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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

UNITED STATES POSTAL SERVICE
REVISED MEMORANDUM ON RECONSIDERATION
(May 18, 2005)

Summary

The Postal Service's Governors have asked the Postal Rate Commission (PRC) to reconsider and revise its recommendations in this docket in three respects: (1) the Commission should reconsider and change its conclusion that discounts established by the Negotiated Service Agreement (NSA) with Bank One should be capped at a level of revenue approximating the cost savings created by the NSA; alternatively, the Commission should clarify and explain further its decision to impose the cap; (2) the Commission should elaborate on the type and level of proof it would find persuasive to establish reliable estimates of Bank One's before-rates volumes; and (3) the Commission should explain further its view of the role of settlements in reviewing and recommending proposals based on NSAs.

The Governors' Decision was founded on their belief that the Commission should evaluate the need for caps on volume-related discounts (declining block rates) in light of a progressive standard that realistically takes into account the full economic potential of

rate and service agreements with individual mailers. In this memorandum, the Postal Service expands and supplements the Governors' views. The Postal Service proposes and supports the following practical standard to guide the Commission's determination on proposed NSAs:

> When evaluating a declining block rate proposal, the standard to apply is whether
>
> (1) The forecasts are reliable and reflect an appropriate tolerance for error in light of industry practice, sound regulatory principles, and the requirements of the Postal Reorganization Act; and
>
> (2) The Postal Service has demonstrated that risks in the NSA are reasonably constrained by (a) identifying factors that could impact mail volumes; (b) using contract terms to minimize risks, and (c) showing that any residual risk is offset by the potential benefits.

The merits of applying this standard in Commission proceedings are supported by sound economic principles; the Postal Service's own disciplined analysis in negotiating and evaluating NSAs with mailers; common business practices; the application of sound regulatory principles; and reasonable interpretations of the policies and procedures of the Postal Reorganization Act. In applying the standard, the Commission should determine the need for caps in light of the particular circumstances involved in each specific proposal. The Commission should not rely on any *a priori* determination that discounts must be capped for NSAs to be functionally equivalent or legally viable. Finally, the Commission should not discourage the practice of settlement in proceedings to consider NSAs. Rather, the Commission may rely on settlement agreements among affected parties to resolve contested issues and develop realistic solutions to problems arising out of NSA proposals.

I. INTRODUCTION

A. Background

On December 17, 2005, the Postal Rate Commission issued its Opinion and Recommended Decision approving, with the significant addition of a cap on discounts, the rate and fee changes necessary to implement the Bank One Negotiated Service Agreement (NSA).[1] The Commission imposed a cap on discounts tied to the cost savings, following a methodology that is substantially similar to the one used to impose a discount cap in the Capital One NSA case.[2] As in its Capital One recommended decision, the Commission found that such a stop-loss provision was necessary to protect against the potential loss of revenue from applying discounts to mail that would have been sent anyway, even in the absence of the agreement. In its Opinion and a Concurring Opinion signed by the four Commissioners who issued the main Opinion, the Commission emphasized its perceived deficiencies in the before-rates volume estimates submitted to support the declining block rates.[3] The Commission noted that the record provided no means of evaluating the sensitivity of the volume estimates to changes in exogenous factors.[4] The Commission found that the unreliability of these estimates created an unacceptable risk of financial loss which would be remedied by the imposition of a cap.[5]

The Commission stated that, without the cap, the NSA would not protect the interests of mailers who were not a party to the NSA, and who would have to make up

[1] PR Op. MC2004-3.
[2] PRC Op. MC2002-2.
[3] PRC Op. MC2004-3, at 60-61; Concurring Opinion of Chairman Omas, Vice Chairman Hammond, Commissioner Covington and Commissioner Goldway (Concurring Opinion), at 3.
[4] PRC Op. MC2004-3, at 67.
[5] See *id.* at 4, 61; Concurring Opinion, at 3.

any losses the NSA might produce, and as a consequence, the NSA would not accord with the requirements of the Postal Reorganization Act (PRA). The Commission concluded that a cap would eliminate the risk of harm to the interests of mailers who are not parties to the NSA.[6] By doing so, it implied that it would not recommend any NSAs that were supported by volume forecasts unless the attendant risks could be eliminated.

The Commission imposed the cap even though a nearly-unanimous and unopposed settlement was reached with the Office of Consumer Advocate and mailers from a broad cross-section of mail subclasses who had intervened. The settlement represented a belief by those who actively participated in the review of the Bank One NSA that the conditions that led to the imposition of the cap in the Capital One case did not exist in the Bank One record and that financial benefits need not be similarly limited. The Commission's decision also suggested that settlement should have a limited role in functionally equivalent cases.

Despite the stated reservations, all the Commissioners who issued the Recommended Decision renewed their strong support for NSAs and held out the prospect that not all NSAs with declining block rates would need to be constrained with a cap.[7] Their Concurring Opinion stated that the addition of a stop-loss cap should not be construed as a precedent for all NSAs, or even for all NSAs that are functionally equivalent to the Capital One NSA. It noted that the reliability of before rates volume estimates is a factual issue that must be evaluated by the Commission.[8]

On February 18, 2005, the Governors of the United States Postal Service, acting pursuant to 39 U.S.C. § 3625(c)(2), allowed under protest the rate and classification

[6] PRC Op. MC2004-3, at 40-41, 77.
[7] Concurring Opinion at 1, 3
[8] *Id.* at 3.

changes recommended by the Commission and returned the matter to the Commission for reconsideration and a further recommended decision.[9] In their decision, the Governors expressed substantial agreement and appreciation regarding the Commission's recommendations enabling the NSA. The Governors, however, disagreed with the Commission's decision to impose a cap. They expressed three concerns: (1) that the standards the Commission has erected in evaluating forecasts may not be realistic or attainable; (2) that the Commission has not clearly explained its expectations about how declining block rates could be decoupled from a stop-loss cap; and (3) that the Commission's decision to overlay unwanted conditions on the settlement agreement and its views on settlement in NSA cases may inhibit the role of settlement as a means for creative resolution of issues.

In particular, the Governors requested that the Commission give currency to the views expressed in their Decision and that it reconsider the recommendation to impose the cap on the Bank One NSA. The Governors also asked the Commission to elaborate and provide specific guidance on the type of evidence that the Commission might find persuasive to recommend uncapped volume based discounts in future NSAs. And, they asked the Commission to clarify the role of settlement in functionally equivalent NSA cases. The Governors anticipated that the Commission could address these issues and render their further recommended decision on the existing record.

On March 7, 2005, the Postal Service requested leave to file a memorandum addressing the issues raised by the Governors in their decision and proposed additional procedures for this stage of the proceedings. In the motion it filed on March 7, 2005, the

[9] Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision Approving Negotiated Service Agreement with Bank One Corporation, Docket No. 2004-3, (February 16, 2005)("Governors' Decision")

Postal Service stated that its experiences in developing NSAs, as well as its financial and ratemaking objectives, substantially shaped the context for the Governors' views. To begin reconsideration and explanation of an evidentiary standard to support uncapped NSAs, the Postal Service requested leave to file a memorandum that would present its views on the questions raised by the Governors in their Decision and address the pertinent legal, economic, and practical issues. The memorandum would also propose an evidentiary approach that could serve as a standard for future NSA proposals.

The Postal Service also suggested procedures designed to facilitate the development of a realistic approach to establishing a record support for declining block rates that meets the requirements of the PRA without unduly restricting the potential of NSAs. In a second stage of the proceedings, intervenors, including past and prospective NSA partners, and the Office of the Consumer Advocate would be able to comment on the Postal Service's views, which would allow NSA stakeholders to address suitable evidentiary standards, in light of their own capabilities and concerns.

The Postal Service then suggested a third stage that would permit the Commission to take full advantage of the opportunity to comprehensively explore these issues in the context of the record in this case. The Postal Service recommended that the Commission, either through a Notice of Inquiry or other mechanism, elaborate on its views of the appropriate standard of evidence necessary to support uncapped declining block rates. At this stage, the Commission would address the Postal Service's and other parties' proposals, in light of the Commission's own expectations, and would propose an approach that would overcome its concerns. The Commission would then

permit parties the opportunity to comment on the practical and legal implications of the Commission's preliminary guidance.

Finally, the Commission would deliberate, based on the existing record, supplemented by the comments submitted on reconsideration, and would issue a further recommended decision, including further explanations and guidance for future cases.

In Order 1433, issued on March 16, 2005, the Commission granted the Postal Service's request to file a memorandum but delayed any decision on subsequent procedures until after it has reviewed the memorandum. On April 14, 2005, the Postal Service, after consultation with the Office of the Governors, requested an extension of time in which to file its memorandum. On April 15, 2005, the Presiding Officer issued Presiding Officer's Ruling No. 8 granting the extension until May 13, 2005.[10] Pursuant to Order 1433 and POR 8, the United States Postal Service respectfully submits this memorandum on the pertinent, economic, legal, and practical issues raised by the Governors in their decision.

B. A Unique Opportunity

The reconsideration of the Commission's opinion and decision in the Bank One NSA case comes at an important juncture in the development of the Commission's practice in reviewing NSAs. The Commission's support for NSAs, not only in this docket but also in the Capital One NSA and Discover NSA cases, provides valuable flexibility within the current ratemaking statutory scheme. But its concerns about the reliability of volume forecasts, combined with the Commission's more traditional

[10] Presiding Officer's Ruling Granting Extension of Time, MC2004-3/POR- 8 (April 15, 2005).

expectation that discounts should be linked to cost savings, present an impediment to further progress that may not be warranted. As will be explained below, NSAs that grow contribution through inducing cost-savings behavior will be the exception not the rule. Rather, the Postal Service and the Governors believe that the opportunities for increasing contribution through volume incentives are far better than through cost-based discounts. The reconsideration presents a unique opportunity to explore the issues related to the evidence necessary to support these important volume incentives, and for the Commission, the Postal Service, and the postal community, to work together to develop a realistic approach that is consistent with the PRA.

The Postal Service has carefully reviewed the record and the Commission's relevant Opinions and Recommended Decisions. The Bank One decision, more than the other NSA decisions, addressed the extent of the Commission's concerns about the reliability of the volume forecasts, given non-price factors that could lead to an underreporting of the before rates volumes. The Postal Service has consulted with outside experts and its NSA partners to craft a proposed conceptual and practical approach to these concerns, one that we believe tolerates a level of risk commensurate with the requirements of the PRA. The proposed standard of evidence requires an extensive factual review.

In the course of its review, the Postal Service has concluded that additional information could illuminate and guide the Commission's reconsideration. For example, the Postal Service applied an all-encompassing vetting process in its assessment of the reliability of Bank One forecasts. The process incorporates analysis of a wide range of exogenous variables, which the Postal Service believes is rigorous and reliable. Yet,

the details of the Postal Service's due diligence and its risk assessment of the NSA have not previously been explained. Moreover, the Postal Service crafted its evidentiary approach in Bank One, by reviewing, not only Commission precedent, but also common practices employed by business and other regulators when faced with need to make decisions on the basis of less than perfect information. This context has also not been described previously.

We propose to fill these gaps with three declarations. The first declaration from witness Plunkett explains how the Postal Service assessed the reliability of the Bank One forecasts and how it determined that risk that the agreement would yield a negative contribution was well within acceptable tolerances. The second is from Dr. Samuel Hadaway, a principal of Financial Analysis Consultants (FINANCO, Inc.) and an adjunct finance professor at the University of Texas at Austin, who has extensive experience in regulatory economics, both as a senior member of the Public Utility Commission of Texas staff and as an expert witness. The third is from Dr. John Matthews, Professor Emeritus, Graduate School of Business, University of Wisconsin, Madison. Dr. Matthews has consulted and provided expert witness testimony for thirty years in the areas of automotive network analysis, trucking, dealership/distribution issues, and other industries. He also owns and operates a small business involved with manufacture and assembly of internationally sourced components for sporting goods.

The Postal Service believes that this supplemental information creates a useful framework to explain its proposals for a progressive standard for evaluating proof of NSA volume estimates and NSA proposals generally. In submitting these declarations, we are mindful that the Governors in their Decision expressed the expectation that the

evidentiary record would not need to be reopened for the Commission to reconsider its recommendations in Bank One, and for it to clarify the type and level of proof it would find convincing and reliable in future cases. While we do not believe that this additional information need have the status of evidence for the second purpose, the Commission could conclude that it should not rely on it in connection with its reconsideration of the Bank One recommendations, unless it is incorporated as evidence and subjected to adversarial testing. In that event, the Office of the Board of Governors has agreed that the Postal Service may represent that the Board would not object to reopening the record for that limited purpose.

II. THE COMMISSION, POSTAL SERVICE, AND MAILERS SHARE A COMMON INTEREST IN ENSURING THAT NSAs ARE PROFITABLE

In each of the NSAs that the Commission has recommended, it has required that the discounts be capped at the amount of cost savings. It has done so because its paramount concern is that rates be sufficient to cover costs, and that mailers other than the NSA partner will not be made worse off.[11]

The Postal Service shares the same interest in ensuring that NSAs will yield a positive contribution. As the Governors stated in their Decision, the downward pressure on First-Class Mail volumes impels the Postal Service to innovate and to seek out new sources of revenue growth.[12] The Postal Service approaches NSAs as a prudent business would—it seeks to maximize the contribution while minimizing risk that the contribution will be negative. In Bank One, it pursued and evaluated these possibilities by developing as much information as possible to improve and support its negotiating

[11] MC2002-2, Op. at 4
[12] Governors' Decision at 15 & n. 28.

position, exercising due diligence in its assessment of Bank One's volume information, minimizing risks through contract terms, and by vetting the information through a rigorous internal review process.

Mailers also share a common interest in ensuring that NSAs are profitable, as evidenced by the intervention, in each of the NSA cases filed to date, of mailers representing almost every class of mail. These mailers have enriched the records in these cases on a wide range of costing and revenue issues. This is particularly evident in the settlement of the Bank One case, which added a mechanism to guarantee a positive marginal contribution. It was an innovative resolution crafted with the thoughtful input from the OCA, representing the public, and Valpak, a Standard Mailer, and had nearly unanimous support and no opponent.

III. THE DOWN-SIDE OF CAPS

A. Practical Issues

Coupling caps with the cost-savings as a requirement for NSA presents practical problems. The Postal Service anticipates very few NSA candidates will have enough cost-saving potential to justify the transaction costs associated with obtaining Commission review of each NSA. The Postal Service's rate schedule is replete with rates and classifications that induce cost-saving behavior and, in most cases, it is usually more appropriate to induce such behavior through classification changes rather than through NSAs. Based on experience so far, however, cost savings NSAs will likely be the exception, not the rule.

The Postal Service's experience in the credit card industry is illustrative. Only a credit card company that sends a significant volume of solicitations through First-Class

Mail can generate a pool of cost-savings large enough to justify an NSA. Yet, most credit card companies rely almost exclusively on Standard Mail for their marketing purposes. Only a handful of companies generate the necessary First-Class Mail savings, and the Commission has already reviewed NSAs with three of these companies: Capital One, Bank One, and Discover. Its recommended decision on a fourth, HSBC, is pending. The Postal Service knows from its extensive research in the credit card industry, however, that the opportunities for this type of NSA have almost run dry.[13]

B. Economic Issues

Imposition of a cap based on cost savings may lessen the risk of revenue leakage, but it does not necessarily lessen total system risk. Unless a mailer's elasticity of demand with respect to price is non-existent, a stop-loss cap of this type reduces or eliminates the mailer's incentive to send additional contribution-generating volume. Thus, by seeking to minimize a perceived unfair transfer of value from the Postal Service to one customer, the cap may prevent the system as a whole from benefiting from a similar transfer from that customer. Just as the system as a whole must shoulder the burden if there is revenue leakage, so must it suffer when volume growth is artificially curtailed. See the Appendix to this memorandum for a fuller discussion of the economic issues surrounding the imposition of a stop-loss cap.

[13] Data Collection Report, September 1, 2003 to September 30, 2004, Docket No. MC2002-2, at 17, MC2002-2 at 17 (January 31, 2005).

IV. COMMON PRACTICES IN BUSINESS AND IN OTHER REGULATORY CONTEXTS PROVIDE A MODEL FOR EVALUATING NSAs UNDER THE POLICIES OF THE POSTAL REORGANIZATION ACT

The type of risk that the Commission sought to address by imposing a cap is not unique to Postal Service NSAs. Similar risks are faced and managed by entities in the private sector in unregulated contexts and by regulators in other industries. The experiences of these other entities is instructive and supports the Postal Service's position that it has maximized reduction of the risk through various actions it took; that imposition of the cap induces additional, unwarranted risk; and that the Postal Reorganization Act does not require the Commission to eliminate all risk.

A. An Examination of Common Business Practices and Results for Managing Risk Supports the NSA Without the Need for a Cap

The Postal Service and the Commission are not faced with a unique situation in having to address the "what ifs" and "anyhows" inherent in this situation. Indeed, in the attached Declaration, professor emeritus and business expert, Dr. John P. Matthews, provides several illustrations of risk reduction in non-regulated business contexts—both corporate and personal. He explains the measures that are generally taken in such situations to meet the often conflicting goals of generating new business and mitigating risk of loss. He then examines the Bank One NSA issue in light of his experience in this area and the examples he provides.

Dr. Matthews found that the Postal Service had undertaken the relevant risk-reduction measures. The Postal Service had "gathered additional useful information before and during the negotiation period," and "developed data and analyzed the factors that influence demand for mail in the credit card industry and Bank One's First-Class

Mail volume" before negotiating the block rates, so as to "independently assess Bank One's volume projections with and without the NSA." This was followed by public scrutiny by the Commission and other interested parties. Moreover, the NSA features a review cycle with formula-based adjustments, a provision to account for mergers and acquisitions, and a limitation of duration.

Dr. Matthews notes that the Commission's stop loss provision introduces "the risk that the full gains from a mutually beneficial contract will not be realized." Ironically, the mechanism that the Commission applies to deal with the issue of anyhow volume itself suffers from the same inability to distinguish such volume. As Dr. Matthews notes, the "'stop loss' provision apparently does not distinguish between discounts that represent lost contribution due to exploitation of private information by Bank One or other adverse outcomes, and discounts that reflect the success of the NSA terms in generating additional volume." In other words, due diligence having been done, the "stop loss" provision might be even more effective as a "stop gain" provision, which reduces the benefit of the NSA to Bank One, the Postal Service, and, ultimately, all ratepayers.

B. Other Regulators Rely on Similar Mechanisms and Take a Relatively Permissive Approach

In the cases of other regulated industries, once courts cleared the way for non-cost based discounts and for customized pricing, regulators have relied on very similar safeguards to those at work in the market, as described above. For example, the courts have held for more than a century that rate discounts based solely on competition, rather than cost savings, violate neither the just and reasonable rate standard of the Interstate Commerce Act, nor its prohibition of unjust discrimination or undue

preference.[14] In the late 1970s, the Interstate Commerce Commission and the courts began to allow volume discounts to be established in private rate and service contracts—*i.e.*, NSAs—with individual ratepayers. Although the Interstate Commerce Act did not explicitly authorize the Commission to approve customized rate and service contracts, the ICC and reviewing courts held that the traditional ratemaking norms of the Act (which, like the Postal Reorganization Act, required that rates be just, reasonable and nondiscriminatory) were sufficiently flexible to enable the Commission to give effect to customized rate and service contracts.[15]

In 1992, an Administrative Law Judge of the Federal Energy Regulatory Commission found that a common carrier petroleum pipeline could reasonably establish a variety of annual volume discounts and geographically-limited discounts to meet the threat of intermodal competition. No cost savings caps were imposed on these discounts.[16]

The attached declaration of Dr. Samuel C. Hadaway surveys the range of guidelines used by regulators to minimize risk without unduly restricting the benefits of contract rates. These guidelines include those elements at work here: expert analysis, limited scope, public scrutiny of uncertainties, potential benefit to the system as a whole, and periodic regulatory review. The general regulatory approach to managing the inherent risks associated with contract rates is to provide an open process whereby all interested parties can scrutinize the supporting information. The realistic objective is to

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[14] *See Associated Gas Distributors v. Federal Energy Regulatory Commission*, 824 F.2d 981, 1011 (D.C. Circuit), *cert. denied*, 485 U.S. 1006 (1988); *accord*, *National Gypsum Co. v. United States*, 353 F. Supp. 941, 946-49 (W.D.N.Y.); *Williams Pipe Line Co.*, 58 FERC ¶ 63,004 (1992) at 65,024-27.

[15] *See Railroad Contract Rates: Policy Statement*, Ex Parte No. 358-F, 43 Fed. Reg. 58189 (1978) (Policy Statement I); *Burlington Northern R.R. Co. v. ICC*, 679 F.2d 934 (D.C. Cir. 1982); *Sea-Land Serv., Inc. v. ICC*, 738 F.2d 1311 (D.C. Cir. 1984).

[16] Williams Pipe Line Co., 58 FERC 63,004 (1992) at 65,024-65,027.

end up with reasonable forecasts, rather than to eliminate the uncertainty and risk inherent in all contract negotiations.[17]

Examining this experience in the context of postal NSAs, Dr. Hadaway states: "While the PRC cannot be given absolute assurance that additional discounts will be the sole cause of incremental volumes, it can only test this approach by allowing it and evaluating the results. This is the approach that utility regulators by necessity have had to apply. The results have been favorable because they have led to pricing policies that are more consistent with market forces. The PRC and the Postal Service and its customers should benefit from a similar approach."

C. The Postal Reorganization Act Does Not Require that Ratemaking Be Free from Risk and the Commission Has Appropriately Acted Accordingly in Other Contexts

One of the principal purposes of the Postal Reorganization Act was to allow the Postal Service to operate in a businesslike manner. But Congress understood that imprecision inheres even in the most "scientific" of business activities—in the ratemaking and financial management areas. Notwithstanding the concerted efforts of the Postal Service, and its ratemaking partner, the Commission, Congress explicitly recognized that even in the context of one of the most basic tenets of the PRA—that rates cover costs—the process could not be so finely calibrated as to guarantee that result and, instead, it qualified that goal with the standard "as nearly as practicable." 39 U.S.C. § 3621.

Just as Congress anticipated the risk that break even could not so easily be

[17] California Public Utilities Commission, Decision 88-03-008, March 9, 1988, Rulemaking Proceeding on the Commission's Own Motion to Revise Electric Utility Ratemaking Mechanisms in Response to Changing Conditions in the Electric Industry, at 38.

ordained in ratemaking, it gave the Commission sufficient authority, through the fullness of its proceedings, to accept a reasonable degree of risk in the outcomes of its recommendations. Most recently, in the Priority Mail Flat Rate Box case, the Commission reviewed the Postal Service's balancing of the risks and rewards from the experiment and found the risk to be minimal, since the risk of revenue leakage was likely to be more than offset by the potential financial benefits. The Commission found that "a reasonably bounded risk of potential revenue leakage estimated by the Service does not significantly detract from the merits of its proposed innovation." PRC Op., Docket No. MC2004-2, at 14.

Accordingly, in areas as large as the revenue requirement and as small as a few rate cells, the Commission has always been able to tolerate appropriate risk. Where, as here, the attempt at protection from a possible risk—the discount cap—is itself a potential cause of greater loss of benefits from possible net revenues that exceed the unrelated cost savings, such "protection" ought not to be imposed.

V. DECOUPLING DISCOUNTS FROM A COST-SAVINGS CAP

In the Bank One decision, the Commission imposed the stop-loss cap on the available discounts because it found that volume forecasts were unreliable and that the NSA had an unacceptable level of risk. By limiting the discounts by the amount of cost-savings, the Commission determined that it had eliminated the risk. Yet, that action was in no way required to comport with the policies of the Postal Reorganization Act. Commission precedent, or accepted business and regulatory practices, all of which show tolerance for a reasonable degree of risk. Moreover, the cap introduced the risk of limiting revenues that might otherwise benefit the postal system as a whole and all

ratepayers.

In its March 7, 2005 motion, the Postal Service indicated that it would propose a standard of evidence for the Commission to consider when evaluating an NSA proposal that seeks rate and fee changes for volume incentives in the absence of cost savings. After careful consideration of the Commission's concerns in its Bank One Opinion and the Commissioners' Concurring Opinion, the issues raised by the Governors, relevant Commission precedent, as well the input from the experts whose declarations are attached and from our NSA partners, the Postal Service has developed a standard that it believes, is realistic and comports with the requirements of the PRA.

A. A Proposed Standard:

When evaluating a declining block rate proposal, the standard to apply is whether

(1) The forecasts are reliable and reflect an appropriate tolerance for error in light of industry practice, sound regulatory principles, and the requirements of the Postal Reorganization Act; and

(2) The Postal Service has demonstrated that risks in the NSA are reasonably constrained by (a) identifying factors that could impact mail volumes; (b) using contract terms to minimize risks, and (c) showing that any residual risk is offset by the potential benefits.

B. Application of the Standard to the Bank One NSA

The facts presented during the initial evidentiary phase of this proceeding, as supplemented by the attached declaration of witness Plunkett, fully support a Commission finding that the proposed standard has been met. The Postal Service has demonstrated that the Bank One forecasts are reliable, that the risks are reasonably constrained and well within acceptable tolerances, and that any risks not mitigated by terms in the contract are more than offset by the potential benefits. In his declaration, Mr. Plunkett explains the details of how the Postal Service negotiated the NSA with Bank One, evaluated the tradeoffs among different types of risks and rewards, and determined that the NSA would yield a positive contribution.

The Postal Service has developed a formalized framework for the development of NSAs built upon comprehensive research and analysis.[18] Before negotiating with Bank One, the Postal Service conducted extensive research on the company and its use of the mail.[19] The Postal Service also relied upon its extensive expertise on the credit card industry and the factors that influence the demand for mail.[20] It used these data to identify key exogenous factors that could impact Bank One's mail volume. It then performed several separate analyses to develop a reliable range for projections of Bank One's mail volume. The Postal Service analyzed Bank One's volume trends, the economic variables that affect mail volume, and the correlation between the growth in accounts and the growth in mail volume.[21] In addition, the Postal Service incorporated into its projections input from financial analysts and from Bank One's responses to

[18] Declaration of Michael K Plunkett (Plunkett Declaration), ¶15-19
[19] *Id.*, ¶¶ 20-39.
[20] *Id.*, ¶¶ 12-14.
[21] *Id.*, ¶¶ 20-64

negotiating strategies.[22] These analytical tools enabled the Postal Service to develop a projection of Bank One's mail volumes. The Bank One forecasts submitted in support of the Postal Service's Request fell within this range and were determined to be reliable.

The Postal Service also mitigated most of the risks that before rates volumes might be underreported through the use of four contract terms. The contract terms that mitigate this risk are the limited duration of the agreement (three years); the annual adjustment mechanism, which modifies the volume threshold for discounts based on changes in the number of accounts; the limitation on the number of flats; and the merger provisions.[23] In its Opinion, the Commission found that the annual threshold adjustment limited the risks associated with operational mail volume,[24] but it imposed a cap because of its concern about the forecast with marketing mail volume.

As Mr. Plunkett explains in his declaration, the annual threshold adjustment also mitigates the risk inherent in the solicitation mail forecast.[25] This adjustment is based upon changes in the number of accounts. The growth in the number of accounts is highly correlated with growth in marketing mail volume. The exogenous factors that drive the growth in accounts, such as a reduction in the cost of credit (e.g., decline in interest rates) or increase in demand (e.g., rise in household income) also drive up mail volume. Therefore, by adjusting the threshold upward based on the growth in the number of accounts, the NSA also controls for the impact of exogenous factors that would result in an increase in the Before Rates volumes. As a result, even if an

[22] *Id.*, ¶¶ 42 and 45.
[23] *Id.*, ¶ 78. See also Docket No. MC2004-3, PRC Op. at 70-71.
[24] Docket No. MC2004-3, PRC Op. at 70-71
[25] Plunkett Declaration ¶ 80

exogenous factor would cause an increase in mail volume that cannot be anticipated, the agreement self-corrects.

The Postal Service has also shown that the residual risks, i.e., the risks that could not be mitigated through contract terms, are more than offset by the potential benefit of the volume incentives.[26]

By meeting the standard, the Postal Service has addressed the concerns that the Commission expressed in its Opinion and Concurring Opinion about the reliability of volume forecasts and the appropriate level of risk. As a result, the Commission should recommend the rates and fees necessary to implement the NSA, without the imposition of the cap.

VI. FUNCTIONALLY EQUIVALENT STATUS SHOULD NOT DICTATE IMPOSITION OF A CAP

In the Bank One Opinion, the Commission's discussion of functional equivalency dominates its Findings and Conclusions.[27] The Commission relied substantially on a finding that a cap needed to be imposed on the Bank One NSA, because, without it, Bank One would lose its claim to status as functionally equivalent to the baseline NSA with Capital One. *See* PRC Op. MC2004-3, at 37-41. In summarizing its conclusions in this regard, the Commission stated:

> The Commission finds that one of the differences [between the Capital One NSA and the Bank One NSA], the absence of a stop-loss cap, does not preserve the win-win situation that is present in the baseline agreement. This is inconsistent with the requirements of the Act because the interests of mailers not party to the agreement are not protected from harm. The Commission employed similar reasoning in its findings and conclusions in the Capital One decision. Following logic consistent with the Capital One decision, the Commission recommends the addition of a stop-loss cap to the Bank One Negotiated Service Agreement. This

[26] *id.* ¶¶ 86-91.
[27] PRC Op. MC2004-3, at 37-65.

> recommendation will bring the Bank One Negotiated Service Agreement into compliance with the requirements of the Act by assuring that mailers other than Bank One will not be made worse off as a result of the agreement.

Id. at 41.

In the Commission's discussion, functional equivalency has two dimensions. On one hand, the Commission acknowledges the procedural origins of the role of functional equivalency as a mechanism that justifies incorporating testimony from the baseline case to support the recommendation of a related NSA. This dimension and use of the concept, as a practical matter, is critical to realizing the value of the NSA approach to ratemaking flexibility. Only by streamlining procedures for NSAs, and expediting proceedings, will it be possible to hold transaction costs to a level that makes NSAs a viable pricing alternative for more than the largest customers. As noted by the Governors and elsewhere in this memorandum, furthermore, this has been a major concern of the Postal Service in seeking new, mutually beneficial NSAs, since the uncertainty surrounding functionally equivalent status that has emerged from the Commission's previous recommendations, culminating in its Bank One decision, has apparently had a chilling effect on the hunt for future NSAs.

On the other hand, in finding that a cap must be imposed, the Commission, in effect, has also used functionally equivalent status as short-hand for a finding of legal consistency between NSAs and the policies and requirements of the PRA. The heart of this legal finding lies in the Commission's reconciliation between NSAs as rate contracts with individual mailers, the policies of equity and nondiscrimination embodied in the PRA, and the balancing of cost allocation and revenue generation that the Commission must ensure in recommending rates for all mailers. This reconciliation is epitomized in

the Commission's determination that NSAs in general, and any NSA in particular, must represent a "win-win" situation in which all mailers benefit and no mailer is disadvantaged, even in the abstract, as a result of the NSA.

In the context of the instant proceeding, the two different dimensions of functional equivalency intersect on the issue of proof of before-rates volumes. The Commission states:

> The Commission finds the uncertainties presented with the Bank One volume estimates produce a similar effect as the uncertainties presented by the Capital One volume estimates. The recent Bank One merger with J.P. Morgan Chase adds to these uncertainties. The risks associated with misestimation of before rates volume estimates identified in the testimony of witness Panzar, and discussed in the Capital One Decision continue to be present with the Bank One Negotiated Service Agreement. Without the addition of a stop-loss cap, the win-win situation important to Negotiated Service Agreements is not preserved. Mailers not party to the agreement would not be adequately protected from the risk of harm. On this basis, the Commission recommends the addition of a stop-loss cap.

Id. at 61 (footnote omitted).

By equating a cap with Bank One NSA's legal status, the Commission has undermined functional equivalency status as a procedural mechanism. In practical effect, it has also elevated caps to a structural and legal requirement.[28] In the future, the Postal Service will apparently only be able to proceed under the more efficient rules for functional equivalency, if it can establish at the outset that the NSA will inevitably increase postal revenues without a cap. Demonstrating this, however, would normally require adversarial testing and review of the estimates on which the NSA proposals rely. Alternatively, the Postal Service must include a cap in order for the NSA to be deemed functionally equivalent for procedural purposes.

[28] As a practical matter, the Commission's conclusions may similarly restrict other types of NSAs, insofar as they involve cost savings associated with volume discounts.

At the least, this result appears inconsistent with other Commission pronouncements. As noted by the Governors, in the Commission rulemaking that created specialized procedures for functionally equivalent NSAs, the Commission only identified two elements as essential to functional equivalency with the Capital One NSA. PRC Order No. 1391, Docket No. RM2003-5, at 50. These did not include a cap. Furthermore, the Commissioners' concurring opinion in Bank One stated:

> The addition of a stop-loss cap in this case should not be construed as establishing a precedent that all NSAs functionally equivalent to the Capital One agreement must include a stop-loss cap. That is not the Commission's view. The reliability of before rates volume estimates is a factual issue that must be evaluated by the Commission, but this does not bar an NSA without a stop-loss cap.

PRC Op. MC2004-3, Concurring Opinion, at 3.

In Bank One, the Presiding Officer initially determined that the case could proceed under the functional equivalency rules, even though the NSA did not include a cap. The Commission's subsequent determination that a cap must be imposed on the otherwise acceptable settlement agreement could be characterized as an attempt to validate Bank One's procedural status, and reconcile it with the Commission's later conclusion that a cap was necessary for legal sufficiency. Whether that was the intent, the practical effect of the Commission's finding apparently was to require the Postal Service to prove the win-win situation through credible proof of before rates volumes, before the status of functional equivalency can be established procedurally.

This situation amplifies the Governors' request for clarification. Unless the Commission really intends to establish a cap as a structural requirement for future functionally equivalent NSAs, it should not confuse the procedural status of functionally equivalent with the legal status of the proposed NSA. Under the Commission's

formulation in Bank One, the legal status should depend on a determination of the financial effects of the proposal, which can only be made after testing and review of the evidence presented to support the Postal Service's and Bank One's estimates of volumes and revenues. The Commission should therefore make clear that this issue need not be resolved prior to determination of a proposal's status as functionally equivalent. Otherwise, the prospect of being unable to prevail on the issue of "win-win" legal sufficiency, particularly without Commission guidance on the type of proof it would prefer, will effectively inhibit pursuit of potentially beneficial NSAs.

The only other practical option would be for the Commission to adopt a realistic standard of risk to determine whether win-win can be achieved, and to clearly describe the type of proof that the Postal Service must submit. If the Commission could identify a type and level of proof that would create a prima facie presumption of sufficiency under the Commission's legal standard for NSAs, procedural status of functional equivalency could be established at the outset. Under either alternative, furthermore, the Commission should describe a realistic way of demonstrating that a proposed NSA is functionally equivalent, and that it will meet the legal standard that the Commission has erected.

VII. WHEN PARTICIPANTS IN FUNCTIONALLY EQUIVALENT CASES BELIEVE SETTLEMENT NEGOTIATIONS ARE FRUITFUL, THE COMMISSION SHOULD NOT UNNECESSARILY DISCOURAGE THEM

The Governors asked the Commission "to clarify whether, as a policy matter, it disfavors settlements in functionally equivalent NSAs," and, if so, "to reconsider such a policy." Governors' Decision at 9. A brief review of the negotiations in this matter

reveals a tremendous amount of both work and resulting benefits, and the Commission should encourage such negotiations.

First, the Postal Service negotiated an agreement with Bank One, and reached the conclusion that the agreement would be beneficial, not only to the Postal Service but to mailers in general. Among the items it negotiated, not present in the Capital One agreement, were a threshold adjustment mechanism, an enhanced mergers and acquisitions clause, and an annual limit on the mailing of flat-shaped mail. All three of these items limited risks that the Postal Service considered serious enough to warrant such clauses. In contrast, the Postal Service concluded that an overall cap on discounts available to Bank One was not only unnecessary, but could be counterproductive, possibly resulting in a loss of new First-Class Mail volume contribution.

Second, after extensive negotiations, the Postal Service was able to reach an agreement with other participants in this docket. Specifically, the participants negotiated an additional risk avoidance mechanism designed to meet a concern expressed by some participants that there was too great a risk presented by the fact that Bank One anticipated that new First-Class Mail volume generated by the NSA would be converted from Standard Mail volume, as opposed to being entirely new mail volume. This negotiated mechanism protects the Postal Service (and other ratepayers) from loss by incorporating actual data (the ACS success rate, the forwarding rate, and the return rate) into an analysis of the cumulative impact of the deal, and then limits the discounts available only to those that will yield a positive result.

Thirteen participants, by signing the settlement, expressed their agreement that the risk avoidance mechanisms were now sufficient, and that a cap on discounts was unnecessary. These participants represented a broad range of interests in postal matters -- Alliance of Nonprofit Mailers, American Bankers Association, American Postal Workers Union, AFL-CIO, Association for Postal Commerce, Discover Financial Services, Inc., Magazine Publishers of America, Inc., National Association of Postmasters of the United States, National Newspaper Association, National Postal Policy Council, Inc., Office of the Consumer Advocate, Parcel Shippers Association, Valpak Dealers' Association, Inc., and Valpak Direct Marketing Systems, Inc. The other two participants-- Newspaper Association of America and David B. Popkin, did not oppose the settlement. Significantly, no competitor of Bank One saw fit even to intervene in the case to oppose the NSA.

Thus, 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 interpretations of the Commission's standards for recommending NSAs that are functionally equivalent to the Capital One NSA. 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.

To have the Commission add an additional term based on its expressed concern for other mailers, in a case where such a wide variety of types of mailers were represented and did not share that concern, might negatively affect the NSA process. Parties to an NSA may be less willing to agree to undertake new burdens, such as risk

avoidance mechanisms, if they deem it likely that the Commission not only will approve those mechanisms but impose additional ones as well.

While the Commission is not bound by settlement agreements, but must independently recommend changes based on the record and its own interpretation of statutory and other requirements, the Commission's decision in this case is potentially harmful. As the Governors expressed, "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." Governors' Decision at 9.

Experience now dictates that functionally equivalent cases are likely to have issues arise that were not litigated in the baseline case. As demonstrated in both the Discover and the Bank One cases, 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.

Conclusion

The Postal Service respectfully requests that the Commission consider the proposed standard for evaluating the need for caps on declining block rates in the specific context of the Bank One NSA. The Postal Service believes that the information and views presented above provide useful guidance for further consideration of the questions raised in the Governors' Decision. The Postal Service also believes that the circumstances of this reconsideration create a unique opportunity for the mailing community to consider and comment on these issues. As noted above, and in its motion filed on March 7, 2005, the Postal Service respectfully suggests that the

Commission establish procedures for further consideration and comment. While the Commission might elect to reopen the record to incorporate the new material submitted by the Postal Service, subsequent proceedings should include an opportunity for other participants to comment on the Postal Service's memorandum, as well a separate stage in which the Commission would express its own views, and the participants would be allowed to submit subsequent comments. Finally, the Commission would issue a further recommended decision that specifically addresses the Governors' Decision.

Respectfully submitted,

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May 18, 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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May 18, 2005