Revised May 18, 2005

REVISED DECLARATION OF MICHAEL K. PLUNKETT

I, Michael K. Plunkett, declare under penalty of perjury:

1. I am the manager of Pricing Strategy (previously Pricing Innovation) for the Postal Service. In this position, I have management responsibility for overseeing the development and implementation of the Postal Service's strategy for Negotiated Service Agreements ("NSAs"). I participate in, and oversee the research, analysis, negotiation, and implementation of NSAs. This declaration supplements my earlier testimony in support of Docket No. MC2002-2, the Capital One NSA case, and Docket No. MC2004-3, the Bank One NSA case. I offer this declaration in support of the Postal Service's Reconsideration Memorandum in the Bank One case.

2. In my previous testimony and answers to discovery requests and Presiding Officer's Information Requests, I provided details of how the Postal Service negotiates and reviews NSAs generally. This declaration provides further detail 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. Specifically, I discuss how the Postal Service negotiated declining block rate discounts and thresholds, evaluated Bank One's Before and After Rates volume forecasts, included contract terms to minimize the risks of declining block rates, and evaluated the risks and rewards associated with the NSA.

I. The Postal Service's Process for Evaluating Before Rates Forecasts

3. Over the past three years, the Postal Service has learned a considerable amount about the factors that influence demand for mail in the credit card industry. It

has developed expertise in this area through its own independent research, its experience with the Capital One case, and a multitude of discussions with other banks and financial firms. Even before we began to negotiate the Bank One NSA, we had compiled, developed, and analyzed a tremendous amount of information on the factors that are likely to affect Bank One's First-Class Mail volumes, and had developed extensive knowledge of how credit card companies work and how they communicate with, acquire and retain customers through use of the mail and other channels. After the commencement of negotiations with Bank One, we did extensive additional research on the company, using data from Postal Service systems and from publicly available sources.

4. Before we negotiated the specific declining block rate discounts and thresholds, we worked with Bank One for several months to confirm and refine the information we had developed independently. We first spent considerable effort understanding Bank One's relationship with the Postal Service; then we obtained Bank One's projection of its Before Rates and After Rates volume forecasts for the term of the agreement. Bank One indicated that these forecasts were based on its company plan, which was used in making general business decisions in the ordinary course of business. Rappaport Direct (BOC-T-1) at 6-7. Through our own independent analyses, we verified that the forecasts were within a reasonable range and were thus reliable.

5. The Postal Service uses a combination of qualitative and quantitative tools to evaluate the forecasts provided by potential NSA partners. As the Postal Service gains experience in negotiating more and more NSAs, we are able to further refine and supplement our methodologies for evaluating forecasts. The processes identified below

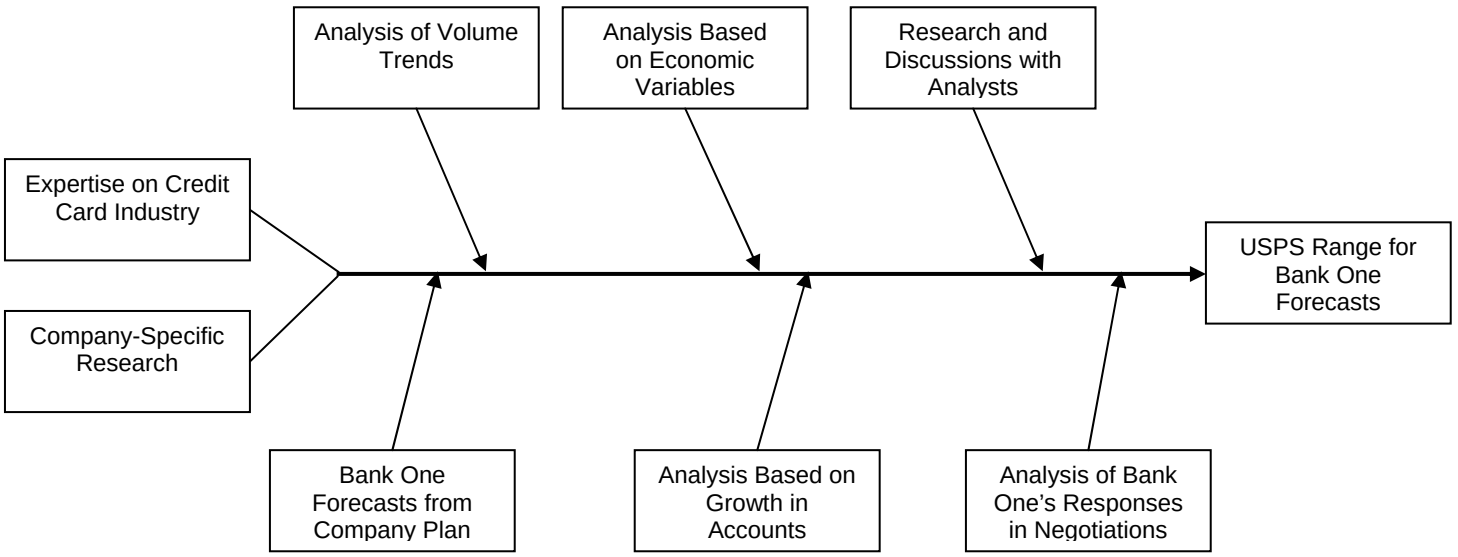
form the framework for our analysis; however, we are continually incorporating new data and data sources to improve the specific tools.

6. For the Bank One NSA, we used the following analyses to evaluate the reliability of the company's Before Rates volume forecasts:

- Analysis of volume trends
- Analysis based on economic variables
- Analysis based on growth in accounts
- Research and discussions with analysts
- Analysis of Bank One's responses in negotiations.

7. The chart below illustrates how the different processes and models were combined to develop the USPS Bank One volume forecast range for evaluating the NSA.

ANALYSES USED BY USPS TO VERIFY VOLUME FORECASTS



8. Forecasting mail volumes for an NSA is difficult for many credit card companies. Many companies forecast budgets which include postage but do not forecast the actual number of mail pieces for more than three-fiscal quarters. For example, a company may have forecasts for expected marketing expenses but may not have allocated that budget across media channels.

9. Before engaging in any formal discussions, we require potential NSA partners to provide forecasts for the entire period of the proposed NSA. Many of the initial forecasts provided by customers to satisfy this requirement are based on volume trends. It is usually infeasible for a customer to undertake the effort, expense, and process changes required to provide a more detailed forecast before NSA negotiations have even begun. Once a customer has entered negotiations and has built an internal business case for pursuing an NSA, however, the customer will develop a more detailed forecast that incorporates data from its various individual business lines.

10. As in all negotiations, Bank One and the Postal Service had asymmetrical information. To improve the Postal Service's bargaining position, we apply our analytical tools for generating additional information about our potential NSAs partners and testing and assessing their negotiating positions. We also use these tools during our discussions with potential NSA partners to assess the risks and benefits of various negotiating positions. Throughout this process, we identify potential risks to the profitability of the deal and implement strategies to mitigate those risks.

11. Once the parties have negotiated an agreement, the NSA undergoes a rigorous internal review process at the Postal Service, including review by a cross

functional group of managers and executives. It must then be approved by the Board of Governors.

A. USPS' Experience and Expertise In Credit Card Mail

12. The Postal Service has developed a detailed understanding of the credit card industry through extensive research of its own, and through discussions with over ten credit card companies that collectively account for 90 percent of the credit card market. We analyze major newsletters and data services covering the industry and routinely engage in discussions with key members of the industry and with the industry analysts of brokerage firms. For example, we collect data on the number of accounts and cards issued, by issuer, as well as outstanding balances. We also research the various markets for credit (prime, near prime, and subprime), the market shares and product niches of individual financial institutions in each of these markets, and the methods these firms use to compete in each market. The expertise we have developed and maintain allows us to develop a company profile and assess the reliability of company's forecasts.

13. We have also studied in detail the mailing practices in the industry and the factors that affect its mail volumes. For example, we have studied the historical mail volumes of many credit card issuers and have collected information on their growth and marketing strategies, which influence mail volumes.

14. Credit card companies use First-Class Mail for two main purposes. The first is to maintain account relationships with current customers. This mail, typically called "operational mail," includes statements and correspondence with existing customers. The second purpose is to market products to existing customers and to solicit new ones. This mail is typically called "marketing mail." The forecasting tools

and process developed by the Postal Service reflect the different economic drivers for these different categories of mail demand.

B. USPS' Pre-Negotiation Due Diligence

15. The Postal Service has developed a formalized framework and specific guidelines for initiating NSA discussions. The Postal Service uses this approach in developing, negotiating, seeking regulatory approval for, and implementing NSAs.

16. Before formal NSA discussions begin, the Postal Service collects and analyzes data about the potential NSA partner. The specific due diligence tools we use are:

Tool Name	Purpose
Negotiation Pack	To provide a common fact base for negotiating by capturing key data on the specific company's business and mail usage, and on trends in the industry.
Model Checklist	To ensure that the Postal Service negotiating position reflects sound economics by listing the requisite financial analyses for each type of agreement.
Business Case for NSA Candidate (presentation template)	To present relevant NSA characteristics to internal USPS committees.
NSA Dashboard	To track the progress of the NSA through the various stages from initial negotiations to approval to implementation.

17. The negotiation pack, which provides the foundation for evaluating the business and mailing profile of the potential NSA partner, is the first step in the Postal Service's due diligence. The negotiation pack consists of the following templates:

- Executive summary
- Industry trends
- Company information
- Mail usage
- Candidate's mail usage relative to competition
- Underlying economic drivers
- Risk/reward evaluation

- Negotiating position
- Financial analysis.

18. The negotiation pack enables the Postal Service to understand the business environment of the customer before beginning to negotiate. The information from the negotiation pack allows us to exploit our initial discussions to gain insight into specific business and strategic factors that influence the customer's mailing decision process.

19. By starting our due diligence early, we can often evaluate the customer's mail demand functions at an early stage. For example, our ability to anticipate business line rollouts or regulatory changes allows us to determine whether the initial forecasts provided by a customer appropriately reflect these circumstances. This early due diligence has also enabled us to avoid pursuing NSAs with companies whose business climate and/or profile are too volatile to develop accurate volume forecasts.

C. Analyzing Volume Trends To Verify Forecasts

20. The first step in evaluating the volume forecast of a company such as Bank One is to analyze its volume trends. We use this relatively simple approach to gain an initial sense of the company's mailing patterns and to predict future movements in mail demand.

21. Our trend analysis forecasts mail demand solely as a function of time, rather than a function of multiple economic, demographic, legislative, policy, technological, or market variables. Based on historical volumes, we extrapolate the bank's mailing history in a linear fashion into the future. We generate separate trend

analyses for three subsets of the bank's mail volume: First-Class Mail operation volume, First-Class Mail marketing volume, and Standard Mail marketing volume.

22. For Bank One, we ran a simple regression to identify any correlation between the three categories of mail. This analysis was based on limited data sets because of the lack of long-term customer specific historical data.

23. We realize that a simplified trend analysis ignores exogenous factors such as pricing changes, interest rates, bankruptcy rates, competitors' strategies, unemployment rates and a host of other variables. But the trend analysis is intended to provide only a starting framework for understanding the mailing profile of our partner and a useful cross-check of the company's short-term forecasts. We also used our trend analysis to identify topics to explore during our initial discussions with Bank One.

24. Our trend analysis for Bank One mail volume indicated that (1) First-Class Mail marketing volume was declining, (2) First-Class Mail operational volume was fairly stable, and (3) total Standard Mail marketing volume was growing slowly. Bank One's independent estimate of future mail volume was consistent with our trend analysis.

25. Based on these observations, the Postal Service focused its early discussions with Bank One on the forces driving the short-term trends in mail volumes and the likelihood that the factors underlying those trends would continue. During these initial discussions, Bank One provided information and data to aid the Postal Service in understanding the economic and policy decisions that were driving the mail volume trends we had identified.

26. These initial analyses showed that Bank One's future volume trajectory was likely to be fairly typical of that of the credit card industry as a whole: electronic bill presentment would have a depressing effect on operational mail, which would be partially offset by slow growth of the account base. These findings enabled us to develop a lower and upper range for Bank One's mail volumes and produce our first iteration of possible financial values under various forecasts. The analysis provided us with a decision point: whether to continue to pursue an NSA or to re-evaluate with the customer whether an NSA would really satisfy its requirements.

D. Testing Volume Forecasts With Multiple Economic Variables

1. Analyzing Marketing Mail Volume

27. With this general understanding of mail volumes, we could then focus on marketing mail. Mail solicitation volume is influenced by a wide range of economic factors. To determine the specific effect of these variables on Bank One volume, my group researched SEC filings and the reports of financial analysts. We also conducted discussions about these factors with financial analysts. In addition, we studied commercially available data from firms that track commercial trends in the credit card industry, such as Synovate and Forrester. These reports provided the Postal Service with key industry benchmarks and metrics to isolate significant economic factors that influence mail volumes.

28. Our research focused first on variables that affect overall mail expenditure for marketing mail, and then on the factors that influence the allocation of marketing mail volume between First-Class Mail and Standard Mail. Our research, not surprisingly, revealed that overall expenditures for marketing mail are affected by a host of variables. Our research was based on the total number of credit card solicitations

mailed by the top 15 credit card issuers, which collectively account for almost 95 percent of credit card solicitation volume.

29. We were able to identify a small number of specific economic variables that affected not only Bank One's mail volumes, but also the volumes of many of other credit card issuers. The economic variables we identified were:

- Household Income
- Prime-interest rates
- Response rates
- Consumer Price Index
- Charge-off rates
- Bankruptcy rates
- Unemployment rates
- Company's marketing budget
- General postal rate increase.

30. Most of these variables were highly correlated with total marketing mail volumes. For example, we found that when the cost of credit (interest rate) increased, marketing mail volume declined. When the cost of mail increased, the marketing mail volume declined. When the demand for credit cards increased (e.g., because of a rise in household income), marketing mail volume increased.

31. We derived a demand function specific to marketing mail for Bank One:

- MD = f (Y, Pi, Pj, I, S, C)

Where,

- MD = marketing mail demand
- Y = Household Income
- Pi = Own marketing expenditure
- Pj = Own net income
- I = Prime-interest rates
- S = CPI
- C = Charge-off rates.

32. This combination of variables produced the highest coefficient of determination (R^2 of 82%) in our stepwise regression analysis. We thus used this equation as an exploratory tool to identify the potentially important predictors of marketing mail demand. Then we compared results from the model with the volume estimates provided by Bank One. Again, Bank One's forecasts were consistent with the results of our model.

33. Other variables, such as average account balances, credit card fees, average FICO scores[1], directly impact the decision making process of credit card issuers and are highly correlated to mail volumes. However, we were unable to identify a statistically significant combination of those variables. Although they do not enter into the regression, we can use them outside of the regression to verify volume predictions.

34. The equation identified above helped us to better understand the impact that changes in exogenous factors have on mail volumes. For example, based on our understanding of the U.S. economic environment, we concluded that interest rates over the period of time covered by the NSA would most likely not decrease, and thus reductions in interest rates over the course of the NSA would be unlikely to spur

[1] Credit issuers use "FICO scores" (named after Fair, Isaac and Co., which pioneered the use of scoring models of this kind) or analogs to FICO scores, to evaluate the creditworthiness of potential borrowers. The higher the FICO score the greater the indicated creditworthiness.

additional marketing mail volume. We applied the same approach to the other variables, and concluded from our analysis that, based on current market conditions, no exogenous economic factor would likely result in significantly higher mail volumes.

35. In addition, we discovered that the equation identified above also predicted the total number of accounts for credit card issuers. In fact, if marketing expenditure were removed from the equation, the result would be a higher R^2 than the original demand function. I will describe the implications of this later in this declaration. See ¶ 41, below.

2. Analyzing Operational Mail Volume

36. Credit card operational mail volume includes statements, plastics, credit increase letters, renewals, and other customer specific correspondence. For Bank One, we tried to develop a demand function for operational mail based on exogenous economic factors. We were unsuccessful. The reason for this outcome, we believe, is that by far the most important variable affecting First-Class Mail operational volume is the number of accounts.

37. A less significant factor in First-Class operational mail volume is the market penetration of electronic bill presentment ("EBP"), which often substitutes for operational mail. Because of the gradual adoption of EBP by consumers and the varying degree to which individual financial institutions have invested in and promoted EBP to their customer base, we were unable to model this factor adequately. Sources such as Forrester, however, allowed us to evaluate more effectively the online diversion threat for each financial institution. We used these data and statements by a number of financial institutions regarding their partnerships with online EBP providers to gauge the level of EBP activity and its potential effect on mail volumes. According to Forrester,

on-line adoption rates for both billing and marketing purposes vary widely across the credit card industry.

38. Finally, a statistically significant relationship exists between marketing mail volumes and operational mail volumes. An increase in marketing mail volume generally leads to a higher number of accounts, which, in turn, generates higher operational volume.

39. Our analysis failed to identify a meaningful correlation between operational mail volumes and econometric factors. As with marketing volume, however, we observed a significant correlation between operational mail volume and the total number of accounts.

E. Using The Number Of Accounts to Verify Forecasts

1. The Relationship Between Number Of Accounts And Overall Mail Volume

40. As previously described, the economic factors that influence marketing mail demand correlate closely with the total number of accounts. Furthermore, because operational mail is used to communicate with existing accounts and marketing mail is used to acquire new accounts, the volumes for both types of mail are directly related to the number of accounts.

41. An important determinant of both operational and marketing mail is thus the number of active customer accounts. Forecasting mail volumes based on the number of accounts diminishes the need to use a greater variety of macro and micro economic variables, and provides insulation against factors that cannot be modeled, such as regulatory requirements. Therefore, as a second independent checkpoint, we

developed an analysis based on number of accounts to verify the NSA partner's volume forecasts.

42. We utilized reports and research provided by analysts to help us identify the growth in the number of accounts. Analysts employed by investment firms track the performance of major companies to provide investment advice to their clients. These analysts have extensive knowledge of both the industry and the individual companies in the industry. They develop intricate models to provide detailed forecasts of account growth at individual companies. They also receive information from the companies themselves and analyze the economic and regulatory factors affecting the competitive marketplace. Because postage is a substantial line item expense for a credit card issuer, analysts track and estimate this specific information. The analysts' reports can provide an independent check on mail volume estimates based on a neutral source of data. We also conduct discussions with analysts before entering negotiations with a firm.

43. The credit card company's strategies and goals for total number of accounts may be affected by exogenous factors that influence profitability. For example, an increase in charge-off rates (i.e., the rate at which receivables are written off) tends to lower a credit issuer's profitability, in turn causing the company to become more selective in its marketing programs. Higher selectivity then lowers the target pool of potential credit card holders and results in lower mail volumes.

44. Moreover, many issuers have clearly defined goals for growth. Credit card companies that have chosen to follow a managed growth strategy may be less

likely to invest in mass-marketing mail campaigns, while new entrants into a market may have much more aggressive marketing strategies, resulting in higher mail volumes.

45. Instead of developing forecasts of the number of Bank One accounts from scratch, we relied on independent financial analysts' projections of Bank One's account growth. These projections could incorporate not only the analysts' findings about Bank One's growth strategy, but also their analysis of changes in economic variables. For example, analysts could adjust the account growth projected by Bank One because the analysts believed that the anticipated rise in interest rates and unemployment rates would increase the cost of credit and decrease the demand for credit cards.

46. The public nature of the NSA process helps ensure that customers do not provide misleading forecasts. If customers were to provide significantly lower mail forecasts to the Postal Service while forecasting higher account growth to investment analysts, the contradiction would be obvious. Postage remains one of the largest line items for issuers, and any changes relating to this expense would not go unnoticed. In addition, it is highly unlikely that a company would provide unrealistically low forecasts in a public NSA proceeding, which might artificially depress the company's stock price.

47. The effect of total accounts on operational and marketing mail volumes is discussed below.

2. Using The Number of Accounts to Verify Operational Mail Volume Forecasts

48. To validate forecasts of operational mail volume, we developed the following model based on the end-use method:

- $M = N \times B \times C$

Where

- M = mail consumption for operational purposes
- N = number of accounts
- B = number of billing cycles per year
- C = fixed factor for other mailings such as privacy notices, welcome kits, cards.

49. The number of accounts, factor N, is disclosed in the company's annual report as well as SEC filings. By far the greatest percentage of operational mail is statement mail, for which credit card companies are required to provide statements each month (factor B).

50. For factor C, we used a combination of internal and external data sources to generate ranges for the average number of First-Class Mail pieces, excluding monthly statements, sent by the ten largest issuers, to existing accounts. Our research indicated that companies mail 0.86 to 1.5 pieces per year in addition to statements.

51. As discussed above, because a credit card company's use of operational mail correlates closely with the number of accounts, it is relatively easy to estimate a company's operational mail volume over the next several years. We checked Bank One's operational mail forecast against the forecast derived above and found that the two were consistent.

3. Using The Number of Accounts to Verify Forecasts of Marketing Mail Volume

52. We also developed a demand function for total marketing mail based on the total number of accounts:

- MD = f (N, C, R)

Where

- MD = Marketing mail demand

- N = Net New Number of Accounts
- C = Charge-off rate (the average rate at which accounts receivable balances are charged off as uncollectible)
- R = Response rate.

53. This function allowed us to estimate total marketing mail volumes prior to our NSA negotiations. For the model, we used response rates that we learned from discussions with potential NSA partners or that we found in publicly available data sources such as Mail Monitor, which tracks and reports on the volume of credit card solicitations sent through the mail. We obtained data on charge-off rates from the SEC 10-Q Reports filed by publicly traded financial institutions (including the corporate parent of Bank One). Data on net new accounts—i.e., the average number of new accounts of the particular NSA partner in a given period—were obtained from the estimates of independent financial analysts.

54. Table 1 illustrates how we use the relationship between the number of accounts and mail volume to verify forecasts. In Table 1, we have assumed a response rate of 0.4% and that 75% of those responding will be approved. For each additional 1 million pieces of marketing mail a customer will gain an additional 30,000 accounts.

Additional Volume	New Accounts
1,000,000	30,000
10,000,000	300,000
25,000,000	375,000
50,000,000	750,000
75,000,000	1,125,000

Assuming that the NSA partner will acquire all of its new accounts through the mail, we can estimate how much marketing mail will be required to obtain the new number of accounts expected by the analysts.

55. For example, Bank One currently has 43 million cards outstanding. Thirty thousand new accounts would represent an increase of 0.07 percent, an insignificant

amount. However, 375,000 new accounts would represent an increase of almost 0.9 percent. The average account growth rate for most credit card companies is in the range of 0.5% to 2.0% annually.

56. To estimate the volume of marketing mail implied by a given target growth in the net account base, we convert the net growth target into a gross growth rate by adding the expected annual attrition of existing accounts, and then multiply the result by the reciprocal of the expected yield rate of mail solicitations for new accounts. The mail volume target thus derived provides a good indication of the likelihood that a bank will increase its marketing mail volumes even without any incentive from the proposed NSA discounts. We checked Bank One's forecast using this approach.

4. Analysis of Factors that Influence the Company's Division Of Marketing Mail Volume Between First-Class Mail And Standard Mail

57. Another estimate that we seek to validate is the company's allocation of its marketing mail between First-Class Mail and Standard Mail. The factors that influence this decision are not readily modeled by the tools described so far. We have thus developed a more qualitative analysis based on our research and specific discussions with credit card companies.

58. First, we identify whether the credit card company is targeting the type of customer that issuers generally solicit with First-Class Mail. We study the demographics of customers that are likely to have higher response rates in First-Class Mail and whether the credit card company has adopted a strategy that would result in an increase in First-Class Mail volumes without a price incentive.

59. We also ask potential NSA partners to give us an overview of the products that they currently offer. We supplement this information with data from

external sources, and then analyze the product offerings by matching particular products to the customer segments that they target. For example, a 0% interest-card with a high credit limit is more likely to be offered to individuals with very good credit profiles. Banks tend to use Standard Mail rather than First-Class Mail to market to these individuals, because they tend to move less often. Hence, the forwarding service included with First-Class Mail is less valuable for those customers. Similarly, we also track the average FICO scores of each company's card holders. A decrease in the average FICO score of a company's customer base indicates that the Company's use of First-Class Mail for marketing may increase. Thus, we use FICO score information as another factor in determining whether a company would move into First-Class Mail from Standard Mail without the need of NSA discount incentives.

60. We also study the individual portfolios of card customers comprised within each card issued by the bank. A brand of card like the Bank One card is, in reality, an umbrella for a variety of portfolios of cardholders. Each portfolio uses different marketing strategies, and each is focused on different customer segments. We ask each potential NSA partner to explain how it intends to use First-Class Mail as a marketing medium for each of its business lines.

61. The main factors that affect the division of marketing mail between First-Class Mail and Standard Mail are the relative cost and potential benefits of the two classes of mail. Credit card companies choose First-Class Mail for marketing if the value of the additional customer response rate (also known in industry parlance as "lift ") from First-Class Mail exceeds the significantly higher costs of acquiring customers through this class. Witness Buc's testimony in MC2004-3 provides a top-level view,

without proprietary customer-specific data and variables, showing how a bank chooses between First-Class Mail and Standard Mail.

62. Budgetary constraints force customers to develop cost-benefit analyses to choose between the classes of mail. Assuming no other advantages, First-Class Mail is economically superior to Standard Mail as a marketing medium only when the higher response rate (lift) or revenue per customer (or both) outweighs the lower cost of marketing via Standard Mail. Table 2 provides a simple illustration of this optimization analysis.

Table 2

Table 2	Standard Mail	First-Class	Difference
Cost	$0.177	$0.292	64.97%
Acquisition Pieces	56,497,175	34,246,575	-39.38%
Response Rate	0.30%	0.40%	33.33%
New Customers	169,492	136,986	-19.18%
Revenue	100	124	24.00%
Total Revenue	$16,949,153	$16,986,301	0.22%

In the example, Bank One's portfolio X has a budget of $10 million for postage. Under this scenario, First-Class Mail would need to increase the response rate by at least 33%, and revenue per customer by at least 24%, for First-Class Mail to be preferable to Standard Mail as a marketing medium.

63. Shifts between mail classes can also be caused by strategic shifts in markets. Information about the latter appears in many sources. It is highly unlikely that a company could migrate wholesale from Standard Mail to First-Class Mail without a significant shift in underlying marketing strategy. Such a strategy shift is almost certain to become public knowledge, and we are confident that our evaluation tools allow us to identify major marketing shifts while they are in progress.

64. We used the approach described above to review Bank One's forecasts of its First-Class Mail and Standard Mail marketing volumes. The forecasts provided by Bank One forecasts fell well within the forecasts we generated using the methods described above.

F. Using Bank One's Responses to Negotiating Strategies to Verify Forecasts

65. As in any negotiations, the Postal Service adopts different opening positions when exchanging proposals and counterproposals with potential NSA partners. It is my responsibility to evaluate the mailer's response to our positions, and to ensure that the Postal Service reaches an agreement that has a high probability of producing an acceptable return. The responses of a potential NSA partner to our proposals provide an additional way to test the credibility of the Before Rates and After Rates volume estimates that we have received from that mailer.

Table 3

Scenario	A	B
Threshold volume	90	105
Company's Initial Forecast	100	100
More Accurate Forecast	130	130
Pieces eligible for discount	40	25
Effective Discount/piece	2.5¢	5¢
Total Discounts	100	125

66. For example, we often make an opening offer that would allow the mailer to earn much higher discounts in exchange for volume thresholds that are significantly higher than volume in any previous year. Table 3 illustrates such an offer. If, for example, during the negotiation process a customer provided a forecast of 100 million pieces but actually intended to mail 130 million pieces, it would be in the self-interest of a mailer who has understated its expected test-year Before Rates volume to opt for the deal in column B.

67. Using various opening positions of this kind allows us to gauge the credibility of the mailer's volume forecasts and refine our negotiating strategy. By presenting offers with different combinations of discounts, thresholds, and block increments, we can roughly approximate the company's demand curve.

68. We have also found that the imposition of a stop-loss cap has hardened the negotiating positions of some potential NSA partners. Because the maximum potential benefit of an NSA now appear much more limited than previously thought, mailers have become increasingly reluctant to explore potentially beneficial avenues, or to make what one might consider relatively innocuous concessions. The effect of this phenomenon has been the cessation or suspension of many negotiations.

G. Summary of The USPS' Analyses To Verify Before Rates Forecasts

69. In our experience, potential NSA partners do not submit point estimates of Before Rates volume that are knowingly false. As with Bank One, the volume forecasts we receive from our NSA partners are often based on data generated in the ordinary course of business and used for internal management purposes that are far more important to the company than the dollar savings in postage potentially available from an NSA. These estimates are very unlikely to be manipulated.

70. In no case, however, does the Postal Service take these customer-provided forecasts on faith. As described above, we have developed tools and processes, based on third party or publicly verifiable data sources that allow us to set reliable upper and lower bounds on the likely Before Rates volume of each potential NSA partner. We use these volume forecast ranges as a check on the credibility of the customer's point estimate. Based on these evaluations, we have rejected Before Rates estimates and even suspended negotiations with some mailers. For example, one

customer initially provided a flat volume forecast which, under our analyses, we did not find plausible, and we suspended NSA discussions. In the months that followed, the customer's volumes grew as we had predicted.

71. Although the volume ranges we develop are not as precise as a point estimate, they are relatively tight: we can develop a target range for volume forecasts within 25 million pieces. A forecasting range of error of 25 million pieces corresponds to a potential risk exposure of approximately $750,000. Balanced against the much larger potential benefits of an NSA, this level of risk in forecast variance is quite reasonable.

72. The relatively short term of an NSA also provides the Postal Service with further protection from risk. The realization that agreements will expire, requiring their renewal and perhaps re-negotiation, along with the knowledge that the Postal Service will analyze and report the results of the NSAs, provides a strong deterrent to gaming the process by offering unrealistically low Before Rates volume projections. The value of an NSA to a company is maximized if it can continue the NSA over a long period of time. The options and benefits of the NSA can affect a customer's long-term strategic position. A company whose volume forecasts are at odds with the company's actual volume over the initial term of the NSA is less likely to receive favorable consideration of any proposal to renew or re-negotiate the NSA. Most companies are unwilling to jeopardize their long-term business relationship with the Postal Service for short-term postage discounts that may amount to less than two percent of total postage spending over the three-year life of the NSA.

II. Evaluating After Rates Forecasts

73. We have also developed tools to evaluate After Rates forecasts. These tools emulate a credit card issuer's decision process for selecting media mix. All credit card issuers have models that allow the allocation of spending among the various marketing channels based on cost effectiveness. Our internal models replicate these models at a high level. We also look at available budgets and the company's current allocation of marketing across channels. For example, a credit card issuer that already acquires 95 percent of its customers through the mail obviously cannot switch a large additional share of existing media spending the mail, regardless of the NSA discount. Conversely, a company that currently spends much of its marketing budget on non-postal marketing channels has more resources to switch to the mail.

74. The Commission's decisions have focused on the risk of offering discounts for "anyhow" volume, which is purely a function of the Before Rates forecast. It is important to emphasize, however, that After Rates forecasts tend to be less certain than Before Rates forecasts, and are far more likely to be understated. In fact, the After Rates forecasts presented in all of the NSA cases thus far have been remarkably conservative, and there is a strong possibility that existing NSAs will induce more First-Class Mail volume than indicated in After Rates forecasts.

75. A number of factors cause the Postal Service and its NSA partners to tend toward conservatism in projecting the After Rates volume effects of NSAs. The most basic reason is that organizations in general are risk averse. This produces projections of future results that do not differ too greatly from known trends. For NSA partners, the natural inclination toward risk aversion that organizations exhibit is compounded by regulatory considerations as well. The individuals who have testified

on behalf of NSA partners represent their organizations in a public setting, where their statements may be reviewed by competitors, stock analysts, and SEC officials. It is therefore not surprising that projections of the After Rates volumes are conservative.

III. Mitigation of Risk

76. We do not contend that the due diligence procedures described above will reduce to zero the risk of error in Before Rates volume estimates. The risk of underestimating the Before Rates volume, by one, two or five million pieces of mail annually, cannot be eliminated in its entirety. Risks are inherent in any volume forecast, even after extensive research and detailed knowledge of a company's marketing plans. For this reason, the Postal Service has insisted on including terms in the NSA contracts, including the Bank One NSA, that mitigate or limit these risks.

77. The sophistication of these contract provisions has increased from one NSA to the next. Each NSA has enabled us to improve our knowledge about the factors that drive mail volume in the credit card industry, and we use this information to improve the risk mitigation factors in subsequent agreements. For example, the Bank One NSA contains risk-limiting terms that were absent from the Capital One NSA.

78. The Commission has stated that its main concern is the risk that the Before Rates forecast has been understated to such an extent that the NSA may result in a negative contribution. Docket No. MC2004-3, PRC Op. at 4. 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; and the expanded merger provisions.

79. The term limit greatly reduces the potential harm from under-reported mail volumes. As with experimental changes in rates and fees that the Postal Service might propose, any potential adverse effects, as well as potential benefits, are limited. The NSA cannot be renewed without review of current data and a reassessment of the appropriate thresholds and discounts. Because the impact of the Bank One NSA is relatively small as a percentage of aggregate presorted First-Class Mail, the opportunity for the Postal Service to lose a material amount of money in this short period of time is almost negligible.

80. The annual adjustment mechanism is perhaps the most important risk mitigation device. This mechanism adjusts the volume discount thresholds up or down depending on the increase or decrease in the number of accounts. As I stated in my previous testimony, this is an important mechanism because it ensures that the Postal Service does not give unwarranted discounts on increases in operational mail. This mechanism mitigates the risk of understated operational mail volume.

81. What I did not explain in my testimony, however, is how the annual adjustment mechanism mitigates the risk of the impact of exogenous factors on Bank One's *marketing* mail volume. As stated above, growth in marketing mail volume correlates highly with growth in the number of accounts. 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, we are also controlling the impact of exogenous factors that would result in an increase in the Before Rates volumes. Hence, even if an exogenous factor

would cause an increase in mail volume that we did not anticipate, the agreement self-corrects.

82. This self-correction occurs in the second and third year of the agreement. The inapplicability of the adjustment to the first year is acceptable because we generally have a higher degree of confidence in forecasts for the first year of the agreement.

83. Finally, the merger and acquisition provisions mitigate the risk that subsequent events may lead to unanticipated growth in mail volumes. Mergers and acquisitions are regularly experienced in the credit card industry. The merger adjustment clause adds the volume of the new entity to Bank One's threshold so that the NSA discounts continue to provide an incentive to grow new First-Class Mail volume. With the inclusion of these terms in the Bank One NSA, we have a high degree of confidence that almost all of the risks inherent in the Before Rates forecast would be mitigated.

84. In that regard, the merger of Bank One and JP Morgan Chase did not increase the risk that estimates of Bank One's Before Rate volume submitted in support of the Postal Service's request would prove to be unrealistically low. First, as noted above, the merger provision and the provisions in the NSA contract that require an "absolute" increase in thresholds based on merger volumes minimize the ability of the merged entity to use First-Class Mail volume inherited from the Chase side of the merger to satisfy the discount volume thresholds.

85. Second, we have no reason to believe that the marketing officials responsible for administering the credit card portfolios inherited from Chase will have a greater relative preference for First-Class Mail vis-à-vis Standard Mail than did their

marketing department counterparts in the pre-merger Bank One. The reason is straightforward: the Bank One marketing people are basically in control of this aspect of the combined marketing operation. The Commission found that this claim was unsupported in the record. The Commission appears to have overlooked the portion of the record that deals with this issue, the response of Bank One witness Rappaport included in the Supplementary answer of Bank One to OCA/USSP-T1-44 (filed Sept. 1):

> [P]ost-merger marketing decisions for the merged corporate entity will be the responsibility of a company-wide marketing composed primarily of former Bank One marketing employees, and headquartered in Wilmington, Delaware, the home of the former Bank One marketing department.

If the Bank One people will be running this part of the show, there is no reason to believe that the merger has increased Bank One's relative preference for First-Class Mail, or the aggregate Before Rates First-Class Mail marketing volume of the merged entities combined.

86. Third, we believe that the result would not be much different even if former Chase marketing managers were still calling the shots. Before the Bank One NSA filing, the Postal Service had also engaged in discussions for a separate NSA with the pre-merger JP Morgan Chase. As part of these discussions, we verified the volume estimates of JP Morgan Chase using the same data, models and other tools described above. After the merger was announced, we performed an analysis of the likely Before Rate volume of the combined entity. In performing this analysis, we made no attempt to reduce the combined volume figures to account for the cost savings that might result from the elimination of duplicate solicitations to consumers having separate accounts with both of the two pre-merger entities. Despite this conservatism, our analysis showed that the combined post-merger Before Rates volume of the merger entity

appeared unlikely to enable the merged entity to claim After Rates discounts for the Before Rates volume inherited from either of the pre-merger entities. For these reasons, we are confident that the merger is not going to allow the combined entity to obtain discounts under the NSA for Before Rates volume generated by either side of the merged entity.

IV. Balancing of Residual Risk and Potential Benefits

87. Although the contract mitigates much of the risk inherent in volume forecasts, some residual risk necessarily remains. We must then evaluate this residual risk, and balance it against the potential benefit of the NSA.

88. To estimate the residual risk, we calculate the value of the NSA at a variety of mail volumes assuming that all of the mail would have been mailed without the incentives provided by the NSA. A similar calculation appears in Table 4, page 47, of the Bank One brief. Brief of Bank One Corporation, Docket No. MC2004-3 (October 6, 2005). We then explore the value of the NSA under a range of distributions of probabilities for the volumes.

89. We next perform a similar calculation for the upside benefits of the NSA. We calculate its value at a variety of After Rates estimates, assuming that Before Rates volumes were accurately estimated. We explore the full range of benefits of the NSA, because we believe many of our NSA partners underestimate their After Rates volume. We also explore the upside benefits under a range of distributions for the probabilities of the volumes. Finally, we compare the residual risk to the expected benefit. In the Bank One NSA, the benefit more than compensates the Postal Service for the residual risk.

90. We also incorporate an allowance for the condition that, on a per-unit basis, the Postal Service under all circumstances receives ample revenue per unit to account for all unit variable costs.

91. Previous comments have assumed that the only risk from NSAs is that customer's Before-Rate forecast is higher than those forecast. However the Postal Service must also consider the possibility that overall mail volumes may decrease and that failure to increase or retain mail volumes represents as significant a risk as underestimating Before Rates volumes.

V. Intenal Processes

92. In addition to the due diligence performed within Pricing Strategy, the Postal Service also processed the Bank One NSA proposal through a series of internal reviews before filing it with the Commission. After we reached an agreement in principle with Bank One on the core elements, including the conversion of marketing mail to ACS and the declining block rate structure, we analyzed the contribution that the NSA would generate. To do so, we modeled the effects of the NSA on the costs, revenues, and volumes of the Postal Service, in compliance with Commission's rules, Rule 193(e). As a result, the internal review process used the financial data that would support the Postal Service's filing with the Commission.

93. Final approval to proceed with the filing of the proposed Bank One NSA at the Commission required four separate levels of internal review. The proposal was reviewed first by a group of Postal Service executive managers from Finance, Marketing, Operations, and the Law Department. The next level of reviewers consisted

of a group of officers from Finance, Operations, Strategic Planning, Marketing, and the Law Department. The third level of review was by the Executive Committee (EC), the senior level of management decision making in the Postal Service. Finally, the EC authorized the presentation of the Bank One NSA to the Board of Governors for approval of the filing the Request.

94. In addition to this internal review process, we had to secure the certification of the cost statements and supporting data necessary for any filing with the Commission. This involved a detailed review of the Bank One financial model by the Finance and Law Departments. Multiple reviews involved careful examination of the basis for our financial projections.

95. The above description of these internal reviews suggests that they occurred sequentially. In fact, the process had multiple iterations. The Bank One NSA was reviewed several times at the manager and officer level before it was finally approved to proceed to the Board of Governors.

96. As a result of our tests, analyses, and reviews, the Postal Service concluded that Bank One's volume forecasts were reliable.

I declare, under penalty of perjury, that the foregoing is true and correct to the best of my knowledge.

Date: 5.18.05

Michael K. Plunkett