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

RATE AND SERVICE CHANGES TO	)	
IMPLEMENT NEGOTIATED SERVICE AGREEMENT	)	Docket No. MC2005-3
WITH BOOKSPAN	)	

INITIAL BRIEF

OF

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iii

STATEMENT OF THE CASE 1

ARGUMENT 13

I. THE POSTAL SERVICE'S POSITION OBSCURED THE UNDERLYING JUSTIFICATION FOR THE PROPOSED NSA AND DECLINED TO PROVIDE THE COMMISSION WITH INFORMATION, REQUIRED BY ITS RULES, THAT IS NECESSARY TO EVALUATE THE REQUESTED DISCOUNTS 13

II. THE POSTAL SERVICE'S CLAIM OF INCREASED CONTRIBUTION FROM THE MIGRATION OF BOOKSPAN FLATS TO LETTERS IS NOT SUPPORTED ON THE RECORD 17

A. Despite Postal Service Efforts to Downplay the Importance of the Conversion of Flats to Letters, the Savings Projected from this Conversion Is a Key Financial Component of this NSA 17

B. The Letter and Flat Rate Categories Used by Bookspan Produce Vastly Different Unit Contributions, a Fact Which the Postal Service Presentation Obscures 18

C. The Postal Service's Methodology in Estimating Net Contribution from Flat to Letter Conversion Is Flawed, Should Be Rejected, and Cannot Be Relied Upon to Find Increased Contribution, as this NSA Actually Could Result in Conversion which Reduces Contribution 22

D. Postal Service Estimates of Net Contribution Should Be Based on Mailer-Specific Costs 29

III. THE POSTAL SERVICE'S HOPE OF EXPERIENCING INCREASED CONTRIBUTION SOLELY FROM INCREASED VOLUME CANNOT JUSTIFY REDUCED RATES 30

A. The Record Does Not Quantify, or Even Demonstrate, Any Alleged Multiplier Effect Generated by the Projected New Volume 31

B. The Postal Reorganization Act Prohibits Non-cost Based Declining Block Discounts as "Unreasonable Preferences" to Certain Users of Mail 34

CONCLUSION 40

TABLE OF AUTHORITIES

Page

Statutes

39 U.S.C. § 403 . . . . . 16, *passim*

Code of Federal Regulations

39 CFR § 3001.193 . . . . . 5, *passim*

39 CFR § 3001.195 . . . . . 5, 12

Cases

United Parcel Service v. United States Postal Service, 604 F.2d 1370 (3rd Cir. 1979) 39

Postal Rate Commission Opinions and Recommended Decisions

Docket No. R87-1 37

Docket No. R90-1 . . . . . 37, 38

Docket No. MC2002-2 38

Miscellaneous

GAO Report GAO/GGD-99-15, *U.S. Postal Service: Development and Inventory of New Products*, November 1998 15

GAO Report GAO/GGD-00-188, *U.S. Postal Service: Postal Activities and Laws Related to Electronic Commerce*, September 2000 15

GAO Report GAO-02-79, *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections*, December 2001 15

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VALPAK DIRECT MARKETING SYSTEMS, INC. AND
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STATEMENT OF THE CASE

Postal Service Request

On July 14, 2005, the United States Postal Service filed a request, pursuant to Chapter 36 of the Postal Reorganization Act ("the Act"), 39 U.S.C. section 3601, *et seq.*, for a recommended decision by the Postal Rate Commission to implement a proposed three-year Negotiated Service Agreement ("NSA") with Bookspan that provides Bookspan with a declining block discount for Standard Mail letters soliciting book club membership.[1]

The Postal Service's case-in-chief consists of the testimony of two Postal Service witnesses:

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[1] Request of the United States Postal Service for a Recommended Decision on Classifications and Rates to Implement a Baseline Negotiated Service Agreement with Bookspan, July 14, 2005.

USPS witness Michael K. Plunkett	USPS-T-1
USPS witness Michelle K. Yorgey	USPS-T-2

Co-proponent Bookspan filed the testimony of two witnesses:

Bookspan witness Robert J. Posch, Jr.	Bookspan-T-1
Bookspan witness Matthias Epp	Bookspan-T-2

In its request, the Postal Service stated that it would rely on the testimony of the two Postal Service witnesses as well as the two Bookspan witnesses, and included a Compliance Statement[2] to that effect.

This case is the first baseline NSA since the initial NSA with Capital One Services, Inc. ("Capital One")[3], and is the first baseline NSA to be filed under the Commission's rules applicable to proposed NSAs, which were established in Docket No. RM2003-5 (Order No. 1391, February 11, 2004).

On July 14, 2005, the Postal Service also filed a request that the Commission: (i) establish settlement procedures as the "relatively straightforward nature of the Bookspan NSA should result in an expeditious and uncomplicated review"; and

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[2] *See* Request, p. 6 and Appendix E-4.

[3] NSAs are currently in effect with Capital One (Docket No. MC2002-2) and two other companies whose NSAs were considered to be "functionally equivalent" to the Capital One NSA: Bank One Corporation (Docket No. MC2004-3) and Discover Financial Services, Inc. (Docket No. MC2004-4). Another functionally equivalent NSA with HSBC North American Holding, Inc. (Docket No. MC2005-2) is scheduled to be implemented on January 1, 2006.

(ii) schedule "a settlement conference immediately following the deadline for intervention."[4]

Commission Proceedings

On July 19, 2005, the Commission issued a Notice and Order (Order No. 1441) on the filing of the Postal Service's request, authorizing settlement negotiations in this docket, appointing the Postal Service as settlement coordinator, and scheduling a settlement conference for August 10, 2005 and a prehearing conference for August 11, 2005.

In accordance with Order No. 1441 and Rule 20 of the Commission's Rules of Practice and Procedure (39 CFR § 3001.20), Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. each filed a notice of intervention on August 4, 2005. These two intervenors, referred to collectively as "Valpak," have proceeded jointly in this docket.

After conducting the prehearing conference and receiving the report on the August 10, 2005 settlement conference,[5] the Commission issued Presiding Officer's Ruling No. MC2005-3/1 on August 16, 2005, which established the procedural schedule for the case. Acting on a Postal Service request that was filed on September 27, 2005 for modification of the procedural schedule to accommodate the Bookspan witnesses,[6] Presiding Officer's Ruling No. MC2005-

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[4] Request of the United States Postal Service for Establishment of Settlement Procedures, July 14, 2005, pp. 1-2.

[5] Report on First Settlement Conference and Proposed Procedural Schedule, August 11, 2005.

[6] Request of the United States Postal Service for Modification of the Procedural Schedule, September 27, 2005.

3/10 (September 28, 2005) revised the procedural schedule. The briefing schedule was further revised in Presiding Officer's Ruling No. MC2005-3/15 (November 4, 2005).

Discovery of the Proponents' Case-in-Chief

By September 7, 2005, the deadline for written discovery,[7] Valpak had conducted written cross-examination of the following witnesses with respect to their direct testimony:

USPS witness Michael K. Plunkett	VP/USPS-T1-1-15
USPS witness Michelle K. Yorgey	VP/USPS-T2-1-9

Valpak timely designated all responses received to its interrogatories for inclusion in the record on October 14, 2005.[8]

Counsel for Valpak conducted oral cross-examination of Postal Service witness Yorgey (Tr. 2/162-219) and Postal Service witness Plunkett (Tr. 2/289-322).

Prehearing Conference and Settlement Process

Valpak participated in the August 11, 2005 prehearing conference. Valpak also participated in both settlement conferences conducted by the Postal Service, on August 10, 2005 and on October 11, 2005. The Postal Service submitted a report on the first settlement

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[7] *See* Presiding Officer's Ruling No. MC2005-3/1, August 16, 2005, Attachment.

[8] *See* Presiding Officer's Ruling No. MC2005-3/12, October 13, 2005, p. 3.

conference to the Commission on August 11, 2005, as cited above, and a report on the second settlement conference on October 12, 2005.[9]

Commission Standards Governing Baseline NSAs

Commission rules which govern baseline NSAs, which were effective March 19, 2004 (after Commission issuance of its Opinion and Recommended Decision in the Capital One case, Docket No. MC2002-2, the only baseline NSA thus far), are being applied to a Postal Service proposal for the first time. These rules provide:

> (a) … The Postal Service request shall include:
> (1) A written justification for requesting a Negotiated Service Agreement classification as opposed to a more generally applicable form of classification; and
> (2) A description of the operational bases of the Negotiated Service Agreement, including **activities to be performed** and facilities to be used **by both the Postal Service and the mailer under the agreement**. [39 CFR § 3001.195 (emphasis added).]

Additionally, Commission rules governing formal requests for NSAs also are being applied to a baseline NSA proposal for the first time. Requests for NSAs are required to include certain financial information, as follows:

> (e) *Financial analysis*. Every formal request shall **include** an analysis, as described in § 3001.193(e)(1), of the **effects of the Negotiated Service Agreement on Postal Service volumes, costs and revenues** in a one-year period intended to be representative of the first year of the proposed agreement. If the agreement is proposed to extend beyond one year, the request shall also include an analysis of the effects of the agreement on Postal Service volumes, costs and revenues in each subsequent year of the proposed agreement, as described in § 3001.193(e)(2). For each year, the analysis shall **provide such detail that the analysis of each component of a Negotiated Service**

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[9] Report on Second Settlement Conference and Motion to Limit Issues, October 12, 2005 (Motion to Limit Issues).

Agreement can be independently reviewed, and shall be prepared in **sufficient detail to allow independent replication**, including citation to all referenced material.

(1) The financial analysis for the one-year period intended to be representative of the first year of the proposed agreement shall:

(i) Set forth the estimated **mailer-specific** costs, volumes, and revenues of the Postal Service for that year, assuming the then effective postal rates and fees absent the implementation of the Negotiated Service Agreement;

(ii) Set forth the estimated **mailer-specific** costs, volumes, and revenues of the Postal Service for that year which result from implementation of the Negotiated Service Agreement;

(iii) Include an analysis of the **effects** of the Negotiated Service Agreement **on contribution to the Postal Service** for that year (including consideration of the effect on contribution from mailers who are not parties to the agreement);

(iv) Utilize **mailer-specific** costs for that year, and provide the basis used to determine such costs, including a discussion of material variances between mailer-specific costs and system-wide average costs; and

(v) Utilize **mailer-specific** volumes and elasticity factors for that year, and provide the bases used to determine such volumes and elasticity factors.

If mailer-specific costs or elasticity factors **are not available**, the bases of the costs or elasticity factors that are proposed shall be provided, including a discussion of the **suitability of the proposed costs** or elasticity factors **as a proxy for mailer-specific costs** or elasticity factors. [39 CFR § 3001.193 (emphasis added).[10]]

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[10] Commission rules also require that the Postal Service's financial analysis for subsequent years include certain specific information, as follows:

(2) The financial analysis for each subsequent year covered by the agreement (if the proposed duration of the agreement is greater than one year) shall:

(i) Identify each factor known or expected to operate in that subsequent year which might have a material effect on the estimated costs, volumes, or revenues of the Postal Service, relative to those set forth in the financial analysis provided for the first year of the agreement in response to § 3001.193(e)(1). Such relevant factors might include (but are not limited to) cost level changes, anticipated changes in operations, changes arising from

Although mailer-specific costs are generally required by these rules, they have not been provided by the Postal Service in this docket. *See* discussion in Section I.D, *infra*.

Scope of Issues to Be Considered

At no time did the Commission limit the issues to be considered in this docket. The second settlement conference report included a motion of the Postal Service to limit cross-examination of Postal Service and Bookspan witnesses to the following topics:

- The **definition of functional equivalency** for this baseline agreement.
- The financial impact of the **multiplier effect** on the Postal Service.
- The reliability and implied elasticity of Bookspan's volume forecasts.
- The extent that inserts for Bookspan's strategic business alliances may be included in solicitation mailings eligible for discounts under the NSA.
- Whether rate structure issues raised in the omnibus rate case affect the analysis in this case. [Postal Service Motion to Limit Issues, Oct. 12, 2005, p. 1 (emphasis added).]

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specific terms of the proposed agreement, or potential changes in the level or composition of mail volumes;

(ii) Discuss the likely impact in that subsequent year of each factor identified in § 3001.193(e)(2)(i), and quantify that impact to the maximum extent practical; and

(iii) Estimate the cumulative effect in that subsequent year of all factors identified in § 3001.193(e)(2)(i) on the estimated costs, volumes, and revenues of the Postal Service, relative to those presented for the first year of the agreement in response to § 3001.193(e)(1). [39 CFR § 3001.193(e)(2).]

Valpak opposed the Postal Service's motion to narrow the issues during cross-examination to the five issues listed in the Postal Service's motion, and identified the following four issues for exploration during cross-examination:

- **Financial effect** on Postal Service from Bookspan NSA.
- Consideration of mailer elasticity of demand in the Bookspan NSA.
- Role and operation of Bookspan NSA termination clause.
- **Impact on Postal Service of mailer conversion from flats to letters** under the NSA. [Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Opposition to United States Postal Service Motion to Limit Issues, Oct. 17, 2005. p. 1 (emphasis added).]

The Newspaper Association of America ("NAA") also filed comments opposed to the Postal Service's Motion to Limit Issues insofar as it would limit the designation of written cross-examination to the issues listed in the motion. Newspaper Association of America Comments on Motion to Limit Issues, October 17, 2005.

The Presiding Officer denied the Postal Service's Motion to Limit Issues, stating that "[t]he issues identified by the participants in their pleading are very useful to the Commission in framing the important issues that affect this proceeding…." Presiding Officer's Ruling No. MC2005-3/16, pp. 2-3.[11]

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[11] The Ruling also indicated that the Motion to Limit Issues "has been overtaken by recent events," such as the hearings on October 19-20, 2005. Presiding Officer's Ruling No. MC2005-3/16, November 7, 2005, p. 3.

THE BOOKSPAN PROPOSAL

In the Bank One NSA docket, the Postal Service has characterized the proposed Bookspan NSA as "**[a]n example of a pure volume discount** case…." United States Postal Service Responses to Notice of Inquiry No. 1 Regarding Status of Settlement (October 14, 2005), Docket No. MC2004-3, p. 3 (emphasis added).[12] However, the Bookspan proposal has several distinct components and purported justifications.

Declining Block Discounts. Specifically, the proposed NSA would offer **declining block discounts** to Bookspan for a three-year period. The discounts would apply only to Bookspan's Standard Mail **letter** solicitations. **Flats** would not receive any discount.

At the outset of this case, it was not clear whether the proposal was to be limited to Standard Regular Mail, or all Standard Mail, as the Postal Service's proposal was ambiguous. During the discovery process, however, it appeared that the discounts were to be available only to Standard Regular letters. *See, e.g.*, response of witness Plunkett to VP/USPS-T1-1 (September 9, 2005), Tr. 2/269. During the hearings, it appeared that Standard ECR could be eligible for the NSA. *See, e.g.*, Tr. 2/189-90. Late in the case, on November 9, 2005, the Postal Service responded to Presiding Officer's Information Request ("POIR") No. 3, Question No. 2 by stating that (irrespective of what was in its filing and how it had responded to interrogatories) it had always been the Postal Service's "intention" to include within the proposal both Standard Regular and Standard ECR Mail. On November 15, 2005, the Postal Service confirmed this position in its response to Notice of Inquiry ("NOI") No. 1. NAA filed

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[12] Postal Service witness Plunkett attempted to nuance this characterization of the Bookspan NSA during his oral cross-examination, Tr. 2/319-322.

thoughtful comments in response to NOI No. 1, which explained that the position of the Postal Service has changed during the course of this case, tracing Postal Service representations back to the July 14, 2005 filing of its request in this case. *See* Comments of the Newspaper Association of America on Notice of Inquiry No. 1 (November 14, 2005). Pending Commission resolution of the legal arguments raised by NAA in its response, this brief analyzes the NSA from the standpoint of the Postal Service's latest position — that both Standard Regular and Standard ECR mail are eligible for discounts under the NSA.

Each year of the agreement has different volume thresholds for the discounts. In years one and two, the incremental discount for qualifying mail would be either 2.0 or 3.0 cents and, in year three, the incremental discount would be 1.0, 2.0, or 3.0 cents. USPS-T-2, p. 4.

Volume Effects. The Postal Service asserts that its incentives to enter into this NSA are that the solicitation mail volume being discounted will:

(1) induce substantial additional Standard letter advertising mail by Bookspan;

(2) induce a substantial amount of Bookspan's flat-shaped mail to **convert** to **letter** shape; and

(3) produce an unspecified additional amount of **mail volume** "in the form of Standard Mail catalogs, Bound Printed Matter book fulfillment, and First-Class Mail correspondence" (the "multiplier effect"). USPS-T-2, p. 2.

Net Revenue Effects. "The total estimated net benefit to postal finances over the three-year period of this NSA is $7.4 million…." USPS-T-2, p. 2; *see* USPS-T-2, Appendix

A, p. 9. The Postal Service's response to Presiding Officer's Information Request No. 1 modified these numbers somewhat. The estimated net benefit increased to $7.7 million.[13]

The Postal Service's projected financial impact analysis has three components, two positive and one negative:

(1) $3.3 million additional contribution from **additional Standard letter mail volume**.

(2) $5.1 million additional "net contribution gain from **conversion** of Standard Mail solicitation **flats** to **letters**" (USPS-T-2, p. 6, emphasis added). *See* discussion at Section II, *infra*.

(3) $0.96 million reduction in contribution from **discounts**.

The "multiplier" effect has been described as a "defining characteristic of the Bookspan NSA" (witness Plunkett response to OCA/USPS-T2-6, Tr. 2/259) and "a key condition of the agreement" (witness Plunkett response to NAA/USPS-T1-2, Tr. 2/217). Nevertheless, despite its asserted importance, no quantification of the financial consequences resulting from the multiplier appears anywhere in the record of this docket. *See* discussion at Section III.A., *infra*.

No Cost-Savings Provisions. Unlike all prior NSAs considered by the Commission thus far, this NSA contains no provisions which would allow the Postal Service to avoid certain work that it performs with respect to Bookspan's mail, nor any provisions which would allow the Postal Service to reduce its costs. Indeed, witness Plunkett has stated: "I hope and

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[13] Response of United States Postal Service to Presiding Officer's Information Request No. 1, Question 4.b.ii, Attachment 5, Appendix A, p. 9.

expect that this docket will establish the precedent for NSAs that do not contain explicit cost savings." Tr. 2/32, ll. 12-14. Accordingly, the Postal Service proposal contains nothing responsive to one of the elements required to be addressed by Commission rules for baseline NSAs — "[a] description of the operational bases of the Negotiated Service Agreement, including **activities to be performed** and facilities to be used **by both** the Postal Service and **the mailer** under the agreement." 39 CFR § 3001.195(2) (emphasis added).

It is important to note that the Postal Service did not begin this docket by arguing that the Bookspan NSA should be approved as consisting of only declining block discounts, offset by no cost savings whatsoever. It may not have been until the Postal Service realized that it (i) failed to meet its burden of demonstrating savings from conversion of flats to letters, (ii) failed to quantify a multiplier effect, and (iii) failed to establish increased Standard Mail volume projections, that it retreated to its current position *(see* Tr. 2/321, ll. 12-14), namely, that the NSA should be approved without offsetting cost savings or other clear benefits to the Postal Service having been established on the record.

Protective Provisions. Lastly, the agreement contains certain protective provisions. There is an **annual volume commitment** which would be adjusted throughout the term of the NSA. The annual volume commitment is set higher than the level where the discounts begin. In addition, if 73,000,000 "Letter Mail Solicitations" were not mailed in the first year, Bookspan would face a one-time fee of $200,000 (presumably to cover the Postal Service's

cost in negotiating and litigating the NSA).[14] Also, the volumes exceed a specific **cap**, an automatic termination clause applies, and each party has an unconditional right of cancellation.

ARGUMENT

I. THE POSTAL SERVICE'S POSITION OBSCURED THE UNDERLYING JUSTIFICATION FOR THE PROPOSED NSA AND DECLINED TO PROVIDE THE COMMISSION WITH INFORMATION, REQUIRED BY ITS RULES, THAT IS NECESSARY TO EVALUATE THE REQUESTED DISCOUNTS.

At the outset of this docket, the Postal Service asserted that the Bookspan NSA would generate a "total estimated net benefit to postal finances over the three-year period of this NSA" (*i.e.*, increased contribution to institutional costs) of "$7.4 million." USPS-T-2, p. 2, ll. 6-7. The gross projected increase in revenue is $8.4 million, less nearly $1.0 million in discounts allowed Bookspan under the NSA. *Id.*, Appendix A, p. 9.

Presiding Officer's Information Request No. 1 revealed a flaw in the Postal Service's filing, in that it did not present data on revenues, costs, and volumes consistently in an after-rates scenario. The Postal Service's response amended USPS-T-2, Appendix 2, page 9, to provide "more internally consistent" (Tr. 2/169, ll. 9-12) data for the Commission to review, resulting in an increase in the **estimated net benefit to $7.7 million**, while the **$1.0 million in discounts** remained unchanged.[15]

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[14] No such "transaction penalty" would apply, however, if Bookspan failed to mail a minimum number of solicitations in year two or year three.

[15] Response of United States Postal Service to Presiding Officer's Information Request No. 1, Question 4.b.ii, Attachment 5, Appendix A, p. 9, August 9, 2005.

The record before the Commission demonstrates, however, that although the estimate of $1.0 million in discounts for Bookspan may be reasonable, Postal Service estimates as to increased contribution are wholly speculative. Indeed, the Postal Service's projected increase in contribution to institutional costs is wholly devoid of record support such as could be reasonably relied on by the Commission.

Moreover, the Postal Service filing did little to identify with clarity the components of this baseline NSA that would make a future NSA "functionally equivalent" to this NSA. Indeed, the Postal Service identified only two elements of its proposal which would be essential for a functionally equivalent docket in its proposed DMCS language:

> Functionally equivalent NSAs, involving declining block rates for Standard Mail letter solicitations for **book or analogous club memberships**, may be entered into with other customers demonstrating a **similar or greater multiplier effect**, as specified by the Postal Service.... [USPS Request, Attachment A, p. 1 (emphasis added).][16]

Of course, the requirement of having "book or analogous club memberships" is not a financial requirement. Only the "similar or greater multiplier effect" is a financial requirement, but in this docket the Postal Service refused to quantify the multiplier effect, thereby making it

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[16] When the Commission proposed changes in this DMCS language in Notice of Inquiry No. 1, Questions 1 and 2 (November 3, 2005), the Postal Service agreed in a one-sentence comment. *See* Response of U.S. Postal Service to Notice of Inquiry No. 1 (November 15, 2005). The Commission's proposed DMCS language appears to avoid the need for a functionally equivalent NSA to demonstrate any quantification of the multiplier in terms of either volume, revenue, or net contribution. It merely must meet three requirements: (i) "at least six times per year, that mailer must send a continuing series of marketing mail," (ii) "send products to a list of people who have agreed to purchase some stipulated minimum number of items on a more or less regular basis," and (iii) "use at least one other subclass for merchandise fulfilment."

impossible for the Commission to determine in subsequent dockets if the multiplier was "similar or greater." This was not an oversight, as the Postal Service candidly admitted that such clarity would have reduced future Postal Service flexibility in determining what type of NSAs it could seek as functionally equivalent to a Bookspan NSA. *See* witness Plunkett response to OCA/USPS-T2-6, Tr. 2/259 ("Quantifying a specific required multiplier effect would create a binding constraint that would impede future negotiations [with other mailers]…."). The Postal Service's tactic of refusing to quantify the multiplier implicitly asks the Commission to defer to the Postal Service's business judgment that the multiplier is adequate, and that it has entered into a wise bargain, both in this baseline docket, as well as all future functionally equivalent dockets.[17] Moreover, the Postal Service's desire for this type of

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[17] The Government Accountability Office ("GAO") has criticized the Postal Service with respect to some of its business decisions, issuing a series of reports that revealed that the Postal Service was losing significant sums of money on e-commerce initiatives. *See* GAO Report GAO/GGD-99-15, *U.S. Postal Service: Development and Inventory of New Products*, November 1998 ("Total revenues and expenses for the 19 products, from inception through fiscal year 1997, as reported by the Postal Service and unaudited by us, were $148.8 million and $233.5 million, respectively." p. 4.); GAO Report GAO/GGD-00-188, *U.S. Postal Service: Postal Activities and Laws Related to Electronic Commerce*, September 2000 ("[I]t is not clear whether USPS management properly reviewed and approved e-commerce initiatives to ensure that they support USPS' overall mission and goals…. [W]e do not believe the e-commerce financial data that USPS provided was sufficiently complete and reliable to be used to assess USPS' progress toward meeting its overall financial performance expectation that revenues generated by e-commerce products and services in the aggregate are to cover USPS' direct and indirect costs as well as make a contribution to overhead." p. 4.); GAO Report GAO-02-79, *U.S. Postal Service: Update on E-Commerce Activities and Privacy Protections*, December 2001 ("Without accurate, complete, and consistent financial information, USPS will not be in a position to assess its progress toward its financial performance goals for its e-commerce program. In addition, USPS does not have clear and comprehensive policies and procedures that would address how all of the direct and indirect revenues and costs associated with its e-commerce and other new products and services are to be reported." p. 3.). Based on the GAO's analysis, it would appear that the Postal Service's business decisions — as well as the financial impact — should be given little deference by the

flexibility should be viewed in the context of a government monopoly seeking discretion to determine what prices to charge its customers, irrespective of the statutory role of the Commission and the constraint of the anti-discrimination/anti-preferences contained in the statute (39 U.S.C. section 403(c)), as well as the rate-setting scheme set up by the Postal Reorganization Act, designed by Congress to protect the mailing public.

The Postal Service having chosen not to quantify the financial gain from the multiplier effect, the Commission should not now waive its rules which require the Postal Service to provide a detailed financial analysis "of the **effects** of the Negotiated Service Agreement on **volumes, costs and revenues**" and that this analysis "provide such **detail** that the analysis of each component of a Negotiated Service Agreement can be **independently reviewed** … to allow **independent replication**…." 39 CFR § 3001.193(e) (emphasis added.)

Despite the Postal Service's exclusive focus on the multiplier effect in its proposed DMCS language for future functionally equivalent NSAs, the Postal Service has sought to justify this particular NSA on the ground that the Bookspan NSA would bring other financial benefits to the Postal Service as well. The major benefit claimed is that contribution will increase from the conversion (migration) of Bookspan flats to letters. This claimed benefit is debunked in Section II, *infra*. The Postal Service's claim of increased contribution from additional volume, both Standard Mail as well as the "multiplier effect," is discussed in Section III, *infra*. Section III concludes that without any quantified financial gain from the asserted multiplier effect, or any offsetting cost savings or other benefits to the Postal Service

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Commission.

having been demonstrated on the record, the proposed NSA does nothing more than offer one mailer substantial declining block discounts for additional volume. Consequently, at the end of the day, the Postal Service is asking the Commission to recommend a "pure" declining block discount without any offsetting cost justification. As such, it must be analyzed under 39 U.S.C. section 403(c) as declining block discounts without offsetting cost savings, similar to as a pure volume discount, and therefore must be rejected by the Commission.

II. THE POSTAL SERVICE'S CLAIM OF INCREASED CONTRIBUTION FROM THE MIGRATION OF BOOKSPAN FLATS TO LETTERS IS NOT SUPPORTED ON THE RECORD.

A. Despite Postal Service Efforts to Downplay the Importance of the Conversion of Flats to Letters, the Savings Projected from this Conversion Is a Key Financial Component of this NSA.

In this docket, the Postal Service asserts and relies on increased contribution from Bookspan converting or "migrating"[18] flats to letter volume.[19] The discounts that would be offered in this NSA are represented as having the effect of accelerating such migration. *Id.*, p. 11, ll. 15-17. At the same time, however, the Postal Service downplays this factor:

> An intended **secondary** effect of this agreement is that the declining block rates **may encourage** Bookspan to increase its

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[18] In this docket, the Postal Service uses the term "migration" to describe the conversion of existing flat volume to letters. *See* Tr. 2/186, ll. 1-17.

[19] Witness Yorgey appears to acknowledge that such references to "migration" are not factually correct. Bookspan's annual volume of both flats and letters generally has been decreasing, with the annual volume of flats decreasing at a higher rate than letters. Tr. 2/186-88. Since such migration normally would mean **a decrease** in flats volume **offset by an increase** in letter volume, it appears to be a non-sequitur for the Postal Service to characterize differences in the rates of decline in volume as "migration."

> conversion of Standard Mail solicitation material prepared and claimed at nonletter rates to mailpieces prepared and claimed at letter-size rates. [USPS-T-2, p. 3, n. 14 (emphasis added).]

Despite these disavowals of primary importance, the increased contribution projected to result from this alleged conversion is considered by the Postal Service to be the primary financial justification for this NSA. Indeed, the Postal Service claims that **over 60 percent** of the projected $8.4 million increase in gross contribution — *i.e.*, over **$5.1 million** — would derive from **conversion of Bookspan's flats to letters** under the NSA. *Id.*, p. 6, ll. 13-16; Appendix A, p. 9. (This estimate of $5.1 million in contribution from conversion did not change in the Postal Service's response to POIR No. 1.) The Postal Service's case-in-chief represents only that the NSA "**may encourage**" conversion, but it then proceeds to calculate and rely heavily on the estimated contribution from projected conversion. Notwithstanding the Postal Service's characterization of conversion as a secondary, not primary, effect, conversion of flats to letters generates the bulk of the NSA's contribution relied on by the Postal Service to justify the offered discounts. Consequently, the migration justification must be tested fully and, when tested, it becomes clear that the NSA cannot be justified financially to any degree whatsoever based on any alleged migration that the Postal Services speculates the discounts "may encourage."

B. The Letter and Flat Rate Categories Used by Bookspan Produce Vastly Different Unit Contributions, a Fact Which the Postal Service Presentation Obscures.

Any increased contribution to the Postal Service from conversion depends on the contribution (net of discounts) from newly converted letters being higher than the contribution

from the flats which converted. To estimate any prospective gain from conversion, witness Yorgey needed to identify per-piece contributions for Bookspan's letters and flats.

As required by Commission Rules (39 CFR § 3001.193(e)), estimates of unit contributions from an NSA should be **customer-specific**; hence, using a revenue or a cost from some other customer (or customers) would not apply. Customer-specific **revenues** are calculable, simply by multiplying Bookspan's billing determinants by the rates, which witness Yorgey has done. Admittedly, developing customer-specific **costs** is somewhat more difficult. Witness Yorgey's testimony assumed that the average costs for all letters and flats in the Standard Mail rate categories used by Bookspan were reasonable proxies for the average costs of Bookspan's letters and flats. Tr. 2/133; 2/170, ll. 6-15.

Her assumption that the unit costs of Bookspan's **letters** equals the systemwide average for all Standard letters may provide a reasonable ballpark estimate of the costs needed for letters. After all, the average per-piece revenue for Bookspan's letters is near the average per-piece revenue for all Standard letters. But witness Yorgey's assumption that the unit cost of Bookspan's **flats** is equal the systemwide average for all Standard flats is **not reasonable**, since the per-piece revenue for Bookspan's flats is quite different from the systemwide average. The Commission requested an explanation about this assumption in Question 3a of POIR No. 1, asking:

> Please discuss the rationale for assuming that the cost of Bookspan's non-letters for each presort level is equal to the average for the Postal Service, when Bookspan's revenue for each presort level is significantly lower than the average for the Postal Service.

Witness Yorgey's response admits that Bookspan's pieces are not average, due to their weight and dropship characteristics. Her response further states "[t]he Postal Service has not conducted an independent evaluation of the costs of Bookspan's specific mail. I have used the Postal Service's average cost as a fair representation of their costs." Response of United States Postal Service to Presiding Officer's Information Request No. 1, Question 3.a., p. 2., August 9, 2005. But since it is known and documented that Bookspan's flats are not average, using these costs cannot be labeled a "fair representation."

In commenting on her decision to use costs that do not apply, witness Yorgey said: "As in past NSAs, the Postal Service has used the Postal Service's average costs as fair representations of the mailer's costs in the absence of more detailed information which would indicate that adjustments to the postal average costs were warranted."[20] *Id*. Interestingly, however, more detailed cost information is available and is used regularly by both the Postal Service and the Commission to design rates for Standard mail.[21]

When computing unit contribution, witness Yorgey choose to rely on company-wide average costs for flat and letter products used by Bookspan, instead of disaggregated costs

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[20] We take witness Yorgey's reference to "mailer's costs" in this quotation to refer to the Postal Service's costs caused by the mailer's mail.

[21] For example, more detailed costs, based on cost-causing characteristics of the way individual mailings are prepared and entered, are available for Periodicals. *See* Docket No. C2004-1. It is clear that mailer-specific costs not only are possible, but also that the Postal Service is in a position to develop such estimates. Such costs would help make rates suitably cost-based, and enable a much greater understanding of costs imposed on the Postal Service by specific mailings.

specific to individual flat and letter rate categories.[22] Witness Yorgey stated on oral cross-examination that the Postal Service neither looked at trends by volume between Standard Regular and Standard ECR (Tr. 2/188, ll. 15-19), nor analyzed trends of changes in flat volume disaggregated to particular rate categories, despite the widely varying net contributions from each subclass and each postal product (Tr. 2/189, ll. 12-13). This failure of analysis helps explain why the Postal Service appears to have entered into the Bookspan NSA agreement based on an insupportable estimate of substantial savings from flat to letter migration. Certainly, the Postal Service has not met the Commission's requirement that it demonstrate the "suitability of the proposed costs" as a "proxy for mailer-specific costs…." 39 CFR § 3001.193(e)(1).

Throughout litigation of this docket, the Postal Service apparently has understood that the Standard Mail rate categories used by Bookspan generate significantly different unit contributions, and not all of Bookspan's pieces would make a greater contribution when entered as letters than they do now when entered as flats.[23] Tr. 2/184, ll. 20-23. It

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[22] Proceeding with this calculation requires knowing which flats convert, as well as the letter categories to which they convert. Witness Yorgey has made untestable assumptions in these regards. Thus, there is no way to gauge how credible her speculations are, and they should not be relied upon by the Commission.

[23] The Postal Service admited that "if Bookspan were to convert all of its solicitation flats to letters, the NSA provides the Postal Service with a $7.2 million increase in contribution" (USPS-T-2, p. 11, ll. 20-22) — $200,000 less than the anticipated benefit to the Postal Service if the conversion from flats to letters were to the lesser degree estimated by the Postal Service's case-in-chief. The Postal Service follows this admission with the seemingly self-contradictory assertion that "although an increase in the conversion rate decreases the value of this NSA, conversion of flats to letters provides the benefit of lower-cost, higher-contribution pieces for the Postal Service." *Id.*, p. 11, l. 23 to p. 12, l. 2.

nevertheless presented its case in a manner which obscured those vastly different levels of contribution, primarily by using company-wide averages for Standard letters and company-wide averages for Standard flats.[24] Fortunately, the confusion wrought in this docket by the Postal Service's methodology has been brought to light, and unreliability of the Postal Service's estimates is now clear on the record.

C. The Postal Service's Methodology in Estimating Net Contribution from Flats to Letter Conversion Is Flawed, Should Be Rejected, and Cannot Be Relied Upon to Find Increased Contribution, as this NSA Actually Could Result in Conversion which Reduces Contribution.

Valpak's oral cross-examination of witness Yorgey used two exhibits which focused on the disaggregated unit costs and revenues for each mail product used by Bookspan. Those cross-examination exhibits, as corrected by witness Yorgey, were transcribed into the record and admitted into evidence. *See* Tr. 2/191-94.

Valpak cross-examination Exhibit XE-1 (Tr. 2/193), set forth below, highlighted how widely the unit contributions from various Standard products used by Bookspan vary. Letters provide a unit contribution that ranges from a low of 2.9 cents (Standard Regular Nonauto 3/5-Digit) to over four times higher — a high of 13.4 cents (Standard Regular Auto Mixed

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[24] Until rather late in the case, the position of the Postal Service and Bookspan with respect to whether the NSA applies only to Standard Regular letters, or to both Standard Regular and ECR letters, was ambiguous, at best. *See* discussion in "The Bookspan Proposal," *supra*.

AADC). Flats provide a unit contribution from a low of -3.6 cents (amazingly, a negative unit contribution, or a unit loss), to a high of 8.0 cents.[25]

[25] The across-the-board rate increase in Docket No. R2005-1 has perpetuated this rate structure for Standard Mail at least through 2006 and beyond, until new rates from an as-yet-unfiled omnibus rate case become effective. In the next rate case, the Commission will have an opportunity to review the unit contributions of individual rate categories within a subclass, and decide whether to reduce or eliminate existing disparities so as to make the Postal Service's financial situation relatively indifferent as to which rate categories mailers elect to use. That would eliminate, or at least attenuate, the current pricing anomalies used by the Postal Service to project increased contribution resulting from conversion from flats to letters.

Valpak Cross-Examination Exhibit XE-1

Mail Category	(1) Bookspan TYAR Revenue Per Piece	(2) USPS National Average TYAR Unit Cost	(3) Bookspan TYAR Unit Contribution
Letters – Standard			
(1) Nonauto Basic	0.276	0.235	0.041
(2) Nonauto 3/5-Digit	0.249	0.220	**0.029**
(3) Auto Mixed AADC	0.228	0.094	***0.134***
(4) Auto AADC	0.216	0.085	0.131
(5) Auto 3-Digit	0.193	0.081	0.112
(6) Auto 5-Digit	0.176	0.070	0.106
Letters – ECR			
(7) Nonauto Basic	0.180	0.094	0.086
(8) Auto Basic	0.156	0.046	0.110
Non-letters – Standard			
(9) Nonauto Basic	0.394	0.351	0.043
(10) Nonauto 3/5-Digit	0.305	0.265	0.040
(11) Auto Basic	0.311	0.351	**-0.036**
(12) Auto 3/5-Digit	0.252	0.261	-0.009
Non-letters – ECR			
(13) Basic Non-letter	0.178	0.098	***0.080***

Valpak cross-examination Exhibit XE-2 replicated columns 1, 2, and 3 from Valpak Exhibit XE-1, added the Bookspan FY 2004 volume, and calculated total contribution based on that volume.

Valpak Cross-Examination Exhibit XE-2

	(1) Bookspan TYAR Revenue per Piece	(2) USPS National Average TYAR Unit Cost	(3) Bookspan TYAR Unit Contribution	(4) Bookspan FY 2004 Volume (pieces)	(5) Bookspan FY 2004 Contribution (dollars)
Mail Category					
Letters – Standard	0.276	0.235	0.041	1,518,805	62,271
(1) Nonauto Basic	0.249	0.220	**0.029**	58,859	1,707
(2) Nonauto 3/5-Digit	0.228	0.094	***0.134***	7,078,780	948,557
(3) Auto Mixed AADC	0.216	0.085	0.131	12,572,357	1,646.979
(4) Auto AADC	0.193	0.081	0.112	60,973,641	6,829,048
(5) Auto 3-Digit	0.176	0.070	0.106	4,630,796	512,065
(6) Auto 5-Digit					
Letters – ECR	0.180	0.094	0.086	5,575,671	479,525
(7) Nonauto Basic	0.156	0.045	0.110	1,405,645	154,621
(8) Auto Basic					
				94,014,755	10,634,772
SUBTOTAL					**0.113**
Average, per piece					
Nonletters – Standard	0.394	0.351	0.043	29,185	1,255
(9) Nonauto Basic	0.305	0.265	0.040	1,387,428	55,497
(10) Nonauto 3/5-Digit	0.311	0.347	**-0.036**	167,112	-6,016
(11) Auto Basic	0.252	0.261	-0.009	97,096,345	-873,867
(12) Auto 3/5-Digit					
Non-letters – ECR	0.178	0.098	***0.080***	65,718,356	5,257,468
(13) Basic Non-letter				164,398,427	4,434,337
SUBTOTAL					**0.027**
Average, per piece					

On oral cross-examination based on Valpak cross-examination Exhibit XE-2, witness Yorgey acknowledged that no category of flats mailed by Bookspan earned 2.7 cents per piece — the average flat contribution identified by the Postal Service in witness Yorgey's testimony. Tr. 2/183, ll. 8-16. Witness Yorgey also acknowledged that, for 99 percent of Bookspan's flat mail, the Postal Service either lost just less than one cent per piece, or earned 8.0 cents. Tr.

2/182, ll. 9-21. In view of the wide disparity in unit contributions, calculating any contribution from conversion requires knowing (i) which flats will convert, and (ii) the letter categories to which they will convert. Witness Yorgey makes the implicit assumptions that (i) converting flats will have the distribution of all Bookspan flats, and (ii) they will turn into a set of letters with the distribution of all Bookspan letters.[26] Unfortunately, she makes no effort to explain the basis for either assumption, and the record presents no basis for determining how close her assumption would be to reality.

Witness Yorgey's implicit assumption derives from the method used to calculate contribution per piece, which starts by computing shape-based averages. The Postal Service identified specific Base Year and estimated Test Year volumes for each postal product (flat and letter) used by Bookspan. Rather than calculate the impact of the NSA on mail from each postal product, however, and compile the results to determine the combined impact, the Postal Service's "Bookspan revenue-per-piece calculation is based on the total revenue per rate category divided by the total volume per rate category." USPS-T-2, Appendix B, p. 2. In other words, the Postal Service first calculates a single **weighted average revenue-per-piece**

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[26] An alternative assumption would be that: (i) Basic flats in Regular became Basic letters in Regular; (ii) 3/5-digit flats in Regular became 3/5-digit letters in Regular; (iii) Basic flats in ECR became Basic letters in ECR; (iv) automation Basic flats in Regular became an average of automation mixed AADC and AADC letters in Regular; and (v) automation 3/5-digit flats in Regular became an average of automation 3-digit and 5-digit letters in Regular.

The fundamental problem for the Commission is that neither witness Yorgey, nor any of the Bookspan witnesses, nor the NSA agreement itself, provide any indication on the record of which flats empirically are likely to "migrate" to letters. Therefore, in order to find increased contribution, the Commission must speculate about (i) which flats are most likely to migrate, and (ii) the letter categories to which they are likely to migrate.

for all Bookspan letters, and a corresponding average for all Bookspan flats. Next, the Postal Service calculates a single **weighted average cost-per-piece** for all Bookspan letters, and a corresponding average for Bookspan flats. Finally, the Postal Service subtracts each shape-based cost-per-piece from the corresponding revenue-per-piece to develop a **contribution-per-piece** for Bookspan letters and flats, respectively. Use of these weighted averages results in witness Yorgey's implicit assumption.

Valpak therefore explored the importance of determining from which flat-sized mail product the anticipated migration would come — the ECR flats earning 8.0 cents per piece, or the flats losing 0.9 cents per piece. As noted above, the institutional contribution from an ECR Basic flat was identified by the Postal Service as 8.0 cents, and the institutional contribution from an ECR Nonauto Basic letter **before any discount** was 8.6 cents.[27] Witness Yorgey acknowledged that, under terms of the NSA, the Postal Service **assumes the risk** that much or all of Bookspan's ECR flat mail, which now produces a significant positive contribution to institutional costs, may migrate to letter categories which — after discounts — would produce a lower net contribution. Tr. 2/184, l. 24 to 185, l. 5. Specifically, the **Postal Service would lose either 1.4 cents per piece or 2.4 cents per piece for each mailpiece which migrates from ECR Basic flats to ECR Nonauto Basic letters**, depending on whether the letter-sized piece qualified for a 2.0 cent or 3.0 cent discount under the NSA. Witness Yorgey further acknowledged that, given the impact of a 2- or 3-cent discounts for each piece of letter mail under the NSA, migration of Bookspan mail from ECR Basic flats to ECR

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[27] *See* cross-examination exhibits, *supra*. *See also* Tr. 2/189, l. 14 to Tr. 2/190, l. 20.

Nonauto Basic letters **could result in a reduced contribution to institutional costs from Bookspan's mail**. Tr. 2/189, l. 14 to Tr. 2/190, l. 20.

A scenario such as that just described is relatively easy to envision. In FY 2004, Bookspan mailed a total of 164,378,427 Standard flat-size pieces. USPS-T-2, Appendix A, p. 1. Over the course of the proposed NSA, Postal Service calculations assume that Bookspan will convert only 56,000,000 of its Standard flats to Standard letters under the NSA — as follows:

- 17,000,000 in FY 2006,
- 19,000,000 in FY 2007, and
- 20,000,000 in FY 2008. Tr. 2/129-130.

According to the Postal Service's data on Bookspan's FY 2004 Volume, reproduced in Valpak cross-examination Exhibit XE-2, *supra*, Bookspan's annual volume of ECR flats amounted to 65,718,356 pieces. That volume exceeds, by more than 45 million pieces, the maximum annual volume of flats expected to convert during any year of the three-year life of the contract. The prospect of potentially losing 1.4 or 2.4 cents per piece in institutional contribution on 56 million pieces was masked by the Postal Service's presentation of letter-sized and flat-sized institutional contribution per piece.

Should the Postal Service suffer reduced contribution, on average, of 1.4 cents per piece on 56 million pieces, it would incur a total loss amounting to $784,000. The contract contains no safeguards to prevent or limit such unprofitable conversion. As witness Yorgey testified, the Postal Service has agreed to "assume the risk" of such an adverse outcome. Any

such loss would cause the effect of conversion to be an offset, or deduction, rather than an addition, to any gains from net new volume.

To sum up, the devil is in the details, as usual, and the Postal Service's use of weighted averages hides the potential for overall decreases in contribution. By using shape-based averages — which lump together contributions per piece ranging from 2.9 cents per piece for Nonauto 3/5-Digit letters to 13.4 cents per piece for Auto Mixed AADC letters, as well as a similar disparity equaling as much as 11.6 cents in contribution per piece obtained from different flat products — the Postal Service's presentation initially obscured the NSA's potential detrimental impact on the Postal Service's net revenue that could arise from any migration of Bookspan's ECR flats to letters. Also obscured was the prospect of some Bookspan letter mail (Nonauto 3/5-Digit letters) receiving a discount which exceeded the product's contribution to institutional costs.

D. Postal Service Estimates of Net Contribution Should Be Based on Mailer-Specific Costs.

Commission rules require that the Postal Service's request sets forth "the estimated **mailer-specific costs**, volumes, and revenues of the Postal Service for that year…." 39 CFR § 3001.193(e) (emphasis added). In this NSA, however, the Postal Service continues its practice of **assuming** that the mail entered by the beneficiary of the NSA has the same unit cost as the **systemwide averages**. Witness Yorgey assumed that the costs of Bookspan's letters and flats are the same as the average costs for all letters and flats in Standard.

Although the Postal Service routinely represents that it would be too difficult to calculate mailer-specific costs, it continues to be Valpak's position that the Postal Service should be required to present mailer specific costs in support of NSAs.[28] Certainly, for NSAs, the Postal Service should be required to develop and use such detailed costs to the maximum feasible extent. It is certainly not satisfactory for the Postal Service to rely on broad averages that are known to be inapplicable to the mailer in question.

III. THE POSTAL SERVICE'S HOPE OF EXPERIENCING INCREASED CONTRIBUTION SOLELY FROM INCREASED VOLUME CANNOT JUSTIFY REDUCED RATES.

Section II, *infra*, demonstrates that the Postal Service's projected savings and resulting increased contribution from the anticipated migration (conversion) of existing Bookspan flat volume to letter shape is completely speculative, and not supported by the record. As demonstrated there, the conversion from flats to letters actually could **reduce** the contribution to institutional costs. The Commission cannot rely upon the type of evidence offered by the Postal Service with respect to migration as demonstrating any increased contribution, and therefore migration certainly not cannot justify $1 million in proposed discounts under the proposed NSA.

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[28] *See, e.g.,* Docket No. MC2002-2, Valpak Initial Brief, pp. 22-27, and Reply Brief, pp. 11-12; Docket No. RM2003-5, Valpak Comments on Proposed NSA Rules Pursuant to Commission Order No. 1383, p. 7 ("An NSA must be based on a demonstrated Postal Service cost savings, specific to the mailer….") and Valpak Reply Comments on Proposed NSA Rules Pursuant to Commission Order No. 1383, pp. 1-5; Docket No. MC2004-4, Valpak Initial Brief, pp. 21-26.

The only possible remaining financial justifications for the Bookspan NSA are the assertions that, if the Postal Service were to give Bookspan a declining block discount:

- Bookspan would increase the volume of its Standard advertising mail; and
- Bookspan's increased use of Standard advertising mail would have a "multiplier" effect in generating other non-Standard mail.

These two arguments are treated in reverse order. First, the alleged "multiplier effect" is analyzed. Second, the legitimacy of reliance upon projected increases in use of Standard advertising mail is examined.

A. The Record Does Not Quantify, or Even Demonstrate, Any Alleged Multiplier Effect Generated by the Projected New Volume.

Witness Plunkett's testimony does not address the multiplier effect, except for one sentence referencing the testimony of Bookspan witnesses Posch and Epp.[29] USPS-T-2, p. 3, ll. 14-18. However, the testimony of witness Epp does not appear to support a multiplier effect at all; he does not even use the word "multiplier" in his testimony. The testimony of witness Posch begins by describing what he extravagantly calls the "massive multiplier effect…." (Bookspan-T-1, p. 2, l. 4), after which he uses more temperate language to describe

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[29] Witness Plunkett did not provide any detail as to the multiplier effect in response to several interrogatories which inquired about this issue. *See, e.g.*, witness Plunkett response to VP/USPS-T1-6(b), Tr. 2/274 ("The Postal Service has **not relied on the quantified value of the multiplier effect** to demonstrate that the proposed NSA produces a net gain in contribution…. However, the presence of a multiplier effect … is a key condition of the NSA…." (emphasis added); OCA/USPS-T2-6, Tr. 2/259 ("Quantifying a specific required multiplier effect would create a binding constraint that would impede future negotiations and might exclude otherwise worthy customers from consideration.").

a "significant multiplier effect" (*id.*, p. 4, l. 5). He asserts that each Bookspan customer generates many other letter and package mailings. In general, he testifies that what's good for Bookspan is good for the Postal Service.

However, witness Yorgey clearly exposes the irrelevance of the multiplier effect to the Commission's consideration of this proposal, leaving the anecdotal testimony of witness Posch as little more than an informational aside in this docket. After referencing the testimony of witness Posch in a footnote (USPS-T-2, p. 2, ll. 8-11), witness Yorgey completely disavows any significance of the multiplier effect when assessing the financial justification undergirding the proposed NSA: "The multiplier effect is **not relied upon** in estimating the financial impact of the NSA on postal finances." USPS-T-2, p. 2, n.13 (emphasis added). Later, witness Yorgey suggests the multiplier effect could be seen as a so-called "second stream of value" that is "expected to result in an additional 25 million pieces of Standard Mail catalogs, Bound Printed Matter book fulfillment, and First-Class Mail correspondence." *Id.*, p. 7, ll. 6-9. However, she provides no cost or revenue information, and reiterates that the multiplier is not part of the purported justification for the NSA, as "[t]he Postal Service **did not include the financial benefits from the 'multiplier effect'** in evaluating the financial value of this NSA." *Id.*, ll. 9-10 (emphasis added). Obviously, mere allegations of financial benefits not demonstrated on the record cannot be relied upon.

Despite the repeated acknowledgments that the multiplier effect has no proper part in the financial analysis of this NSA, paradoxically, the Postal Service has continued to stress its significance. The "multiplier" effect was described as a "defining characteristic of the Bookspan NSA" (Plunkett response to OCA/USPS-T2-6, Tr. 2/259) and "a key condition of

the agreement" (Plunkett response to NAA/USPS-T1-2, Tr. 2/217). Notwithstanding this more recent commentary, if the Postal Service had wanted the Commission to rely on the multiplier effect to justify the NSA financially, it should have presented detailed testimony in its case-in-chief, but it did not. When asked during discovery about the multiplier effect, the Postal Service continued to refuse to quantify it.[30] And now, with the record closed, and at the briefing stage, the Postal Service certainly can do nothing to reverse its course and change fundamentally the nature of this docket by way of supplementation of the record. Moreover, nothing in the Postal Service's initial brief or reply brief will be record evidence, and the Postal Service's arguments cannot be relied on as evidence by the Commission. To sum up, aside from vague, unsupported and unquantified assertions by witnesses Yorgey and Posch, the record contains no credible evidence of any financial impact of the Postal Service for a multiplier effect. Therefore, it should not be relied on by the Commission as part of the Postal Service's financial justification for the NSA.

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[30] Only at the very end of the case, on the eve of oral cross-examination of witness Plunkett, did the Postal Service seek to amend the response of witness Plunkett to an Office of the Consumer Advocate ("OCA") interrogatory (OCA/USPS-T2-6), and have the revised response entered into the record. However, this tactic was opposed by counsel for NAA, OCA, and Valpak, and the Presiding Officer ruled that the last-minute change was inadmissible. The response to that OCA interrogatory entered into the record (Tr. 2/259) was the original response provided by the Postal Service. This ruling was quite appropriate. First, as a matter of basic procedural fairness, after a witness' response to an interrogatory is designated for the inclusion into the record, the witness cannot have unbridled latitude to completely change that response. But additionally, by then, it was much too late for the Postal Service to reverse course and begin to quantify financially the alleged multiplier effect.

B. The Postal Reorganization Act Prohibits Non-cost Based Declining Block Discounts as "Unreasonable Preferences" to Certain Users of Mail.

The Initial Brief of the OCA addresses in detail problems inherent in the Postal Service's volume projections of Bookspan's Standard Mail, and that issue is not dealt with herein. With no record evidence establishing increased contribution from flat to letter conversion (*see* section II, *infra*), and no record evidence establishing increased contribution before the Commission from a multiplier effect (*see* section III.A., *infra*), the only theoretical benefit to the Postal Service is whatever increased Standard Mail volume may be generated by the declining block discounts. However, even if the Postal Service and Bookspan were able to demonstrate on the record some additional contribution from new Standard Mail volume, this would not be enough for the Commission to recommend favorably the NSA, for the reasons set out below.

In another filing with the Commission, the Postal Service has expressly characterized the declining block discounts proposed for Bookspan as "pure volume discounts." Docket No. MC2004-3, United States Postal Service Responses to Notice of Inquiry No. 1 Regarding Status of Settlement (October 14, 2005), p. 3. On cross-examination, witness Plunkett expressed some reservations about this description (Tr. 2/319-22), asserting that the Bookspan proposal differs somewhat from what he views to be a "pure volume discount":

> When I hear the term pure volume discount … that is when a company offers a lower price to one customer or to another just because they buy more of something.
>
> For example, if I buy a Chevrolet I will get one price. If Hertz buys a thousand Chevrolets, they get a very different price. That's a volume discount.
>
> We're not doing that here. We're setting marginally lower prices at a specific threshold. We're not providing a lower price because of the quantity of our services that Bookspan purchases. [Tr. 2/320, l. 22 to 321, l. 8.]

Certainly, economists would recognize a distinction between volume discounts applicable to all mail entered by a large mailer, and discounts applicable only to mail entered by a mailer over a specific threshold, designed to encourage additional volume — a declining block discount. It is true that the propriety of utilizing declining block discounts in certain circumstances was established in the Capital One docket, Docket No. MC2002-2. However, that docket did not establish the precedent that declining block discounts are applicable in all circumstances. In the Capital One docket, and in all three functionally equivalent NSAs following that docket, there was testimony of a cost saving feature — the mailer's willingness to accept electronic address correction information for its Undeliverable as Addressed ("UAA") mail, rather than the more expensive physical return of the mailpiece.

At the outset of this case, it appeared that the Postal Service was arguing for adoption of the Bookspan NSA along lines similar to the Capital One NSA. Instead of a cost savings mechanism being provided by the Address Correction Service, the principal increased contribution ("cost savings") was to be found in the migration of flats to letters. As it turns out, neither increased contribution nor cost savings from this factor have been established on the record. The Postal Service also argued the multiplier effect, and it is theoretically possible that the Commission could have considered this to be a reasonable substitute for a true cost savings mechanism, but the Postal Service failed to quantify it in a way that can be relied on by the Commission. Therefore, neither cost savings nor any suitable substitute for cost savings have been established on the record. The Commission, therefore, is faced with an NSA, at the end of the case, that is very different from the NSA that the Postal Service seemed to be presenting at the beginning of the case. The Commission has a proposed NSA justified

exclusively by the additional volume that will be directly generated by the declining block discounts. Accordingly, as witness Plunkett explained, it may be true that the Bookspan is not a "pure volume discount," but it does appear that it could be characterized as "pure declining block discount" which, at least for pieces above the volume threshold, would offer Bookspan a lower price than any of its competitors, or, indeed, any other user of Standard Mail. Viewed in this way, it is quite similar — almost identical — to a "pure volume discount."

It is clear that the Capital One docket cannot be relied on to support pure volume discounts. Indeed, such issues have come up before, and the Commission is not without precedent as to how to handle pure volume discounts, as it has an established track record within the context of omnibus rate cases. It is not believed that the Commission has ever recommended any volume discount not tied to explicit cost savings, and no such volume discount has ever been ordered by the courts under the Postal Reorganization Act, which states:

> In providing services and in establishing classifications, rates, and fees under this title, the Postal Service shall not, except as specifically authorized in this title, make any undue or unreasonable discrimination among users of the mails, nor shall it grant any **undue or unreasonable preferences** to any such user. [39 U.S.C. section 403(c).]

From time to time, the Postal Service has attempted to bestow a non-cost-justified rate break, but it is believed that no such effort has been successful.[31]

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[31] The advice of witness Panzar in the Capital One docket is instructive on this point: "Since the Postal Service is **not a profit-seeking enterprise**, it **cannot be presumed that any NSA it offers will improve its bottom line**. Ensuring the profitability of any optional tariff offering is a legitimate concern of all mailers." JCP-T-1, p. 20, Docket No. MC2002-2 (emphasis added).

In Docket No. R87-1, the Postal Service sought to establish volume discounts for Express Mail, citing the availability of volume discounts from its competitors in the expedited delivery industry. The Commission rejected the proposal, finding that "[b]efore we could approve a volume discount such as proposed, the Postal Service would have to show how the rates comply with the prohibition, found in section 403(c), of undue or unreasonable discrimination among mailers and undue or unreasonable preferences to a mailer." *Opinion and Recommended Decision*, Docket No. R87-1, para. 6020. Specifically, the Commission criticized the Postal Service's failure to "address the issues that must be considered before accepting **rate differentials** within a subclass that have no origin in – at a minimum – a perception of **some difference in costs**." *Id.* (emphasis added). For example, the Postal Service "has not explained why a mailer of 26 pieces should be treated more favorably than a mailer of 25 pieces … [or] … why a mailer of 26 pieces paying through Corporate Account should be treated more favorably than a mailer of 1000 pieces paying cash." *Id.* The Commission observed that **volume discounts** could be appropriate "if the Postal Service could present **evidence of cost differences** — such as possible lower costs in accepting a mailing of multiple Express Mail pieces." *Id.* (emphasis added). Instead, as in the Bookspan NSA proposal, no effort was made to demonstrate a relationship between costs avoided and discounts provided.

When the Postal Service resubmitted its request for an Express Mail discount in Docket No. R90-1, it acknowledged that the proposed discount was "not based on any quantification of a cost difference." *Opinion and Recommended Decision*, Docket No. R90-1, para. 6533. As a result, the Commission found that the Postal Service "has failed to provide evidence

showing a rate difference for similarly situated mailers is appropriate. The truism that large-volume customers have more options than smaller-volume customers is insufficient to show compliance with the statute's requirement that the Postal Service, a part of the government, treat all its customers fairly," as required by section 403(c). *Id.*, para. 6535.

Finally, the Commission on at least one occasion has explained the applicability of the anti-discrimination/anti-preference statutory provision in the context of NSAs. In the Capital One NSA case, Docket No. MC2002-2, the Commission expressly found that "[i]n view of the significant cost-saving opportunities that the terms of the Postal Service-Capital One NSA make available to the Postal Service, the Commission finds no violation of the prohibitions in § 403(c)." *Opinion and Recommended Decision*, Docket No. MC2002-2, para. 3030. The Commission expressly distinguished its holdings on the Express Mail volume discounts from its recommendation of the Capital One NSA, observing that:

> In both instances, rejection was based on the Commission's assessment that **the proposed discounts were unsupported by any measurable cost difference** between low-volume and high-volume mailings or other empirical justification. Here, by contrast, the agreed-upon declining block rates are justified by Capital One's agreement to take measures that will avoid the potential costs of physical return. [*Id.*, at para. 3031.]

The minimum test for future NSAs established by the Commission in the Capital One docket is clear: NSAs must show "measurable cost differences" in order to justify requested discounts. In the absence of such measurable cost differences, the Bookspan discounts cannot meet the test of 39 U.S.C. section 403(c), and should not be recommended by the Commission.[32]

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[32] When the Postal Service selected 20 mailers to receive special, "experimental" rates in return for certain guaranteed volume at Parcel Post and Third-Class Single Piece mail,

Should the Commission for some reason be tempted to approve this NSA nonetheless, it would need to consider the consequences of approving pure declining block discounts. For instance, such approval would grant the Postal Service the unbridled latitude in negotiating NSAs that witness Plunkett asked for when he said: "I hope and expect that this docket will establish the precedent for NSAs that do not contain explicit cost savings." Tr. 2/321, ll. 12-14. Although the Commission's suggested new DMCS language in NOI No. 1 may be sufficient to avoid this baseline NSA giving rise to functionally equivalent pure volume discount NSAs for any mailer that the Postal Service chooses to favor, it could lead to another baseline NSA proposal which would have that effect. If the precedent is established in the Bookspan case that cost savings are not necessary, and the Postal Service is not required to quantify the financial effects of a multiplier, the precedent of this case may not limit the pricing discretion of the Postal Service in any meaningful way.

For example, the Postal Service could give selected mailers discounts designed to encourage them to enter what the mailer would consider new territory, even though the territory is already being served by one or more other mailers. Nothing is wrong with competitors trying to expand and enter new territories, but with respect to postage rates (which are such a large part of the cost) the playing field should be level. In other words, **pure declining block discounts** (even though they differ and are distinguishable from pure volume

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the U.S. Court of Appeals for the Third Circuit upheld an injunction against the experiment. Among the reasons that the Court identified was the anti-discrimination/anti-preference section of the Postal Reorganization Act, stating "the Act specifically proscribes the Postal Service from discriminating among its users. 39 U.S.C. §403(c)…" United Parcel Service v. United States Postal Service, 604 F.2d 1370, 1377 (3rd Cir. 1979).

discounts) are fraught with problems of undue preference and undue discrimination. Allowing the Postal Service to "reward" selected mailers, or play off one "favored" mailer against others, has the potential to create much mischief.

Further, if declining block discounts can encourage more volume (and profits) without the need to offer lower prices to the entire subclass, the Postal Service would reserve NSAs for mailers whose elasticity of demand substantially exceeded the subclass average. (No such demonstration has been offered with respect to Bookspan.) If used this way, they could offer the Postal Service an easy way to undo Commission rate setting in omnibus rate cases, and to circumvent the Commission's historic refusal to employ the inverse elasticity rule in pricing decisions. If extra volume in response to marginal discounts were to become the only prerequisite for a "functionally equivalent" NSA, the Commission would be hard-pressed to distinguish between (i) mailers who are similarly-situated, and (ii) mailers who are not.

Lastly, if pure volume discounts are to be offered only to favored mailers, the same type of abuses, that have occasionally occurred with respect to procurement decisions, could spread into rate setting, as mailers could seek to manipulate the rate-setting process through political or other improper means.

CONCLUSION

Although the case initially filed was not presented as a "pure declining block discount" with no justification other than incremental volume from incremental discounts, it nevertheless boils down to that critical issue because of (i) the failure to quantify the financial effects of the multiplier; and (ii) the failure either to provide a reliable projection of which flats will migrate,

or to provide a mechanism to prevent highly profitable pieces (flats) from migrating to less profitable rate categories. Authorizing NSAs that offer a mailer nothing more than declining block discounts in return for extra volume has widespread ramifications that extend well beyond Bookspan. (Even witness Plunkett indicated he would not have recommended the NSA based only on additional Standard Mail volume. Tr. 2/217.) This record established in this docket should not be the basis for opening the door by such a precedent.

Negotiated postal discounts, whether characterized as "pure volume discounts" or "pure declining block discounts," at a minimum, should be reserved for instances where the record of the NSA docket reflects that they are cost justified. That not having been demonstrated on the record here, the NSA proposal does not fulfil the requirements of 39 CFR § 3001.193, and the proposed NSA violates 39 U.S.C. section 403(c). The Commission should reject the proposed NSA.

Respectfully submitted,

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