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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001

Rate and Service Changes To Implement	)	
Functionally Equivalent Negotiated Service	)	Docket No. MC2004-3
Agreement with Bank One Corporation	)	

BRIEF OF BANK ONE CORPORATION

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TABLE OF CONTENTS

EXECUTIVE SUMMARY 1

STATEMENT OF FACTS 4

A. Description Of The NSA 4

B. Commission Proceedings 8

C. Settlement Of The Case 9

ARGUMENT 10

I. THE NSA IS LIKELY TO PRODUCE A MASSIVE NET CONTRIBUTION TO THE POSTAL SERVICE 13

A. Introduction 13

B. Before Rates Volume Projections Are Reliable 14

C. After Rates Volumes Estimates are Reliable. 16

D. The Return, Forwarding And ACS Success Rates Assumed By The NSA Proponents Are Reliable 19

1. Return rates 20

2. Forwarding rate 21

3. ACS success rate 22

4. The profitability of the NSA is relatively insensitive to variations in return, forwarding, and ACS success rates from the projected values. 23

E. Unit Cost Assumptions Are Reliable. 24

1. Applicability of average unit return cost for Bank One letters and flats 24

2. Effect of PARS 25

F. The NSA Proponents' Financial Impact Analysis Did Not Adjust For Several Factors That Understate The Profitability Of The NSA. 25

G. The Merger With J.P. Morgan Chase & Co. Is Likely To Make The NSA Even More Profitable. 27

H. The Stop-Loss Trigger Adopted By Stipulation And Settlement Provides Further Protection Against The Remote Possibility Of A Negative Outcome. 30

I. The Broad Support For The NSA By The Participants In This Case Is Further Evidence That The NSA Is Likely To Be Highly Profitable To The Postal Service. 36

II. THE COMMISSION SHOULD NOT IMPOSE A CAP ON THE TOTAL DISCOUNTS AVAILABLE TO BANK ONE. 37

A. The Relevant Standards For Dealing With The Financial Risk Of An NSA. 38

1. The financial risk of an NSA can be rationally assessed only by comparison with the potential reward. 38

2. The Commission, in assessing the reasonableness of the risk-reward tradeoff, should give deference to the business judgment of Postal Service management. 42

B. The Financial Risks Of The Proposed NSA, And Thus The Potential Benefits Of A Stop-Loss Cap, Are Low. 44

1. Before Rates volume estimates are reliable. 44

2. After Rates volume estimates are conservative. 44

3. The NSA includes two provisions to minimize financial risk from underestimating Before Rates volume. 44

4. The potential benefits of a stop-loss cap are therefore small. 46

C. A Cap On Total Discounts Would Expose The Postal Service To Great Risks. 49

1. A cap on total discounts is likely to deprive the Postal Service of millions of dollars of potential contribution from the NSA. 49

2. A cap on aggregate discounts would also have a chilling effect on future functionally equivalent NSAs. 52

D. Other Justifications Offered For A Stop-Loss Cap In The Discover Case Do Not Apply Here 52

1. The discounts received by a mailer under an NSA properly may be "associated" with any of the benefits received by the Postal Service, not just with cost savings. 53

2. The Commission's rules for functionally equivalent NSAs do not require a stop-loss cap. 55

3. Approval of the proposed NSA without a stop-loss cap would not discriminate unduly against Capital One or Discover. 57

III. THE NSA WILL NOT HARM OR UNDULY DISCRIMINATE AGAINST COMPETITORS. 58

CONCLUSION 64

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BRIEF OF BANK ONE CORPORATION

Bank One Corporation ("Bank One") respectfully submits this brief in support of its Request for approval of a proposed negotiated service agreement ("NSA") with the United States Postal Service, filed jointly with the Postal Service on June 21, 2004.

EXECUTIVE SUMMARY

This case involves the third in a series of proposed NSAs involving financial institutions. The Commission has found this proposal to be functionally equivalent to its two predecessors, the NSAs approved in Docket Nos. MC2002-2 (Capital One) and MC2004-4 (Discover Financial Services, Inc., or Discover). The present NSA nonetheless is pathbreaking in two respects.

1. This is the first NSA to be supported by an unopposed Stipulation and Agreement among the proponents and other participants in the case. On September 15, 2004, following protracted and intensive discovery and settlement negotiations, the Office of Consumer Advocate ("OCA") entered into a Stipulation and Agreement with Bank One and the Postal Service supporting approval of the NSA, subject to a stop-loss mechanism that would terminate the NSA rate discounts at the end of the second year of the NSA if the cumulative financial impact of the NSA to the Postal Service was negative. The OCA concurred that this mechanism would adequately protect the Postal Service from the risk of significant financial loss, and that

the Commission should not impose a stop-loss cap based on cost savings (akin to the cap imposed in the Capital One NSA proceeding). Such a cap, OCA agreed, would jeopardize "the potential of the NSA to provide additional contribution to the Postal Service by generating new First-Class Mail volume growth." Stipulation and Agreement (Sept. 15, 2004) at 4.

Ten days later, on October 5, 2004, Valpak Dealers' Association, Inc., and Valpak Direct Marketing Systems, Inc. (collectively "Valpak"), the only other party to indicate opposition to the NSA, reached agreement with the OCA, the Postal Service, and Bank One on a modified Stipulation and Agreement. Rather than mandating early termination of the entire discount structure if the cumulative financial impact of the NSA is negative after two years, the Modified Stipulation and Agreement would require an additional financial analysis to determine at which discount level the incremental contribution turns negative. Rate discount blocks with a positive financial impact upon the Postal Service would be allowed to continue.

The initial Stipulation and Agreement was signed by almost all of the participants in this proceeding, including Discover; and Bank One and the Postal Service anticipate that most or all of the same participants will sign the Modified Stipulation and Agreement. The signers of the initial or modified Stipulation and Agreement represent a broad cross-section of stakeholders in the postal ratemaking process, and their consensus merits considerable weight.

2. The record in this case breaks new ground in its analysis of the merits of a stop-loss cap on discounts. The analysis, which is undisputed by any participant, confirms that a stop-loss cap on the proposed NSA, akin to the constraints imposed in

the Capital One and Discover cases, would be likely to worsen, not improve, the financial health of the Postal Service.

The risk that concerned the Commission in the Capital One and Discover NSA cases—the possibility that the mailers' Before Rates volume projections might be too low, causing the Postal Service to pay significant discounts for mail volume that the mailer would have entered even without the discounts ("anyhow" volume)—is remote. And the odds that the understatement of Before Rates volume (and the resulting payment of discounts for "anyhow" volume) would be severe enough to make the NSA unprofitable overall are vanishingly remote.

By contrast, the financial risks of a cap on the total discounts available to Bank One are large. The record shows that, to a much larger extent than in the Capital One and Discover cases, Bank One's After Rates First-Class Mail volume depends on the availability of the NSA discounts, and the financial benefit to the Postal Service from this NSA depends on the volume of the additional First-Class mail entered by Bank One. Capping the NSA discounts at a level below what Bank One otherwise would have earned is likely to cause the loss of substantial amounts of contribution. As the undisputed analysis submitted by Bank One witness Buc demonstrates, these losses could range into tens of millions of dollars over the three-year life of the NSA.

Finally, implementation of the NSA without a stop-loss cap would neither injure Bank One's competitors nor discriminate unduly against them. As a matter of law, price discrimination that merely reflects differences in volume or demand elasticities has been recognized as lawful under the Postal Reorganization Act and predecessor statutes for over a century. Perhaps the most telling rejoinder to the question of discrimination and competitive injury is the behavior of Bank One's own competitors. As in the Capital One and Discover cases, no competitor of the bank proposing the NSA has opposed it, and no competitor has requested imposition of a stop-loss cap. To the contrary, both Discover and the American Bankers Association have agreed that the Commission should approve the instant NSA without a cap at all.

The recommended decision issued by the Commission today in Docket No. MC2004-2, *Experimental Priority Mail Flat Rate Box*, sets a clear precedent in this regard. In that decision, the Commission has recommended the creation of an experimental rate subclass despite the risk that it could produce a “worst-case annual revenue loss of $12.6 million” by cannibalizing mail volume from other, more profitable subclasses. MC2004-2 Op. & Rec. Decis. at 13. The Postal Service concluded that this “minimal” risk “should be more than offset by the potential financial benefits of the experiment.” *Id*. The Commission agreed, finding that “the reasonably bounded risk of potential revenue leakage estimated by the Service does not significantly detract from the merits of its proposed innovation.” *Id*. at 13-14. A rational balancing of risk and reward likewise warrants approval of the present NSA, and rejection of any stop-loss cap.

STATEMENT OF FACTS

A. Description Of The NSA

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 negotiated service agreement (“NSA”) between the Postal Service and Bank One. Accompanying the Request were the exhibits and supporting documentation required by Rule 190 *et* *seq*., and the testimony of three witnesses: Postal Service witness Michael Plunkett (USPS-T-1); Bank One witnesses Brad Rappaport (BOC-T-1) and Lawrence G. Buc (BOC-T-2).

As explained in the Request and supporting testimony, the proposed NSA is designed to be functionally equivalent to the Capital One NSA recommended by the Commission in 2003 in Docket No. MC2002-2 and the Discover NSA recommended by the Commission last week in Docket No. MC2004-4. Like the Capital One and Discover NSAs, the NSA proposed for Bank One includes (1) a declining block rate discount structure, and (2) an address correction element, under which physical returns of undeliverable-as-addressed (UAA) First-Class Mail marketing pieces are waived and replaced by the electronic transmission of address correction information. Plunkett Direct (USPS-T-1) at 6-7.[1]

The basic schedule of discounts proposed by the NSA are as follows:

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¢

The record in this case is not identical to the records in the Capital One or Discover proceedings, however. The most important difference between the Bank One

[1] The Bank One NSA also incorporates other terms and conditions found in the Capital One and Discover NSAs, such as waiver of the seal against postal inspection, preparation of the mail under certain address hygiene and operations standards, a minimum payment, similar cancellation and termination clauses, and a data collection plan. Plunkett Direct (USPS-T-1) at 7; MC2004-4 Op. & Rec. Decis. at 15-16.

NSA and the latter two NSAs involves the source of the anticipated financial benefits to the Postal Service. The added annual contribution resulting from growth in Bank One's First-Class Mail volume incented by the proposed volume discounts is projected to be in the range of $2.83 million—nearly as much as the projected contribution from ACS savings.[2] By contrast, the primary source of the anticipated financial benefits of the Capital One and Discover NSAs rests in the cost savings from the substitution of electronic notification for physical return of undeliverable mail. For Discover and Capital One, the expected additional contribution from increased First-Class solicitation volume that the Postal Service expects these NSAs to generate is less than the value of the discounts that the Postal Service expects to pay for First-Class volume that the mailer would have entered even without the NSA rate discounts.[3]

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[2] The Bank One NSA proposal also differs from the Capital One NSA in that Bank One has historically sent most of its solicitations as Standard Mail, while Capital One has sent most of its solicitations as First-Class Mail. Answers of Bank One witness Rappaport to OCA/BOC-T1-1-3; MC2004-4 Op. & Rec. Decis. at 3. Although the NSA discounts are likely to cause Bank One to send new solicitations by First-Class Mail, the financial analysis in this case rests on the assumption that 100% of the discretionary mail sent as a result of the NSA incentives is switched from Standard Mail. The same conservative assumption was adopted for the financial analysis of the effect of integrating J.P. Morgan Chase volumes into the NSA. *See* Attachment to Response to OCA/BOC-T1-19. Even under this most conservative assumption, the financial analysis shows that this NSA will generate significant revenues for the Postal Service. *See* Section I, *infra*.

[3] Plunkett Direct Testimony at 11, 12; Ayub, Direct Testimony at 12 (second errata) and Crum, Attachment B in MC2002-2 (Capital One figures were derived by trebling the one-year financial results for Capital One in order to provide a comparable three-year value).

Table 1:
Summary of Financial Effects of Three NSAs
(Millions of Dollars)

	Bank One	Discover	Capital One
ACS Savings	7.8	8.2	39.3
Contribution less Discount	**6.8**	**2.0**	**5.5**
Exposure	-2.9	-3.2	-20.2
Value	11.7	7.1	24.6

A further distinction is that the Bank One NSA includes more elaborate safeguards than does the Capital One NSA against the payment of discounts for First-Class Mail volume that the mailer would have entered even without the NSA. One of the added safeguards is an annual threshold adjustment to raise or lower the discount threshold floor to correspond to an increase or decrease in Bank One's non-discretionary mail (*e.g.*, statements) as measured by the actual change in the number of credit cards and checking accounts. This provision is intended to ensure that Bank One does not receive discounts for increased First-Class Mail volume resulting from an increase in the number of credit card and checking accounts. *See* Bank One NSA at III.F; Plunkett Direct (USPS-T-1) at 8-9; MC2004-4 Op. & Rec. Decis. at 22. Another safeguard allows Bank One to receive discounts on no more than 35 million First-Class flats—the same volume that Bank One actually entered in 2003 and the Before Rates and After Rates volume that Bank One is projected during the NSA. Bank One NSA at III.C.2. These safeguards confine the only possible uncertainty in Bank One's Before Rates volume to marketing letters, which amount to only a small portion of Bank One's total volume of First-Class Mail.

The mechanism for adjusting volume thresholds in response to mergers and acquisitions (Section IV of the Bank One NSA) is also more sophisticated than its earlier counterpart, Section III.I of the Capital One NSA. Section IV of the Bank One NSA prescribes detailed requirements that must be met before mail from a merged entity can be eligible for discounts. For mergers with an entity of comparable size (greater than 300 million pieces annually), Bank One must provide the Postal Service general information for initial notification within 90 days of merger, and more detailed information at the time of actual integration of a particular category of the merged entity's mail. Bank One must demonstrate that the appropriate quality processes are in place, and the Postal Service must provide Bank One authorization before the merged entity's mail volumes may be mailed through the NSA permit accounts. The discount threshold will then be adjusted upward to reflect the new volumes of the merged entity. Plunkett Direct (USPS-T-1) at 9-10.

B. Commission Proceedings

On June 23, 2004, the Commission docketed the request as Docket No. MC2004-3, and appointed Shelley Dreifuss, the director of the Commission's Office of Consumer Advocate ("OCA"), to represent the interests of the general public. Order No. 1409 (June 24, 2004) at 7-8. The following persons 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, 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.

The Commission held a pre-hearing conference on July 15, 2004. On 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 approved by the Commission in Docket No. MC2002-2.

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 and September 2, 2004, respectively, after receiving responses from Bank One and the Postal Service to formal and informal discovery requests concerning the financial impact of the NSA; the effect of the merger between Bank One and J.P. Morgan Chase & Co., which occurred on July 1, 2004, nine days after the filing of the NSA request with the Commission; and other issues.

C. Settlement Of The Case

On September 15, 2004, the Postal Service, Bank One, and OCA filed a joint motion for consideration of a Stipulation and Agreement entered into by the three parties. Since then, 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, National Association of Postmasters of the United States, National Postal Policy Council, Inc., and Parcel Shippers Association have also signed the Stipulation and Agreement.

On October 5, 2004, Bank One, the Postal Service, and the OCA entered into a modified Stipulation and Agreement with Valpak, an individual mailer intervenor. The modified Stipulation and Agreement differs only slightly from its September 15 predecessor. Bank One and the Postal Service believe that many, if not all, of the same parties that signed the September 15 Stipulation and Agreement will also sign the Modified Stipulation and Agreement. At this point, the latter agreement is uncontested by any party.

ARGUMENT

Presiding Officer's Ruling No. MC2004-3/2 held that three issues were relevant in any functionally equivalent NSA proceeding under Rule 196(a)(6):

(1) The financial impact of the Negotiated Service Agreement on the Postal Service over the duration of the agreement;

(2) The fairness and equity of the Negotiated Service Agreement to other users of the mail; and

(3) The fairness and equity of the Negotiated Service Agreement to the competitors of the parties to the Negotiated Service Agreement.

Presiding Officer's Ruling No. MC2004-3/2 at 1 (citing Rule 196(a)(6)).

We discuss the first two of these issues in Sections I and II of this brief. In Section I, we show that the NSA is likely to benefit all mailers by generating a large financial contribution for the Postal Service. As with the Capital One and Discover NSAs, part of this contribution will come from cost savings resulting from the substitution of electronic information for physical return of undeliverable First-Class pieces. In contrast to the two earlier NSAs, however, half or more of the financial benefit to the Postal Service will come from the migration of customer solicitations from Standard Mail to higher-contribution First-Class Mail in response to the incentive effect of the NSA discounts. Even under the most conservative projections of Bank One's volume response, the NSA would gain the Postal Service at least $11.7 million in added contribution over the three-year life of the NSA.

In Section II, we explain why the Commission should refrain from imposing a "stop-loss" cap on total discounts. The likelihood that the discounts will prompt a significant migration of Bank One solicitations from Standard Mail to First-Class Mail further distinguishes this NSA from the Capital One and Discover NSAs. Imposition of a stop-loss cap akin to those imposed in the two earlier cases would harm the Postal

Service by choking off much of the potential financial gain from that migration. Hence, the Commission should not try to remove all risk from the volume incentive provisions of the NSA (a quixotic goal in any event), but should uphold the NSA terms if they appear to reflect a reasonable tradeoff of potential risk and reward. And, in fact, the NSA terms as proposed readily satisfy this test. The risk that Bank One has simultaneously (1) underestimated its Before Rates First-Class volume, (2) overestimated its After Rates volume, and (3) done both by wide enough margins to make the NSA unprofitable is remote. Moreover, a cap on aggregate discounts could reduce the potential contribution of the NSA to the Postal Service by tens of millions of dollars. The broad opposition to such a cap by the other participants in this case underscores the likelihood that a "stop-loss" cap is more likely to stop the Postal Service's potential gains.

In Section III we explain why the NSA will not discriminate against or unlawfully injure Bank One's competitors. The discounts that the Postal Service has offered Bank One are reasonably related to the cost savings and added First-Class volume that the discounts are calculated to elicit. The case law makes clear that volume discounts of this kind are fully consistent with statutory norms against undue discrimination by a regulated monopoly. It is telling that no competitor of Bank One has objected to the NSA discount schedule, and that both the American Bankers Association and Discover Financial Services, Inc., have affirmatively stated their support for the NSA and the Stipulation and Agreement.

In resolving these issues, the Commission should give due weight to the existence of the uncontested Stipulation and Settlement among the active participants. The Commission has held that the terms of uncontested settlements, while not binding on the Commission, merit considerable deference, particularly when "all participants have had an adequate opportunity to comment on the appropriateness of the settlement as a resolution of the issues raised in [the] case, and to determine their position on its suitability as a basis for [the Commission's] opinion and recommended decision."[4] Bank One asks the Commission to apply the same deference here.

For all of these reasons, the record justifies Commission findings that the proposed NSA satisfies the criteria of 39 U.S.C. § 3622 and 3623; is fair and equitable to other mailers, including competitors of Bank One (*id.*, § 3622(b)(1) and 3623(c)(1)); will benefit other users of the mail by increasing the contribution received by the Postal Service (*id*., § 3622(b)(4)); will have no adverse effect on the rates of other mailers (*id*.); will not cause any competitive harm to other users of the mail (*id*.); will improve the rate structure of the Postal Service in recognizing the degree of preparation of mail by the mailer, and will reduce the Postal Service's costs (*id*., § 3622(b)(6); will allow the Postal Service to tailor its rates and classifications more closely to the specific needs and characteristics of Bank One (*id*., § 3622(c)(5)); and will cover the direct and indirect attributable costs of handling Bank One's mail and provide a reasonable contribution to the Postal Service's institutional costs (*id.*, § 3622(b)(3)).

[4] Docket No. MC99-4, *Bulk Parcel Return Service Expedited Minor Classification Case*, Op. & Rec. Decis. (Aug. 19, 1999) at 12; Docket No. MC2001-1, *Experimental Presorted Priority Mail Rate Categories*, Op. & Rec. Decis. (May 25, 2001) at 1-2, 6-12; Docket No. MC2001-3, *Ride-Along Experiment Extension*, Op. & Rec. Decis. (Jan. 11, 2002) at 6 and 8; Docket No. MC2002-3, *Experimental Periodicals Co-Palletization Dropship Discounts, 2002*, Op. & Rec. Decis. (Dec. 20, 2002) at 16; Docket No. MC2003-2, *Experimental Parcel Return Services*, Op. & Rec. Decis. (Aug. 26, 2003) at 17-19; *cf*. Docket No. MC2002-1, *Classification and Fees for Confirm*, Op. & Rec. Decis. (July 26, 2002) at 12-17 (clarifying proposed DMCS language).

I. THE NSA IS LIKELY TO PRODUCE A MASSIVE NET CONTRIBUTION TO THE POSTAL SERVICE.

A. Introduction

An important factor in assessing a proposed NSA is its anticipated effect on Postal Service revenues and costs over the life of the agreement. *See* 39 C.F.R. §§ 3001.193(e), 3001.196(a)(6)(i). This NSA will earn the Postal Service a very large net contribution. The Postal Service estimated in this case that it would benefit by $11.7 million over the life of the NSA: $7.8 million in ACS cost savings plus $6.8 million in increased contribution, minus $2.9 million in "leakage" or "discount exposure" (i.e., discounts paid on First-Class Mail volumes that Bank One would have entered even without the discounts).[5]

In fact, these estimates almost certainly understate—and understate greatly—the likely gain in contribution. The financial analysis in the June 21 Request assumed that the NSA incentives would cause Bank One to increase its volume of First-Class Mail by 19 million, 99 million and 99 million pieces, respectively, in the first, second and third years of the NSA.[6] These estimates are conservative. Mr. Buc's model of the optimization analysis used by credit card marketers to choose between Standard Mail and First-Class Mail for solicitations indicates the existence of a 90 percent probability that the NSA will cause Bank One to enter almost 47 million additional pieces a year, netting the Postal Service $848,000 a year, or more than $2.5 million over the three-year life of the NSA; and an 80 percent probability that the NSA will cause Bank One to enter at least 335 million additional pieces of First-Class Mail annually, netting the

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[5] Plunkett Direct (USPS-T-1) at 11-14 & App. A and B; *see also* Rappaport Direct (BOC-T-1) at 8; Buc Direct (BOC-T-2).

[6] *See* Rappaport Direct (BOC-T-1) at 5-6; Plunkett Direct (USPS-T-1), Appendix A at 11.

Postal Service an increase in contribution of more than $7 million per year, or more than $21 million over the life of the NSA.[7] And there is a 50 percent probability that the NSA will cause Bank One to increase its First-Class volume by nearly 446 million pieces per year, yielding an increase in net contribution in excess of $28 million over the life of the NSA.[8] As Chase mail volumes become integrated into the NSA, the gains will be even greater.

B. Before Rates Volume Projections Are Reliable.

There is no record evidence challenging Bank One's estimate of Before Rates volumes. Bank One's total First-Class Mail volume has been highly stable in recent years—ranging narrowly from 583 million pieces in 2001 to 600 million pieces in 2002 to 596 million pieces in 2003.[9] This total volume history is considerably less volatile than the Capital One volume history at issue in Docket No. MC2002-2: the coefficient of variation for Bank One's First-Class Mail volume as a whole is 0.11, compared with 0.29

[7] Calculated by entering corrected pieces at percentiles from Attachment 3, page 2, to Mr. Buc's testimony (BOC-T-2) (corrected version filed Aug. 16, 2004) into spreadsheet developed for Redirected Answer of BOC witness Buc to OCA/USPS-T1-24 (Aug. 2, 2004) and Attachment OCA-USPS-T1-24 thereto; *see also* Response to BOC witness Rappaport to OCA/BOC-T1-2, T1-4, and T1-9 (confirming that Mr. Buc's analysis reflects how Bank One responds to changes in relative prices of First-Class and Standard mail).

[8] *Id*. These figures, and the figures cited in the previous footnote, are for Bank One only. They exclude the additional gains in volume and contribution that are likely to occur as J.P. Morgan Chase volumes are integrated into the merger.

The NSA proponents' financial analysis also omits any estimate of the net contribution that the Postal Service is likely to gain from reduced forwarding costs for Bank One's Before Rates volume of First-Class Mail. *See* Answers of USPS witness Plunkett to OCA/USPS-T1-10 and OCA/USPS-T1-40.

[9] Rappaport Direct (BOC-T-1) at 4-6. By contrast, Capital One's First-Class mail volume was highly volatile during the three years of historical record in Docket No. MC2002-2. *See* Docket No. MC2002-2, 2 Tr. 207, 209-210.

for the years at issue in the Capital One NSA case. Response of USPS witness Plunkett to OCA/USPS-T1-32 (July 28, 2004).[10]

Moreover, most of Bank One's First-Class Mail (unlike Capital One's First-Class Mail) consists of operational (or "customer") mail—*i.e.*, monthly account statements and the like—not solicitation or marketing mail. In 2003, for example, solicitation letters represented only 60 million pieces—or *11 percent* of Bank One's total First-Class letters in that year—while the operational mail accounted for almost 90 percent of the mail.[11] The volume of operational or customer mail, because largely nondiscretionary and fixed in proportion to accounts, is unlikely to grow in a way that would disturb the relatively stable trend in overall First-Class volume. Operational and customer mail is business mail sent for business purposes. Both the lines of business and business processes that generated these volumes in the past will continue to do so without appreciable change over the next three years.

As to Bank One's discretionary solicitation mail, a veritable explosion in the Before-Rates volume of Bank One solicitation letters entered as First-Class Mail would be needed to drive Bank One's overall First-Class Before Rates volume much above the levels projected in the NSA proponents' financial analysis. The record, however, offers not a scintilla of evidence—or even a theory—to suggest that a volume surge of this magnitude is likely absent the NSA's discount incentives. Beyond the reasons discussed above, Bank One has responded to the growing cost of direct mail by making increasing use of non-postal marketing channels, including the Internet and face-to-face

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[10] J.P. Morgan Chase & Co. First-Class Mail volume also has a relatively stable volume history—ranging from 475 million pieces in 2002 to 462 million pieces in 2003 to a projected 471 million pieces in 2004. Corrected Response to OCA/USPS-T1-44 (Partially Redirected to Witness Rappaport) (filed Aug. 27, 2004).

[11] Rappaport Direct (BOC-T-1) at 5.

solicitations through co-marketing arrangements with partners such as Disney, Starbucks, Amazon and Avon.[12] Further, Mr. Buc's analysis demonstrates that either the "lift" (greater rate of customer response to solicitations) achieved by shifting from Standard to First-Class Mail or the lifetime value of a customer would need to increase greatly for a significant migration to First-Class mail to become cost effective absent the NSA discounts. *See* Buc Direct (BOC-T-2).[13] For all these reasons, it is extremely unlikely that Before Rates volumes are seriously underestimated.

C. After Rates Volumes Estimates are Reliable.

There is also no record evidence challenging Bank One's estimate of After Rates volumes. Witness Buc's direct testimony (BOC-T-2) showed that the incremental After Rates volume projections provided by witness Rappaport (BOC-T-1) and reflected in witness Plunkett's financial analysis (USPS-T-1) are highly conservative. While witness Rappaport projected that the NSA incentives would induce Bank One to enter 19 million, 99 million, and 99 million additional pieces of First-Class Mail, respectively, during the three years of the NSA, Mr. Buc's analysis showed that the volume response will probably be much higher. In his answer to OCA/USPS-T1-24, Mr. Buc showed that there is a 90 percent likelihood that more than 46 million pieces of mail will switch from

[12] Answer of BOC witness Rapport to APWU/BOC-T1-2; Answer of BOC witness Rappaport to OCA/BOC-T1-3; Redirected Answer of BOC witness Rappaport to OCA/USPS-T1-44.

[13] An upward surge in the Before Rates marketing volumes of the pre-merger business of J.P. Morgan Chase ("Chase volumes") is also quite unlikely. Chase's First-Class marketing mail volumes have been *decreasing*—and are likely to decrease further in the wake of the merger. *See* Answer of BOC witness Rappaport to OCA/BOC-T1-19, 44. Post-merger marketing decisions will be made by a company-wide marketing department composed primarily of former Bank One marketing employees. As explained by Mr. Rappaport in his answer to OCA/USPS-T1-44, these former Bank One marketing employees are likely to reduce further Chase's Before Rates use of First-Class Mail for marketing.

Standard to First-Class Mail with the incentives provided by the NSA, and a 30 percent likelihood that nearly 378 million pieces would switch. The following table shows the full range of probabilities, as reported in Attachment 3 to Mr. Buc's testimony (BOC-T-2) (corrected Aug. 16, 2004):

Table 2
How Many Bank One Solicitation Pieces Will The NSA Discounts Induce To Migrate From Standard To First-Class Mail?

Volume Switch Exceeding This Amount (millions of pieces)	Probability
46.7	90%
335.2	80%
377.8	70%
409.2	60%
445.8	50%
466.6	40%
486.1	30%
517.4	20%
564.6	10%
742.0	0%

Mr. Buc based these results on a widely used heuristic model of the fundamental economics of marketing decisions. Banks, like most firms that engage in direct marketing, face economic choices about how much solicitation mail to send, and what class of mail to use for sending it. A firm rationally sends a solicitation to an individual only when the expected benefits of the solicitation exceed its costs. For a particular marketing campaign, the firm must estimate (1) the probability of response for each individual on the list ("response rate") and (2) the present value of the stream of profits over the duration of that individual's relationship with the firm (the "lifetime expected value"). By multiplying the response rate by the lifetime expected value, the firm can determine the expected value of the mailing for each individual. The expected value can then be compared with the costs of producing the marketing material and the postage charges (totaling "costs per piece") to determine whether the economic benefit from a mailing is positive (the "net value"). Buc Direct (BOC-T-2) at 2 and 3.

Mr. Buc ran his model with conservative inputs and assumptions. The response and lift rates, customer lifetime values, and per-piece marketing costs he assumed are based on public data or assumptions that are both plausible and consistent with the observed behavior of Bank One and other credit card issuers. Buc Direct (BOC-T-2) at 3 and 4; responses of witness Buc to OCA interrogatories OCA/BOC-T2-3, OCA/BOC-T2-4, and OCA/BOC-T2-5.

The results obtained by Mr. Buc accord with common sense. It is a "well known axiom" of economics, commonly known as the "law of downward-sloping demand," that reducing the price of a product tends to spur consumers of the product to buy more of it."[14] The difference between First-Class and Standard rates of postage for Bank One solicitation mail is approximately ten cents per piece. Hence, we know that a rate discount of ten cents, by eliminating the cost differential between First-Class and Standard rates, would cause Bank One to migrate *all* of its Standard solicitation mail to First-Class Mail.[15] If the relationship between discount and migration were linear, a rate

[14] OCA Reply Comments (Aug. 5, 2004) at 8; Paul A. Samuelson & William D. Nordhaus, *Economics* 49-50 (14th ed. 1992).

[15] In fact, because First-Class solicitations have a higher response rate than the same solicitations when sent by Standard Mail—a differential known in the industry as "lift"—we know that the migration would be complete even before the rate discount reached ten cents.

discount of five cents per piece (or half the rate differential) would cause half of the solicitation volume to migrate to First-Class Mail; and a discount of 2.5 cents would cause 25 percent of the solicitation volume to migrate to First-Class Mail. With Bank One's Standard solicitation mail volume running at approximately one billion pieces annually, the likelihood that discounts in the range of 2.5 to 5.0 cents per piece could cause an annual migration of several hundred million pieces is hardly implausible.

Significantly, no participant in this case has offered any evidence to suggest the inputs and assumptions of Mr. Buc's model are erroneous or inaccurate, or that the results of his model are at odds with the observed behavior of Bank One or any other credit card issuer.[16]

D. The Return, Forwarding And ACS Success Rates Assumed By The NSA Proponents Are Reliable.

Earlier in this case, certain participants filed interrogatories questioning whether Bank One solicitation mail that migrated from Standard to First-Class rates under the NSA would produce a positive net contribution to the Postal Service's institutional costs. The record clearly answers these questions: even with the deepest discount offered to Bank One under the NSA—five cents per piece—the Postal Service will gain a net contribution of approximately two cents for *every piece* of Bank One mail that migrates from Standard Mail to First-Class Mail as a result of the NSA:[17]

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[16] In the Discover case, the Commission declined to credit the Before Rates and After Rates volume projections offered by Discover on the ground that Discover's 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." MC2004-4 Op. & Rec. Decis. at 41. Mr. Buc's analysis avoids this problem by focusing not on the absolute level of Before Rates or After Rates volume, but the *differential* between the two. Because exogenous factors are likely to affect both Before Rates and After Rates volume, the impacts of those factors are netted out.

[17] *See* Plunkett Direct (USPS-T-1), App. A, at 10 (differences obtained by subtraction).

Table 3:
Net Contribution Less Discount

	Contribution ($ per piece)		
	Year 1	Year 2	Year 3
First-Class After Rates	0.166	0.161	0.155
Standard Rates	0.093	0.089	0.086
Difference Without Discount	0.073	0.072	0.069
Difference With 5¢ Discount	**0.023**	**0.022**	**0.019**

And this is the *least* profitable discount block. Additional volume below the threshold for the full five-cent discount will add a contribution greater than two cents per piece (because the discounts offered for those pieces will be smaller, or zero). Moreover, First-Class Mail volumes that represent net volume gains to the Postal Service, rather than migration from Standard mail, will provide gains of more than ten cents per piece (because there will be no partially offsetting loss in Standard Mail contribution).[18]

The assumptions about return rates, forwarding rates, and ACS success rates that underlie these estimated margins are robust. We discuss each variable in turn.

1. Return rates

The return rates assumed in the Postal Service's financial analysis of Bank One's First-Class Mail are supported by the record. Mr. Rappaport based his estimate of return rates for Bank One's letter-shaped solicitations on Bank One's actual experience with Address Correction Service from 1997 through May 2001. Response of Mr. Rappaport to POIR 1, Question 1. These estimates are consistent with Capital One's

[18] Answer of Bank One witness Buc to Valpak interrogatory VP/BOC-T1-11.

return rates under its NSA to date, and with the return rates reported by other major mailers of First-Class Mail.[19]

For flat-shaped solicitations, Mr. Rappaport based his estimate on actual scanning data in 2002. Response of Mr. Rappaport to POIR 1, Question 1.

2. Forwarding rate

The NSA proponents assumed in their financial analysis that Bank One's forwarding rate would equal the system average of 1.96 percent. Response of USPS witness Plunkett to POIR 1, Question 2. This assumption is reasonable. Capital One has experienced a forwarding rate under its NSA of 2.0 percent, close to the national average. Response of USPS witness Plunkett to POIR 1, Question 2. The record in the present case offers no reason to believe that Bank One's forwarding rate will differ materially. In fact, there is every reason to believe that Bank One's forwarding rate, like that of Capital One, will be close to the system average.

First, in Docket No. MC2002-2, the Postal Service testified that it expected Capital One's forwarding rate to be close to the average because Capital One "processes its . . . solicitation mail addresses" through the NCOA data base "every 60 days," a cycle only one-third as long as the 180-period otherwise required of First-Class mailers that use NCOA to comply with the Move Update requirement. Docket No. MC2002-2, 3 Tr. 552 (USPS witness Wilson). Bank One is already updating most of its solicitation mail addresses within a 60-day cycle, the same interval. Response of USPS witness Plunkett to OCA/USPS-T1-43.

[19] Response of USPS witness Rappaport to POIR 1, Question 2; Response of USPS witness Plunkett to POIR 1, Questions 2 and 7; Response of BOC witness Rappaport to OCA/BOC-T1-10.

Second (and also like Capital One), Bank One will use ACS information to update its addresses. Response to BOC witness Rappaport to VP/BOC-T1-8. Moreover, the concerns expressed by OCA and Valpak in the Discover NSA case about "repeat forwards" do not apply to Bank One. Unlike some other financial institutions, Bank One does not rely primarily on one-use list rentals. Rather, it

> often sends a solicitation mailing to the same list of non-customers more than once. Bank One may make multiple mailings to the same list during the same campaign cycle. Or Bank One may obtain the same list several times for different campaigns over the course of a year or other extended period.

Answer of Bank One witness Rappaport to Valpak Interrogatory VP-BOC-T1-4(a) (filed July 26, 2004).

Finally, the ACS address correction information that Bank One receives under the NSA will have value for Bank One even when the list containing an incorrect address is used only once. When Bank One receives notification from ACS that an address is stale or otherwise invalid, an entry will be placed in the databases to ensure that the address is purged from any future solicitation mailing. This process will ensure that Bank One will not use the address again even if it is included in other existing Bank One lists, or in other lists purchased, rented or otherwise acquired by Bank One in the future. Answer of Bank One witness Rappaport to Valpak Interrogatory VP-BOC-T1-8(a) (filed July 26, 2004).

3. ACS success rate

The financial analysis supporting the proposed NSA assumes that the electronic ACS success rate will be 85 percent. Plunkett Direct (USPS-T-1), Appendix A, page 1. The record contains no evidence that this value is unrealistic. Although electronic ACS success rates were lower during the early shakeout period of this system, current success rates are now in excess of 85 percent. *See Postcom Bulletin* 35-04 (Aug. 12, 2004) at 3-4; MC2004-4 Op. & Rec. Decis. at 29 (upholding use of 85 percent assumption).

In its recent decision in the Discover case, the Commission found "unconvincing arguments that the ACS success rate will very from the estimate used by the Postal Service enough to significantly affect the savings. The 85 percent rate used in the baseline docket [Capital One] has not been discredited to justify deviating from the precedent." MC2004-4 Op. & Rec. Decis. at 29. The record in the present case warrants the same findings.

4. The profitability of the NSA is relatively insensitive to variations in return, forwarding, and ACS success rates from the projected values.

Not only are the actual values for these three variables unlikely to vary significantly from the values assumed in the models of financial impact submitted by the Postal Service herein, but the likely profitability of the NSA for the Postal Service is so great that an unfavorable variance in return, forwarding or ACS success rates would have to be unrealistically large to cause the Postal Service to lose money on the NSA. A study of the sensitivity of the profitability of the NSA to changes in these variables shows, for example, that the NSA would remain profitable at projected After Rates volumes unless return rates for marketing letters exceeded 25 percent[20] or forwarding rates exceeded the system average by more than ten percentage points.[21] Further,

[20] Changing the return rate on Appendix A, Page 1 to 25 percent yields a "USPS Value" of $247,382 for the three-year period.

[21] To eliminate the $11.7 million contribution from the NSA, the unit contribution from the 217 million switched pieces would need to be approximately 5.4 cents lower than estimated. At a combined unit cost per forward and forwarding notice of approximately 40 cents, MC2002-2, 2 Tr. 417 (inflated at 4 percent), Bank One's forwarding rate would need to exceed the systemwide average of 1.96 percent by more than 10 percentage

even if the ACS success rate fell to zero, the agreement would still be profitable for the Postal Service.[22]

The notion that forwarding or return rates could approach these levels is incredible. Bank One's address cleansing practices, discussed above, should limit forwarding rates to no more than system average levels. Moreover, using address lists that generated the volume of undeliverable-as-addressed (UAA) mail needed to render the NSA unprofitable for the Postal Service would be contrary to the economic interest of Bank One itself, and a rational business would take steps to reduce the return rates or avoid the mailings. *Accord*, MC2004-4 Op. & Rec. Decis. at 29-31 (rejecting as unsupported claims that Discover's return, forwarding and ACS success rates are likely to vary significantly from values used in Discover case and this case).

E. Unit Cost Assumptions Are Reliable.

1. Applicability of average unit return cost for Bank One letters and flats

The financial analysis supporting the proposed NSA assumes that the average unit costs of returns of Bank One letters and flats are the same as the national averages. *See* Response of USPS witness Plunkett to POIR 1, Question 3. The use of national average data in these circumstances is reasonable. As Mr. Plunkett has noted, Bank One—like Capital One—has the mail mix and profile of a large national mailer, and thus should have a cost structure that mirrors the national averages. *See* MC2002-2 Op. & Rec. Decis. ¶ 6050; Response of USPS witness Plunkett to POIR No. 1, Question 3; Response of USPS witness Plunkett to POIR No. 6.

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points to reduce the unit contribution by this much. *See* Response of USPS witness Plunkett to POIR 1, Question 2.

[22] Changing the ACS Success Rate on Appendix A, Page 1, to 0 percent yields a "USPS Value" of $176,171 for the three-year period.

2. Effect of PARS

The financial impact analysis in Appendix A to USPS-T-1 includes no adjustments for the planned implementation of PARS. This approach is reasonable. The implementation schedule for PARS has been delayed, and there is no indication that large scale national implementation will occur during the effective life of the NSA. Moreover, even full deployment of PARS will not eliminate the cost disparity between physical and electronic returns. Response of USPS witness Plunkett to POIR No. 1, Question 4.

F. The NSA Proponents' Financial Impact Analysis Did Not Adjust For Several Factors That Understate The Profitability Of The NSA.

The proponents' financial impact analysis fails to reflect several circumstances that are likely to increase the actual profitability of the NSA for the Postal Service.

First, the Postal Service based its unit cost estimates for *Standard Mail* on the *Postal Service's* costing methodology, while basing its unit cost estimates for *First-Class Mail* on the *Commission's* costing methodology. The Commission's methodology tends to produce higher costs and correspondingly lower contribution amounts. Consistent use of the Commission's methodology to cost both mail classes would cause the estimated costs of Standard Mail (and the associated piggybacks) to increase, and the estimated contribution from Standard Mail to decrease accordingly. Thus, the net contribution less discount for each piece of mail that migrated from Standard to First Class would be higher than the model now indicates. Using one approximation of the Commission's methodology, Mr. Buc estimated that the increase in net contribution less discount by correcting the mismatch of methodologies would be $0.003 in Year 1, $0.003 in Year 2, and $0.003 in Year 3.[23]

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[23] Redirected Answer of Bank One witness Buc to OCA/USPS-T1-46 at 2-3. Using the Postal Service's methodology to cost both mail classes would likewise increase the

Second, in the calculations in Appendix A to USPS-T-1, revenues for both Standard Mail and First-Class Mail are assumed to remain constant over the entire life of the agreement. In fact, an omnibus rate increase is likely in early 2006. The effect of a rate increase would be to increase unit revenues of both First-Class and Standard Mail. Unless rates for Standard Mail bear percentage increases that are disproportionate to First-Class rate increases, the absolute difference between unit First-Class and unit Standard Mail rates will also increase, thus increasing the net contribution less discount at least in Year 3 of the NSA agreement for mail that is switched from Standard Mail to First-Class Mail. Assuming, for example, that the next omnibus rate case resulted in an across-the-board increase of 10 percent for all classes, effective at the beginning of Year 3, the net contribution less discount would increase by $0.012 in Year 3. Redirected Answer of Bank One witness Buc to OCA/USPS-T1-46 at 3.

Third, the calculations in Appendix A assume that 100 percent of new First-Class Mail volumes will be migrated volume—*i.e.*, will be offset by an offsetting reduction in Standard Mail volume. If some of the new First-Class Mail volume is from organic growth (*i.e.*, growth not offset by migration from Standard Mail), net contribution less discount will increase, for the obvious reason that entirely new First-Class Mail volumes will not entail any offsetting loss of Standard Mail contribution. For example, if only five percent of the new volume were from organic growth and 95 percent represented migration from Standard Mail, the net contribution less discount would increase by

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estimated net contribution less discount for each piece that migrated from Standard Mail to First-Class Mail, because the estimated costs of First-Class Mail (and associated piggyback costs) would decrease, and the estimated contribution from First-Class Mail would increase accordingly. *Id.*

$0.005 in Year 1, $0.004 in Year 2, and $0.004 in Year 3. Redirected Answer of Bank One witness Buc to OCA/USPS-T1-46 at 3-4; see also Response of USPS witness Plunkett to OCA/USPS-T1-35 and OCA/USPS-T1-36.

G. The Merger With J.P. Morgan Chase & Co. Is Likely To Make The NSA Even More Profitable.

The Postal Service and Bank One signed the instant NSA on May 10, 2004, and filed this case at the Commission on June 21, 2004. On July 1, 2004, Bank One merged with J. P. Morgan Chase. In anticipation of the possibility of a merger, the parties negotiated a detailed section in the NSA on how to handle mergers. Section IV of the NSA follows the approach of the merger provisions of the Capital One NSA, but anticipates and resolves implementation issues that might arise. It establishes three distinct procedures for (1) mergers of entities with First-Class Mail volumes of between 10 million and 300 million pieces annually, Section IV.A; (2) mergers with entities with First-Class Mail volumes of more than 300 million pieces annually, Section IV.B; and (3) sales of portfolios of at least 10 million pieces, Section IV.C. Mergers involving more than 300 million pieces, including the J.P. Morgan Chase merger, are subject to specific requirements, including:

- **Initial Notification.** Section IV.B.1. Within 90 days of the merger, Bank One must provide general information to the Postal Service about the merged entity, including the number of credit card accounts, number or retail customer accounts, and approximate volumes of First-Class Mail in five different categories. This specific information has been provided in this case in Bank One's response to OCA/BOC-T1-13.

- **Adjustments.** Section IV.B.2. Before any mail of the merged entity may be eligible for discounts under the NSA, Bank One must receive authorization from the Postal Service after fulfilling several requirements: (1) Bank One must notify the Postal Service of its desire to integrate the merged entity's volume and provide information as to the category of mail to be integrated, the monthly volume for the prior twelve months of that category of mail, and the permit accounts through which that volume was mailed; (2) the Postal Service must reconcile the mail volumes and provide appropriate notice to Bank One; (3) Bank One must show that it has quality processes in place to ensure compliance with the other provisions of the NSA; and (4) the thresholds must be adjusted upward to add the volumes to be integrated based on the volumes for the twelve months prior to the date of integration.

- **Record keeping.** Section IV.B.3. Bank One must retain records auditable by the Postal Service supporting the information provided.

It the requirements set forth above are not met, Bank One would be barred from mailing the new mail under the permits associated with the NSA. Thus, even before the merger occurred, the Postal Service had negotiated extensive protections against the risk that a merger would cause the Postal Service to pay discounts for First-Class Mail volume that the Postal Service would have received anyway. Those protections enable the Postal Service to (1) adjust the discount threshold upward in response to volume increases resultign from the merger, and (2) delay or withhold authorization until all of the NSA conditions are met.

In addition to the contractual protections negotiated by the parties, Bank One has provided information in its responses to interrogatories to allay any concerns that the Commission might have about the financial impact of the merger on the NSA – and in fact has demonstrated that the merger will likely increase, not decrease, the profitability of the deal to the Postal Service.[24] Although Bank One did not have access to the Chase data until after consummation of the merger, the company has made extraordinary efforts since July to produce the necessary information. As part of the settlement negotiation process and formal and informal discovery, Bank One and the

[24] In the Presiding Officer's Ruling Establishing Procedural Schedule, dated July 23, 2004, the Commission expressed its desire that "adequate relevant data will be made available to allow for an informed Commission decision [on the ramifications of the merger]." Ruling at 3.

Postal Service supplemented the record with data relating to the merger. This information included:

- Historical volume and return rate information for mail entered by J.P. Morgan Chase & Co. ("Chase") before the merger. OCA/BOC-T1-13, 17, 19, POIR 2, Q1.

- Forecasts of Chase volumes, including Before Rates forecasts for 2004, 2005, and 2006 and After Rates forecasts for 2005 and 2006. OCA/USPS-T1-44 (redirected to B. Rappaport). The response details the methodology used, and the calculations performed, to make these projections.

- A financial analysis based on the assumption of integration of all of Chase volumes on January 1, 2005. OCA/ USPS-T1-44.

- Analysis of breakeven Before Rates and After Rates volumes and corresponding discount levels assuming integration of all of Chase volumes on January 1, 2005. OCA/USPS-T1-50.

- Testimony that the merged entity will likely continue to make marketing decisions in a manner similar to that described in Bank One's earlier filed testimony. Redirected Response of Bank One witness Rappaport to OCA/USPS-T1-44.

With the supplemental data, the Commission has all the data that it would have received had Bank One known with certainty that the merger would occur before its original filing date.[25] These data show that the addition of Chase volumes would make

[25] Bank One has provided the Commission far more information than that required by the provisions of its own NSA or those of the Cap One NSA. The banking industry is undergoing a wave of consolidations, and mergers are frequent occurrences. under the current PRC rules. See, e.g., The State Of The Banking Industry: Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs (April 20, 2004) (testimony of Chairman Alan Greenspan) accessible at http://www.federalreserve.gov/boarddocs/testimony/2004/20040420/default.htm). A party could announce a merger shortly after receiving regulatory approval of the NSA by the Board of Governors, and the Postal Service would only be able to rely on the safeguards incorporated in the NSA's merger provisions -- there would be no prior review of the merged entity's volumes by the Commission. In this case, however, Bank One has voluntarily provided the same amount of information, to the extent available, that it would have filed if the merger had been completed before signing of the NSA. As a result, no party could complain that the merger introduces uncertainty into the approval process. And, as demonstrated above, the merged entity's volumes only increase the value of the deal to the Postal Service.

the NSA even more valuable to the Postal Service than projected by the co-proponents in their June 21 Request to the Commission. If the integration of all Chase volume into the NSA occurred on January 1, 2005, for example, the value to the USPS would increase from $11.7 million (USPS-T-1 Appendix A) to $20.3 million (OCA/USPS-T1-44).

The specific contract language, the data on Chase volumes, and the results of the financial analysis of Chase volumes, all point to the conclusion that the merger should not be an obstacle to approval of the NSA, and that it will in fact improve the deal for the Postal Service.[26] Although the OCA originally expressed the desire to seek a hearing on the merger, it concluded, after receiving the Bank One and the Postal Service's extensive interrogatory responses, to withdraw its request for a hearing. Neither OCA nor Valpak has raised any dispute about the merger analysis provided in the interrogatory responses, thus rendering the merger a non-issue.

H. The Stop-Loss Trigger Adopted By Stipulation And Settlement Provides Further Protection Against The Remote Possibility Of A Negative Outcome.

From its initial meeting with the OCA on June 23, 2004, two days after the NSA was filed, to the filing of the Stipulation and Agreement on September 15, 2005, Bank One has tried to respond fully to all of the OCA's concerns. These efforts have involved technical meetings with the economists of OCA, Postal Service, and Bank One, the provision of data in response to formal and informal interrogatories, and many

[26] For example, if integration occurred on January 1, 2005, the threshold adjustment would significantly reduce the Postal Service's discount exposure because much of the Before Rates First-Class solicitation volume entered by J.P. Morgan Chase in 2004 is likely to migrate to Standard Mail in 2005 pursuant to the mailing practices of the merged company. *See* Response of Bank One witness Rappaport to OCA/USPS-T1-44.

negotiation sessions.[27] Although settlement negotiations reached an impasse more than once, Bank One was greatly encouraged by the OCA's willingness to listen to Bank One's analyses and to understand the business requirements of the banking industry. As the parties worked through the issues, an acceptable solution did emerge, which was incorporated in the Stipulation and Agreement filed with the Commmission on September 15. The September 15 Stipulation and Agreement added a trigger mechanism as a further protection to the Postal Service from the remote possibility that the NSA will result in financial loss due to errors in the projections of costs. It provided for early termination of the NSA if the cumulative financial impact of the deal after two years was negative. The parties to the Stipulation also joined in "requesting the Commission not . . . impose in this case a stop-loss cap." Joint Motion filed on September 15, 2004, at 3.

Subsequent discussions with Valpak led to a revised stipulation and settlement, which Bank One, the Postal Service, the OCA and Valpak jointly submitted to the Commission on October 5, 2004. The Modified Stipulation and Agreement adopted the trigger mechanism of the September 15 Stipulation and Agreement – the finding of a negative cumulative financial impact after two years. However, rather than requiring early termination of the NSA if the cumulative financial impact was negative, the Modified Stipulation and Agreement allowed the NSA to continue on the condition that mail in the third year would only be eligible for the deepest block discount that produced a positive incremental financial impact. Specifically, the parties agreed to propose the following changes to the DMCS language, inserting a new section 612.35:

[27] The progress of these negotiations was chronicled in the Reports of the Settlement Coordinator filed on August 19 and September 2, 2004.

612.35 Third Year Discounts

In the third year of the agreement, availability of the discounts in Rate Schedules 612A or 612B will be subject to the following provisions:

(a) If the cumulative financial impact of Section 612 on the Postal Service at the end of the second year after implementation is positive, then the discounts in Rate Schedules 612A or 612B will be available.

(b) If the cumulative financial impact of Section 612 on the Postal Service at the end of the second year after implementation is negative, and the incremental financial impact for volume entered under any rate discount block under Section 612 is also negative, then mail that otherwise qualified for that discount shall instead be eligible for the deepest block discount that produces a positive incremental financial impact.

(c) Determination of the cumulative financial impact within the meaning of paragraph (a) shall be based on the financial analysis submitted into the record as Appendix A to USPS-T-1 by the Postal Service in Postal Rate Commission Docket No. MC2004-3, adjusted solely to reflect the return, forwarding and ACS success rates actually experienced by the Postal Service on eligible letter-shaped solicitations (as defined in Section 612.1) entered as First-Class Mail under this provision during the first two years after implementation.

(d) Determination of the incremental financial impact for volume entered under each rate discount block within the meaning of paragraph (b) shall be based on a financial analysis comparable to that specified in paragraph (c), except that the analysis shall report separately the net incremental contribution per piece for volume within each rate discount block, rather than the cumulative financial impact of Section 612 in the aggregate, and shall be based on inputs from the second year only.

(e) The Postal Service shall submit its determination under this section, along with the Postal Service's supporting analysis, within two years and three months from the implementation date of this provision.

(f) If the Postal Service fails to submit the analysis described in this subsection within 2 years and 3 months after implementation, this provision (Section 612) will expire 2 years and 3 months from the implementation date set by the Board of Governors, rather than at the end of the third year, as otherwise provided by Section 612.5.

As contemplated in the original settlement, the cumulative analysis would be based upon the financial analysis submitted into the record by the Postal Service in this docket *(i.e.*, Appendix A to the Direct Testimony of USPS witness Michael Plunkett, USPS-T-1). The Appendix A analysis would be adjusted solely to reflect actual return, forwarding and ACS success rates experienced by the Postal Service on eligible solicitations (as defined in proposed DMCS § 612.1) that are entered as First-Class Mail during the two-year period. In order to provide greater specificity, the parties provided Attachment D to the Modified Stipulation and Agreement as a model for calculation of the cumulative financial impact. That model could also be used to conduct the incremental financial analysis, if necessary, with the net incremental contribution per piece reported separately within each rate discount block, based on inputs from the second year only.

The OCA and Valpak supported the proposed NSA, as amended by the Stipulation and Agreement, and stated that they believed that the Stipulation and Agreement, the NSA, and the amended DMCS language served the interests of the Postal Service, consumers, and competitors, and complied with the standards and policies of Chapter 36 of Title 39 of the United States Code. They also joined Bank One and the Postal Service in requesting the Commission not to impose in this case a stop-loss cap, or any other constraints on the proposed NSA, different from that set forth in the proposed DMCS language. Based on the record developed in the Bank One case and the amended DMCS language, the OCA and Valpak concluded that they were satisfied that the Postal Service was protected against the risk of significant financial loss. Furthermore, they agreed that the potential of the NSA to provide additional contribution to the Postal Service by generating new First-Class Mail volume growth should be preserved. Moreover, the OCA, the Postal Service, and Bank One agreed that the record in the Bank One case demonstrated that the risk of loss to the Postal Service from anyhow volumes relating to misestimates of Before Rates was de minimis. (Valpak stated that it could not take a position on the last issue because it had not litigated the specific issue.)

The settlement reflects a careful balance of several competing objectives. First, the timing of the profitability review—two years after the implementation of the NSA—balanced the importance of allowing sufficient time for the mailer to adjust its business plans to incorporate the NSA's incentives against the remote possibility that the deal may yield a negative financial impact after one year. Setting the review at the end of the first year would increase the risk to mailers that their litigation, transaction and other initial sunk costs would be stranded, and thus would discourage mailers from pursuing NSAs.

Second, the mailer-specific variables specified for updating the Appendix A financial analysis—actual forwarding, return, and ACS success rates—corresponded to the primary concerns of the OCA and Valpak regarding potential sources of uncertainty in the profitability of the NSA. The four parties decided not to specify additional variables which might complicate the analysis or inject controversy and uncertainty.

The trigger mechanism was also crafted to avoid giving the Postal Service the discretion to manipulate other, more subjective or judgmental input values in Appendix A. The settling parties chose this course to minimize the risks that the discount-limitation mechanism might be found to constitute an unlawful delegation of rate-setting authority to the Postal Service, an issue that both J.P. Morgan Chase & Co. and the Commission noted in the Discover NSA case. *See* Docket No. MC2004-4 Op. & Rec. Decis. at 40-42; Docket No. MC2004-4, Reply Brief of J.P. Morgan Chase & Co. (Sept. 15, 2004) at 15-18 (citing precedent); *id*. at 18 n. 12 (explaining how a loss-avoidance mechanism could be designed to avoid this legal infirmity).[28]

In addition, the risk-limitation mechanism does not saddle Bank One with the risk that it will be penalized for unforeseeable changes in rates, rate structures and other factors totally beyond its control. Finally, restricting changes to three key inputs and adopting a two-year fixed implementation period allows Bank One enough certainty and time to incorporate the NSA's incentives into its marketing plans so that it can indeed respond with greater First-Class Mail volumes.

The result is a simple yet powerful stop-loss mechanism that addresses the key area of concern of the OCA and ValPak in this proceeding—the possibility that the Postal Service will lose money on the NSA. The protection added by this trigger mechanism complements the other protective safeguards in the NSA, including the annual discount threshold adjustment provision, the limitation of flat-shaped pieces

[28] Bank One believes that implementation of the mechanism is sufficiently ministerial and transparent to distinguish the mechanism from the adjustment procedures found unlawful in *United Parcel Service, Inc. v. USPS*, 455 F.Supp. 857 (E.D. Pa. 1978), *aff'd*, 604 F.2d 1370 (3rd Cir. 1979), and Docket No. MC86-1, *Destination-BMC Parcel Post Classification and Rate Changes (Experiment), 1985*, PRC Op. & Rec. Decis. (June 5, 1986) at ¶¶ 531-538. Should the Commission disagree, however, we ask the Commission to substitute the early-termination mechanism set forth in the Stipulation and Agreement of September 15, 2004, rather than frustrate entirely the expectations of OCA and Valpak, the primary proponents of the third-year mechanisms. Such a result would be more appropriate than imposing a cap based on cost-savings.

eligible for discounts, the merger adjustment provision, and the address hygiene requirements.[29]

I. The Broad Support For The NSA By The Participants In This Case Is Further Evidence That The NSA Is Likely To Be Highly Profitable To The Postal Service.

The likelihood that the NSA will have a positive financial effect on the Postal Service is evidence by the support for the NSA by the other participants in this case. No participant in this case ultimately chose to oppose the NSA. And the participants that have joined Bank One and the Postal Service in affirmatively supporting the NSA represent a broad cross-section of the Postal Service's stakeholders. They include Discover Financial Services, Inc., a major competitor of Bank One; the American Bankers Association, the principal trade association of the banking industry; five other trade associations of mailers, representing a broad spectrum of mail classes and subclasses (Alliance of Nonprofit Mailers, Association for Postal Commerce, Magazine Publishers Association, National Postal Policy Council, Inc., and Parcel Shippers Association); two major organizations of postal labor (American Postal Workers Union and National Association of Postmasters of the United States); a mailer that has been

[29] In negotiating the stop-loss trigger proposed herein, the parties considered and rejected several other risk-limitation mechanisms, including a cap on total discounts ("stop-loss cap"), a rate adjustment mechanism to maintain minimum per-piece contribution margins, and an increase in the minimum volume threshold for discounts to make the threshold equal to projected Before Rates volume ("free rider" adjustment). The Commission should refrain from imposing any of these adjustments on its own initiative. In Section II, *infra*, we explain why imposing a stop-loss cap in this case is likely to worsen, not improve, the Postal Service's finances. In the Discover case, the Commission declined to impose either a margin-adjustment mechanism or a "free rider" adjustment. Docket No. MC2004-4 Op. & Rec. Decis. at 40-42, 52 (rejecting margin adjustment); *id*. at 50-52 (rejecting "free rider" adjustment). The Commission's reasoning applies with equal force here. *See* Docket No. MC2004-4, Reply Brief of J.P. Morgan Chase & Co. (Sept. 15, 2004) at 11-21.

an active intervenor in all three NSA cases to date (Valpak); and the Commission's Office of Consumer Advocate. Most of these participants would have a clear economic or institutional incentive to oppose the NSA if they believed that the agreement posed a material threat to the Postal Service's revenues or institutional cost coverage. Their support for the NSA is substantial evidence of its likely benefit to all mailers.

II. THE COMMISSION SHOULD NOT IMPOSE A CAP ON THE TOTAL DISCOUNTS AVAILABLE TO BANK ONE.

In the Capital One case, the Commission imposed a cap on the total discounts available to the bank over the life of the NSA. MC2002-2 Op. & Rec. Decis. ¶¶ 5061-5074, 8024-8031. In the Discover case, the Commission accepted the cap negotiated by the co-proponents. MC2004-4 Op. & Rec. Decis. at 36-42. The Commission acted in each case out of a concern that the Before Rates First-Class Mail volume projected by the NSA proponents in each case might be low; that the Postal Service might thereby be paying discounts for First-Class volume that would have been mailed in any event; and that the revenue thereby foregone might be large enough to render the NSA unprofitable. MC2002-2 Op. & Rec. Decis. ¶¶ 5061, 5093-5102; MC2004-4 Op. & Rec. Decis. at 36. The Commission did not confront the possibility that an overall cap on discounts would reduce the overall financial benefits of either NSA, for in neither case did the NSA proponents offer evidence that the cap was lower than the aggregate discounts that the mailer would qualify for if the discounts were uncapped.

The record in this case is quite different. No participant supports a cap on aggregate discounts; the record provides no evidence that the proponents' Before Rates volume estimates are uncertain enough to jeopardize the profitability of the NSA for the Postal Service; the NSA includes two mechanisms that protect against an underestimate of Before Rates volumes; and there is ample evidence that a cap would greatly reduce the upside potential of the NSA for the Postal Service. Under these circumstances—and in light of the stop-loss mechanisms to which the parties have stipulated—the Commission should uphold the uncapped discount structure as a reasonable balancing of risk and reward by Postal Service management.

The recommended decision issued by the Commission today in Docket No. MC2004-2, *Experimental Priority Mail Flat Rate Box*, sets a clear precedent for this course. In Docket No. MC2004-2, the Commission approved an experiment in which the Postal Service will offer two box-shaped containers of standardized size for Priority Mail shipments, at a flat rate of $7.70. The Commission endorsed the experiment despite its potential for "revenue leakage resulting from Priority Mail customers who currently pay higher rates for relatively heavy and/or long-distance shipments 'buying down' to the flat rate box"—a leakage that could produce a "worst-case annual revenue loss of $12.6 million." MC2004-2 Op. & Rec. Decis. at 13. The Postal Service contended that this "minimal" risk "should be more than offset by the potential financial benefits of the experiment." *Id*. The Commission agreed, finding that "the reasonably bounded risk of potential revenue leakage estimated by the Service does not significantly detract from the merits of its proposed innovation." *Id*. at 13-14. The same risk/reward logic warrants approval of the instant NSA as well.

A. The Relevant Standards For Dealing With The Financial Risk Of An NSA.

1. The financial risk of an NSA can be rationally assessed only by comparison with the potential reward.

When a proposed rate or classification changes entails financial risk or uncertainty for the Postal Service, the Commission is entitled to consider whether the Postal Service has a struck a rational balance between risk and expected reward.

Bank One respectfully submits, however, that the Commission cannot shelter the Postal Service from all financial risk, and should not try to do so. Zero risk is a chimera, and micromanagement of the degree of risk undertaken by the Postal Service is beyond the Commission's authority.

First, "zero risk" is an unattainable goal. Postal ratemaking, as the D.C. Circuit has noted, is an inherently imprecise exercise:

> The Service makes projections about its costs and revenue that may or may not come to pass; projections are no more than educated guesses. The use of projections for future costs and revenues necessarily will involve some imprecision when actual data become available.

United Parcel Service, Inc. v. USPS, 184 F.3d 827, 834 (D.C. Cir. 1999).

The same is true of business and regulatory decisions in industry generally. Virtually every such decision involves a trade-off between risks and rewards: it is a rare contract or regulation that provides only an upside benefit without any corresponding downside risk. As a prominent economist has noted, the zero-risk framework for regulation "is a straw man unworthy of serious consideration. Even the attempt to maintain the facade is increasingly recognized by the regulatory agencies to be impossible." Lester B. Lave, *The Strategy of Social Regulation: Decision Frameworks for Policy* 12 (1981). Risk is unavoidable because every alternative to a risky choice—including the alternative of inaction—has risks of its own:

> Zero risk – On this criterion any action that involves any risk at all should be rejected. The definiteness and simplicity of decision processes based on such a criterion are soon seen to be false, however, because although the criterion may be stated, it is not possible to carry it out. Every action, including inaction, has some risk associated with it, either directly or through indirect risks..

Richard Wilson and Edmund Crouch, *Risk/Benefit Analysis* 92 (1982). Hence, reducing one risk will almost always increase another.

Volume discounts exemplify this truism. A minimum level of financial risk is inherent in every volume incentive discount structure, for the determination of an appropriate discount schedule by any firm, regulated or unregulated, necessarily requires predictive judgments about the level of customer demand absent the discounts. As the Commission noted in the Discover case, "To some extent, uncertainty of forecasts will exist with any functionally equivalent agreement." MC2004-4 Op. & Rec. Decis. at 36.

Under the circumstances, it is tempting to impose in every NSA case a stop-loss cap similar to those imposed in the Capital One and the Discover cases, for an aggregate cap on discounts may, at first glance, appear to reduce the Postal Service's risk of financial loss to zero. But capping total discounts at cost savings, or any other level below the aggregate discounts that a mailer would choose to qualify for in the absence of the cap, creates risks and costs of its own. These stem from the likelihood that the mailer will respond to the discount cap by entering fewer First-Class Mail solicitations, thereby depriving the Postal Service of potential revenue and contribution from First-Class mail that would have been entered absent the cap.

This risk is particularly serious in the Postal Service's current economic environment, which has made the need for additional revenue increasingly urgent. As The President's Commission found last year:

> [T]he trends they [analysts] foresee are sobering and credible: The traditional mail stream will likely continue to migrate to cheaper Internet-based alternatives. Largely as a result, the Postal Service will increasingly find it difficult to meet its "break-even" mandate . . . And, even if postage rates continue to adjust for inflation, the Postal Service, over the next 15 years, is likely to run substantial deficits. Equally discouraging, these obligations would pile on top of the Postal Service's $92 billion in current debt and other unfunded obligations.

Report of the President's Commission on the United States Postal Service, *Embracing the Future: Making the Tough Choices to Preserve Universal Mail Service* (2003) at iv; *accord*, *id*. at viii, xii, 1, 5. NSAs offer one of the "most promising new areas for exploration" of ways to increase the volume of high-margin First-Class Mail. *Id*. at 88. But this promise will be stunted if an undue regulatory aversion to risk prevents the Postal Service from taking full advantage of profitable business opportunities.

Hence, just as business managers and investors balance the risks and potential rewards of proposed investment decisions, accepting greater risk in exchange for greater rewards, the Postal Service should be permitted to balance the potential risks of an NSA against its potential rewards of an NSA (such as increased First-Class Mail volumes induced by the NSA).[30] As the Third Circuit noted in upholding the reasonableness of NSA-like volume discounts for international mail,

> Congress repeatedly indicated that a primary purpose underlying the [Postal Reorganization Act] was to require the Postal Service to discard its system of political patronage and bureaucratic decision-making in favor of modern business practices. We see nothing in the [Act] that prevents the Postal Service from innovative attempts to increase its business and profits, as long as it stays within the bounds of the relevant statutes.

UPS Worldwide Forwarding, Inc. v. United States Postal Service, 66 F.3d 621, 634 (3d Cir. 1995) (internal citations omitted). *Accord*, Docket No. MC2004-2, *Experimental Priority Mail Flat Rate Box*, Op. & Rec. Decis. (Oct. 6, 2004) at 14 (finding that the risk of an experimental new service with a "worst-case" potential revenue loss of $12.6 million annually did not "significantly detract from the merits of [the Postal Service's] proposed innovation").

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[30] *See, e.g.,* Paul Samuelson and Robert Nordhaus, *Economics* 483 (16th ed. 1998) (noting that investors rationally make tradeoffs between risk and expected reward); Investopedia.com, "Financial Concepts: The Risk/Return Tradeoff" (available at http://www.investopedia.com/university/concepts/concepts1.asp).

2. The Commission, in assessing the reasonableness of the risk-reward tradeoff, should give deference to the business judgment of Postal Service management.

Deciding to assume a financial risk in a specific venture entails a business judgment by the Postal Service's management and the Board of Governors. The assessment of risk and reward in deciding whether to offer a volume discount epitomizes the kind of managerial judgment reserved primarily for the Postal Service and its Board of Governors.

The courts have held repeatedly that Congress "inten[ded] . . . to vest in the Board of Governors exclusive authority to manage the Postal Service"; hence, "a management decision by the Postal Service may not be overruled or modified by the Rate Commission." *Governors of the USPS v. Postal Rate Commission*, 654 F.2d 108, 114-15 (D.C. Cir. 1981); *Newsweek, Inc. v. USPS*, 663 F.2d 1186, 1203 (2d Cir. 1981), *aff'd* in relevant part, *National Ass'n of Greeting Card Publishers v. USPS*, 462 U.S. 810, 819 (1983); *Time, Inc. v. USPS*, 710 F.2d 34, 37 (2d Cir. 1983). While the precise boundaries between the Commission's ratemaking authority and the Board of Governors' managerial authority continue to be a source of litigation, the risk-reward tradeoff inherent in the design of an NSA discount structure clearly falls within the class of managerial judgments that the Commission should refrain from overturning unless clearly imprudent or unreasonable.

With respect to the Postal Service's operating costs, for example, the Commission has held that

> does not scrutinize the wisdom of Postal Service spending plans. It presumes good faith on the part of the Postal Service in preparing these forecasts of dramatic spending increases. *See West Ohio Gas v. Public Utilities Comm. of Ohio*, 294 U.S. 63, 72 (1935). The intervenors must remember that the Postal Service does not face the same constraints as a typical regulated utility in its decisionmaking: this Commission cannot disallow expenses except in extraordinary circumstances.

R97-1 Op. & Rec. Decis. (May 11, 1998) at ¶ 2119, *aff'd*, *United Parcel Service, Inc. v. USPS*, 184 F.3d 827, 833-35 (D.C. Cir. 1999).

Likewise, in *Governors of the USPS*, *supra*, 654 F.2d at 110-117, the D.C. Circuit held that the Commission had no authority to limit the financial risk of the Electronic Computer Originated Mail ("E-COM") service by recommending it only as an "experimental service" of "limited duration" in order to "gain more information regarding a potentially beneficial new service," when Postal Service management had determined that the service was more likely to succeed if implemented without a fixed termination date.

In other regulated network industries, cases involving volumes discounts reveal similar deference to the risk-reward tradeoffs made by the regulatee. In *Huron Portland Cement Co. v. Baltimore & O. R.R.*, 332 I.C.C. 655 (1968), the Interstate Commerce Commission upheld as just and reasonable certain annual volume discount rates offered by railroads for transportation of coal to customers in Toledo, Ohio. The discounts, the ICC found, were justified by the "threatened construction" of a competing "coal-slurry pipeline." *Id*. at 659. "The defendant railroads *conducted their own investigation and satisfied themselves* that the utility companies could obtain their coal at a lower price if such a pipeline were constructed and used." *Id.* (emphasis added).

Bank One does not suggest that the Commission lacks authority to reject or modify proposed rate and classification changes when it is clear the risks of the proposals to the Postal Service outweigh their likely benefits. Given the modest volume response claimed by the proponents of the Capital One and Discover NSAs, capping the volume discounts in those cases may very well have been a prudent course. When the Postal Service has a reasonable basis for finding that the likely benefits of leaving

NSA discounts uncapped justify the likely risk, however, the Commission should abstain from second-guessing the Postal Service's judgment. *See* MC2004-2 Op. & Rec. Decis. at 13 (accepting judgment of Postal Service that risk of $12.6 million annual loss from experimental new service was outweighed by the potential for "additional institutional cost contribution from new Priority Mail volume"). As we explain next, the record makes clear that precisely those circumstances prevail here.

B. The Financial Risks Of The Proposed NSA, And Thus The Potential Benefits Of A Stop-Loss Cap, Are Low.

The potential uncertainties in both the Before Rates and After Rates volume estimates are small; hence, the potential benefits of a cap are also small.

1. Before Rates volume estimates are reliable.

For the reasons explained in Section I.B, *supra*, the record provides no evidence that Bank One's Before Rates volumes will exceed projections—let alone exceed them by a margin wide enough for the discounts received by "anyhow" volume to make the NSA unprofitable.

2. After Rates volume estimates are conservative.

For the reasons explained in Section I.C, *supra*, the record evidence demonstrates that the After Rates volumes estimated for Bank One are highly conservative.

3. The NSA includes two provisions to minimize financial risk from underestimating Before Rates volume.

To reduce further the risks of potential volume misestimates, the co-proponents of the NSA agreed to (1) a threshold and merger adjustment and (2) a limitation on the number of flats eligible for discounts.

First, the volume adjustment and merger integration provisions of the NSA ameliorate the risks that an underestimate of Before Rates statement mail or an unanticipated growth in Before Rates volume resulting from merger or internal growth in the scale of the mailer's business may cause the Postal Service to pay discounts for First-Class Mail that the customer would have entered anyway. The Commission acknowledged the effectiveness of these mechanisms in its recommended decision in the Discovery NSA case:

> 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 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.

MC2004-4 Op. & Rec. Decis. at 37 and 38. The reasoning applies equally here.

Second, the Bank One NSA contains a mechanism to protect against an underestimate of flat-shaped mail volume. The terms of the proposed NSA limit the total number of flats eligible to be counted toward the discount volume thresholds to 35 million pieces—the number of flats that Bank One mailed in 2003 and is projected to mail with or without the NSA in 2004. *See* Request, Attachment A, ¶ 612.1. Because of this limit, an underestimate of the number of flats has no effect on the value of the deal. Hence, the risks avoided by a cap on discounts would be small even if the discounts did not induce any additional First-Class volume.

4. The potential benefits of a stop-loss cap are therefore small.

A cap would benefit the Postal Service only if it underestimated Bank One's Before Rates volumes *and* Bank One failed to enter enough additional After-Rates First-Class volume for the added contribution to offset the leakage from the misestimated Before Rates volumes. Because those risks are small, so are the potential benefits of a stop-loss cap.

To demonstrate this fact, we begin with the most extreme scenario: the limit case in which all volume increases would have occurred without the discount—i.e., the discounts provided by the Postal Service (and incurred revenue leakages) were unnecessary to induce any of the additional volume entered by the mailer under the NSA. Then, the benefit of the cap would simply equal the cost savings from electronic returns on these pieces minus the sum of the discounts on all volume above the cap.

Computing the losses avoided by a stop-loss cap in this extreme scenario is a straightforward calculation. The Year 1 Before Rates "break even" volume in this scenario (under the methodology used in the Capital One case as adjusted to take into account that "anyhow" volume above Mr. Rappaport's estimate would consist of solicitations) is about 647 million pieces. Response of USPS witness Plunkett to OCA/USPS-T1-50. If Bank One entered a Before Rates First-Class volume of 647 million in Year 1 of the NSA, the Postal Service's net gain from the NSA would equal zero. And if Bank One's Before Rates volume exceeded 647 million pieces in Year 1, the Postal Service would incur a net loss. The incremental loss per piece would depend on the level of discount provided within each volume block. Under the rate schedule proposed for the NSA, volumes between 647 and 680 million would receive a discount of 4.5 cents per piece while volumes above 680 million receive a discount of 5 cents per piece. Plunkett Direct (USPS-T-1) at 6. With this information, we can construct a table showing the benefit of the cap at various volumes, on the assumption that all of the volume was "anyhow" volume (i.e., would have been entered even in the absence of the NSA discounts):

Table 4:

The Loss Avoided By A Capital One-Style Stop-Loss Cap If All Of The First-Class Mail Entered By Bank One In Year 1 Were "Anyhow" Volume

Volume (millions of pieces)	Loss Avoided By Cap (millions of $)
647	0
660	0.377
670	0.667
680	0.957
690	1.297
700	1.637
710	1.977
720	2.317
730	2.657
740	2.997
750	3.337

As noted above, this analysis assumes that *all* of the First-Class volumes entered by Bank One in Year 1 would have materialized anyway without the NSA incentive. How likely is this scenario—i.e., that all volume actually entered in excess of the Before

Rates volumes projected by the NSA proponents would in fact be "anyhow" volume? For the reasons explained next, the likelihood of this scenario is extremely remote.

First, the largest number of total First-Class Mail pieces for Bank One in any of the last three years (from 2001 through 2003) was 600 million in 2002, 47 million fewer pieces than this "break even" volume. Rappaport Direct (BOC-T-1) at 5. Second, for the cap to have *any* benefit (i.e., for the payment of discounts to "anyhow" volume to make the NSA unprofitable overall)—even in the unrealistic scenario in which incentives induce no additional volume—marketing letters would need to total approximately 105 million pieces (more than 350 percent of Mr. Rappaport's Before-Rates forecast. The probability of this occurrence is extremely small, given the stability of Bank One's marketing volumes and the criteria used by Bank One for choosing between Standard and First-Class Mail in marketing. *See* Section I.B, *supra*.

The likelihood that the losses avoided by a cap would be large is even more remote. As shown in Table 4, above, for example, the losses prevented by such a cap would approach the $1 million annual threshold only if Before Rates First-Class volume equaled or exceeded 680 million pieces per year—more than 100 million pieces above Mr. Rappaport's Before Rates estimate. Based on his Before Rates estimates, a total First-Class Mail volume of 678 million pieces would require 140 million solicitation letters, *more than four times his estimate*.

The remoteness of the odds that a stop-loss cap would avert significant economic loss to the Postal Service becomes even more obvious when one makes the more realistic assumption that the discounts would in fact induce some Bank One mail to migrate from Standard to First-Class Mail. If the discounts induced even 100 million pieces (or only ten percent of Standard solicitation volume) to migrate to First-Class

Mail (and Mr. Buc's Monte Carlo runs indicate a 90 percent probability that this will occur), then actual Before Rates volumes would have to exceed 718 million pieces—147 million pieces in excess of Mr. Rappaport's Before Rates estimate—for the NSA to become unprofitable for the Postal Service. Response of USPS witness Plunkett to OCA/USPS-T1-50. To produce such an estimate, Before Rates solicitation letter volumes would need to exceed witness Rappaport's estimate by *500 percent*.

And if the discounts induced a switch of 200 million pieces—also a likely outcome[31]—then actual Before Rates volumes would need to exceed 785 million pieces before the NSA became unprofitable for the Postal Service. Response of USPS witness Plunkett to OCA/USPS-T1-50. This would require an underestimate of Before Rates volume on the order of *214 million pieces*.

In sum, the record makes indisputably clear that a stop-loss cap is unlikely to provide any meaningful benefits to the Postal Service.[32]

C. A Cap On Total Discounts Would Expose The Postal Service To Great Risks.

1. A cap on total discounts is likely to deprive the Postal Service of millions of dollars of potential contribution from the NSA.

The most likely outcome of a cap on total discounts is reduction of the volume of Bank One solicitation mail that migrates from Standard to First-Class Mail, and a

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[31] More than 80 percent of Mr. Buc's Monte Carlo runs resulted in switches greater than 200 million pieces. *See* Section I.C, *supra*.

[32] Mr. Buc's analysis also allays any concern that "free riders"—pieces First-Class Mail that receive discounts because the Postal Service has deliberately set the discount volume threshold below the likely level of Before Rates volume—may contribute to the unprofitability of an NSA. *Cf*. MC2004-40 Op. & Rec. Decis. at 51. The analysis assumes the same discount thresholds as proposed by the Postal Service and Bank One; hence, the adverse effect (if any) of free riders to the Postal Service is fully incorporated into his contribution analysis.

consequent loss of the contribution that this migration could have provided. If the Before Rates and After Rates volume projections of the NSA proponents are close to accurate, the resulting loss of contribution could run into tens of millions of dollars over the life of the NSA.

Consider first the effect of a cost savings cap based on the methodology of the cost savings cap prescribed by the Commission in the Discover case. The Discover cap methodology would produce a three-year constraint of $11 million if applied to Bank One volumes alone.[33] The magnitude of the contribution that these caps would choke off is demonstrated by Mr. Buc's Monte Carlo analysis, which estimates the volume of mail that could switch from Standard Mail to First-Class Mail absent a cap.[34] The analysis shows an 80 percent probability that the cap would cost the Postal Service at least $6.1 million in annual contribution; a 50 percent probability that the cap would cost the Postal Service at least $8.7 million in annual contribution; and a ten percent probability that the cap would cost the Postal Service at least $11.5 million in annual contribution. Over the three-year term of the NSA, these figures translate into an 80 percent probability that the lost contribution would exceed $18.3 million, an even probability that the lost contribution would exceed $ 26.2 million, and a ten percent probability that the lost contribution would approach or exceed $34.5 million. These are

[33] *See* Response to OCA/USPS-T1-36. The cap would be $12 million if Chase volumes were integrated into the NSA at the beginning of the second year. *See* Response of USPS witness Plunkett to OCA/USPS-T1-50 (95 percent of discounts at "break even" from Tables 1-3 for the "0" switched volume case).

[34] Calculated by entering corrected pieces at percentiles from Attachment 3, page 2, to Mr. Buc's testimony (BOC-T-2) (corrected Aug. 16, 2004) into spreadsheet developed for Redirected Answer of BOC witness Buc to OCA/USPS-T1-24 (Aug. 2, 2004) and Attachment OCA/USPS-T1-24 thereto. The cap based on the Commission method in the Discover case is derived from Plunkett response to OCA/USPS-T1-36.

substantial risks to a business facing economic prospects as desperate as the Postal Service.

The adverse impact of an annual discount cap of $2.5 million—the approximate size of a cost savings cap based on the Capital One methodology—would be even more severe. There is an 80 percent probability that the cap would cost the Postal Service at least $7.1 million in annual contribution (or $21.2 million over the life of the NSA); a 50 percent probability that the cap would cost the Postal Service at least $9.7 million in annual contribution (or $29 million over the life of the NSA); and a ten percent probability that the cap would cost the Postal Service at least $12.4 million in annual contribution (or more than $37.2 million over the life of the NSA). *See* Redirected Response of Bank One witness Buc to OCA-T1-24. With these effects, a stop-loss cap, if applied to the Bank One NSA, would be more accurately described as a "stop-gain" cap.

These adverse effects constitute another major difference between this case and the Capital One and Discover cases. In both of the two earlier NSA cases, the stop-loss cap prescribed by the Commission appeared far less likely to reduce the financial benefit of the NSA. The After Rates volumes predicted for both Cap One and Discover are below the volume needed to exceed the prescribed discount ceilings. Thus, if the Before Rates and After Rates volumes estimates provided by the NSA proponents are correct, the Capital One and Discover stop-loss caps will have no effect on the First-Class volume that either bank will be encouraged to enter. In marked contrast, if Before Rates and After Rates projections in the present case are close to correct, the economic incentives for Bank One to shift solicitation volumes from Standard Mail to First-Class Mail will be drastically reduced.

The Bank One NSA also differs from its two predecessors in the financial impact of any dampening of this migration. As shown in Table 1 on page 7, *supra*, increased contribution from migration of solicitation volumes to First-Class Mail represents well over half of the expected benefit of the Bank One NSA to the Postal Service consists of increased contribution. For the Capital One and Discover NSA, the added contribution from inter-class mail migration represents a considerably smaller portion of the overall value of the NSA to the Postal Service.

2. A cap on aggregate discounts would also have a chilling effect on future functionally equivalent NSAs.

Another risk from capping discounts at ACS cost savings transcends this case. Limiting the discounts to the costs savings generated by solicitations currently mailed as First-Class Mail would have a chilling effect on future functionally equivalent NSAs. Many banks currently enter large volumes of solicitations as Standard Mail. An uncapped discount incentive could enable the Postal Service to induce a large share of this volume to migrate to First-Class Mail, benefiting the Postal Service, banks, and other mailers. Very few (if any) other banks, however, currently send enough First-Class Mail to justify the energy, time, and money needed to obtain a functionally equivalent NSA with discounts capped at ACS savings on Before Rates First-Class volumes. Hence, a policy of capping functionally equivalent bank NSAs at cost savings "would kill the goose that could lay the golden egg." ABA Reply Comments (Aug. 5, 2004) at 3.

D. Other Justifications Offered For A Stop-Loss Cap In The Discover Case Do Not Apply Here.

Apart from concerns of financial risk (discussed in Sections II.A through II.C, above), the Commission's Recommended Decision in Docket No. MC2004-4 offers three other grounds for imposing a stop-loss cap on Discover's NSA: (1) a stop-loss cap may be necessary to "associate[] the cost savings element of the agreement to the discount element"; (2) an NSA lacking a stop-loss cap similar to the one imposed on the Capital One NSA "might not be considered functionally equivalent" to that NSA; and (3) failure to condition approval of the Bank One NSA on a stop-loss cap similar to the one imposed on the Capital One NSA might constitute undue discrimination against Capital One. MC2004-4 Op. & Rec. Decis. at 25. None of these considerations justify imposing a stop-loss cap in the present case. We discuss each one in turn.

1. The discounts received by a mailer under an NSA properly may be "associated" with any of the benefits received by the Postal Service, not just with cost savings.

In rejecting as conceptually unsound the "competitive" cap proposed by Discover in Docket No. MC2004-4, the Commission observed that the "methodology employed to calculate the stop-loss mechanism [in the Capital One case] effectively associates the cost savings of the element to the discount element." MC2004-4 Op. & Rec. Decis. at 25. By contrast, the "competitive" cap proposed by the NSA proponents in the Discover case

> functions as a limit on the benefit that DFS may receive and not primarily as a protective mechanism for the Postal Service or other mailers. Because of this, the mechanism 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.

Id.

The import of these observations is not entirely clear. If their point is that the design of a stop-loss cap must be rationally related to the likely financial impact of imposing or omitting a cap on the Postal Service, Bank One fully agrees. Likewise, if the thrust of the quoted language is that Discover's competitive cap was *not* rationally related to the goal of protecting the Postal Service's contribution, Bank One also agrees.[35] As noted above, the record in this case makes clear that the absence of a stop-loss cap, and the presence of the other safeguards supported by the NSA proponents and the signers of the Stipulation and Agreement, are rationally related to the Postal Service's financial interests.

If, however, the intent of the quoted language is that the discounts offered by an NSA may never exceed the Postal Service's cost savings, or must always correlate closely with them, then Bank One respectfully disagrees. A properly designed contract between a supplier and its customer can benefit the supplier by increasing its revenue and contribution, not just by reducing its costs. An NSA that encourages a mailer to enter more mail, use a higher-margin class of mail in lieu of a lower-volume class, or refrain from migrating to lower-margin mail classes or non-postal media such as the Internet is as legitimate as an NSA that encourages the mailer to engage in cost-saving behavior.[36] Indeed, in a well-designed declining block rate structure, the benefits received by the supplier may consist *entirely* of added revenue or contribution, with no cost savings at all.[37] The only "association" required between the discounts received

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[35] As the Commission noted, however, the conceptual shortcomings of the "competitive" cap were of little practical significance for Discover, for the value of the cap, as applied to Discover's mail profile, was not much higher than a cap derived from the Commission's cost savings methodology. *Id*. at 42.

[36] *See*, *e.g.*, MC2002-2 Op. & Rec. Decis. ¶ 3007 (citing *Postal Ratemaking in a Time of Change: A Report by the Joint Task Force on Postal Ratemaking* (June 1, 1992) at 43) (noting that "[w]here rate differentials as between customers are not based on cost differences, they must have some other adequate justification" such as the attraction of additional volume from "high-volume users").

[37] A declining-block rate structure is, in economic terms, a form of second-degree price discrimination. Second-degree priced discrimination benefits a firm by allowing it to capture more of the potential surplus available in the area between the customer's demand curve and the supplier's marginal cost curve. The cost curve itself need not shift at all. *See, e.g.,* F.M. Scherer and David Ross, *Industrial Market Structure and*

by the mailer and the benefits received by the Postal Service from the arrangement is that the *aggregate* benefits of all kind received by the Postal Service under the NSA exceed the *aggregate* costs incurred by the Service in return. *See* MC2002-2 Op. & Rec. Decis. at ¶¶ 3058, 8006, 8010 (holding that the relevant dimension of profitability is the overall profitability of the NSA as a whole, not any individual component); Order No. 1391, *Negotiated Service Agreements*, 69 Fed. Reg. 7574, 7577-78, 7580 (2004) (same); MC2004-4 Op. & Rec. Decis. at 52 (same).

2. The Commission's rules for functionally equivalent NSAs do not require a stop-loss cap.

In discussing the stop-loss cap issue, the Commission's Recommended Decision in the Discover case also suggested that differences between the stop-loss mechanisms of two NSAs, if great enough, may warrant a finding that the two NSAs are not functionally equivalent under Rule 196. MC2004-4 Op. & Rec. Decis. at 25. Whatever the implications of this statement in the context of the Discover case, the doctrine of functional equivalency cannot justify imposition of a stop-loss cap here.

First, it is too late in this case to be raising questions about the functional equivalency of the proposed NSA. Functional equivalency is not a substantive test of reasonableness under 39 U.S.C. §§ 3622 or 3623, but a threshold procedure designed to reduce the burden of trying an NSA case by "allowing proponents of the agreement to rely on relevant record testimony from a previous docket." MC2004-4 Op. & Rec. Decis. at 20. A finding of functional equivalency avoids the need to relitigate some of the facts

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Economic Performance 489-90 (3rd ed. 1990); Robert D. Willig, "Pareto-superior nonlinear outlay schedules," *Bell J. of Economics*, vol. 9, no. 1 (Spring 1978) at 56. Significantly, the basic analysis of declining block tariffs offered by the Commission and its witness, Professor John Panzar, in the Capital One case made no assumptions about the existence of cost savings. *See* MC2002-2 Op. & Rec. Decis. ¶¶ 5001-5036.

that were established in the earlier baseline case. *Id*.; 39 C.F.R. § 3001.196(a)(6), (d). The effect of a Commission finding that a proposed NSA is not functionally equivalent to an earlier baseline case is not the rejection of the NSA, but merely its diversion early in the case to the Rule 195 track provided for baseline NSA proposals. Consistent with the role of functional equivalency as a procedural screening device, Rule 196(c) requires that the determination of functional equivalency be argued at the initial prehearing conference, and resolved by the Commission "promptly" thereafter.

Bank One and the Postal Service made clear at the outset of this case that they had intentionally omitted a stop-loss cap from their proposed NSA, and opposed the imposition of such a cap by the Commission. Plunkett Direct (USPS-T-1) at 15-17; Buc Direct (BOC-T-2); Response of USPS witness Plunkett to POIR 1, Question 5 (filed July 26, 2004). Nonetheless, no other participant requested at the prehearing conference that the NSA be classified as a baseline NSA; no participant has challenged Presiding Officer's Ruling No. MC2004-3/1, which held that the NSA was functionally equivalent to the Capital One NSA; and no participant has asked the Commission to divert the case to the baseline NSA procedural track since then. The record in the case has now closed. To hold now that the NSA must be rejected (or subject to a stop-loss cap) because the NSA proponents failed to meet the additional proof requirements of a baseline NSA would be a clear denial of due process.

Second, even assuming *arguendo* that the issue of functional equivalency were still open for debate, the Commission's rules make clear that the threshold classification of an NSA as functionally equivalent vs. baseline is distinct from the ultimate question whether a stop-loss cap is appropriate. Rule 196(a)(6) specifies that the "financial impact" of the NSA "on the Postal Service," the impact of the NSA on "other users of the mail," and the "fairness and equity of the NSA" to competitors of the NSA proponents are issues in every NSA case, not just baseline cases. 39 C.F.R. § 3001.196(a)(6)(i)-(iii). And the Presiding Officer specifically ruled in this case that the issue of a "stop-loss provision" fell with the "ambit of issues" that the Commission has stated "will *always* be under consideration in *any* request predicated on a Negotiated Service Agreement." Presiding Officer's Ruling No. MC2004-3/2 at 6 (emphasis added). In compliance with these rulings, Bank One and the Postal Service have submitted extensive testimony analyzing the stop-loss cap issue, responded to multiple discovery requests on the issue, and briefed it thoroughly. No other participant in this case has asked the Commission to impose a stop-loss cap. Most of the participants have signed a stipulation and settlement opposing such a step. Whether this record justifies a stop-loss cap is a question of fact to be resolved under the rate and classification standards of the Postal Reorganization Act. The Commission's taxonomy of NSAs as "functionally equivalent" or "baseline" does not address, let alone resolve, this issue.

3. Approval of the proposed NSA without a stop-loss cap would not discriminate unduly against Capital One or Discover.

On page 25 of its Recommended Decision in the Discover case, the Commission states that a "more advantageous" (i.e., less constraining) stop-loss cap for a mailer "may discriminate against the recipient of the baseline agreement and leave that mailer competitively worse off." MC2004-4 Op. & Rec. Decis. at 25. We discuss the general question of discrimination and competitive injury in Section III, *infra*. For the reasons explained there, the absence of a stop-loss cap on the proposed NSA would not injure or unreasonably discriminate against Capital One (the mailer party to the relevant baseline NSA) or Discover (the mailer party to the other functionally equivalent NSA).

III. THE NSA WILL NOT HARM OR UNDULY DISCRIMINATE AGAINST COMPETITORS.

Rule 193(f) requires the Commission to consider the impact of the NSA on competitors of the mailer party to the NSA and competitors of the Postal Service. With respect to a functionally equivalent NSA, Rule 196(a)(6)(iii) likewise requires consideration of the "fairness and equity of the [NSA] in regard to the competitors of the parties to the [NSA]." And 39 U.S.C. § 403(c) forbids the Postal Service from making any "undue or unreasonable discrimination among users of the mails," or "any undue or unreasonable preferences to any such user." The record offers no evidence that the proposed NSA would violate any of these norms.[38]

The Commission gave thorough consideration to these issues in the Capital One case. Concerns about competitive injury, the Commission found, "did not apply with much force" because Capital One's competitors "did not object to the NSA during the proceeding" and "the party most likely to represent direct competitors, the American Bankers Association, signed the Stipulation and Agreement" supporting the NSA. MC2002-2 Op. & Rec. Decis. ¶ 5048. Volume discounts, the Commission further found, do not violate the antidiscrimination provision of 39 U.S.C. § 403(c) as long as the Postal Service offers functionally equivalent arrangements to similarly situated mailers. *Id*. at ¶¶ 3023-3031, 5076, 7003-7023.[39]

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[38] As with the Capital One and Discover NSAs, the Bank One NSA raises no concerns about harm to competitors of the Postal Service itself. The Private Express Statutes give the Postal Service a legal monopoly over the delivery of First-Class Mail solicitation mail.

[39] And the Postal Service's finances would not be threatened by the proliferation of functionally equivalent NSAs among other credit card issuers, for they are likely to respond to an increase in Capital One's solicitation mail volume by launching their own advertising campaigns. MC2002-2 Op. & Rec. Decis. at ¶ 5046.

The Commission reached the same conclusion last week in the Discover case. MC2004-4 Op. & Rec. Decis. at 43-44. Neither of the two banking industry intervenors in the Discover case—the American Bankers Association and J.P. Morgan Chase & Co.—opposed the NSA.[40] Capital One did not seek to participate in the Discover case at all. Such a record, the Commission found, provided no basis for making a finding of competitive injury:

> 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.

Id. at 44.

The same conclusion is warranted here. As in the Capital One and Discover cases, not a single competitor of the bank proposing the NSA opposes it. Capital One has not attempted to participate in the case at all.[41] Both of the banking industry participants that have intervened—the American Bankers Association and Discover—have signed the Stipulation and Settlement. The ABA has also argued in its initial brief that approval of the NSA would give a positive boost to competition:

> . . . ABA, as the only representative of the banking industry to intervene in this case, urges the Commission to approve this request as filed. Such an approval will, in appropriate cases make the NSA process available to a wider variety of mailers, including banks, by reducing the time, money and other resources necessary to pursue an NSA.

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[40] J.P. Morgan Chase & Co. is the successor to Bank One as a result of the merger between the two companies on July 1, 2004.

[41] Capital One's decision not to participate in the case cannot be regarded as inadvertent. Capital One's outside counsel in Docket No. MC2002-2 is appearing in this case on behalf of the Parcel Shippers Association.

ABA Br. at 1-2; *accord*, Plunkett Direct (USPS-T-1) at 14; Response of USPS witness Plunkett to POIR 1, Question (noting absence of any expression of competitive concern over the proposed NSA from contacts in the banking industry). As in the Capital One and Discover cases, the Commission "has not been presented with record evidence in this docket . . . to conclude that the competitive effects of this agreement will be different from the competitive effects of the Capital One [and Discover] agreement[s]." MC2004-4 Op. & Rec. Decis. at 43.

Moreover, to the extent that the availability or unavailability of an NSA has any competitive impact at all, this factor weighs in favor of the instant NSA proposal because two direct competitors of Bank One will already have functionally equivalent NSAs in place or approved. One of the main purposes of the functionally equivalent NSA is to expedite the approval process so that the competitor which has already received an NSA does not receive a competitive advantage (in the form of postage discounts for a key input) while other similarly situated competitors seeking functionally equivalent NSAs are delayed by a cumbersome approval process. As the Commission found in the Discover NSA case:

> Preventing similarly situated mailers from obtaining functionally 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.

MC2004-4 Op. & Rec. Decis. at 44.

Finally, the Commission's expression of concern in the Discover NSA case that the presence or absence of a stop-loss cap may raise issues of "fairness and equity between two mailers" (MC2004-4 Op. & Rec. Decis. at 25) is unfounded—at least for the Capital One, Discover and Bank One NSAs. Neither Capital One nor Discover has objected to the terms of the instant NSA as unduly discriminatory, let alone asked the Commission to impose a stop-loss cap. As noted above, Capital One has not even intervened in the case, and Discover has signed the Stipulation and Agreement supporting approval of the NSA without a stop-loss cap.

Indeed, no legitimate claim of undue discrimination could have been raised even if one of Bank One's competitors had objected to the omission of a stop-loss cap from the Bank One NSA. As the Commission has recognized, discrimination between two mailers with respect to their stop-loss caps is unlawful only if the mailers are similarly situated with respect to that element of the NSA:

> Without attempting a complete definition of similarly situated, this would have to include similar mailing practices and characteristics, and in this instance [a comparison of Capital One vs. Discover] 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 [Capital One and Discover] are sufficiently similarly situated that the ["competitive" stop-loss cap proposed by Discover] resulted in a reasonable estimation of a stop-loss value.

MC2004-4 Op. & Rec. Decis. at 41-42.

With respect to a stop-loss cap, Bank One is clearly dissimilar to Capital One and Discover. As noted above, the record contains ample evidence that a Capital One- or Discover-style stop-loss cap would severely limit the total discounts that Bank One could otherwise earn; the records in the Capital One and Discover cases, by contrast, are devoid of any evidence that the volume of First-Class mail entered by either bank will ever reach the limits imposed by their stop-loss caps.[42]

[42] If the First-Class Mail volumes entered by either Capital One or Discover were to grow to the point that their stop-loss caps become binding constraints, the sensible response would be to request approval of a new or amended NSA with a higher discount ceiling, or no cap at all. *See* 39 C.F.R. § 3001.198 (reserved) (contemplating future requests to modify existing NSAs).

At bottom, the notion that failing to impose a stop-loss cap on Bank One would discriminate unduly against Capital One or Discover reduces to the proposition that it is unlawful for the Postal Service to offer Bank One greater discounts in the aggregate merely because Bank One's demand for First-Class Mail is more responsive to price than are the demands of Capital One or Discover. That proposition, however, is clearly incorrect. It has long been held that differences in demand and elasticities of demand can justify differences in price. *See*, *e.g.*, *UPS Worldwide Forwarding*, 66 F.3d at 634 (holding that 39 U.S.C. § 403(c) does not bar the Postal Service from limiting an NSA-like volume discount program to a "relatively small percentage of large-volume mailers"); *Sea-Land Service, Inc. v. ICC*, 738 F.2d 1311, 1317 (D.C. Cir. 1984) ("Because shippers meeting those volume requirements are not similarly situated with other shippers tendering lower volumes of traffic, no discrimination results from differential pricing in these circumstances."); *Williams Pipe Line Co*., 58 FERC ¶ 63,004 (1992) at 65,026 (same).[43]

[43] The proposition that that a regulated monopoly may charge lower prices to customers with more elastic demand, and higher prices to customers with less elastic demand, without engaging in unreasonable pricing or undue discrimination or preference has been recognized under the Interstate Commerce Act and other precursors of the Postal Reorganization Act since the late 1800s. *See*, *e.g.*, *Petroleum Products, Williams Bros. Pipeline Co*., 355 I.C.C. 479, 494 (1976), remanded on other grounds, *Farmers Union Central Exchange v. FERC*, 584 F.2d 408 (D.C. Cir. 1978); *Nat. Electric Mfrs. Ass'n v. Aberdeen & R. R.R*., 349 I.C.C. 502, 512 (1974), *aff'd* on this point, *Nat. Electric Mfg. Ass'n v. United States*, 407 F. Supp. 598, 602 (W.D. Pa. 1976); *Agrico Chemical Co. v. Seaboard Coast Line R. Co*., 361 I.C.C. 333, 337-39 & n. 6 (1979) (citing traditional case law), *aff'd per curiam*, *Agrico Chemical Co. v. ICC*, 652 F.2d 195 (D.C. Cir. 1981) (per curiam); ICC Docket No. 37028, *Anaconda Co. v. Burlington Northern Inc*. (decision served Nov. 15, 1979), vacated on other grounds, *Burlington Northern Inc. v. United States*, 661 F.2d 964, 967 (D.C. Cir. 1981) (citing traditional case law); *Wheeling-Pittsburgh Steel Corp. v. ICC*, 723 F.2d 346, 355-56 n. 22 (3d Cir. 1983); *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984).

This conclusion follows from the economic logic of differential pricing. As Alfred Kahn explained in his classic treatise on regulation:

> Whenever there is some separable portion of the demand sufficiently elastic that a rate below fully-distributed costs for it would add more to total revenue than to total costs, any insistence that each service or group of patrons pay their fully allocated costs would be self-defeating. It would force the firm to charge a price that would result in its turning away business that would have covered its marginal costs -- in other words, would prevent it from obtaining from customers with an elastic demand the maximum possible contribution to overheads. Thus, under the guise of ensuring a fair distribution of common costs and preventing undue discrimination, it would be serving the interests neither of the patrons who would be prepared to take additional quantities if prices were closer to marginal costs, nor of the customers with the more inelastic demands.

1 Alfred K. Kahn, *The Economics of Regulation* 155 (1970).

Professor John Panzar, a witness for the Commission in the Capital One NSA case, agreed on this point:

> The use of quantity discounts has long been widely practiced in both monopoly and competitive environments. Analysis of the practice also has a long history in economic theory. Long classified as "2nd Degree Price Discrimination," the modern term "nonlinear pricing" is more accurate. It refers to the use of a price schedule under which the total outlay is not the simple product of a constant price times the quantity purchased. The practice is not inherently discriminatory because the same outlay schedule is available to all consumers. There is a vast theoretical economic literature on the subject.

Docket No. MC2002-2, 8 Tr. 1583 (Panzar) (internal citations omitted). That most customers "will typically not have an equal ability to avail themselves of the quantity discounts incorporated in said schedule" does not render the volume discounts unduly discriminatory. *Id*. at n. 3.

CONCLUSION

For the foregoing reasons, Bank One Corporation respectfully requests that the Commission recommend the proposed NSA, subject to the conditions established by the Modified Stipulation and Agreement among the participants in this case.

Respectfully submitted,

/s/

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October 6, 2004

CERTIFICATE OF SERVICE

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

/s/

Joy M. Leong

October 6, 2004