

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

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

Docket No. MC2004-3

NOTICE OF THE UNITED STATES POSTAL SERVICE  
OF DECISION OF THE GOVERNORS  
(February 22, 2005)

The United States Postal Service hereby provides notice of the attached  
Decision of the Governors in Docket No. MC2004-3:

**Decision of the Governors of the United States Postal Service  
on the Opinion and Recommended Decision of the Postal Rate  
Commission Approving Negotiated Service Agreement with Bank  
One Corporation, Docket No. MC2004-3 (February 16, 2005)**

Respectfully submitted,

UNITED STATES POSTAL SERVICE  
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February 22, 2005

## **CERTIFICATE OF SERVICE**

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

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475 L'Enfant Plaza West, S.W.  
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February 22, 2005

**DECISION OF THE GOVERNORS OF THE UNITED STATES POSTAL SERVICE  
ON THE OPINION AND RECOMMENDED DECISION OF THE POSTAL RATE  
COMMISSION APPROVING NEGOTIATED SERVICE AGREEMENT WITH BANK ONE  
CORPORATION, DOCKET NO. MC2004-3**

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February 16, 2005

**STATEMENT OF EXPLANATION AND JUSTIFICATION**

On December 17, 2004, the Postal Rate Commission issued its Opinion and Recommended Decision in Docket No. MC2004-3. The Commission recommended, with the significant addition of a "stop-loss" cap, the rates and classification language contained in the Postal Service's Request for a recommended decision,<sup>1</sup> with certain modifications embodied in an unopposed settlement agreement.<sup>2</sup> PRC Op. MC2004-3, at 85. The rates and classification language are needed for the Postal Service to implement a negotiated service agreement ("NSA") that it signed with Bank One Corporation ("Bank One").

We have concluded that the changes recommended by the Commission to give effect to the NSA warrant implementation. As a result of implementing, the Postal Service and the mailing community will benefit from improved addressing practices; Bank One will benefit from receiving ACS at no charge and from rate discounts applied to First-Class Mail solicitations above specified volume thresholds; and the Postal Service and all mailers will benefit from cost savings generated by substituting electronic Address Correction Service (ACS) for physical return of undeliverable First-Class Mail, and from increased revenue contributions to costs created by additional First Class Mail volume.

We disagree, however, with the Commission's determination to place an overall limit on the discounts available to Bank One during the course of the NSA. The Commission rejected a near-unanimous, unopposed settlement agreement that excluded such a

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<sup>1</sup> See Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees To Implement Functionally Equivalent Negotiated Service Agreement With Bank One Corporation, Docket No. MC2004-3 (June 21, 2004).

<sup>2</sup> See Modified Stipulation and Agreement, MC2004-3 (October 5, 2004).

"stop-loss cap," and it imposed a cap as a condition in its recommendations. As we observed in our decisions approving substantially similar NSAs with Capital One Services, Inc. (Docket No. MC2002-2), and Discover Financial Services, Inc. (Docket No. MC2004-4), we believe that limiting the discounts is unnecessary and could constrain significant potential benefits from the NSA.

We note that, in a concurring opinion signed by all participating Commissioners in this proceeding, the Commission expressed general support for the NSA approach to rate flexibility, and stated that future NSAs might not need to be similarly limited.<sup>3</sup> The Commission did not, however, give explicit guidance concerning the circumstances under which caps might be excluded, or describe specifically how the Postal Service would demonstrate that limiting the discounts would be unnecessary. This is the third time the Commission has elected to recommend capping discounts created by similar NSAs. As discussed below, we request that the Commission reconsider the cap in this case, in light of our views, and based on the existing record. We also believe that pursuit of future NSAs would benefit greatly from a more detailed explanation regarding the type of evidence the Commission would find persuasive to overcome its concerns.

Among our statutory options, the one that comes closest to meeting our objectives is to allow under protest and return the recommended decision to the Commission for reconsideration and a further recommended decision. 39 U.S.C. § 3625(c)(2). This course will allow the Postal Service and Bank One to take timely advantage of the changes recommended. It will also give the Commission an opportunity to reconsider the standards it applied to conclude that the discounts must be capped. In this regard, we are not asking the Commission to reopen the record to receive additional testimony, although we expect that the Commission will solicit comments from the participants, as it has in the past. If, based on the record already compiled, the Commission concludes that it must again recommend the NSA changes with a cap, we ask that it clarify and explain further the thoughts in its Opinion and Concurring Opinion regarding the potential for uncapped NSAs of this type. We, furthermore, request that the Commission elaborate on the type and level of proof that it might find persuasive in avoiding caps in

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<sup>3</sup> Concurring Opinion of Chairman Omas, Vice Chairman Hammond, Commissioner Covington, and Commissioner Goldway, Docket No. MC2004-3, at 1, 3-4 (Dec. 17, 2004) ("Concurring Opinion").

future cases. Finally, we believe that discussion of the role of settlement in these uncontested cases would be useful for future cases and in developing interest among potential NSA partners to request changes at the Commission. We believe that such guidance will greatly assist the Postal Service and customers in pursuing future NSAs.

Notwithstanding our request for reconsideration and further explanation, we find that the rates and fees and classification changes recommended by the Commission are adequately explained and supported by substantial record evidence.

## **BACKGROUND**

The Postal Service initiated this proceeding on June 21, 2004, by filing a Request, in accordance with 39 U.S.C. §§ 3622 and 3623. The Postal Service supported its proposals with the written direct testimony of witness Michael K. Plunkett (USPS-T-1) and other documents. Also on June 21, 2004, Bank One, as a co-proponent, filed the written direct testimony of witness Brad Rappaport (BOC-T-1). One week later, on June 28, 2004, Bank One filed the Direct Testimony of Lawrence G. Buc (BOC-T-2).

The Commission's Office of the Consumer Advocate ("OCA") and fourteen intervenors participated in this proceeding. The co-proponents responded to discovery requests from OCA, Valpak Dealers' Association, Inc. and Valpak Direct Marketing Systems, Inc. ("Valpak"), and the American Postal Workers Union, AFL-CIO ("APWU"), as well as several Presiding Officer's Information Requests.

The Postal Service patterned the NSA with Bank One after the previously-concluded NSA with Capital One Services, Inc. that the Commission had recommended for implementation and we approved in Docket No. MC2002-2.<sup>4</sup> Pursuant to its recently established Rule 196, the Commission granted the Postal Service's motion to use specialized procedures for consideration of NSAs that are "functionally equivalent" to established "baseline" NSAs.<sup>5</sup> Under these streamlined procedures, the Commission limited the issues in the proceeding to those related to financial and competitive aspects

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<sup>4</sup> Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission Recommending Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One, Docket No. MC2002-2, at 15-21 (June 2, 2003) ("Governors' Capital One Decision")

<sup>5</sup> 39 C.F.R. § 3001.196. See Presiding Officer's Ruling No. MC2004-3/1, Docket No. MC2004-3 (July 23, 2004).

of the Postal Service's Request.<sup>6</sup> In this instance, for purposes of Rule 196 procedures, the Commission determined that the Bank One NSA was functionally equivalent to the Capital One NSA.<sup>7</sup>

During the Bank One proceeding, the Postal Service and Bank One engaged in extensive settlement negotiations with the other participants.<sup>8</sup> Eventually, Valpak, which had initially opposed settlement, joined the Postal Service, Bank One, and the OCA in an unopposed, modified agreement to settle all issues in the case.<sup>9</sup> The Modified Stipulation and Agreement, which was filed on October 5, 2004, added significant measures to protect against financial loss during the life of the NSA.<sup>10</sup> Twelve intervenors adhered to the settlement, two abstained, and no intervenor opposed it.

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<sup>6</sup> Presiding Officer's Ruling No. MC2004-3/2, Docket No. MC2004-3 (August 13, 2004).

<sup>7</sup> We agree with this determination. As we understand the Commission's rules, functional equivalency status is basically a procedural issue determining whether a case should proceed under Rule 193 for baseline NSAs, or under 196 for functionally equivalent NSAs. In this context, we do not understand functionally equivalent status to be determinative on the issue of whether a cap is warranted in the particular circumstances of this case. Nor do we understand the apparent conflict between the Commission's earlier statements, which led us to believe that presence of a cap was not among the elements necessary for an NSA to be considered functionally equivalent to the Capital One NSA (See PRC Order No. 1391, Docket No. RM2003-5, at 50), and its conclusion in its Opinion here that, without a cap, the NSA could not be functionally equivalent. PRC Op. MC2004-3, at 41.

<sup>8</sup> See Notice of United States Postal Service's Intention to Conduct Settlement Conference, MC2004-3 (July 6, 2004); Notice of United States Postal Service's Intention to Conduct Settlement Conference, MC2004-3 (July 20, 2004); Reports of Settlement Coordinator (July 22, August 5, August 19, and September 2, 2004).

<sup>9</sup> The Postal Service, Bank One, the OCA and Valpak jointly moved for an adjustment to the procedural schedule to accommodate the settlement. The briefing schedule was postponed 16 days in all. Joint Motion of the United States Postal Service, Bank One Corporation, and the Office of the Consumer Advocate For Adjustment of the Procedural Schedule, Docket No. MC2004-3 (September 15, 2004); Joint Motion of the United States Postal Service, Bank One Corporation, Valpak Direct Marketing Systems, Inc., Valpak Dealers' Association, Inc., and the Office of the Consumer Advocate For Adjustment of the Procedural Schedule, Docket No. MC2004-3 (September 30, 2004).

<sup>10</sup> See Joint Motion of the United States Postal Service, Bank One Corporation, For Consideration of Modified Stipulation and Agreement as the Basis for Recommended Decision, Docket No. MC2004-3 (October 5, 2004); Modified Stipulation and Agreement, Docket No. MC2004-3 (October 5, 2004).

We are grateful to the participants for the substantial amount of time, effort, and resources they dedicated to reaching a negotiated settlement. The settlement agreement represented a cooperative and creative response to the Commission's expression of concern about the risk of financial loss embodied in the Capital One NSA. We especially commend the OCA and Valpak, as well as the other signatories, for their astute analyses of the issues, and their willingness to compromise. Significantly, the settlement represented an unopposed expression of confidence that a cap on discounts would not be needed. In other words, the parties agreed that the conditions that led the Commission to recommend a stop-loss cap in the Capital One case need not constrain the potential for financial gain benefiting all mailers that is inherent in the Bank One NSA's discounted rates. In this regard, we are disappointed that the Commission did not adopt the settlement solution as concluded, but instead imposed a stop-loss cap, in addition to the terms of the NSA and the settlement. As we explain below, we believe that the Commission missed an important opportunity in this respect.

#### **SUMMARY AND EVALUATION**

Under the terms of the NSA, Bank One agreed to accept "electronic returns" of certain undeliverable-as-addressed ("UAA") First-Class Mail through the Address Correction Service (ACS), in lieu of actual physical return of the pieces. This type of provision suits Bank One, as it did Capital One in Docket No. MC2002-2, because Bank One makes significant use of First-Class Mail to send solicitations that advertise its credit card services. ACS will provide Bank One with information about each undeliverable piece electronically. This change will result in cost savings for the Postal Service, because the costs of providing the information electronically are lower than the costs of physical return of each UAA First-Class Mail solicitation piece.

In addition to the provisions regarding returns, the NSA also provides Bank One with the opportunity to pay lower "declining block rates," if it provides very high volumes of First-Class Mail (over 535 million pieces in the first year). Under this arrangement, Bank One receives discounts starting at 2.5 cents off each piece above 535 million, up to 5.0 cents for each piece above 680 million. This provision is comparable to, but not identical with, the provision of declining block rates to Capital One in the baseline docket. The NSA will benefit all mailers because Bank One has committed itself to various measures that we and the Commission both conclude will reduce costs in ways that exceed the

cumulative value of the discounts. Importantly, the record demonstrates that the NSA will yield net contribution from increased First-Class Mail volume.<sup>11</sup>

In the instant docket, the Commission also approved of several customer-specific terms that were not present in the Capital One NSA. These terms included an annual threshold adjustment, which is designed to keep alive the incentives for Bank One to increase its First-Class Mail solicitations in the second and third years of the agreement, an enhanced mergers and acquisitions clause, an annual limit on the mailing of flat-shaped mail, and a negotiated trigger mechanism to guard against certain financial risks during the life of the NSA.

In accordance with the Rules of Practice Governing NSAs, the Bank One record also provided three years of financial information, overcoming another deficiency identified in the Capital One case. No party challenged the forecasts or the other cost data, and the only change to the financial analysis made by the Commission in its recommended decision was the removal of the contingency.<sup>12</sup>

As noted above, the Commission also imposed a "stop-loss" provision, or cap, tied to the estimated cost savings. PRC Op. MC2004-3, at 68. Under the cap, the total discounts paid cannot exceed a specified dollar limit. In Capital One, the discounts were capped at \$40.6 million over the three years of the agreement. In Bank One, the Commission recommended capping the discounts at \$11.5 million.<sup>13</sup> The Commission found that

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<sup>11</sup> In its Opinion in Bank One, the Commission observed that the estimated additional contribution resulting from growth in First-Class Mail volume induced by the volume discounts would be "nearly as much" as the contribution realized from the address correction element. From this, it concluded that the Bank One NSA is "predicated on a different financial basis" than the Capital One NSA. PRC Op. MC2004-3, at 38. We do not agree. We believe this to be a mere difference in the value of the functional elements, not a difference in the functional elements themselves, since the NSA still provides significant contribution from ACS savings. See PRC Order No. 1391, Docket No. RM2003-5, at 51.

<sup>12</sup> See PRC Op. MC2004-3, at 75.

<sup>13</sup> In formulating the cap, the Commission followed a methodology that is substantially similar to the one used to calculate the Capital One discount cap. Although we are troubled by the imposition of the cap, the Commission improved its methodology for calculating the cap in this case in two ways. First, it incorporated into its estimation of ACS savings an assumption that any First-Class Mail volume above the forecasted volume will be solicitation mail with additional ACS cost savings. Second, it provided for a 100 percent pass-through of the savings. The result yields a higher cap than the Capital One methodology and the record supports both assumptions.

such a stop-loss provision was necessary to protect against any potential loss of revenue from applying discounts to mail that would have been sent anyway, even in the absence of the agreement. *Id.* at 4. Without this element, the Commission stated that the NSA would not protect the interests of mailers who were not parties to the NSA, and who would have to help make up any losses to contribution the NSA might produce. As a consequence, the Commission found that an uncapped NSA would not accord with the requirements of the Postal Reorganization Act.<sup>14</sup>

The record provides full support for the Commission's conclusion that the Bank One NSA is fair and equitable to other users of the mail, including competitors of Bank One. PRC Op. MC2004-3, at 79-80. With respect to competition, we repeat our belief that the best way for issues of competition and undue discrimination to be addressed is through notice and opportunity to be heard. As the Commission noted, no competitors of Bank One, or other mailers, argued that this NSA was anti-competitive or unduly discriminatory. *Id.* at 80.

We agree with the Commission that the record supports the recommended changes in rates and classification, and we allow them under protest, pursuant to 39 U.S.C. 3625 (a) and (c). We also find that the recommended decision is consistent with the policies of sections 3622 and 3623 of the Postal Reorganization Act. See discussion at PRC Op. MC2004-3, at 80-82.

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<sup>14</sup> We do not read the decision to impose the cap as predicated primarily on the uncertainty created by Bank One's merger with J.P. Morgan Chase although it is one of the reasons given. See, e.g, PRC Op. MC 2004-3, at 38-39; 54-58. We note that the Commission found in the Discover case that a cap based on cost savings was also necessary, despite the absence of a merger. Despite the uncertainty of the merger's precise impact on mail volumes, we believe that the NSA contains enough safeguards to adequately protect the Postal Service and other mailers. As a result, the merger does not justify the imposition of a "stop-loss" cap.

## ISSUES FOR RECONSIDERATION

Before discussing the issues for reconsideration, we want to acknowledge that the Commission has made significant contributions to ratemaking flexibility in recommending implementation of three successive NSAs. In allowing the Commission's recommendations to take effect under protest and returning for reconsideration, we seek primarily to take advantage of the Commission's judgment recommending changes that will give effect to the mutually beneficially NSA with Bank One. At the same time, we are requesting the Commission to reevaluate its decision to impose a cap, in light of views from our perspective as Governors of the Postal Service.<sup>15</sup> While we might not entirely agree with the Commission's interpretation of the Act in every situation, we respect its views. We simply are asking the Commission to consider our concerns, to the extent it might conclude it has discretion to moderate its standard for approving NSAs of this type, particularly with regard to the level of financial and other risk that the system can tolerate. Finally, the Postal Service would prefer to be able to provide the Commission with the type of support for its NSA rate and classification proposals that the Commission believes it needs to satisfy its view of its statutory obligations, even if we disagree. We are therefore asking for explicit guidance and examples regarding how the Postal Service might satisfy the Commission's concerns in future case.

In the arena of NSA proposals in general, and the Bank One NSA in particular, we are troubled by three main concerns. First, we are not convinced that the standards the Commission has erected in evaluating estimates to support NSAs are realistic or attainable. Second, we believe the Commission has not clearly explained its expectations about the possibility of uncapped NSA provisions, or provided guidance about the level of support generally needed to justify NSAs, without stringent mechanisms to protect against financial loss. As a result, it has failed to provide clear guidance for the negotiation of future NSAs and their proposal to the Commission. In particular, postal management is concerned that the Commission's restrictive approach

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<sup>15</sup> Over the past several years, we have in several instances found the Commission to be cooperative and creative in adapting the Act's ratemaking procedures to meet some of the specialized needs of the Postal Service and mailers in the modern business environment.

has chilled the prospects for future beneficial agreements.<sup>16</sup> Third, we are also concerned that the Commission's decision to superimpose unwanted conditions on the settlement agreement, and its views on settlement in NSA cases, need clarification. In particular, we are concerned that the Commission's views on the role of settlement might inhibit future progress and discourage innovative resolution of issues in potentially contentious cases involving NSAs.

In its reconsideration of its initial Bank One recommended decision, we respectfully request that the Commission meet several narrow objectives. First, we ask the Commission to reconsider, clarify, and elaborate upon a) the evidentiary requirements necessary to support volume discounts in the Bank One case, and b) whether the Commission's policy for recommending NSAs will be based on the need to eliminate risk entirely, or on some other standard. In light of the reconsideration of these issues, we then request the Commission to reevaluate the record evidence and determine whether the \$11.5 million cap should be imposed or otherwise modified.<sup>17</sup> We also request the Commission to clarify whether, as a policy matter, it disfavors settlements in functionally equivalent NSAs. If so, we ask the Commission to reconsider such a policy.

We believe that returning the recommended decision for reconsideration and a further recommended decision is the appropriate vehicle for obtaining these objectives. The Commission's reasoning for imposing a cap on the Bank One NSA was broad and did not appear to be narrowly tailored to the facts in this case.<sup>18</sup> Thus it is appropriate to reconsider its reasoning and provide guidance in the context of this evidentiary record. Second, the concurring opinion in this case expressed strong support for NSAs and took the position that the addition of the cap should not be construed as a precedent for all NSAs, or even all NSAs functionally equivalent to Capital One. Reconsideration will enable the Commission to elaborate on these views in this docket and to obtain input

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<sup>16</sup> See generally Data Collection Report, September 1, 2003 to September 30, 2004, Docket No. MC2002-2, at 17 (January 31, 2005).

<sup>17</sup> We are not requesting the Commission to reopen the evidentiary record at this time.

<sup>18</sup> The Commission did not, for example, rely primarily on potential uncertain impact on mail volumes created by Bank One's merger with JP Morgan Chase, although such uncertainty was cited as a secondary concern. See footnote 14 above.

from stakeholders, without the concern that such deliberation will delay the benefits that the NSA offers to the Postal Service, Bank One and all mailers.<sup>19</sup>

Finally, as noted above, management is concerned that mailer interest in NSAs has diminished in the wake of the Bank One recommended decision. Substantive guidance from the Commission will enable mailers and the Postal Service to have the confidence to negotiate, propose and support NSAs that will be sustainable.

### **VOLUME ESTIMATES AND THE REQUIREMENT OF A COST-SAVINGS CAP**

As we view the situation in the wake of the Bank One Recommended Decision, it seems clear that an NSA has a far better chance of being considered, recommended, and approved, as functionally equivalent to the Capital One NSA, if it incorporates a discount cap tied to ACS cost savings. It is unclear, however, whether any NSA creating volume discounts could pass the Commission's review, without a cap tied to cost savings.

In this regard, we observe that, in Bank One, the Commission took the unusual step of issuing a concurring opinion signed by all of the Commissioners who elected to recommend the changes we are here allowing.<sup>20</sup> Concurring Opinion, MC2004-3. In that concurring opinion, the Commissioners expressed strong support for NSAs. *Id.* at 1. They emphasized that the Bank One decision should not be construed as dictating the inclusion of a stop-loss cap in every case. *Id.* at 3-4. The Commission, in its main Opinion, also noted the possibility that a pure, or primarily, volume-based discount might be approved as part of a baseline case without a cap, under Rule 195. PRC Op. MC2004-3, at 38-39, 61, n. 41.

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<sup>19</sup> We do not believe that a procedural rulemaking would be the appropriate vehicle for addressing the policy issues that the Bank One decision presents. The issues that concern us here relate to substantive matters, such as what evidence is needed to prove a point, and what policy concerns should be paramount in evaluating an NSA. These concerns are not directly related to the Commission's rules applicable to Negotiated Service Agreements, for which it is seeking comments in the newly opened rulemaking docket. See PRC Order No. 1429, RM2005-2 (January 25, 2005).

<sup>20</sup> We hope that, despite the statement in the concurring opinion that the Commissioners urge the Postal Service to pursue NSAs that reduce the Postal Service's costs, they will also strongly support NSAs that induce profitable volume growth or improved service as well. We believe that the potential for increased contribution to the Postal Service's institutional costs may be greater for NSAs that contain volume growth or service incentives than cost-savings incentives.

Nevertheless, the Commission has imposed a stop-loss cap or its equivalent in three successive cases reviewing NSAs. The NSA decisions and the Order issuing the NSA rules have not provided enough guidance on how the Postal Service and its NSA partners might develop a record necessary to support volume discounts uncapped by cost-savings. In the baseline case, Docket No. MC2002-2, the Commission instituted a "stop-loss" cap because of the variability in the volume history of Capital One, noting the company's history of rapidly increasing First-Class Mail volume. PRC Op. MC2002-2, at 148. Specifically, it found that Capital One's estimates of Before Rates volume were "so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA." *Id.*<sup>21</sup> It also cited as justification for imposing the cap that the volume forecasts were only for a single year and were not representative of the three year term. *Id.* at 150. It stated that it expected that future cases would likely not experience similar problems with the volume forecasts, because the experience of the Capital One case and the Commission's Opinion would inform the NSA stakeholders. The Commission also stated that it would institute a rulemaking that would deal with the need for NSAs to be supported by volume projections that are representative of the term of the proposal. *Id.*

Following the Capital One case, the Commission conducted the promised rulemaking, (Docket No. RM2003-5), and issued rules requiring that volumes be projected for the life of the agreement. See 39 C.F.R. §3001.193(e) (2004). The Order issuing the final rules also provided guidance on the features that needed to be included in an NSA for it to be considered functionally equivalent to the Capital One case. PRC Order No. 1391, Docket No. RM2003-5, at 50. As an instructive example, the Commission identified the two functional elements of the Capital One NSA: 1) an address correction element, which is the primary cost savings element for the Postal Service, and 2) a declining block rate element. *Id.* Omitted from the example was any discussion of a need for a discount cap as one of the necessary functional elements. This omission encouraged Postal Service and NSA candidates to believe that a cap would not necessarily be needed for cases that otherwise met the functionally equivalent requirements.

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<sup>21</sup> It also found that "[a]bsolutely no evidence suggests that the volume projected for the current year will be representative of experience in each of the following three years when the NSA would be in effect." PRC Op. MC2002, at 148-49.

In the Discover and the Bank One cases, the Postal Service and its NSA partners relied primarily on the guidance the Commission had provided in both the Capital One Recommended Decision and the Order issuing the NSA rules. In each case, the Postal Service's testimony accompanying its Request sought to distinguish the circumstances that gave rise to the imposition of the stop-loss cap in the Capital One case from the record presented to support these functionally equivalent NSAs.

In the Discover case, the Commission again concluded that a cost-savings-linked cap was necessary, despite a history of *declining* mail volumes and a stable Before Rates forecast.<sup>22</sup> Notwithstanding these factors, the Commission stated that "[t]o some extent, uncertainty of forecasts will exist with any functionally equivalent agreement," PRC Op. MC2004-4, at 36, and concluded that some form of stop-loss mechanism was necessary to account for "the possible effects of deviations from the volume estimates" due to "changes in exogenous factors" that affect "assumptions for myriad non-price factors that affect mailing behavior far into the future." *Id.* at 41. In approving the parties' negotiated competitive cap of \$13 million in that case, the Commission implied that it was acceptable only because it was close to the Commission's calculation of a stop-loss cap (\$11.8 million).

In the Bank One case, the Commission noted that the NSA had three risk limiting features not found in the Capital One case: an annual threshold adjustment, a flats volume limit, and an enhanced mergers and acquisitions clause. PRC Op. MC2004-3, at 70-71. Still, the Commission justified the imposition of a stop-loss cap by pointing out that, while Bank One had a stable volume history, its Before Rates forecasts envisioned a significant drop in First-Class Mail solicitations absent the NSA, and that such a forecast could benefit a mailer under an NSA, because it would justify beginning the discounts at lower levels of volume. PRC Op. MC2004-3, at 57, 60-61. Moreover, the Commission faulted the estimates as implicitly incorporating assumptions for myriad non-price factors that affect mailing behavior far into the future, without providing an

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<sup>22</sup> The record demonstrated that Discover's First-Class Mail totals had dropped from 549 million in 2002 to 442 million in 2003. Testimony of Karin Giffney (DFS-T-1), Docket No. MC2004-4, at Appendix I. Discover's Before Rates volume projections were then stable -- 451 million in the first year of the agreement, 446 million in the second year, and 441 million in the third year. *Id.* at 8.

analysis of the sensitivity of the forecast to changes in those exogenous factors. *Id.* at 67.

It does not appear likely to us that, in projecting the effects of NSA proposals involving volume discounts, the Postal Service might ever be able to construct the kind of forecasts typically used to estimate volumes and revenues for general rate changes. Furthermore, in light of the Commission's discussion of company-derived forecasts as presenting a "moral hazard" because of inherent bias, PRC Op. MC2004-3, at 60, it is unclear what role, if any, a company's forecast should play. Most companies, even if they have suitable data, are likely to be reluctant to share it in a public forum for competitive reasons. The Commission seems willing to accept a forecast based upon "an analysis of the sensitivity of the forecast to changes in exogenous factors," but has given no guidance on how such an analysis would be accomplished in the Bank One case or in any other case.

If these considerations present insurmountable obstacles to proving the cases for NSAs with volume discounts, unless capped by cost-savings, the Commission should explain that condition explicitly, rather than offering vague expressions of hope. The fact is that, in the current environment, with the three Commission NSA recommendations as a guide, we are informed by postal management that many firms with whom the Postal Service has been pursuing ideas for NSAs have either now lost interest, as a result of the artificial constraints the Commission has imposed, or have been deterred by the complications and expense that future NSA litigation promises, with little assurance of ultimate success. That is not to say that the effort to develop future NSAs has come to an end. The Postal Service will continue to pursue viable NSAs with mailing partners willing to devote the resources required to obtain the changes in rates and fees necessary to implement the NSA.

Alternatively, the Commission should make known its views, if it is possible to do so, on what would be necessary to provide reliable information to support volume discount proposals. We would ask the Commission to formulate and specify conditions under which it would find testimony by NSA partners adequate to support unconstrained NSA discount proposals. Such guidance would be a great help in maintaining and promoting private sector interest in potentially beneficial NSAs, and in developing successful proposals for presentation to the Commission.

## ACCEPTABLE RISK

In both its Opinion and in the Concurring Opinion in Bank One, the Commission emphasized perceived deficiencies in the before-rates volume estimates submitted to support the NSA proposals. The Commission believes that unreliability of these estimates creates an unacceptable risk of financial loss that justifies imposing a cap.<sup>23</sup>

The Commission has also concluded that, to be consistent with the legal requirements in the Act, NSAs must, in effect, guarantee against, and eliminate the risk of harm to the interests of mailers who are not parties to the NSA.<sup>24</sup> The cap represents the Commission's means of ensuring against such unacceptable financial risk.<sup>25</sup>

In this analysis, the Commission apparently has placed the requirement that rates be sufficient to cover costs in the forefront of its consideration.<sup>26</sup> To this extent, we do not disagree that rates must cover costs and that the cumulative effect of rate changes should be to allow the Postal Service to break even over time.

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<sup>23</sup> See PRC Op. MC2004-3, at 4, 61; Concurring Opinion, at 3.

<sup>24</sup> PRC Op. MC2004-3, at 40-41, 77.

<sup>25</sup> We wish to clarify that the "financial loss" that the Commission seeks to prevent through the addition of the cap is a lower contribution on volume that would have otherwise existed in the absence of the agreement ("anyhow volume"). Because First-Class Mail makes a substantial contribution to the institutional costs of the Postal Service, none of the proposed discounts will result in First-Class Mail that fails to cover its costs. Even if the deepest discounts available under the agreement were provided on anyhow volume, the contribution to the institutional costs would still be sizable. Limiting the assessment of risk to whether anyhow volume could reach a level where discounts paid will exceed cost savings, fails to address the opportunity costs that would result if a cap limits new First-Class Mail volume generated in response to the discounts. The risk of harm caused by unanticipated growth in anyhow volume should be balanced against the risk that a "stop-loss cap" will also operate as a "stop-gain" cap by limiting the contribution from new discount-induced volume.

<sup>26</sup> The "break-even" requirement is embodied in 39 U.S.C. § 3621, which directs us as, Governors, to ensure revenue sufficiency in establishing rates and fees, pursuant to Commission recommendations or other procedures in the Act.

Where we part company with the Commission's views, however, is in its apparent insistence that NSAs, in effect, must guarantee that they will always result in a win-win situation, in which both the mailer that is party to an NSA, and all nonparticipating mailers, receive a positive benefit over the life of the agreement. We understand this condition to be that under no conceivable circumstances will NSAs result in a financial loss of any magnitude.

If the Commission has established a policy that NSAs must eliminate financial risk entirely, we believe that the Commission has established an overly strict standard.<sup>27</sup> With First-Class Mail volume on the brink of long-term decline,<sup>28</sup> and in the face of adverse economic conditions, we view the goal of entirely eliminating risk in every situation to be misguided. The future viability of the Postal Service, and the continued stability of moderate rates and fees for all mailers, will depend on our ability to promote volume and revenue growth consistent with reasonable and practical interpretations of the policies in the Act, and to stem the decline of volume in all classes of mail. If we are to find innovative ways to increase revenue contribution, we need the latitude to accept a reasonable amount of risk in light of a realistic appraisal of circumstances. Indeed, some amount of risk is inherent in every Commission recommendation. Not all rates recommended by the Commission and approved by the Governors have consistently produced sufficient revenues to cover attributable and assignable costs over the entire course of a rate cycle.<sup>29</sup> Given the relatively limited scale and scope of the three NSAs

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<sup>27</sup> We note that this policy would also be contrary to the more lenient approach adopted in the Commission's recent Recommended Decision in the Flat-Rate Box case where it recommended the creation of an experimental rate, despite the risk that it could produce a "worst-case annual revenue loss of \$12.6 million" by cannibalizing volume from other more profitable mail. PRC Op. MC2004-2, at 13. The Commission found 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.

<sup>28</sup> See *Embracing the Future*, Report of the President's Commission on the United States Postal Service, at viii (July 21, 2003).

<sup>29</sup> In order to assess and predict costs, volumes, and revenues, postal ratemaking primarily relies on comprehensive and sophisticated systems that measure and report financial and operational data. The sheer scale of postal operations, however, and the fact that the Postal Service's primary objective is to move mail rather than study it, results in a situation where much of the basic information used to formulate rates and fees are only estimates. In such an environment, the goal to guarantee favorable results with complete certainty is illusory.

that have come before the Commission, we view the risks in those cases as minimal. In our view, placing undue emphasis on the complete elimination of all risks, rather than striving to recognize and balance material risks, is not a prudent ratemaking objective.

## **SETTLEMENTS**

Finally, as we noted above, the instant docket benefited substantially from the efforts of the litigation participants to formulate a settlement that would meet their own concerns, as well as their perceptions of the Commission's standards for recommending NSAs that are functionally equivalent to the Capital One NSA. In light of the Commission's previous focus on financial risk, as well as their own reservations, the parties crafted a creative, reasonable, and realistic mechanism to address the possibility of financial loss as a result of potential error in several key operational estimates during the life of the NSA. In addition, they mutually agreed that, in the particular circumstances of the Bank One proposal, the conditions that led the Commission to impose a cap on discounts in the Capital One case need not similarly constrain the potential for economic gain by Bank One and all other mailers. No party opposed the Modified Stipulation and Agreement that the parties offered to settle the issues raised by the Postal Service's proposal.

Although the Commission found the protective measures created by the settlement acceptable, it nevertheless rejected the settlement and imposed a cap on the discounts. Ultimately, it concluded that its views requiring, in effect, a guarantee against the consequences of any financial loss had to override the reasoned compromise reached by the parties.

We fully appreciate that the Commission is not bound by such settlement agreements, but that it must independently recommend changes based on the record and its own interpretation of statutory and other requirements. In this instance, however, we believe that the Commission should have been persuaded to rely on the collective judgment of the parties to the settlement agreement regarding acceptable risk and the sufficiency of proof. The settlement, in fact, represented the interests of several parties whose

concerns ranged beyond the direct effects of the Bank One NSA into the realm of general economics, postal policy, and overall consistency with the Act. No competitor of Bank One saw fit even to intervene in the case to oppose the NSA, and no other participant opposed the settlement.

The inferences we draw from the Commission's treatment of settlement in the Bank One are complicated by statements the Commission has made that appear to distinguish and disfavor settlements in functionally equivalent cases. In its Notice and Order of Request Seeking Recommendation of Functionally Equivalent Negotiated Service Agreement for the Bank One case, the Commission noted that in functionally equivalent cases "conducting a settlement conference for the purpose of eventually developing a proposed Stipulation and Agreement is both unnecessary and could interfere with the intent of the rules to expedite the schedule." PRC Order No. 1409, Docket No. MC2004-3, at 7 (June 24, 2004). It went on to encourage communication among the parties and established the counsel for the Postal Service as the settlement coordinator. *Id.* In its recent advance notice of a rulemaking on NSAs, the Commission stated that the Bank One settlement and its modification late in the proceeding was a "complicating factor[s]" that was unlikely "to be present in future requests for functionally equivalent cases." Notice of Advance Rulemaking Soliciting Comments on the First Use of its Rules Applicable to Negotiated Service Agreements, PRC Order No. 1429, Docket No. RM2005-2, at 4.

If the Commission is suggesting that settlements have a limited role in these cases, we do not necessarily agree. Functionally equivalent cases are likely to have issues arise that were not dealt with in the baseline case. As was shown in both the Discover and the Bank One case, the Commission's rules on functionally equivalent NSAs are flexible enough to handle such issues, as long as the core requirements of functional equivalency are met. As such, it benefits the proceedings if contested issues can be resolved through settlement.<sup>30</sup>

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<sup>30</sup> The settlement in Bank One had another welcomed benefit as well. It provided an opportunity to address the concerns of Valpak, which was an active opponent in the Capital One and the Discover cases and in the Bank One case until it joined the settlement at the end. Addressing the mutual concerns through settlement is an effective tool and should not be diminished to suit the needs of expedition. We note that  
(continued...)

In addition, we are concerned that the Commission's rejection of the settlement will send the wrong signals to potential NSA partners and to litigants in future proceedings. In the past few years, both the Postal Service and the Commission have benefited substantially from the efforts and willingness of participants in Commission cases to settle, and thereby avoid complicated and costly litigation. In the context of NSAs, where many of the objectives related to particular mailer relationships might be relatively small, the avoidance of transaction costs, and the reliability of expectations for success are critical factors. The ability to rely on settlements in the absence of controversy and opposition will continue to be a powerful incentive in future ratemaking proceedings, although the Commission has expressed reservations about their utility in functionally equivalent cases.

Particularly where it does not clearly explain its expectations and provide specific guidance, the Commission should not dim the potential of settlements by rejecting those that provide viable resolutions of the issues raised by the Postal Service's proposals.

#### **ESTIMATE OF ANTICIPATED REVENUE**

The Postal Reorganization Act requires that our Decision include an estimate of anticipated impact on postal revenues (39 U.S.C. § 3625(e)). According to the evidentiary record, the Postal Service will benefit by \$11.7 million over the life of the agreement -- \$ 7.8 million in ACS Cost Savings, plus \$ 6.8 million in increased contribution, minus \$2.9 million in discount exposure (referred to in the Capital One proceedings as leakage).

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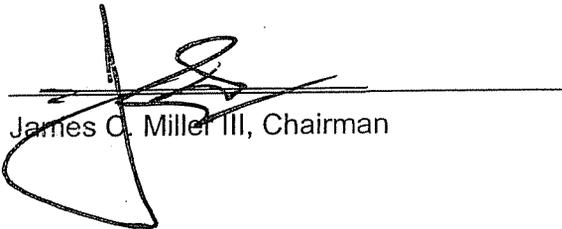
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the parties valued reaching a settlement at the cost of a short delay in the proceedings. See footnote 9 above.

**ORDER**

In accordance with the foregoing Decision of the Governors, the changes in rates and classifications set forth in the Attachments are hereby approved and ordered into effect. In accordance with Resolution 05-3 of the Board of Governors, dated February 16, 2005, the waiver of fees for ACS notices for First-Class Mail solicitations that comply with the rules and regulations associated with the Change Service Requested ("CSR"), option 2 endorsement, will take effect at 12:01 a.m. on March 1, 2005. All remaining changes will take effect at 12:01 a.m. on April 1, 2005.

By The Governors:



James C. Miller III, Chairman

**ATTACHMENTS TO THE DECISION OF THE GOVERNORS OF THE  
UNITED STATES POSTAL SERVICE ON THE OPINION AND  
RECOMMENDED DECISION OF THE POSTAL RATE COMMISSION  
APPROVING NEGOTIATED SERVICE AGREEMENT WITH BANK ONE  
CORPORATION, DOCKET NO. MC2004-3 (FEBRUARY 16, 2005)**

**BANK ONE NSA**  
**RATE SCHEDULE 612A**

<u>Volume Block</u>	<u>Incremental Discounts</u>
<u>535,000,001 to 560,000,000</u>	<u>2.5¢</u>
<u>560,000,001 to 585,000,000</u>	<u>3.0¢</u>
<u>585,000,001 to 610,000,000</u>	<u>3.5¢</u>
<u>610,000,001 to 645,000,000</u>	<u>4.0¢</u>
<u>645,000,001 to 680,000,000</u>	<u>4.5¢</u>
<u>680,000,001 and above</u>	<u>5.0¢</u>

**BANK ONE NSA  
RATE SCHEDULE 612B  
FOR ADJUSTED THRESHOLD (A.T.)**

<u>Volume Block</u>	<u>Incremental Discounts</u>
<u>A.T. to A.T. + 25,000,000</u>	<u>2.5¢</u>
<u>A.T. + 25,000,001 to A.T. + 50,000,000</u>	<u>3.0¢</u>
<u>A.T. + 50,000,001 to A.T. + 75,000,000</u>	<u>3.5¢</u>
<u>A.T. + 75,000,001 to A.T. + 110,000,000</u>	<u>4.0¢</u>
<u>A.T. + 110,000,001 to A.T. + 145,000,000</u>	<u>4.5¢</u>
<u>A.T. + 145,000,001 and above</u>	<u>5.0¢</u>

NEGOTIATED SERVICE AGREEMENTS  
CLASSIFICATION SCHEDULE

612      BANK ONE NEGOTIATED SERVICE AGREEMENT

612.1    Eligible First-Class Mail

Eligible First-Class Mail under this section is defined as: (1) all Bank One letter shape First-Class Mail customer account mail (statements and correspondence) related to credit and banking products and services, account holders; and (2) First-Class Mail solicitations for credit and banking products that bear the endorsement specified by the Postal Service, except that no more than 35 million flat shape solicitation pieces will be counted annually toward the discount threshold or be eligible for discounts. Eligible First-Class Mail does not include Business Reply Mail, Qualified Business Reply Mail, Cards, or Priority Mail.

612.2    Waiver of Address Correction Fees

The fees for address correction in Fee Schedule 911 are waived for those First-Class Mail solicitations on which Bank One uses the endorsement specified by the Postal Service.

In exchange for a waiver of ACS fees, Bank One will update any databases it maintains for solicitation mail, other than First-Class Mail customer correspondence related to account holders, and use the information in all future marketing campaigns.

If, during the first year after implementation, Bank One Corporation mails fewer than 25 million pieces of eligible First-Class Mail, Bank One agrees to pay \$200,000.

612.3    First-Class Mail Discounts

612.31    Discount Threshold. The Discount Threshold is set at 535 million pieces of eligible First-Class Mail for the first year of the agreement.

612.32    Discounts. Bank One's Eligible First-Class Mail is subject to the otherwise applicable First-Class Mail postage in Rate Schedule 221 less the discounts shown in Rate Schedule 612A, for the first year of this Agreement if Bank One meets the Discount Threshold. The discounts apply only to volume above the Discount Threshold. Each incremental discount applies only to the incremental volume within each volume block.

- 612.33** Annual Threshold Adjustment. The Postal Service shall annually adjust the Discount Threshold based on the percentage change from year to year in the sum of the number of Bank One's credit card and checking accounts, as listed in Bank One's annual report. This adjustment shall be determined as follows: if the percentage change is an increase or a decrease of greater than 5%, the threshold shall be adjusted upward or downward by the difference between the percentage change and 3%. No adjustment shall be made for a percentage change of 5% or less. If the percentage change is more than 5%, Rate Schedule 812B would apply in lieu of Rate Schedule 812A.
- 612.34** Threshold Adjustment for Mergers and Acquisitions; and Portfolio Purchases. In the event that:
- a. Bank One merges with and/or acquires an entity and/or purchases a portfolio with annual First-Class Mail volume in excess of 10 million pieces but less than 300 million pieces, the discount threshold will be adjusted to add the volume of First-Class Mail sent by the merged or acquired entity, or on behalf of the purchased portfolio during the 12 months preceding the merger, acquisition, or purchase. In that event, beginning in the succeeding fiscal quarter immediately following the date that mail volumes due to the merger, acquisition, or purchase begin to be mailed through the threshold permit accounts, Rate Schedule 812B would apply in lieu of Rate Schedule 812A.
  - b. Bank One merges with, or acquires, another banking entity that has an annual First-Class Mail volume of over 300 million pieces, the discount threshold will be adjusted upward to add the volume of the merged or acquired entity for the 12 months prior to the date the mail of the merged entity is first mailed through the threshold permit accounts. In that event, beginning in the succeeding fiscal quarter immediately following the date the mail of the merged entity is first mailed through the threshold permit accounts, Rate Schedule 812B would apply in lieu of Rate Schedule 812A.
  - c. Bank One loses or sells a portfolio with annual First-Class Mail volume of at least 10 million pieces, the discount threshold will be adjusted downward by the product of the number of active accounts lost or sold multiplied by 12. In that event, beginning in the succeeding fiscal quarter immediately following the date that the mail volumes due to the loss or sale will no longer be mailed through the threshold permit accounts, Rate Schedule 812B will apply in lieu of Rate Schedule 812A.

- 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.

612.36 Discount Limit. The maximum cumulative discount available to Bank One Corporation over the duration of this negotiated service agreement shall not exceed \$11,508 million.

612.4 Rates

The rates applicable to this Agreement are set forth in Rate Schedules 612A and 612B.

612.5 Expiration

The provisions of section 612 expire on [insert date three years from implementation date set by the Board of Governors.]

612.6 Precedence

To the extent any provision of section 612 is inconsistent with any other provision of the Domestic Mail Classification Schedule, the former shall control.

**RESOLUTION OF THE BOARD OF GOVERNORS  
OF THE  
UNITED STATES POSTAL SERVICE  
Resolution No. 05-3**

Effective Date of Rate and Service Changes to Implement  
Negotiated Service Agreement with Bank One Corporation

**RESOLVED:**

Pursuant to section 3625(f) of Title 39, United States Code, the Board of Governors determines that the rate and service changes to implement the Negotiated Service Agreement with Bank One Corporation, that were ordered to be placed into effect by the Decision of the Governors adopted on February 16, 2005, shall become effective as follows: The waiver of fees for ACS notices for First-Class Mail solicitations that comply with the rules and regulations associated with the Change Service Requested ("CSR"), option 2 endorsement, will take effect at 12:01 a.m. on March 1, 2005. All remaining changes will take effect at 12:01 a.m. on April 1, 2005.

The foregoing Resolution was adopted by the Board of Governors on February 16, 2005.

  
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William T. Johnstone, Secretary