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Before the
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Rate and Service Changes to)
Implement Baseline Negotiated)
Service Agreement with Bookspan)

Docket No. MC2005-3

Initial Brief

Of

The Office of the Consumer Advocate

(Redacted Version; Released on December 9, 2005)

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SUMMARY OF ARGUMENT

The Commission should reject the Bookspan NSA. Neither the Commission nor the Postal Service can know whether any benefit is likely to accrue to the Service from this NSA. The purported benefits depend entirely on estimates of Bookspan's mail volume. But Bookspan cannot predict its own volumes three *months* in advance, much less three years.

The Bookspan NSA constitutes the Postal Service's first attempt to gain approval of an NSA that consists exclusively of discounts intended to stimulate new volumes of Standard Mail solicitation mailpieces. Unlike the earlier family of NSAs that began with the Capital One NSA, the Bookspan NSA produces no cost savings for the Postal Service. Whether other mailers benefit from new contribution or suffer from lost contribution depends solely on the Postal Service's ability to analyze and verify Bookspan's estimates of the volumes and margins that are induced by the NSA discounts.

It is OCA's position that the Postal Service has failed to discharge adequately its responsibility to assess the reliability of Bookspan's volume estimates. The Postal Service has performed and presented only crude, simple, uncritical volume checks and turned a blind eye to the implausibility of Bookspan's estimates. OCA's independent review of Bookspan's volume forecasts leads us to conclude that only a small fraction of the new volumes Bookspan claims will be induced by the NSA discount can be accounted for by the proposed price reduction. The balance of the forecasted new volumes is undoubtedly "anyhow" volumes, i.e., volumes that would have been sent

regardless of the NSA. There is some information in the record to suggest where the “anyhow” volume might be coming from;¹ but whatever its source, the vast majority of forecasted new pieces is not the result of a price response.

Several critical pieces of information combine to present a clear picture of the unreliability and implausibility of Bookspan witness Epp's forecasts of discount-induced volumes:

- In the face of a 5.4 percent increase in the price of Standard Mail letters, witness Epp forecasts that Bookspan would mail 78 million letters, a reduction of 2 million letters (2.5 percent) from its estimate of 80 million letters under a “No rate hike, no NSA” scenario.
- By contrast, witness Epp testifies that a 10 percent decrease in the price of Standard Mail letters (i.e., the average NSA discount of 2 cents) will generate 27 million letters, 10 million new letters (a 13 percent increase) and 17 million letters converted from flats.²

It is important to assess the plausibility of each of these post-NSA forecasts. If a 5.4 percent change in the price of Standard Mail letters produces a 2.5 percent reduction in letter volume, why would a 10 percent change in price trigger a 13 percent volume increase in new letters? The price-to-volume ratio in response to the omnibus rate case is roughly 2 to 1; that is, a price increase produces a volume response roughly half of the price change. Why does the price-to-volume ratio suddenly reverse itself when it comes in the form of an NSA discount? Why should the NSA price reduction produce a volume response even larger than the percentage change in price? No sensible demand curve could ever predict such bizarre behavior in a mail purchaser.

¹ Namely, the ill advised NSA provision allowing Bookspan to include strategic partner inserts in mailpieces eligible for the discounts. See Brief section II.C.

² The combined effect of the 27-million-piece increase is 34.6 percent.

If witness Epp has reasonably replied to the Presiding Officer's Information Request for a "No rate hike, no NSA" volume estimate that could be compared to Epp's "Rate hike, no NSA" volume estimate,³ then one would expect a proportionate response to stem from the availability of an NSA discount. If a 5.4 percent rate hike triggers a 2.5 percent volume reduction, a 10 percent rate reduction should trigger roughly a 5 percent volume increase. This rough 5 percent increase in volume would lead to an expected increase of 4 million new letters. Witness Epp's 10-million new-letters forecast means that 6 million letters will arise from a non-price (non-discount) source. OCA believes that the inclusion of strategic partner mail (an NSA provision that has the potential to be a serious drain on postal finances) may be the source,⁴ but even if OCA has not identified the source of the 6 million new letters, these are "anyhow" volumes and should not be considered NSA-induced volume that will generate new revenue for the Postal Service.

With respect to the 17 million letters that are expected to convert from the flat format, the one-to-one conversion presented by witness Epp makes no sense. The postage needed to mail 17 million Standard Mail flats (\$3.79 million) should allow Bookspan to mail 19.2 million new letters. Why aren't these volume estimates concordant?

³ Witness Epp has attempted to disparage the 80-million figure. E.g., Response of Witness Epp to POIR No. 3, November 9, 2005, at 2. However, the two-million-piece change from 78 to 80 million is very similar to the 2007 change to 75 million from 2006 volume of 78 million. That change was caused "primarily because we anticipate a further postage rate increase." Tr. 3/385. And that increase was assumed to be of similar magnitude as the 5.4-percent increase of 2006. Tr. 4/515, ll. 9-10 (redacted version). Unless Bookspan now wishes to withdraw its pre-NSA volume estimate for 2007, the 80-million estimate for 2006 is eminently reasonable.

⁴ Discussed in Brief section II.C.

The Bookspan NSA puts in stark relief how dependent the Postal Service, the Commission, and other mailers are on the representations made by the mailer that will benefit from the NSA. All three entities are “outsiders” who have no way of judging whether the information provided by the NSA beneficiary is complete or accurate. One fact, however, is quite clear – the NSA partner’s statements are, by necessity, self-serving. The volume estimates that are submitted by the NSA partner are those that are most likely to give the appearance of benefiting the Postal Service and other mailers. Since the Postal Service, the Commission, and other mailers are “outsiders,” there is no way of determining the true facts. Such utter dependence on the mailer that is in full control of the most essential evidence in the case creates a risky situation for all other mailers.

The deficiencies and one-sidedness in the evidence in the instant proceeding prove the astuteness of the Commission’s savings cap solution in the Capital One family of cases. Mailers who are not participants in the Capital One NSA (and functionally equivalent NSAs) are protected by a fund of savings that pays for one-mailer-only discounts out of cost savings that have been banked due to previous beneficial activity by the NSA partner. In the Capital One line of NSAs, the accuracy of the volume forecasts was not so critical, particularly for those discounts paid on volumes that were covered by the savings cap. There is no such assurance in the instant proceeding. The Bookspan NSA must be rejected because of the financial riskiness of the agreement to other mailers.

ARGUMENT

I. INTRODUCTION

The Office of the Consumer Advocate (OCA) supports Postal Service “revenue growth strategies [designed to] sustain the mission of providing universal service at reasonable rates.”⁵ The Postal Service holds a monopoly over the carriage of letters so that it can generate sufficient revenue to provide universal service. Unfortunately, the “projected decline of First-Class Mail impacts the Postal Service’s ability to continue to finance the growing universal service network.”⁶ In such an environment, it makes sense for the Postal Service to offer customized pricing as a means to maintain universal service.

Since September 2002, the Postal Service has brought five Negotiated Service Agreements (NSAs) to the Commission for approval.⁷ These agreements are intended to generate approximately \$72.8 million in new contribution to institutional costs.⁸ However, to the extent that new contribution is based on new volume, the actual financial impact will never be known. This is due to the high uncertainty surrounding the estimates of volumes that customers would have mailed in the absence of an NSA.⁹ As in prior cases, the plausibility of pre-NSA volume estimates is an issue in this

⁵ USPS Strategic Transformation Plan 2006-2010, September 2005 at 6.

⁶ *Id.* at 7.

⁷ Docket Nos. MC2002-2, 2004-3, 2004-4, 2005-2, and 2005-3.

⁸ PRC Op. MC2002-2 at 2, para. [1008] (\$40.6 million); PRC Op. MC2004-3 at 4, para. [1012] (\$11.6 million); PRC Op. MC2004-4 at 1 (\$7 million); PRC Op. MC2005-2 at 1 (\$6.2 million); USPS-T-2, App. A at 9 (\$7.4 million).

proceeding. But in this case, the issue is paramount. There is no benefit to the Postal Service from this NSA other than the highly uncertain value of new volume. Unlike the Capital One family of NSAs, the Bookspan NSA generates no cost savings.

The time has come to reexamine the entire approach to customized pricing that the Postal Service has used in its first five NSAs. The negotiation process has taken years. The litigation process has consumed significant resources. And the ultimate value of the existing NSAs will never be known. Are there other ways for the Postal Service to implement customized pricing—ways that take less time, generate more contribution, and avoid the whiff of favoritism that exists when so few customers actually obtain NSAs? OCA submits that there are.

Just a cursory review of economic and marketing literature produces several books and articles that explain how a monopolist can design profitable customized prices,¹⁰ even when a customer's demand is uncertain. Better yet, these pricing mechanisms involve no negotiations. The method is known as monopolistic screening¹¹ or second-degree price discrimination.

Cell phone calling plans are a familiar example.¹² The same menu of calling plans is offered to all potential customers. A customer selects the plan (monthly charge, "free" minutes, extra-minutes charge) that fits its needs. The plans are

⁹ E.g., PRC Op. MC2002-2 at 72, para [5035].

¹⁰ Future research will allow OCA to formulate and present concrete proposals in future NSA proceedings.

¹¹ E.g., A. Mas-Colell, M.D. Whinston, & J.R. Green, *Microeconomic Theory* at 488-501 (Oxford University Press 1995).

¹² E.g., Eugenio J. Miravete, "Are All Those Calling Plans Really Necessary? The Limited Gains From Complex Tariffs," January 21, 2004, mimeo, <http://www.econ.upenn.edu/~miravete/papers/EJM-Gains.pdf>

designed to generate more contribution to fixed costs than would a single plan for all customers.

If the Postal Service wishes to engage in pure price discrimination (without a customer-specific requirement for new cost-savings behavior), then it should make optional pricing available to all its customers. There is no need to engage in lengthy and costly negotiations when monopolistic screening is available as a pricing device.

II. BOOKSPAN'S VOLUME ESTIMATES ARE *PRIMA FACIE* IMPLAUSIBLE, AND THE POSTAL SERVICE HAS NOT EXPLAINED WHY IT ACCEPTS BOOKSPAN'S VOLUME ESTIMATES

In this proceeding, Bookspan witness Epp presents volume forecasts for the three year period of the Bookspan NSA.¹³ From these forecasts, Postal Service witness Yorgey develops a model to estimate the financial benefit to the Postal Service.¹⁴ The Postal Service's estimate of the financial benefit is totally dependent upon the volume forecasts presented in the financial model.¹⁵

Witness Epp's volume forecasts for the Bookspan NSA are implausible, given the record evidence about Bookspan's pre-NSA volume trends, its implicit expenditures on postage assuming implementation of the NSA, and the forecasted proportion of "new" letters and letters converted from flats. The implausibility of the volume forecasts is demonstrated in the examination of the resulting implausible demand curves. The

¹³ BOOKSPAN-T-2 (Epp), at 11.

¹⁴ USPS-T-2 (Yorgey), Appendix A.

¹⁵ Id. at 2.

Postal Service's uncritical reliance on witness Epp's volumes forecasts leaves other mailers to wonder whether financial benefit or loss will result from the Bookspan NSA.

A. The Volume Estimates of Bookspan Are Unsupported by Any Replicable Analysis

The objective (to the Postal Service) of the proposed Bookspan NSA is to increase the volume of Standard Mail letter-shape solicitations in order to generate additional contribution to institutional costs. The evaluation of the value to the Postal Service is completely dependent upon the reliability of estimates of the volume of letter-shaped Standard Mail expected to be induced by the discounts. If discounts are paid on mail that would have been mailed anyhow, then the NSA not only fails to generate additional contribution, but may actually reduce contribution since "anyhow" volume would have been entered at an undiscounted rate.

An understanding of Bookspan's demand for mail services, and a reliable projection of Bookspan's future volumes with and without the NSA, are essential for evaluating the NSA's financial impact. Unfortunately, Bookspan's intentions are unknowable—even *by Bookspan*. Witness Epp maintains that Bookspan's mailing plans change on a monthly basis:¹⁶

Each month, BOOKSPAN management reevaluates actual results with respect to meeting our annual financial goals. While we establish marketing budgets at the beginning of a year, variances in the actual results compared to the financial goals can trigger a re-evaluation and re-allocation of the marketing budget. In general, campaign plans are reviewed and re-planned on a monthly basis, with adjustments occurring both on the overall and at detailed levels. Marketing campaigns and lists may go on or off our list of active campaigns depending upon actual

¹⁶ Tr. 3/382 (BOOKSPAN-T-2 at 8).

financial and marketing performance. . . . Another way of saying this is that with each monthly financial forecast, our forward-looking marketing budget for operational purposes is subject to adjustment.

1. Witness Epp's volume forecasts do not command credibility

Postal Service witness Yorgey (USPS-T-2) states that witness Epp's testimony "may be relied upon in presentation of the Postal Service's direct case."¹⁷ However, witness Epp provides no analytical basis for substantiating or verifying his volume estimates. His estimates are judgmental and speculative. He testifies that they are based on his understanding of budgets, costs, and market results along with input from other Bookspan personnel.

According to witness Epp, "The percentage that each media represents in our overall marketing portfolio shifts, largely depending on price and relative effectiveness."¹⁸ He explains how Bookspan determines the profitability of an individual mail campaign's performance:¹⁹

What we do is look at past response rates. We look at past payment rates. We look at past cost.

Then we take a new assumption for cost, whether it's paper or book prices, royalty rates, postage, media costs such as the cost of renting lists. We put them together. We estimate a response rate.

We then estimate the future contributions as to the members generated from this campaign will provide to Bookspan. We put those two things into relation, and you get a return on that particular investment.

¹⁷ USPS-T-2, at 1, lines 13-15.

¹⁸ Tr. 3/380 (BOOKSPAN-T-2 at 6), lines 4-5.

¹⁹ Tr. 3/442, lines 1-13.

The determination of whether letter-shape or flat-shape mail will be used is a function of list selection. A choice to use internal lists results in letter-shape mail being used; a choice to use external lists results in the use of flat-shape mail.²⁰ The assessment of a marketing campaign's projected profitability determines whether it is implemented.²¹

If the campaign does not project to be profitable it would not be executed. If it does meet certain profitability thresholds then we would move forward with it provided that we have the budget to do so.

Witness Epp describes how Bookspan prepares its marketing budget:²²

That process involves a number of departments and is not concluded until October. During that time we spend a lot of time and resources on planning the campaigns for the following years. We do not go through the same rigor for two years and three years out. We simply could not because of the resources involved.

However, here in this testimony I provided the best estimates that we had for those years on the basis of current assumptions with regard to profitability, mailing universe, et cetera.

Corporate strategy appears to be an important component of Bookspan's marketing efforts.²³

[REDACTION OF WITNESS EPP QUOTE]

Bookspan's demand for mailing services is largely a function of the corporate budgeting process, the projected profitability of individual campaigns, the choice of lists,

²⁰ Id. at 443, lines 12-18. This casts doubt on the existence of "converted" flats. If the nominal price of flats does not change, the profitability of a campaign directed at external lists does not change either. Converting flats to letters requires abandoning a profitable external campaign to focus on internal lists. What is the cause and what is the effect? Changes in postage rates or changes in corporate strategy?

²¹ Id. at 442, lines 14-18.

²² Id. at 435, lines 3-13.

²³ Tr. 4 (Under Seal)/477, line 19 – 478, line 11.

and corporate strategy balancing marketing objectives and overall corporate profit goals. A change in strategic growth strategies can result in major revisions to the marketing process and demand for mailings. In short, witness Epp has summarized a myriad of conditions and factors that affect Bookspan's mailing decisions. Nearly all of these factors are entirely separate from postal prices. Thus, volume forecasts one, two, and three years from today are a chimera. Those outside the Bookspan organization, including the Commission, the Postal Service, and other mailers, have no way of independently assessing the soundness and disinterestedness of Bookspan's volume estimates.

2. Although witness Epp has summarized the factors driving Bookspan's marketing efforts, he has not presented them in a form that permits prediction of mail volumes

Witness Epp has presented a variety of considerations for developing and implementing a marketing budget. He does not, however, present in analytical form—for example, a model or a spreadsheet—the information indicating how marketing budgets and programs, media purchases, and the overall profitability of marketing efforts result in decisions on the mix of mail. Accordingly, we are left with no way to reproduce or verify the accuracy of his results.

Witness Epp states that there exists no direct relationship or quantifiable elasticity of mail volume in relation to postage.²⁴ He elaborates on this point by stating that postage is an important factor in driving mail volume, but other factors are also important. They include the costs of books and paper, royalty rates, list costs, rental

²⁴ Response of witness Epp to Partially Redirected Request of Presiding Office at Hearings, Tr. 2/203, October 28, 2005.

terms, other media costs, and marketing goals. Furthermore, witness Epp testifies that if the NSA is approved, Bookspan might shift money from other channels in order to achieve the commitment goals set by the NSA. As well, corporate strategy could direct higher marketing goals, possibly resulting in an increase in the overall marketing budget.

The Postal Service is not a private enterprise but, rather, a government monopoly with broad authority, providing citizens with essential services. Accordingly, rate proposals need to be well-documented and based on probative evidence. Witness Epp simply has not made the case that his forecasts are reliable. It is clear that Bookspan spends a substantial amount of effort in determining its marketing budget. It is not clear how this market planning translates into pieces of mail and/or other media buys. The cost of postage is only one of a number of factors considered by Bookspan in determining its marketing plan. Witness Epp testifies that other factors, such as response rates, are also of great significance. When asked for projections of volume as a result of various increases in postage rates, he states:²⁵

That would be pure speculation simply because postage is one component of the overall equation as we calculate a return on marketing investment. There are other components.

We have little information about Bookspan's mailing budget and how it relates to the overall marketing effort. Therefore, we do not have the tools to predict independently whether future mail volume would increase or decrease absent an NSA. Bookspan has failed to provide a clear, comprehensive explanation of how the various factors that it considered work together to produce specific mail volume estimates.

²⁵ Tr. 4 (Redacted Volume)/484, line 25 – 485, line 3.

3. The demand forecasts for mail as an input to Bookspan's marketing efforts are not plausible.

Witness Epp has cast Bookspan's volume forecasts in terms of "the company's dynamic response to a long term price contract, rather than a static model of a response to a simple change in price."²⁶ His preference for a dynamic, rather than static, explanation grows out of a reluctance to be pinned down to a logical, straightforward explanation that ends with a straightforward estimate. He prefers, instead, to backpedal from the strangeness of the volume estimates and their underlying demand curves. The advantage of the "dynamic" approach to Bookspan is to allow it to heap speculation upon speculation. Self-serving estimates that are so utterly unsubstantiated cannot serve as the basis for a Commission recommendation.

Bookspan has provided various "what-if" cases—projected volumes of Standard Mail letters assuming that certain changes in rates occur. The prices and volumes for various marketing cases are summarized in Table 1.

²⁶ Response of Bookspan witness Epp to Presiding Officer's Information Request No. 3, at page 3, filed November 9, 2005.

Table 1: Bookspan Forecasts

	Volume (000)		Average Revenue per Piece (cents)	
No Rate Increase, 2006	80,000	[1]	18.7	[3]
TYBR 2006 (Rate Increase, No NSA)	78,000	[2]	19.8	[4]
TYAR 2006 (Rate Increase, NSA)	105,000	[2]	19.4	[5]
No Rate Increase, No NSA--2007	78,000	[1]	18.7	[1]
Rate Increase, No NSA--2007	75,000	[2]	20.8	[6]

Sources:

- [1] Response of Bookspan Witness Epp to Presiding Officer's Information Request No. 1, Question 4(a), at 2.
- [2] BOOKSPAN-T-2 (Epp), at 11.
- [3] USPS-T-2 (Yorgey), Appendix A, at 3.
- [4] Response of United States Postal Service Witness Yorgey to Presiding Officer's Information Request No. 3, Question 3.
- [5] Response of United States Postal Service Witness Yorgey to Request of Presiding Officer at Hearing (October 28, 2005), at 1.
- [6] = [4] * (1 + 0.054); Tr. 4/515.

A comparison of the projected volumes under different pricing assumptions for 2006 shows that a one-cent change in price results in a two-million-piece change in volume, but a two-cent change in price results in a 27-million-piece change in volume. The nonsensical demand curve associated with these estimates is displayed in Figure 1 in section II.A.5 (page 19) of this brief.

The price/quantity reactions delineated by witness Epp are not consistent with this statement. In particular, a 27-million-piece change is disproportionate in comparison to the two-million piece-change case. Witness Epp testifies that the 27-

million-piece case is in reaction to a three-year longer run price change,²⁷ but the 5.4-percent increase resulting in a change of two million pieces is an even longer run price change—it is permanent. The contradictory nature of his estimates – modest volume responses to modest omnibus rate increases and explosive volume responses to modest price decreases from the NSA – leads one to suspect that Bookspan feels itself completely unconstrained in its projections of future behavior.

Both Bookspan and the Postal Service have stated that changes in rates are only one of the factors affecting volume. While price is an important factor in determining the demand for letter-shaped mail, there are many other important factors at work. The evidence provided does not permit an outside analyst to separate price effects from other simultaneous influences (e.g., corporate strategy).

Postal service is an input to Bookspan's production process. The demand for an input is derived from the value of the additional output that an increment of the input can produce, holding the prices of other factors of production constant.²⁸ Witness Epp has alluded to some of Bookspan's other factors of production when discussing the price of paper, the price of books, etc.²⁹ The problem for the Commission is that witness Epp cannot seem to hold the prices (and quantities) of these other factors constant when estimating Bookspan's demand for postage. Until these other factors

²⁷ Response of witness Epp to POIR No. 3, question 1, November 9, 2005: "My forecasts reflect the company's dynamic response to a long term price contract, rather than a static model of a response to a simple change in price." Also, "[a]n NSA of three years' duration will have a durable favorable effect on Bookspan's postage costs . . ."

²⁸ R.G. Lipsey & P.O. Steiner, *Economics* 330 (3d ed. 1972);

<http://www.google.com/search?num=100&hl=en&lr=&q=%22marginal+profit%22+%22derived+demand%22+>

²⁹ Tr. 3/442, lines 4 – 8.

are fully identified, and their effects on demand for postage isolated, the Commission will be unable to evaluate Bookspan's volume estimates.

Witness Epp's references to "dynamic response" appear to refer to a situation where all factors of production can vary in response to changes in prices of all inputs. In other words, the 10 million "new" pieces of letter-shaped mail are the result, not only of a discount, but also of changes in demands for other inputs. These changes in demands for other inputs generate "anyhow" volume. That is, the use of more of other inputs would shift the demand curve for postal services, even if there were no discount. Until the shift effect ("anyhow" volume) can be isolated, and the NSA volume thresholds raised to avoid losses generated by "anyhow" volume, the Bookspan NSA should be rejected.

4. Bookspan's post-NSA postage expenditures are implausible.

The changes in volume predicted to occur as a result of the Bookspan NSA imply an increase in Bookspan's expenditures on postage of \$1.18 million in the first year of the NSA. This compares to \$0.96 million in discounts to be earned over the entire three years of the NSA. Table 2 presents Bookspan's total expenditures on postage for letter-shaped mail and for flats, pre-NSA and post-

NSA.

Table 2						
BOOKSPAN Pre-NSA and Post-NSA Postage Expenditures						
2006 and 2007						
	BY2004		2006		2007	
Letters Average Revenue per Piece	\$ 0.187	[1]	\$ 0.198	[3]	\$ 0.208	[5]
Flats Average Revenue per Piece	\$ 0.211	[2]	\$ 0.223	[4]	\$ 0.235	[6]
Postage Expenditures, Pre-NSA (2006)						
Letters Postage			\$ 15,410,640	[7]		
Flats Postage			\$ 30,539,781	[8]		
Total (Pre-NSA)			\$ 45,950,421	[9]		
Postage Expenditures, Post-NSA (2006)						
Letters Postage			\$ 20,745,093	[10]		
Letter Discounts			\$ (360,000)	[11]		
Flats Postage			\$ 26,750,173	[12]		
Total (Post-NSA)			\$ 47,135,266	[13]		
Additional Postage Expenditures, Post-NSA (2006)			\$ 1,184,845	[14]		
Postage Expenditures, Pre-NSA (2007)						
Letters Postage					\$ 15,618,091	[15]
Flats Postage					\$ 30,309,284	[16]
Total (Pre-NSA)					\$ 45,927,375	[17]
Postage Expenditures, Post-NSA (2007)						
Letters Postage					\$ 21,865,328	[18]
Letter Discounts					\$ (400,000)	[19]
Flats Postage					\$ 25,845,126	[20]
Total (Post-NSA)					\$ 47,310,453	[21]
Additional Postage Expenditures, Post-NSA (2007)					\$ 1,383,078	[22]
NOTES & SOURCES:						
[1]	USPS-T-2 (Yorgey), Appendix A, at 3.			[15]	= 78,000,000 * [5]	
[2]	USPS-T-2 (Yorgey), Appendix A, at 5.			[16]	= 129,000,000 * [6]	
[3]	OCA/USPS-T1-16(c), Attachment OCA-1, page 2.			[17]	= [15] + [16]	
[4]	= [2] * (1+ 0.054)			[18]	= 105,000,000 * [5]	
[5]	= [3] * (1+ 0.054)			[19]	= -(105,000,000 - 85,000,001) * \$0.02	
[6]	= [4] * (1+ 0.054)			[20]	= 110,000,000 * [6]	
[7]	= 78,000,000 * [3]			[21]	= [18] + [19] + [20]	
[8]	= 137,000,000 * [4]			[22]	= [21] - [17]	
[9]	= [7] + [8]					
[10]	= 105,000,000 * [3]					
[11]	= -(105,000,000 - 87,000,001) * \$0.02					
[12]	= 120,000,000 * [4]					
[13]	= [10] + [11] + [12]					
[14]	= [13] - [9]					

For 2006, Bookspan's pre-NSA postage expenditures totaled \$45.9 million, \$15.4 million from letter-shaped mail and \$30.5 million from flats. Post-NSA expenditures would total \$47.1 million (rounded), consisting of \$20.7 million from letter-shaped mail,³⁰ \$26.8 million from flats, and a subtraction of \$0.36 million in discounts. The difference between the pre-NSA and post-NSA total postage expenditures amounts to \$1.2 million (rounded). In effect, in return for \$0.36 million in discounts under the NSA, Bookspan proposes to spend \$1.2 million more in postage.

As a business proposition, this trade-off is incredible on its face. In 2006 alone, Bookspan would spend more in total postage (\$1.2 million) than it would receive in total discounts (\$0.96 million) during the three-year period of the NSA.³¹ What type of business logic would drive such unfathomable economic behavior? Bookspan has not furnished an explanation.

5. Predicted letter-shaped volumes generate implausible demand curves

Witness Epp describes the effect of changes in postage rates on Bookspan's demand for letter-shaped mail in its marketing campaigns as follows:³²

Thus, when postage rates go *up or down* only a few percentage points, particular direct mail campaigns (or specific lists within campaigns) go *off or on* our list of executable campaigns.

³⁰ Of this \$20.7 million, \$3.36 million (17 million * \$0.198) consists of postage for letters that converted from flats. If those same flats had not converted, Bookspan would have spent \$3.79 million in postage, or \$430,000 more. Assuming Bookspan spends the same amount of postage for letters as it intended for flats (\$3.79 million), Bookspan could have entered 19.2 million (\$3.79 million / \$0.198) letters, or 2.2 million more than the 17 million letters it claims. Stated alternatively, in 2006, for the same expenditure on postage, Bookspan could have entered 1.128 letters (19.2 million / 17 million) for every one flat.

³¹ USPS-T-2 (Yorgey), Appendix A, at 9

³² Tr. 3/382 (BOOKSPAN-T-2 (Epp) (emphasis added)).

Witness Epp’s statement describes a plausible relationship between changes in postage rates and “executable campaigns.” That is, small changes in postage rates of a few percentage points, “up or down,” produce a symmetrical response in terms of demand—direct mail campaigns go “off or on” Bookspan’s list of executable campaigns.

Witness Epp’s forecast volumes for letter-shaped mail are inconsistent with his statement. He forecasts an asymmetrical response in volume to small changes in postage rates—one up and one down—clearly indicating the fallacy of his price analysis.

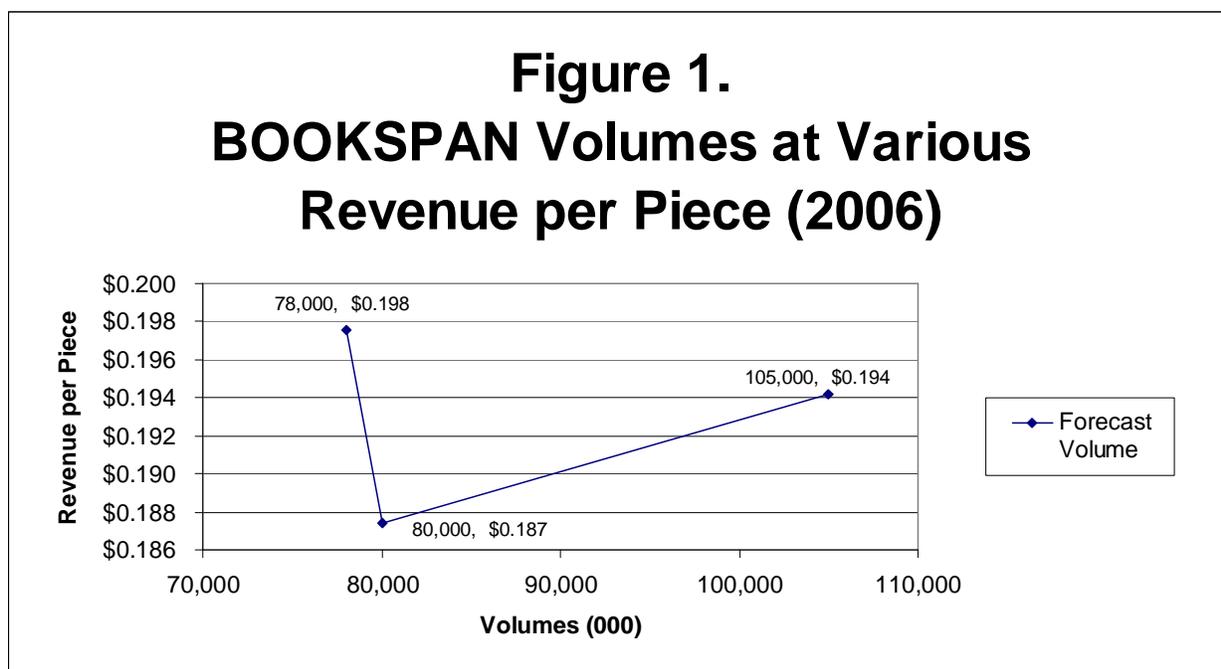
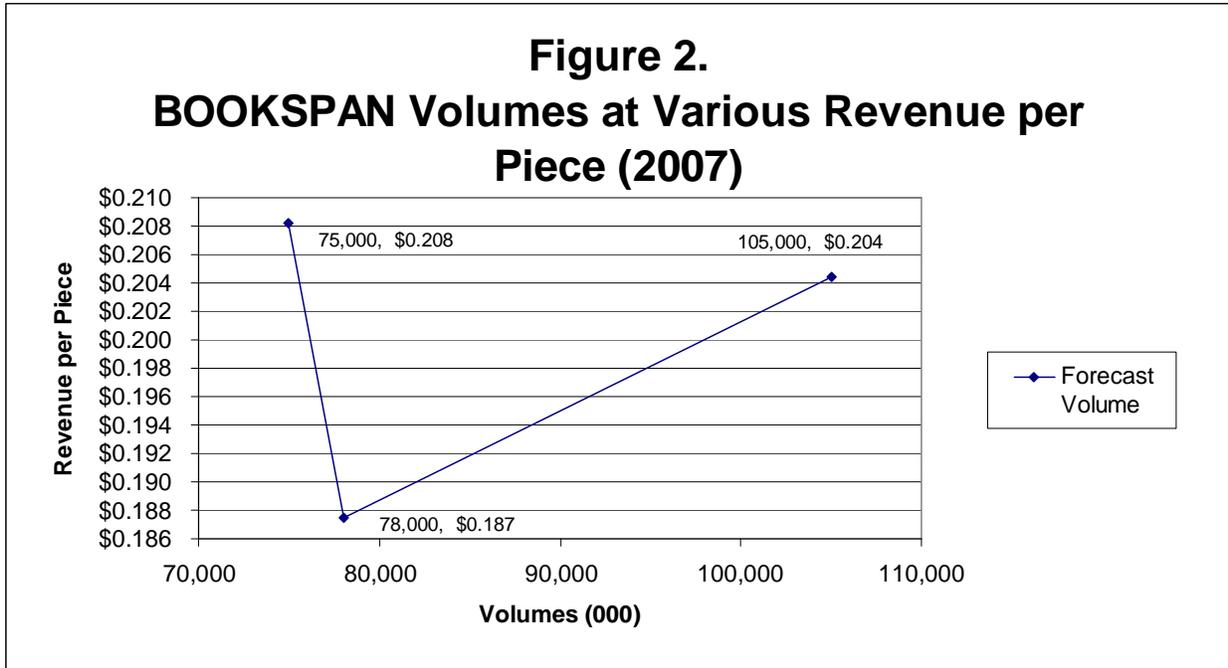


Figure 1 displays the price/volume relationships presented on the record. According to witness Epp, Bookspan’s expected response to the 5.4 percent ($\$0.198 / \$0.187 - 1$) increase in average (and marginal) revenue per piece resulting from Docket No. R2005-1 is a small decrease in forecast volume of 2 million, or -2.5 percent (-2

million / 80 million). By contrast, in response to a marginal decrease in revenue per piece of 10.1 percent (\$0.02 / \$0.198), witness Epp forecasts a disproportionate increase in volume of 27 million—ten million new letter-shaped pieces, and 17 million letter-shaped pieces converted from flats. This represents a 34.6 percent (27 million / 78 million) forecast volume increase associated with a 10.1 percent marginal decrease in revenue per piece.

If the symmetrical relationship between price and volume described by witness Epp in the quote above is to be believed, one would expect the proposed NSA discounts to produce a volume response of 3.7 (rounded) million $((0.025 / 0.054) * 0.101 * 78 \text{ million})$ letter-shaped pieces. However, witness Epp forecasts an additional 27 million pieces. Such a disproportionate increase seems highly implausible. Accordingly, little credibility can be placed in witness Epp's forecast volumes for the Bookspan NSA.

Figure 2 displays similar results for known average (and marginal) revenue per piece and forecast volumes for 2007.



It is clear that witness Epp’s asymmetrical volume forecasts—one positing a substantial (ten million piece) increase and the other a slight (three million piece) decrease—in response to two small changes in postage rates (a 10.1-percent decrease, and 5.4-percent increase, respectively) lack plausibility. Accordingly, one can place no faith in witness Epp’s volume forecasts.

B. The Postal Service Has Not Explained Why It Believes Bookspan’s Volume Estimates

Under the Bookspan NSA, the only sources of increased contribution to the Postal Service are new letter volume and conversion of flats to letters. The value of converting flats to letters is dubious, given that the value will evaporate as soon as a real rate case comes along. The only long-term value to the Postal Service will come from increased letter volume.

1. Witness Yorgey's volume forecasts do not command credibility

Witness Yorgey indicates that Bookspan relies primarily on mail and that profitability and future growth prospects may be limited due to unfavorable market trends. "It is unlikely that Bookspan's mail volume could increase significantly in the current business and market environment in the absence of this proposed agreement."³³ She has not, however, presented empirical data to support her conclusion.

Table 3: Letter-Shaped Standard Solicitation Mail, 2002-2005³⁴

Ending September	Millions
2002	84.7
2003	83.0
2004	94.0
2005	79.4

Table 3 summarizes Bookspan's letter-shaped solicitation mailings in recent years. FY2005 volume was approximately 95 percent of the average of FY2002 and FY2003, with letter-shaped volume having increased in FY2004 by 12 percent over the 2002/2003 average. No trend is immediately obvious. The increase in letter-shaped mailings in FY2004 is explained as the result of a redeployment of telemarketing budget funds to direct mailing and increased direct mail marketing efforts in order to meet membership acquisition goals.³⁵ The number of letter-shaped mailings in FY2005 substantially declined in comparison to FY2004—indicating that changes in price are

³³ USPS-T-2 (Yorgey) at 8, lines 9-11.

³⁴ Response of United States Postal Service Witness Yorgey to Presiding Officer's Information Request No. 1, Attachment 1, Revised 10/18/05. Tr. 3/87.

³⁵ October 31, 2005 Response of Bookspan Witness Epp to information request of the Office of the Consumer Advocate at Closed Hearings, Tr. 4/475-6. This is a sealed response.

not paramount in determining mail volume, there having been no price changes between FY2004 and FY2005.

Witness Yorgey also states that a downward trend in total Standard Mail is expected to continue in the absence of an incentive.³⁶ She states that “extensive growth is not expected by firms that are solely in the business of marketing and distributing books, such as Bookspan.”³⁷ She continues, “[I]t appears that general merchandisers and online retailers may continue to increase market share at the expense of mail-order clubs.”³⁸

She does not substantiate these assertions. A Bookspan transaction, based on membership in a book club with offerings tailored to specific customer interests, appears to be very different from a standard on-line (e.g., Amazon) transaction in terms of purchaser motivation, vendor contact, vendor choice, and customer interests. Bookspan appears to be active in marketing books: it selects offerings, identifies demographic and psychographic interests, tailors programs and messages, and focuses on motivating customer interest. In contrast, mail order organizations, such as Amazon, take orders for books. Clearly the marketing process and markets served are very different. Bookspan’s marketing process appears to be highly targeted—so much so that the company appears to be able to offer “strategic partners” an opportunity to market a variety of seemingly unrelated products based on Bookspan’s understanding of customer psychographics and demographics and subsequent selection of

³⁶ USPS-T-2 (Yorgey) at 10.

³⁷ USPS-T-2 at 10, lines 1-2.

³⁸ *Id.* at 10, lines 5-7.

appropriate marketing lists. Accordingly, witness Yorgey's comments do not lead to an obvious conclusion concerning the future level of Bookspan's sales and demand for mail services.

Witness Yorgey's projections of Bookspan's future mailings are not reliable. In response to POIR No. 1, question 1, witness Yorgey indicates that she developed estimates of Bookspan's pre-NSA volumes using the Excel forecast feature and monthly, quarterly, and annual data for FY2003 and FY2004,³⁹ and subsequently updated with newly available FY2005 data. She explains,⁴⁰

Actually, we submitted three sets of ranges for their estimates for forecasting their volumes and based on that forecasting, which was using the historical data, and based on what Bookspan was telling us about their business and in market research we felt that those numbers that they provided with us were reasonable.

In response to a question on whether the numbers presented in POIR No. 1 were actual independent forecasts that she performed, she stated,⁴¹

No, they were not my forecast numbers. They were a trend analysis based on historical volumes that were obtained from Bookspan and those volumes were in an Excel forecast formula to provide us with a trend for the future.

Witness Yorgey's response is vague in terms of the status of her forecasts. If the numbers are somewhat meaningless as implied by her response, we would be left wondering why the numbers were initially presented and subsequently updated.

³⁹ Attachment to Response of United States Postal Service to POIR No. 1, Question 1(a) (i)-(ii). (Revised October 18, 2005), Attachment 1.

⁴⁰ Tr. 2/199, lines 3-9.

⁴¹ Id. at 204, lines 3-7.

Accordingly, a careful review of witness Yorgey's projections is appropriate—first, because the Postal Service apparently gave the projections some credibility, and second, because the numbers are the only analytical information presented by Bookspan or the Postal Service in the record that can be reviewed or reproduced. Witness Yorgey's Annual Projections based on Bookspan's annual data are presented in Table 4. Over the course of approximately two months witness Yorgey substantially changed the projections, updating the projections based on the availability of new data.⁴² In approximately two months the Year 1 projection changed by almost -13 percent.

**Table 4: Comparison of Witness Yorgey's Annual Projections
Not Adjusted for NSA or Rate Increase**

	Letters	Letters	Flats	Flats	Percent Change	
	8/09/05	10/18/05	8/09/05	10/18/05	Letters	Flats
Year 1	96,553,781	84,063,555	141,165,154	104,319,698	-12.9	-26.1
Year 2	101,213,758	84,063,555	115,691,907	104,319,698	-16.9	-9.8
Year 3	105,873,735	83,832,563	90,218,660	90,564,979	-20.8	0.4

Witness Yorgey also presented Quarterly Projections, summarized in Table 5. Again, a comparison of witness Yorgey's August 9 and October 18 estimates—estimates revised after a period of slightly more than two months—shows substantial changes in the forecasts.

⁴² Attachment to Response of United States Postal Service to Presiding Officer's Information Request No. 1, Question 1(a) (i)-(ii). (Revised October 18, 2005), Attachment 1.

**Table 5: Comparison of Witness Yorgey's Quarterly Projections
Not Adjusted for NSA or Rate Increase**

	Letters	Letters	Flats	Flats	Percent Change	
	8/09/05	10/18/05	8/09/05	10/18/05	Letters	Flats
YR1 QTR1	25,169,260	21,960,441	41,256,121	29,885,321	-12.7	-27.6
YR1 QTR2	25,686,306	22,035,897	40,214,307	28,209,124	-14.2	-29.9
YR1 QTR3	26,203,353	22,111,353	39,172,493	26,532,927	-15.6	-32.3
YR1 QTR4	26,720,399	22,186,808	38,130,679	24,856,731	-17.0	-34.8
YR2 QTR1	27,237,446	22,262,264	37,088,865	23,180,534	-18.3	-37.5
YR2 QTR2	27,754,492	22,337,720	36,047,051	21,504,337	-19.5	-40.3
YR2 QTR3	28,271,539	22,413,176	35,005,237	19,828,141	-20.7	-43.4
YR2 QTR4	28,788,586	22,488,632	33,963,423	18,151,944	-21.9	-46.6
YR3 QTR1	29,305,632	22,564,088	32,921,609	16,475,747	-23.0	-50.0
YR3 QTR2	29,822,679	22,639,543	31,879,794	14,799,550	-24.1	-53.6
YR3 QTR3	30,339,725	22,714,999	30,837,980	13,123,354	-25.1	-57.4
YR3 QTR4	30,856,772	22,790,455	29,796,166	11,447,157	-26.1	-61.6

Table 6 compares witness Yorgey's annual and quarterly projections on an annualized basis with witness Epp's. For the first year of the proposed NSA the projections range from 84 million pieces of mail to 104 million pieces of mail, with the more recent projections being between 84 and 88 million pieces.

Table 6: Comparison of Yorgey and Epp Forecasts⁴³

	Annual Projections		Quarterly Projections Annualized		Witness Epp	
	Letters	Letters	Letters	Letters	Before	After
	8/09/05	10/18/05	8/09/05	10/18/05		
Year 1	96,553,781	84,063,555	103,779,318	88,294,499	78,000,000	105,000,000
Year 2	101,213,758	84,063,555	112,052,063	89,501,792	75,000,000	105,000,000
Year 3	105,873,735	83,832,563	120,324,808	90,709,085	75,000,000	107,000,000

Witness Yorgey's projections are based solely on the extrapolation of previous trends. The presentation does not account for any economic or other impact that would

⁴³ Witness Epp's forecasts assume implementation of two 5.4 percent rate increases. Witness Yorgey makes no explicit mention of the rate increases. The Year 1 forecast by witness Epp assuming no NSA and no rate increase is 80 million pieces, as detailed in Response of Bookspan Witness Epp to Presiding Officer's Information Request Number 1, Questions 4(A) and 4(c). Witness Epp's projections based on the implementation of a general rate increase are presented in BOOKSPAN-T-2 at 11, Tr. 3/385.

cause a deviation from previous trends. Her approach does not account for implementation of the proposed NSA, which could provide an upward adjustment, for the 5.4 percent rate increase, which would provide a downward adjustment, or for the institution of joint mailings with strategic business partners, which could provide an upward adjustment.⁴⁴ Given that there is no assumption about the implementation of the proposed NSA in witness Yorgey's projections, the most comparable projection by witness Epp for Year 1 would be 80 million pieces based on the assumption of no rate increase and no NSA (78 million pieces are shown in the table given the assumption of a 5.4-percent rate increase) versus 84 million or 88 million pieces by witness Yorgey.

Witness Yorgey testifies that there was a downward trend in Bookspan's mail volume through 2003 and a "deviation from this trend for Standard Mail letter-size volume in 2004." USPS-T-2 at 8. She chooses to disregard this 13 percent volume increase (FY2004 over FY2003, i.e., 94 million – 83 million/83 million, Tr. 3/384), because "Bookspan explained to us that this was a one-time occurrence in response to new legislation limiting telephone solicitation." Id.

In fact, there were additional reasons for the increase in solicitation mail volumes in FY2004, conditions that could certainly be repeated in the period of the NSA discounts. In Witness Epp's Response to an Information Request of the Office of the Consumer Advocate at Closed Hearings, he testifies:

[REDACTION OF WITNESS EPP QUOTE]

⁴⁴ Volumes for FY2002, 2003, and 2004 do not reflect inserts from strategic business partners. Tr. 2/161.

The Postal Service's inability to understand all of the reasons for the 2004 volume spike, and its readiness to believe Bookspan's representations, constitutes strong evidence that an NSA based solely on a goal to increase volumes is fraught with risk for other mailers.

2. Witness Yorgey cannot independently verify Bookspan's volume estimates because of very limited information, relative to previous NSAs

In this proceeding, witness Yorgey places substantial confidence in Bookspan's post-NSA volume forecasts. According to witness Yorgey, "the Postal Service believes that Bookspan's presentations of its future plans are reasonable and can be relied upon to support the agreement."⁴⁵ That confidence is based upon the Postal Service's so-called "independent analysis," which is described in her testimony in the context of evaluating the pre-NSA volume forecasts.⁴⁶

The "independent analysis" witness Yorgey describes—company-specific research, volume trend analysis, and analysis of the market environment—is not obtained from public or independent sources or is otherwise of limited value. With respect to the trend analysis, section II.B.1. of this brief (above) reveals that such analysis was not an independent forecast, but rather an Excel extrapolation based upon historical data obtained directly from Bookspan. Interestingly, even the Postal Service

⁴⁵ USPS-T-2 (Yorgey), at 10.

⁴⁶ Id. With an irony seemingly lost on the Postal Service, the Service states that it can "make informed inferences regarding Bookspan's marketing strategies and its potential for growth over the next several years." The alleged "informed inferences" are nothing more than the Postal Service parroting the information that has been supplied by Bookspan and its corporate parents, i.e., "past financial transactions and statements by Bookspan's parent companies (Bertelsmann and Time Warner), and discussions with Bookspan." USPS-T-2 at 8.

considers trend analysis to be a “first step” and a “relatively simple approach . . . to predict future movements in mail demand.”⁴⁷ According to the Postal Service, the value of trend analysis is limited because it “ignores exogenous factors such as pricing changes, interest rates . . . competitors’ strategies . . . and a host of other variables”⁴⁸—variables that would be valuable in analyzing Bookspan’s short-term volume forecasts. For Bookspan, the trend analysis is the only analysis provided to test its volume forecasts.

The Postal Service’s company-specific analysis is of minimal value in analyzing Bookspan’s volume forecasts. As stated by witness Yorgey, “Data on Bookspan is limited because it is a privately held company and therefore is not subject to the same reporting requirement as firms whose shares are traded publicly.”⁴⁹ With respect to analysis of the market environment, witness Yorgey relies on general trade publications on market trends related to the book publishing industry and retail book sellers—markets largely tangential to Bookspan’s mail-based marketing of books. These are the only information sources relied upon by witness Yorgey.⁵⁰ While her efforts to learn as much as she can about “the business of marketing and distributing books” is commendable, this type of general information is wholly unsuited to making specific volume estimates for a specific company. It falls far short of the company-specific information that is readily available for publicly traded companies.

⁴⁷ Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 7.

⁴⁸ Id., at 8.

⁴⁹ USPS-T-2 (Yorgey), at 7-8.

⁵⁰ Tr. 2/233.

In general, the Postal Service states that it likes to “consult a number of independent sources” when evaluating the volumes of prospective NSA partners.⁵¹

The sources favored by the Postal Service include⁵²

SEC filings, stock analysts reports, trade association publications, company reports, company press releases, competitor information, and macroeconomic forecasts. In addition to published information, the Pricing Strategy group occasionally consults outside experts to aid in decision making.

In the case of Bookspan, however, there are virtually no “independent sources” for the Postal Service to utilize. No volume estimates for Bookspan were obtained from entities outside the Postal Service (other than Bookspan itself); nor did the Postal Service use any entity to corroborate the volume estimates provided by Bookspan.⁵³ Not surprising, therefore, is witness Yorgey’s claim that “Bookspan itself is in the best position to provide the after-rates volume forecasts.”⁵⁴ Conversely, the Postal Service is at a significant disadvantage to independently analyze Bookspan’s after-rates volume forecasts.

The paucity of independent sources available to the Postal Service to analyze Bookspan’s volume forecasts is even more apparent when compared to the information resources relied upon in previous NSAs. For all previous NSA partners—Capital One, Bank One (now JP Morgan Chase), Discover, and HSBC North America Holdings—the Postal Service had available to it extensive public and independent sources of

⁵¹ Id.

⁵² Id.

⁵³ Id.

⁵⁴ USPS-T-2 (Yorgey), at 10.

information to utilize in evaluating company volume forecasts. In the case of the Bank One NSA, such sources permitted the Postal Service to compile, develop and analyze “a tremendous amount of information on the factors” likely to affect the Bank One’s First-Class Mail volumes, and “develop extensive knowledge” concerning how credit card companies work and how they communicate with, acquire and retain customers using the mail and other marketing channels.⁵⁵

To test Bank One’s volume forecasts, the Postal Service was able to obtain from numerous public and independent sources “key industry benchmarks and metrics to isolate significant economic factors that influence mail volumes.”⁵⁶ Since Bank One is publicly traded, the Postal Service obtained Bank One’s filings provided to the SEC.⁵⁷ The Postal Service also utilized the reports of financial analysts employed by investment firms, and discussed with those analysts their understanding of the economic and regulatory factors affecting the companies and the market place for credit card services.⁵⁸ In addition, the Postal Service availed itself of data from independent firms, such as Synovate and Forrester, that track commercial trends in the credit card industry.⁵⁹

⁵⁵ Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 2.

⁵⁶ Id., at 9.

⁵⁷ Id. All other previous NSA partners are also publicly traded companies.

⁵⁸ Id., at 14.

⁵⁹ Id., at 9.

Even witness Yorgey recognizes the serious handicap under which the Postal Service operates in analyzing and verifying Bookspan's volume forecasts, as compared to Bank One, to wit:⁶⁰

The type of analysis possible in the Bookspan case is necessarily different from what was possible in the Bank One case. When the Bank One agreement was consummated, the Postal Service had experience analyzing a number of different customers in the same industry, and had already acquired several years' worth of experience with credit card banks. Moreover, credit card banks are publicly traded companies. Consequently, there is a wealth of readily available information to support the analysis described in witness Plunkett's declaration. The Bookspan agreement was crafted for a privately held company occupying a unique niche in a different industry. *It would therefore have been impossible to perform as comprehensive analysis as described in the Bank One declaration.*

It is clear from this record, therefore, that, unlike all previous NSAs, no such publicly available and independent information sources were available to assist the Postal Service in analyzing Bookspan's volume forecasts. Even with the relatively greater information resources available to the Postal Service, at least with respect to the only other baseline NSA with Capital One, the Commission was troubled by questions of reliability of the Postal Service's volume estimates. With respect to the Bookspan NSA, questions of reliability are even more sharply in focus, and should cause the Commission to reject the Bookspan NSA.

⁶⁰ Tr. 2/85 (emphasis added).

3. Given the unreliability and implausibility of the volumes estimates, the Commission's opinion in Docket No. MC2002-2 requires that the Bookspan NSA be rejected

OCA has been very concerned about the ability of the Commission and litigants to make independent estimates of an NSA partner's volume. In the first NSA proceeding, Docket No. MC2002-2 (Capital One NSA), OCA witness Callow testified that "volume thresholds must be developed without reliance on unverifiable statements of mailers."⁶¹ In fact, the Commission fashioned a stop-loss cap for the Capital One NSA in order "to prevent a large loss in net revenue if it turns out that the Postal Service has seriously underestimated Capital One's derived demand for First-Class presorted mail."⁶² The stop-loss cap is an ingenious device that averts a violation of postal statutes that require recommended classifications to be fair and equitable, eschewing any unreasonable preference for a single mailer.⁶³ "[A] special low rate for one mailer [that is] likely to result in higher rates for other mailers" violates these essential classification principles.

The Commission found that "the estimates of 'before rates' volumes for Capital One are so unreliable that without a stop-loss provision there is no reasonable assurance that the Postal Service will not lose money on this NSA."⁶⁴ The volume estimates of Capital One suffered from the following defects:⁶⁵

⁶¹ Tr. 7/1373 (OCA-T-2 at 18), Docket No. MC2002-2.

⁶² PRC Op. MC2002-2 at 86, para. 5063.

⁶³ Id. at 148, para. 8012.

⁶⁴ Id., para. 8013.

⁶⁵ Id. para. 8014.

- Capital One does not project its volumes more than six months in advance.
- In the year preceding the NSA filing, Capital One mailed record levels of mail that it claimed were “anomalous.”
- Simple volume projections suggested mail volumes far in excess of the threshold amount.

In the face of these uncertainties, the Commission held that:⁶⁶

The decisional issue before the Commission is whether it can reasonably conclude that volume discounts paid to “free riders” (mail that would have been sent even absent the NSA) over the course of the NSA will not exceed the savings generated by the electronic address correction features of the agreement. Under the circumstances set out above, the Commission can not reasonably make that conclusion unless a stop-loss provision is added. To the contrary, the Commission finds that absent such a provision there is a serious risk that discounts given to “free riders” will exceed savings to the Postal Service, and that other mailers will be worse off because of the NSA.

The Bookspan NSA contains no cost savings that can serve to offset the unreliability and unverifiability of its volume estimates. Without such cost savings, the Bookspan NSA must be rejected.

C. Bookspan’s Bizarre Volume Estimates May Be the Product of the Troubling NSA Provision Allowing It to Include Solicitation Inserts of Strategic Business Partners

Under the proposed NSA, the Postal Service will allow Bookspan to include in letters eligible for a discount “up to two inserts promoting Bookspan’s strategic business alliances.”⁶⁷ OCA is troubled by this laxity on the part of the Postal Service. The effect of the NSA discounts is to create a new rate for Standard Mail advertising that is

⁶⁶ Id. at 149, para. 8016.

⁶⁷ Proposed DMCS §620.11. “Notice of the United States Postal Service of Revised Attachment A to Request Containing Proposed DMCS Language,” October 18, 2005.

available for a single mailer – Bookspan. It is evident from the examples of inserts submitted as Bookspan-LR-1 that virtually any kind of advertising material could be inserted into the discounted mailpieces. The inserts provided consist of advertising material from Cosmetique (cosmetics club), Oreck,⁶⁸ and Proactiv (skin care products). It is obvious that these products have no apparent relationship to books or book clubs. Witness Epp states that they were selected to participate in an insert test program because they had rented Bookspan's mailing lists for many years.⁶⁹ It is hard to imagine *any* kind of product that would be disqualified from candidacy as an insert.

In earlier sections of the Brief, OCA expressed perplexity at how such substantial amounts of non-price-related volume might arise. This one-mailer-only advantage may be the answer to OCA's questions.⁷⁰ It is entirely possible that Bookspan will enter into arrangements with other companies that result in mailpieces eligible for two-cent discounts that are not available to any other Standard mailer. So long as Bookspan includes a minimal amount of its own solicitation material in the envelope, it would appear to qualify as a mailpiece "promoting Bookspan's strategic business alliances." A real possibility exists that the explosive, unexplained volume increases under the NSA are the result of Bookspan essentially splitting the difference of the discount (two cents)

⁶⁸ Oreck's advertising material promoted vacuum cleaners (one offer included a free iron) and an air cleaner (an offer including a refrigerator purifier or a hand mixer).

⁶⁹ Tr. 4 (Redacted)/501.

⁷⁰ The Postal Service's effort to assess the effect of the Bookspan NSA on competitors suffers from a serious omission. The Postal Service focuses solely on book vendors as Bookspan's competition, (USPS-T-2 at 13 – 15), failing to understand that, in fact, all solicitation mail will now compete with Bookspan for the strategic partner inserts that the Postal Service allows in the instant NSA.

that the Postal Service proposes to make available to it exclusively with other companies that wish to advertise by mail.

In fact, the Postal Service has no provision in the NSA to prevent such an outcome. OCA asked witness Yorgey: “What is to prevent Bookspan from becoming a ‘presort bureau’ for those who belong to ‘Bookspan’s strategic business alliances?” Her answer tries to minimize the seriousness of that possibility by saying that that the Postal Service monitors all NSA customer volumes on a monthly basis; any unusual deviation from normal mailing patterns would trigger an inquiry; and that if Bookspan were found to be acting as a presorter, the Postal Service would consider appropriate action, that could include its right to terminate the agreement.

The Postal Service’s data collection plan certainly makes no provision to account for this type of misuse of the discounts. Also, the Postal Service testimony in this proceeding is silent about how its monitoring activities might identify such misuse. Furthermore, the presence of *any* Bookspan promotional material might qualify under the proposed DMCS sections as a mailing “promoting Bookspan’s strategic business alliances.” The Postal Service has taken no steps to define what such a mailpiece might be.

With respect to her assurance that “[a]ny unusual deviation from normal mailing patterns would trigger an inquiry,” there isn’t any normal mailing pattern that would serve as the benchmark for an unusual deviation. Witness Posch testified that:⁷¹

⁷¹ Tr. 3/465. He also states: “[I]nserts were included in New Member solicitations as part of a test conducted for the first time in 2005.” Response to interrogatory OCA/USPS-T1-8, redirected from witness Plunkett to witness Posch. This material, found on the last page of witness Posch’s response, was designated by OCA to be included in the record (and transcript) but was inadvertently omitted in assembling Transcript 3. OCA has been informed by the Commission’s docket section that a transcript correction will resolve this problem.

Historically, when soliciting its new members, Bookspan generally has not included inserts for third parties in its own mailpieces. Nonetheless, this year, Bookspan is testing inserts. For purposes of reaching this Agreement, Bookspan mail with and without inserts were included in Bookspan's solicitation volumes. The sentence concerning "strategic business alliances" was included to ensure that Bookspan's Standard Mail solicitation letters that include inserts would qualify for the NSA discount regardless of the relationship of the company to Bookspan.

In other words, there is no history of a Bookspan insert program against which a "deviation" could be measured.

It appears that Bookspan may have incorporated the unique opportunities afforded by such an exclusive (and discriminatory) privilege into its volume estimates. Witness Posch further testifies that, "Bookspan simply cannot speculate on the types of strategic business alliances that may develop in the future;" and, "*to the extent that there could be future strategic business alliances that generate new mail volumes, these volumes are within the forecasts.*"⁷²

The effect on overall Standard Mail volumes that results from introducing a new, lower-priced, rate tier for a single mailer, denying it to other Standard mailers, is difficult to predict. One possibility might be an increase in Bookspan mailings due to increased revenue from the inclusion of promotional pieces. A distinct alternative possibility is that there could be a negative impact on the overall value of the NSA if the insertions from strategic business partners resulted in the partners mailing fewer pieces of mail at full (undiscounted) rates. It is important to bear in mind that neither Bookspan nor the Postal Service has provided any data or analysis of the specific volume effect of strategic partner inserts.

⁷² Id. at 465 (emphasis added).

As is industry practice for Standard Mail, Bookspan would sell the space in a mailpiece to its strategic business partners to defray costs.⁷³ These products are from companies that are well known and that possibly conduct mail advertising campaigns independently of Bookspan. Importantly, there are a number of uncertainties:

1. Participation in a Bookspan mailing may reduce the mailing efforts of a strategic business partner or cause the partner not to consider new, expanded, or extended mailing efforts. It is possible that a decline in mailings by a strategic business partner would not be offset by an increase in Bookspan's additional mailings.⁷⁴ Bookspan maintains that it would not be working with a larger marketing budget due to the defraying of some of the costs of Bookspan's solicitation mailings by strategic allies: "No. The marketing budget is set independently based on Bookspan's member acquisition goals."⁷⁵

2. Under the proposed NSA the Postal Service does not have a contractual relationship with any of Bookspan's strategic business partners that would permit the Postal Service to obtain, or require such partners to furnish, information on their market behavior and actual or proposed mail volumes. It does not appear that the Postal Service will be in a position to evaluate whether the mail levels of Bookspan's strategic business partners have been diminished as a result of the NSA, for the Postal Service will not have a history of the volume of their mailings available to it.

⁷³ Tr. 3/461 and 463.

⁷⁴ In Docket No. MC2002-2, witness Panzar described a similar possibility. See Tr. 8/1589 – 92.

⁷⁵ Tr. 3/461 and 463.

3. We do not know whether the insertion of apparently unrelated messages by a strategic business partner in a Bookspan mailing will affect the response rate to Bookspan promotions. Furthermore, we have no information on projected or actual response rates to any of the strategic business partner's promotions. It is impossible to determine what the net effect will be on the volume of mail and resulting margins for the Postal Service. The potential adverse effects of the strategic business alliance provision alone warrant rejection of the proposed NSA.

III. THE OPTIONAL PRICE SCHEDULE NEGOTIATED WITH BOOKSPAN IS INCONSISTENT WITH THE POSTAL SERVICE'S STATED GOAL FOR NSAs.

The Postal Service is losing billions of dollars as FCM leaves the system. The Postal Service's institutional costs are rising as the delivery network expands. One of the Postal Service's responses has been customized pricing. The articulated goal of customized pricing is to generate new contribution and maintain universal service. Unfortunately, the gains to date from customized pricing have been trivial compared to the Service's growing revenue burden.

Two problems seem to be inhibiting the potential of customized pricing. One is the lengthy negotiation process employed by the Postal Service. The other—related to the first—is the attempt to develop credible predictions of pre- and post-NSA volumes for individual customers. If it were possible to develop a “pick-your-own-discount” approach to customized pricing, both problems could be solved. *Mirabile dictu*, such a pricing mechanism actually exists and is used by many private firms. The mechanism is a modern version of second-degree price discrimination known as monopolistic screening. It is an anonymous mechanism, in that the firm using it does not need to (indeed, cannot) know any individual customer's demand curve. Rather, the firm only

needs to know the distribution of customer demands.⁷⁶ “The trick is to package jointly both [periodic] charges paid by customers and the quantity . . . that they consume.”⁷⁷ An equivalent is to combine a periodic charge with a per-unit charge.⁷⁸ By offering varying combinations of periodic and per-piece charges, the firm can induce high-demand and low-demand customers to choose combinations that maximize firm profits.⁷⁹

As detailed in Part II, the Postal Service cannot know a customer’s future plans or future demand for mail. If a customer seeks only a discount, without concomitant changes in behavior that reduce costs, there is nothing to negotiate. If neither the Postal Service nor a customer can know the customer’s future demand, then negotiations over thresholds are pure speculation. “The firm’s profit-maximizing strategy is a first and final offer of a nonlinear price schedule”⁸⁰ Rates set in omnibus rate proceedings are not, of course, profit-maximizing. But given the existence of a fair and equitable rate schedule available to all, as well as the need to recover an increasing institutional cost burden, it would seem that optional rates should seek to

⁷⁶ For the Postal Service, the frequency distribution of Standard Mail letter customers probably exhibits a large hump with a long, skinny tail extending to the right. In other words, a large number of customers with relatively small volumes and a small number of customers with relatively large volumes. The log-normal distribution, with mean and standard deviation of one, exhibits this property. E.g., J.L. Devore, *Probability & Statistics for Engineering & the Sciences* 167 (3d ed. 1991).

⁷⁷ L. Papell, D.J. Richards, & G. Norman, *Industrial Organization: Contemporary Theory and Practice* 119 (2002).

⁷⁸ D.F. Spulber, *Market Microstructure* 189 (1999).

⁷⁹ E.g., J. Hirshleifer & J.G. Riley, *The Analytics of Uncertainty and Information* 319-25 (1992); H.R. Varian, *Microeconomic Analysis* 457-64 (3d ed. 1992); M.H. Riordan, “On Delegating Price Authority to a Regulated Firm,” 15 *The Rand J. of Econ.* 108 (1984); E. Maskin & J. Riley, “Monopoly with Incomplete Information,” *Idem* at 171.

⁸⁰ D.F. Spulber, “Bargaining and Regulation with Asymmetric Information about Demand and Supply,” 44 *J. Econ. Theory* 251, 252 (1988).

maximize contribution from customers who choose to use them. Anything short of profit- (i.e., contribution-) maximization means a higher revenue burden to be recovered from the general rate schedule.⁸¹

In the rehearing of the Bank One proceeding, the Postal Service filed two declarations concerning the need for customized pricing in regulated industries.⁸² Both declarations pointed to the need for regulated utilities to meet competition by offering special deals to customers who threaten to leave. The Postal Service faces no such threats. There are no close substitutes for direct mail advertising, and Joe's Post Office has not yet started business. The Postal Service has a strong monopoly that can and should be used judiciously to sustain universal service.

Until recently, the Postal Service did not engage in customer-specific pricing. Its attempts to date have been controversial because of uncertainty about customer demand. Such uncertainty cannot be resolved by observing past purchasing behavior. Indeed, "[a] seller may be better off if it can commit to ignore information about [a] buyer's past decisions."⁸³ Instead of using past demand to predict a customer's future demand, the Postal Service should treat its customers anonymously, as it does now under the established rate schedules. If there is a customer "need" for lower prices, this "need" can be met by selling the "needed" product: bigger marginal discounts in

⁸¹ For a general discussion of nonlinear pricing in the public utility context, see W.K. Viscusi, J.M. Vernon & J.E. Harrington, Jr., *Economics of Regulation and Antitrust* 348-50 (3d ed. 2000).

⁸² Docket No. MC2004-3, United States Postal Service Memorandum on Reconsideration, May 13, 2005 at 69-114. http://www.prc.gov/docs/44/44164/Memorandum_final.pdf

⁸³ D. Fudenberg & J.M. Villas-Boas, "Behavior-Based Price Discrimination and Customer Recognition," 2 (mimeo Sept. 2005, forthcoming in *Handbook of Economics and Information Systems*) http://post.economics.harvard.edu/faculty/fudenberg/papers/Behavior_Based_Price.pdf

return for bigger up-front payments.⁸⁴ “The consumer, facing this particular choice . . . replicates, by his own free will, precisely the firm’s optimal take-it-or-leave-it offer.”⁸⁵

Given the possibility of using second-degree price discrimination instead of face-to-face negotiations to gain contribution to institutional costs, the Commission should consider optional nonlinear tariffs before recommending a pure discount NSA.⁸⁶

⁸⁴ See, e.g., D.M. Kreps, *Microeconomics for Managers* 170-75 (2004).

⁸⁵ *Id.* at 175.

⁸⁶ See generally <http://www.google.com/search?num=100&hl=en&lr=&q=%22second+degree%22+%22price+discrimination%22+>