presence or absence of a cap, as suggested in Rule 196 and Order 1391, evaluation of functionally equivalent status should consider 1) whether any protective mechanisms are necessary and adequate to prevent a reasonable risk of loss to the Postal Service, and 2) whether the mechanisms are fair and equitable, in relation to the baseline NSA. As we argue above, in this case, the facts demonstrate that the Bank One NSA, as modified in the settlement, protects the Postal Service (and other ratepayers) from any reasonable risk of loss. Also, the fairness and equity of the stop-loss mechanism in the modified settlement has already been addressed. Both Capital One and Discover have had notice and an opportunity to object to the imposition of different stop-loss mechanisms and have failed to do so. See PRC Op. MC2004-4 at 43-44. In fact, Discover has signed the original Stipulation and Agreement.

The Bank One NSA contains four mechanisms to limit risk to the Postal Service and protect the interests of mailers not party to the agreement: an annual threshold adjustment, a flats adjustment, an enhanced mergers and acquisitions clause, and the stipulated stop-loss mechanism. The specific requirements of each mechanism are tailored to the unique relationship between the mailer and the Postal Service, yet none of these mechanisms alters the functionally equivalent status of the Bank One NSA.[20]

The annual threshold adjustment protects the Postal Service against non-price factors that increase operations mail. In general, NSAs patterned after Capital One are intended to increase First-Class Mail marketing volumes, among other objectives. However, statement volume growth could have the unintended consequence of diminishing the incentives for new marketing mail volume. The annual threshold adjustment protects against this contingency, and also mitigates additional discount leakage from operations mail, by adjusting the thresholds in the years following the first year of the agreement, using a formula based on the percentage change in the sum of the number of Bank One's credit cards and checking accounts.[21] The overall result however remains the same: the ability to adjust the discount thresholds in response to changes in the number of customer accounts virtually eliminates uncertainty with respect to the estimated volume of statement mail. Because statement mail volume makes up almost 90 percent of the Before Rates forecast volume (when compared to solicitation mail), the annual threshold adjustment mechanism is a powerful protective mechanism.

The second protective mechanism is that the discounts available for flat-shaped pieces are limited to the before rates volume; no more than 35 million flat shape solicitation pieces will be counted annually toward the thresholds or be eligible for

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[20] *See* PRC Op. MC2004-4 at 21.
[21] The slight difference between the Bank One mechanism and the mechanism used in the Discover NSA (which is based on the percentage change in domestic gross active accounts) is purely the result of tailoring the specific mechanism to the specific mailer. A detailed explanation of how the Bank One NSA annual adjustment mechanism works can be found in testimony of Michael K. Plunkett (USPS-T-1), at 8-9.

discounts. As a result of this mechanism, only letter-shaped solicitations could be subject to non-price factors that would cause additional leakage. Letter-shaped pieces only account for 5 percent of the total First-Class Mail volume.

The third protective mechanism is the detailed mergers and acquisitions clause, which provides structural safeguards against the risk that Bank One could obtain volume-related discounts for increases in First-Class Mail volume caused by a merger or an organic increase in the scale of Bank One's business, rather than by discounts. The mergers and acquisitions clause in the Capital One NSA was expanded to provide more detail relating to the integration of merged volumes, and it also has a provision to accommodate portfolio purchases, losses and sales.

The annual adjustment, flats cap, and mergers and acquisitions clause protect the Postal Service against risks associated with 95 percent of the Before Rates forecast volume.

The Bank One stop-loss mechanism is the fourth protective mechanism, and it is designed to protect against significant financial loss caused by errors in the projections of the costs and revenues of the Postal Service. In its Opinion and Recommended Decision Approving the Discover NSA, the Commission stated that "[a] comparison of stop-loss mechanisms…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 [NSA] may discriminate against the recipient of the baseline agreement and leave that mailer competitively worse off." There is no record evidence to support the conclusion that a negative competitive effect could exist. The Postal Service and Bank One provided notice of their negotiations through numerous settlement reports. Capital One, however, did not intervene. Moreover, American Bankers Association and Discover Financial Services, Inc., two parties that appear to have interests in the same industry as Bank One, actually signed on to the original Stipulation and Agreement, which also lacked a stop-loss cap.[22] With no negative comment from the recipient of the baseline agreement, and positive comment from competitors, there is no record evidence to support a Commission conclusion that the Bank One stop-loss mechanism is discriminatory.

3. Other Terms and Conditions

The Bank One NSA incorporates other terms and conditions found in the Capital One NSA. The agreement waives the seal against postal inspection of mail; requires Bank One to prepare mail under applicable standards and to enhance its address management practices; includes a minimum payment; and contains a provision for Bank One to make necessary records and data available to the Postal Service to facilitate and monitor compliance. It also 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 NSA, or to use the NSA. *See* Request, Attachment F.

B. The Bank One NSA Will Have a Positive Economic Effect on the Postal Service and All Postal Ratepayers.

The overall cost, volume, and revenue effects of the proposed Bank One NSA are relatively modest, both in the first year of the proposed agreement and in later years. As proposed, the changes would apply to only one, discretely-positioned mailer.

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[22] The Postal Service expects that most, if not all, of the original signatories will remain parties to the settlement.

The duration of the rates, fees, and classifications would be limited to three years by the terms of the NSA. The proposed changes would apply to the rates, fees, and classifications for Address Correction Service and First-Class Mail. The rates, fees and classifications for no other mail classes or special services would be affected.

The impacts of this proposal are described fully in the testimony of Postal Service witness Plunkett (USPS-T-1) at 11-14, Appendices A and B. The Postal Service estimates that it will benefit by $11.6 million over the life of the NSA -- $7.7 million in ACS cost savings plus $6.8 million in increased contribution, minus $2.9 million in revenues referred to in the Capital One proceedings as leakage.[23] The ACS cost savings that will result from the Bank One NSA are significant, since approximately nine percent of its marketing First-Class Mail letters, and approximately 11 percent of its marketing First-Class Mail flats are currently physically returned. *See* Rappaport Testimony (BOC-T-1) at 9. Also, as in Capital One, the Bank One NSA will generate significant contribution from new First-Class Mail volume. Plunkett Testimony (USPS-T-1) at 7, Appendix A at 1, 10, 11.

Witness Plunkett also estimates that the Bank One NSA will have minimal impact on Bank One's competitors, the Postal Service's competitors, and on mail users. Plunkett Testimony (USPS-T-1) at 14-15. In providing his analysis of the competitive impact, witness Plunkett relies upon the extensive evidence in the Capital One case.[24]

It is worth noting that in its Opinion and Recommended Decision in the Capital One case, Docket No. MC2002-2, the Commission determined that the Capital One

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[23] Witness Plunkett refers to this amount as "discount exposure" in his testimony. Plunkett Testimony (USPS-T-1) at 9.
[24] Particularly, Docket No. MC2002-2, Tr. 8/1571-1789 and Tr. 10/2060 to 2141.

NSA's effect on competition was a minor concern, particularly since no participant alleged that the Capital One NSA would cause competitive harm. PRC Op., MC2002-2, at 79, 159. The Postal Service considers that the competitive impact of extending the same terms and conditions to Bank One, a competitor of Capital One, should garner similar concern. The converse is not true, however. Failure to permit Bank One, a similarly situated competitor, access to the functionally equivalent NSA could be seen as unduly or unreasonably discriminatory, in violation of the Postal Reorganization Act. See PRC Order No. 1391 at 52.

The NSA provides a foundation for these changes to the DMCS and Rate Schedule, and those changes should be read in concert with the terms of the NSA. Among other provisions, the Bank One NSA specifies: (1) the key conditions making the NSA possible; (2) obligations undertaken by Bank One to ensure reduction of postal costs associated with handling of returned and forwarded mail; (3) volume thresholds pertaining to mail qualifying under the NSA for additional discounts; (4) information concerning other issues, such as monitoring, compliance, regulatory review, implementation, withdrawal, and cancellation; and (5) conditions affecting public communications, amendments, and notices.

The proposed data collection plan (USPS-T-1, Appendix C) will provide the same types of data as the data collection plan approved in the Capital One case, Docket No. MC2002-2.

The proposed classifications will further the general policies of efficient postal operations and reasonable rates and fees enunciated in the Postal Reorganization Act.

See 39 U.S.C. §§ 101(a), 403(a), and 403(b). The requested changes also conform to the criteria of 39 U.S.C. §§ 3622(b) and 3623(c).

IV. THE PROPOSED PRICES ARE CONSISTENT WITH THE CRITERIA OF THE ACT

39 U.S.C. § 3623(c) requires that the Commission evaluate proposed changes in the classification schedule in accordance with the policies of the Title and the following factors:

1. the establishment and maintenance of a fair and equitable classification system for all mail;
2. the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;
3. the importance of providing classifications with extremely high degrees of reliability and speed of delivery;
4. the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;
5. the desirability of special classifications from the point of view of both the user and of the Postal Service; and
6. such other factors as the Commission may deem appropriate.

Section 3622(b) requires that postal rates and fees reflect the policies of the Postal Reorganization Act, and accord with the following factors:

1. the establishment and maintenance of a fair and equitable schedule;
2. the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to, the collection, mode of transportation, and priority of delivery;
3. the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type;
4. the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters;
5. the available alternative means of sending and receiving letters and other mail matter at reasonable costs;
6. the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service;

7. simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services;
8. the educational, cultural, scientific, and informational value to the recipient of mail matter; and
9. such other factors as the Commission deems appropriate.

The arguments presented in the Capital One NSA are also applicable to the Bank One NSA:

> …by negotiating directly with individual customers, it may be possible, through negotiated service agreements such as the one submitted here, to more accurately present prices that represent the value that the user places on the service being provided (pricing criterion 2) for mail classifications that are desirable to the mailer and the Postal Service (classification criterion 5). In this case, the Postal Service has directly negotiated with the sender of the mail to arrive at classifications and prices that the Postal Service considers to be fair and equitable (classification criterion 1 and pricing criterion 1). As indicated in the testimony of witness Crum, there can be no doubt that the prices presented in this case will cover the costs of providing the service (pricing criterion 3). In fact, the address improvement steps that Capital One has agreed to will serve to lower the costs currently borne by other customers (pricing criterion 6). For this reason, the classifications and prices presented in this agreement confer beneficial effects on the general public and other ratepayers (classification criterion 1 and pricing criterion 1). The proposed rates do not have an adverse impact on the rates paid by the general public, or other business mail users (pricing criterion 4). The proposed declining block rate structure is relatively simple and maintains a transparent, identifiable relationship between volume levels and applicable rates and fees (pricing criterion 7).

(MC2002-2, USPS-T-2, page 9, line 36 – page 10, line 15).

These pricing and policy issues were comprehensively addressed in the Capital One NSA docket, and that the logic of functional equivalence enables the Postal Service and the Commission to rely on the findings in that case. In this instance, the close comparability of the structure and elements of the Bank One and Capital One NSAs, the similarity of their situations as mailers, and their status as competitors, warrant full reliance on the Commission's Docket No. MC2002-2 findings to justify recommending the current classification, rate and fee change proposals based on the Bank One NSA. Further, the customer-specific rates offered to Bank One through the NSA more than cover the costs associated with Bank One's mail, thus satisfying pricing criterion 3. By extending the benefits of a functionally equivalent NSA, the Commission would promote increased efficiency in postal operations and greater fairness and equity in the DMCS and Rate Schedules.

CONCLUSION

Although the Bank One stop-loss mechanism differs from a cost-savings based stop-loss cap, the postal ratemaking statutory scheme affords enough flexibility to permit both mechanisms to co-exist in NSAs of direct competitors. There is no requirement that the same mechanism developed in the baseline be applied to its functionally equivalent offspring; nor should one be imposed. During this nascent phase of negotiated pricing, it is important that multiple approaches to addressing the core issues—such as ensuring a positive outcome—be permitted. A more rigid approach is likely to cut off innovation in pricing.

WHEREFORE, the Postal Service requests that the Commission submit a recommended decision in accordance with its Request.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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CERTIFICATE OF SERVICE

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

____
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