

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION

Before:

Chairman Omas,
Vice Chairman Tisdale,
and Commissioners
Goldway and Hammond

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

Docket No. MC2005-3

OPINION
AND
RECOMMENDED DECISION



Washington, DC 20268-0001
May 10, 2006

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RECOMMENDED DECISION

CONCURRING OPINION OF CHAIRMAN OMAS AND
COMMISSIONER HAMMOND

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APPENDIX ONE

APPENDIX TWO

APPENDIX A

I. INTRODUCTION AND SUMMARY

[1001] The Commission finds that the proposed Bookspan Negotiated Service Agreement (NSA) meets the requirements of the Postal Reorganization Act (the Act), that the Agreement is in the best interest of the Postal Service and the mailing community, and that the financial analysis supports approval of the Agreement.

[1002] This decision was made difficult by the Postal Service's lack of an attempt to comply with applicable regulations requiring mailer specific cost and revenue data, or a thorough and adequate explanation as to why proxies the Postal Service has chosen should be used instead. Further, as with previous NSAs, the Commission finds the Postal Service's lack of independent analysis of Bookspan's before- and after-rates volume estimates a serious flaw. Nonetheless, given Bookspan's special multiplier effect, the probable positive effect of volumes shifting from flats to letters, the contractual protective mechanisms, and the potential positive outcomes under the analysis first suggested by Professor Panzar, the Commission finds that the Agreement supports a favorable recommendation under the circumstances.

[1001] The Commission's Further Opinion and Recommended Decision in Docket No. MC2004-3 responds to the Governors' request for guidance on volume discount proposals, by identifying how an alternative methodology might be useful in streamlining litigation and reducing costs involved in volume projection. This Opinion contains suggestions for developing more mailer specific costs and revenue estimates. The Commission urges the Postal Service to focus on compliance with existing rules in order to keep the NSA program on a fast track to benefit the Postal Service, NSA partners, and the entire mailing community.

II. PROCEDURAL HISTORY

[2001] On July 14, 2005, the United States Postal Service filed a request seeking a recommended decision from the Postal Rate Commission approving a Negotiated Service Agreement (NSA) with Bookspan.¹ The NSA is proffered as a new baseline agreement. This is the second baseline NSA, and the first baseline agreement filed under the Commission's new rules for baseline NSAs. Rule 195 [39 CFR § 3001.195]. The Request, which includes six attachments, was filed pursuant to Chapter 36 of the Postal Reorganization Act, 39 U.S.C. § 3601 *et seq.*²

[2002] The Postal Service identifies Bookspan, along with itself, as parties to the NSA. This identification serves as notice of intervention by Bookspan. It also indicates that Bookspan shall be considered a co-proponent, procedurally and substantively, of the Postal Service's Request. Rule 191(b) [39 CFR § 3001.191(b)].

[2003] The Postal Service filed Direct Testimony of Michael K. Plunkett (USPS-T-1) and Direct Testimony of Michelle K. Yorgey (USPS-T-2) in support of its Request. Bookspan separately filed Direct Testimony of Robert J. Posch, Jr. (Bookspan-T-1) and Direct Testimony of Matthias Epp (Bookspan-T-2). The Postal Service also submitted a contemporaneous filing which requests the establishment of settlement procedures.³

[2004] The Commission issued Order No. 1441 to announce the filing of the Request; authorize settlement negotiations; appoint the Postal Service as settlement

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 (Request).

² Attachments A and B to the Request contain proposed changes to the Domestic Mail Classification Schedule and the associated rate schedules; Attachment C is a certification required by Commission rule 193(i) specifying that the cost statements and supporting data submitted by the Postal Service, which purport to reflect the books of the Postal Service, accurately set forth the results shown by such books; Attachment D is an index of testimony; Attachment E is a compliance statement addressing satisfaction of various filing requirements; and Attachment F is a copy of the Negotiated Service Agreement.

³ Request of the United States Postal Service for Establishment of Settlement Procedures, July 14, 2005.

coordinator; designate the Director of the Commission's Office of the Consumer Advocate (OCA) as the representative of the interests of the general public; establish the deadline for intervention; and set the date and agenda for a prehearing conference.⁴

[2005] The prehearing conference was held on August 11, 2005 to identify issues in this docket and to solicit information necessary to establish a procedural schedule. The participants identified several issues that needed further exploration in this case, including the before-rates and after-rates volume forecasts, the quantification of the financial impact of the NSA on the Postal Service, the criteria of the "multiplier effect," whether mergers or acquisitions trigger an adjustment of volume thresholds, Bookspan's use of the Standard Mail rate categories to send periodic notices to consumers, and why this case is an NSA as opposed to a more general classification case.

[2006] On October 18, 2005, the Postal Service filed amendments to the proposed Domestic Mail Classification Schedule (DMCS) language (amending Attachment A to the Request) and the proposed data collection plan (Attachment E to the Request).

[2007] Evidentiary hearings were held on October 19 and 20, 2005, to enter the proponents' testimony and cross-examination into the record. No participant filed rebuttal testimony.

[2008] The Commission issued Notice of Inquiry No. 1 on November 3, 2005, seeking comments on proposed changes to the DMCS and data collection plan language.⁵ Bookspan, Newspaper Association of America, and the Postal Service submitted comments to Notice of Inquiry No. 1 on November 14 and 15, 2005.⁶ Reply

⁴ Notice and Order on Filing of Request Seeking Recommendation of Baseline Negotiated Service Agreement, July 19, 2005.

⁵ Notice of Inquiry No. 1 in Regard to Domestic Mail Classification Schedule and Data Collection Plan Language, November 3, 2005 (NOI No. 1).

⁶ Comments of the Newspaper Association of America on Notice of Inquiry No. 1, November 14, 2005; Response of U. S. Postal Service to Notice of Inquiry No. 1, and Comments of Bookspan on Notice of Inquiry No. 1 in Regard to Domestic Mail Classification Schedule and Data Collection Plan Language, both filed November 15, 2005.

comments were filed by Bookspan and the Postal Service on November 21, 2005.⁷ The record was closed on December 1, 2005.⁸

[2009] Initial briefs were filed December 6, 2005, by the Alliance for Nonprofit Mailers (ANM); the American Postal Workers Union, AFL-CIO (APWU); Bookspan; Discover Financial Services, LLC (DFS); the Postal Service; Newspaper Association of America and National Newspaper Association (NAA and NNA); Time Warner, Inc. (Time Warner); OCA; and Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc (Valpak).⁹ Reply briefs were filed on December 15, 2005, by Advo, Inc. (Advo); Bookspan; Direct Marketing Association (DMA); DFS, ANM, Magazine Publishers of America (MPA); OCA, Pitney Bowes, Inc. (Pitney Bowes), Association for Postal Commerce (PostCom), and the Postal Service.¹⁰

[2010] Several interrogatory responses, portions of hearing testimony, and portions of both Initial and Reply Briefs were submitted under seal due to their confidential and commercially sensitive nature.¹¹ This protected information deals with Bookspan's

⁷ Reply Comments of Bookspan on Notice of Inquiry No. 1, and Reply Comments of the United States Postal Service to Comments of the Newspaper Association of America on Notice of Inquiry No. 1, both filed November 21, 2005.

⁸ P.O. Ruling No. MC2005-3/19, December 1, 2005.

⁹ Initial Brief of Alliance of Nonprofit Mailers; Initial Brief of American Postal Workers Union (AFL-CIO); Initial Brief of Bookspan (Bookspan Brief); Initial Brief of Discover Financial Services, LLC (DFS Brief); Initial Brief of the Newspaper Association of America and the National Newspaper Association (NAA and NNA Brief); Initial Brief of the Office of the Consumer Advocate (Under Seal) (a redacted version was filed on December 9, 2005) (OCA Brief); Initial Brief of Time Warner Inc. (Time Warner Brief); Initial Brief of the United States Postal Service (Postal Service Brief); Initial Brief of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (Valpak Brief), all filed December 6, 2005.

¹⁰ Reply Brief of Advo, Inc., December 15, 2005; Reply Brief of Bookspan, December 15, 2005; Reply Brief of Direct Marketing Association, Inc., December 15, 2005; Reply Brief of Discover Financial Services, LLC, December 15, 2005; Reply Brief of Magazine Publishers of America, Inc., December 15, 2005; Reply Brief of the Office of the Consumer Advocate (Under Seal), December 15, 2005 (a redacted version was filed on December 20, 2005); Reply Brief of Pitney Bowes Inc., December 15, 2005; Reply Brief of the Association for Postal Commerce, December 15, 2005; Reply Brief of the United States Postal Service, December 15, 2005.

¹¹ The Commission does not cite to any protected testimony in this Opinion. All transcript citations are to the redacted versions. All citations to participant briefs are to the redacted versions.

response rates, monthly mail volumes, specific advertising campaigns, and specific business alliances and are subject to the Commission's protective conditions. The Commission recognizes and appreciates the efforts and willingness of Bookspan to provide the Commission with as much information as possible, and its willingness to expeditiously work with the participants to allow the Commission to promptly disclose as much information as possible into the public record.¹² Many difficult procedural issues relating to information placed under seal were avoided due to participants' cooperation. As a result, the Commission will be able to provide recommendations based on solid data and evidence without compromising its "strong public policy favoring open and transparent Commission recommendations."¹³ Such cooperation between participants should serve as a model for future cases.

¹² See Motion of Bookspan to Unseal Portions of the Transcript of Proceedings, November 8, 2005; P.O. Ruling No. MC2005-3/17, November 9, 2005; Office of Consumer Advocate Notice of Filing Redacted Version of Initial Brief, December 9, 2005; Office of Consumer Advocate Notice of Filing Redacted Version of Reply Brief, December 20, 2005.

¹³ P.O. Ruling No. MC2005-3/5, September 9, 2005, at 3.

III. SUMMARY OF PROPOSAL

A. Witness Posch's Testimony

1. Direct Examination

[3001] Bookspan witness, Robert J. Posch, Jr., (Bookspan-T-1) describes the history of Bookspan, how Bookspan and others in the direct mail industry generate business for the Postal Service through a massive multiplier effect, how a discount on promotional mail will increase mail volumes at Bookspan, and Bookspan's rigorous address update practices. Tr. 3/449b.

[3002] *Bookspan history.* Witness Posch gives a detailed history of Bookspan's business beginning in 1926 when Harry Scherman concluded that rural America had been underestimated and underserved by publishers and booksellers. Witness Posch explains that Mr. Scherman knew that he could reach those Americans by direct mail and established the Book of the Month Club®. He further notes that at the same time, Samuel W. Craig was developing a similar concept for the New York Theatre Guild which resulted in the launch of The Literary Guild® in 1927. The Literary Guild later was acquired by Doubleday & Co. in 1934. Witness Posch then recounts how these two entities expanded independently and eventually formed a partnership in March 2000 called Bookspan, bringing together all their bookclubs (approximately 40 current ones).

[3003] *The multiplier effect.* Witness Posch explains the multiplier effect. He states that it is a generally accepted principle that advertising mail bolsters the growth of mail across all classes. He says that in order for Bookspan to reach its potential customers, it directly generates significant volumes of solicitation mail. Each solicitation letter, whether or not it produces an addition to Bookspan's member base, contributes to the mailstream. When Bookspan successfully recruits a member, there is a significant "multiplier effect" inherent in Bookspan's business model. He estimates that one successful recruit generates anywhere from 50 to 60 mailpieces during the first

12 months. He notes that this number includes a significant number of parcels, a competitive market in which the Postal Service is Bookspan's carrier of choice.¹⁴ He also testifies that Bookspan plans to maintain its current level of use of the Postal Service including, among other things, sending invoices and order fulfillments through the Postal Service.

[3004] *Promotional mail discount effectively increases mail volumes.* Witness Posch explains that increasing the maximum weight for automation-rated letters has made it more economically feasible for many direct marketers to expand their mailing efforts and develop new lines of business.¹⁵ He notes that the reduction in postage meant that Bookspan could test more targeted mailing lists. He suggests this could result in more desirable lists, and lead to more mailings.

[3005] *Address update practices.* Witness Posch explains that Bookspan already pays rigorous attention to address quality and, accordingly, cannot enter into an NSA with the requirement that Bookspan upgrade its address hygiene methods. He explains Bookspan's address hygiene practices. They include tools, proprietary to Experian, which correct each and every list Bookspan's uses:

1. Merge/Purge Duplicate Elimination: combines multiple customer files;
2. Address Coding Manager: corrects ZIP Codes by completing ZIP+4, appends carrier route code and CASS certifies names;
3. Advanced Address Correction/Apartment Append: auxiliary address correction system that reconciles non-ZIP+4 coded records and records without valid apartment numbers against external databases;
4. NCOA Link: a product that applies the USPS National Change of Address

¹⁴ He testifies that Bookspan sends nearly 100 percent of its parcels through the Postal Service.

¹⁵ As an example, he points out that one of Bookspan's predecessors made use of the increased automated letter weight in developing a large member base for Bookspan's Christian family interest book club. He believes that this would have been more difficult without the more favorable automation rates. In particular, when the Postal Service increased the automated letter weight, Bookspan recognized the opportunity this discount afforded it and was able to cost effectively include inserts promoting Bookspan's Christian family interest book club in its existing member promotional mailings as well as promote the club through inserts in promotions of related products.

database to update new addresses;

5. Locatable Address Conversion System: a product that converts a former rural style address to a street style address; and
6. CCOA, PCOA, and MCOA: proprietary change of address databases compiled by Experian.

He concludes that Bookspan has given exceptional attention to address hygiene in the past and will continue to do so because it saves Bookspan money.

2. Cross-examination

[3006] OCA sought more details from witness Posch on how one Bookspan solicitation generates anywhere from 50 to 60 mailpieces for each member successfully recruited in the first 12 months.¹⁶ Bookspan witness Posch testifies that, in his experience, each direct mail offer that receives a customer response results in member enrollment and an introduction package from Bookspan (1.5 shipments), 19 catalogs mailed to the new customer by Bookspan of which 13 generate “don’t send” responses, 3 generate positive orders, and the other 3 do not generate responses from customers. This, in turn, results in 6 shipments by Bookspan to the customer. The shipments result in 12 additional mailpieces of which 3.5 are payments, 1.5 are returns, 2 are inbound correspondence to Bookspan, and 5 are outbound correspondence.¹⁷ This leads witness Posch to conclude that a direct mail piece that results in a new member generates 55.5 additional mailpieces over the rest of the year. *Id.* at 454.

[3007] Witness Posch also provides information in response to several OCA questions relating to Bookspan’s expectations regarding the eligibility of mail including

¹⁶ The typical response rate in the direct marketing industry is 2 percent. The actual response rate for a particular campaign depends on many factors which include: day of the week on which the solicitation was received, time of year, current events, economy, previous experience, the actual offer, and the cost of the product. *Id.* at 455.

¹⁷ *Id.* at 454, 456. The outbound correspondence includes responses to inbound correspondence, out of stock notices, bills, etc.

inserts from Bookspan's strategic business alliances.¹⁸ Witness Posch testifies that Bookspan cannot speculate on the types of strategic business alliances that may develop in the future, as Bookspan's marketing budgets drive its mail volume forecasts. He expects that any new strategic business alliances will be required to operate within Bookspan's overall budgetary constraints and that to the extent that there could be future business alliances that generate new mail volumes, those volumes would be within forecasts. *Id.* at 465.

¹⁸ See Request, Attachment A at Section 620.11; NOI No. 1 at 3.

B. Witness Epp's Testimony

1. Direct Examination

[3008] Bookspan witness Mathias Epp (Bookspan-T-2) describes Bookspan's business and history, its approach to marketing, and how mailing decisions are made. He reviews its volume history, and forecasts volume both before and after the Bookspan NSA. *Id.* at 375.

[3009] *Bookspan background.* Witness Epp asserts that Bookspan attempts to provide the public with a superior book buying and reading experience through targeted editorial selection, great savings, and exemplary customer service. He asserts that Bookspan achieves these goals by operating various book clubs that are either based on general interest, or designed to serve specific groups of consumers with common reading interests. Witness Epp contends that although there are few other companies offering book clubs, Bookspan faces competition from retail stores and on-line sales. These competitors include: (1) large discount chains; (2) large buying club stores; (3) on-line shopping sites; and (4) large retail booksellers. *Id.* at 376.

[3010] He contends that industry statistics suggest that the overall rate of growth in the book publishing industry is relatively flat and that the combined category of book club and mail order sales is declining at a rate of roughly 9 percent per year since 2002. Nonetheless, despite these industry trends, witness Epp states that Bookspan attributes its continued success to the following three essential characteristics of Bookspan's clubs: the convenience of at-home delivery, editorial pre-selection of titles, and low cost. Since Bookspan uses the mail both to serve existing customers and reach new customers, according to witness Epp, postage costs are obviously a major factor influencing Bookspan's business plan. He states that the availability and pricing of good marketing lists is a critical success factor. Bookspan spends a significant amount of financial resources up front to acquire new members, with the hope that each member will buy not only the few books that Bookspan needs to break even, but additional

monthly purchases beyond these required commitments that will provide Bookspan with a return on its investment.

[3011] *Marketing efforts and its relationship to Bookspan's mailing practices.*

Witness Epp testifies that Bookspan invests a lot of money in advertising and marketing to acquire new members. One of the ways this is done is through attractive introductory offers. In exchange for receiving several books at a nominal price plus shipping and handling, new members agree to a minimum purchase commitment. Members then are solicited to purchase monthly selections at discounted prices. Every three or four weeks, Bookspan mails catalogs and notices to its members. Bookspan requires its members to proactively respond to its catalogs and notices if they wish to decline the monthly selection.

[3012] Witness Epp states that one of the ways that Bookspan grows its membership is through direct marketing. Bookspan uses primarily Standard Mail letters and flats for direct mail. Bookspan also grows its membership through print advertising in various magazines, insets in newspapers, or enclosures in third-party mailings and shipments, and through telemarketing and the internet.

[3013] Witness Epp explains that the percentage that each medium represents in Bookspan's overall marketing efforts is fluid, depending on price and relative effectiveness. The marketing media used by Bookspan are priced differently and there are vast differences in the effectiveness of the various channels; however, he believes that, on average, the cost to reach one consumer is much lower in print advertising, relative to Standard Mail. On the other hand, he believes that Bookspan's ability to target customers is better through direct mail than through print advertising. Further, regulatory changes have recently limited Bookspan's telemarketing abilities.

[3014] Witness Epp explains Bookspan's complex and circular marketing plan as follows: First, Bookspan begins with annual growth, revenue, cost and profitability goals that are set by the corporate owners. Then, based upon various business metrics including historical revenues, costs, profitability, existing membership base, average member purchases, and duration of membership, Bookspan develops an overall

marketing budget that it expects will meet its owners' goals. Marketing campaigns are developed next. In determining which marketing campaigns actually get executed, Bookspan takes into account such factors as expected cost per mailing, response rate, and average revenue contribution. These campaigns are then ranked and the ones that meet internal profitability thresholds are ultimately executed. The campaigns are re-evaluated monthly to see if actual results conform with annual financial goals. While Bookspan establishes marketing budgets in the beginning of the year, variances in actual results can trigger a reallocation of the marketing budget.

[3015] Accordingly, even small differences between campaigns, such as postage costs and expected response rates, can change the ranking of a campaign and whether Bookspan decides to execute it.

[3016] He asserts that postage typically constitutes a significant percentage of the costs of Bookspan's direct mail campaigns — roughly half the cost per thousand customers reached in a typical campaign. He argues that due to this, postage is the single most influential factor dictating which direct mail campaigns are executed. Considering Bookspan ranks hundreds of campaigns and each campaign has the option of purchasing as many as 150 different marketing lists, even small changes in postage can have significant effects on Bookspan's mail volume. He simply states "the greater the price incentive, the more Bookspan would mail." *Id.* at 383.

[3017] *Bookspan's volume history and volume forecasts.* Witness Epp presents four years of historical volumes based upon data drawn from its own postal systems and then verified against Postal Service permit data. *Id.* at 384; see Tr. 2/87.¹⁹

¹⁹ During the pendency of the case, FY2005 data became available and was incorporated into the testimony.

Table 3-1
Bookspan's Historic Solicitation Volumes

	FY 2002	FY 2003	FY 2004	FY 2005
New Membership Std letter-size	84,694,802	82,991,923	94,014,756	79,403,578
New Membership Std flat-size	215,324,921	196,631,597	164,378,427	129,792,945
Total	300,019,723	279,623,520	258,393,183	209,196,523

Witness Epp believes these data show a general trend of declining solicitation mail volume. He submits that the increase shown for Postal Service's 2004 fiscal year are uncharacteristic and due to one-time factors that do not suggest future growth in mail volumes.²⁰

[3018] Witness Epp then presents Bookspan's before-rate and after-rate volume projections over the three years of the proposed Agreement. See Table 3-2. He states that while the Postal Service may project its future mail volumes based upon experience, Bookspan cannot forecast the number of mailpieces independently from its planning of other direct marketing campaigns. Its decision process dictates that it cannot offer a mail volume forecast more than a few months in advance. Nonetheless, he develops a three-year before-rate and after-rate mail volume forecasts based upon the information that Bookspan currently possesses.²¹

²⁰ He believes that these uncharacteristic circumstances include Bookspan's decision to severely limit its telemarketing during the 2004 fiscal year due to regulatory restrictions, and the fact that the 2004 fiscal year was an election year which enhanced Bookspan's expectations regarding the popularity of certain special interest group book clubs. *Id.* at 384. The regulatory restrictions include the FTC and FCC's enforcement of the Do Not Call Registry, which requires that marketers refrain from calling telephone numbers on the list unless they have an existing business relationship with the called party. *Id.* at 399.

²¹ *Id.* at 384-85. He also adds the caveat that since Bookspan has not planned all its potential marketing campaigns for the prospective three-year period, he used Bookspan's marketing budgets for current and previous years as applied to Bookspan's best estimate of future cost increases as well as its expected growth in profitability over the next few years to arrive at its best estimate of mail volumes.

Table 3-2
Bookspan's Forecasted Solicitation Volumes

	FY 2006	FY 2007	FY 2008
Before Rate			
New Membership Std. letter-size	78,000,000	75,000,000	75,000,000
New Membership Std flat-size	137,000,000	129,000,000	130,000,000
Total	215,000,000	204,000,000	205,000,000
After Rate			
New Membership Std letter-size	105,000,000	105,000,000	107,000,000
New Membership Std flat-size	120,000,000	110,000,000	110,000,000
Total	225,000,000	215,000,000	217,000,000

Id. at 385.

[3019] Witness Epp believes that the before-rate volume forecast reflects Bookspan's expectation that there will be a significant drop in new member Standard Mail letter and flat solicitations beginning in the first year of the Agreement, a modest further drop in volume in the second year, and relatively level volumes in the third year. He believes the drop in the first year is primarily due to the 5.4 percent increase in postage rates resulting from Docket No. R2005-1. He predicts further drops primarily because he anticipates additional postage rate increases.

[3020] Witness Epp explains that the after-rate volume forecasts demonstrate significant increases in Standard Mail letter volumes, but deeper cuts in Standard Mail flat volumes. He asserts that providing Bookspan with a discount on Standard Mail letters will cause a modest migration of mail from flats to letters. He does not believe that the proposed incentive will result in shifting all or most of Bookspan's mail from flats to letters. Witness Epp explains that there is a limit to how much flat mail can be converted over to letter mail. Bookspan uses lists of both internal and external names to market to prospective club members, and experience has shown that responses for most clubs are

higher using a flat mailpiece format when marketing to external lists.²² Witness Epp believes that given Bookspan's method of ranking campaigns by expected profitability, changes in mailing costs for one format will offset some of the lower response rate, allowing Bookspan to shift the corresponding volume to letter format. However, Bookspan needs to continue to add new members and new names to its marketing lists. It cannot simply shift all of its flats to letters and still grow the business since flats are more effective when marketing to external lists.

2. Cross-examination

[3021] In response to Presiding Officer's Information Request No. 1 (POIR No. 1), witness Epp provided his best estimate of new member standard mail solicitation volumes on the assumption that there would be no rate increase due to Docket No. R2005-1.²³ Those estimates are as follows:

Table 3-3
No Rate Hike, No NSA
(in millions)

	2006	2007	2008
Letters	80	78	78
Flats	140	135	135
Total	220	213	213

Id. at 424.

²² He postulates that this may occur because the mailpiece draws more attention and accordingly has a greater impact, or because it resemble a typical catalog mailpiece. On the other hand, his experience shows that response rates are higher using a letter format for marketing for internal lists. He postulates that this may occur because members are already accustomed to receiving letter mailings from Bookspan. *Id.* at 386.

²³ *Id.* at 424-26.

Witness Epp notes that his estimated reduction of letter and flat volume in 2007 is not predicated on the assumption that there would be a rate increase in 2007; rather, it reflects his judgment that, but for the NSA, there would be some shift of letters and flats to electronic media in that year.

[3022] Witness Epp also provides information in response to questions from OCA relating to Bookspan's strategic business alliance insert program. Only 0.17% of its new member solicitations Standard Mail letters included inserts of its strategic business alliances for 2005. *Id.* at 410.

C. Witness Plunkett's Testimony

[3023] Postal Service Witness Plunkett (USPS-T-1) describes the policy considerations that support the Postal Service's proposed baseline negotiated service agreement with Bookspan. He details the business objectives and strategies of the Postal Service in negotiating NSAs generally, and how the Bookspan NSA, in particular, fits into this Agreement. USPS-T-1 at 1.

[3024] *Importance of NSAs to the Postal Service.* He testifies that the NSAs that have been approved demonstrate that negotiated pricing can work in the Postal Service's regulatory environment. He believes that declining block rates are a useful tool for stimulating additional use of the mail by customers that advertise and exercise discretion over how much mail to send. Witness Plunkett asserts that the first year results of the first NSA with Capital One demonstrate that the business impact of an NSA can be meaningful to both the customer and Postal Service. He contends that subsequent NSAs built upon that first NSA and included crafted contract terms that better manage risk and improve the quality of the agreements for all parties.

[3025] According to witness Plunkett, since the Capital One NSA, dozens of customers have approached the Postal Service to express their interest in discussing NSAs. As the manager responsible for NSA development, he strongly believes that NSAs have tremendous potential to improve the Postal Service's ability to price its products, provide greater value to its customers, and help maintain the long-term viability of the Postal Service. He believes that in order for this potential to be fulfilled, it is important for NSAs to move beyond the relatively narrow scope defined by the Capital One agreement. Postal Service customers in every subclass are interested in NSAs, he attests, and NSAs can become viable for a much wider range of postal customers through the prudent implementation of additional baseline agreements.

[3026] *Extension of NSAs to Standard Mail.* Witness Plunkett believes that there is a trend toward customization of postal services. He further believes that NSAs represent a logical growth of that trend, and for that trend to continue, NSAs will have to evolve and

improve over time. To date, all of the Postal Service's NSAs have dealt with First-Class Mail; however, because First-Class Mail is generally used to reach a defined customer base, demand is less likely to expand solely on the basis of a price incentive. Therefore, he concludes, the potential for expanding negotiated pricing in First-Class Mail beyond the few NSAs already in effect is limited.

[3027] Plunkett asserts that the logical progression from established precedent is to employ a proven technique in a new way. That is why the Postal Service is seeking to employ declining block pricing in Standard Mail. The results demonstrated thus far by the Capital One NSA provide strong empirical support for the application of declining block pricing for postal services. He believes the Capital One NSA alone improved contribution to the Service's institutional costs by \$12.4 million. He contends that the prudent extension of declining block rates into Standard Mail will allow the Postal Service greater use of declining block pricing and create more opportunities for further increases in contribution.

[3028] *Declining block discounts in the absence of unrelated cost savings.* Witness Plunkett acknowledges that the Capital One NSA and its functionally equivalent agreements were based upon a combination of declining block rates and Postal Service cost savings resulting from changes in mailer practices. He recognizes that the Commission recommended the changes needed to implement these two parts with the caveat that the total discounts should be capped at the amount of the unrelated cost savings in order to address issues regarding the difficulties of single-company volume forecasting.

[3029] Witness Plunkett acknowledges that the proposed Bookspan NSA concerns only volume generation; there are no savings involved upon which a cap might be based. Nonetheless, he assures the Commission that the Agreement contains other risk mitigation features outlined in witness Yorgey's testimony.²⁴

²⁴ Witness Plunkett summarizes these risk mitigation features as the volume commitments, the level of those commitments relative to the before-rates forecast and discount thresholds, the automatic termination at 150 million pieces, and the unconditional cancellation provision. These risk mitigation factors are explained in greater detail in witness Yorgey's testimony. *Id.* at 5.

[3030] *Importance of the Agreement's Integrity to the Postal Service.* Witness Plunkett explains that in crafting NSAs, the Postal Service tries to identify competitors of the NSA partner and potentially functionally equivalent customers. He recognizes that NSA partners' competitors must be given the opportunity to enter into similar arrangements. He believes that the Bookspan Agreement presents an opportunity to create a new, more hospitable environment for potential functionally equivalent NSA partners.

[3031] He believes that the imposition of the cap in the Capital One NSA case had a retarding effect on NSA progress. He contends that it limited the universe of potential NSA customers to those who present substantial cost savings opportunities. Further, he points out that the real possibility that an agreement might be altered adds time to the negotiation process, tends to harden negotiation positions, and appears to increase transaction costs. His experience has further taught him that an unintended consequence of the cost savings cap is to make NSAs impractical for some companies who consider themselves to be competitors of the NSA partner because they do not present a large enough cost savings opportunity to justify the perceived transaction costs. Accordingly, he urges the Commission to strive to maintain the integrity of this proposed Agreement and recommend the Bookspan NSA as negotiated.

D. Witness Yorgey's Testimony

1. Direct Examination

[3032] Postal Service witness Yorgey (USPS-T-2) describes the details of the Agreement, its financial impact, the Postal Service's evaluation of volume forecasts both before and after the Bookspan NSA, and the expected impacts of this proposed NSA on the Postal Service. USPS-T-2 at 1.

[3033] *Terms and conditions of the Bookspan NSA.* Witness Yorgey asserts that the Bookspan NSA is designed to provide incentives to Bookspan to increase soliciting members for its various book clubs.²⁵ These incentives, she believes, will encourage Bookspan to mail additional solicitation letters and increase its membership numbers.²⁶

[3034] Witness Yorgey testifies that the incentives take the form of declining block rates for volumes at negotiated levels. She points out that to protect the Postal Service's financial interests, before discounts earned become payable, Bookspan must meet a higher volume commitment. Additionally, she states that the lowest volume block threshold for discounts is set well above the before-rates volume forecast. She presents the following chart to illustrate how the declining block rate structure is set up.

²⁵ She states that solicitation letters are defined as letters sent as Standard Mail by Bookspan seeking new members for a particular book club, or seeking members of a club to renew their expiring memberships. *Id.* at 2.

²⁶ Witness Yorgey asserts that the Postal Service will benefit from the additional revenue generated by the increased volume for each new book club member in the form of Standard Mail catalogs, Bound Printed Matter book fulfillment, and First-Class Mail correspondence. This is the "multiplier effect" as explained in witness Posch's testimony. The Postal Service is not relying upon the multiplier effect in estimating the financial impact of the Bookspan NSA on postal finances.

Table 3-4
Declining Block Rate Structure of Bookspan NSA

Year 1 Structure		
Before-Rates Volume Forecast:	78,000,000	
	Volume Blocks 87,000,001 — 120,000,000 120,000,001 — 150,000,000	Incremental Discount 2.0 cents 3.0 cents
Volume Commitment:	94,000,000	
Year 2 Structure		
Before-Rates Volume Forecast:	75,000,000	
	Volume Blocks 85,000,001 — 110,000,000 110,000,001 — 150,000,000	Incremental Discount 2.0 cents 3.0 cents
Volume Commitment:	95,000,000*	
Year 3 Structure		
Before-Rates Volume Forecast:	75,000,000	
	Volume Blocks 94,000,001 — 100,000,000 100,000,001 — 120,000,000 120,000,001 — 150,000,000	Incremental Discount 1.0 cents 2.0 cents 3.0 cents
Volume Commitment:	105,000,000*	
* Subject to adjustment		

[3035] Witness Yorgey also describes an annual adjustment mechanism. She believes this adjustment procedure mitigates risks associated with both forecasting errors and the effects future rate increases may have on volumes. The second and third years of the Agreement are subject to adjustment based on the actual volumes mailed in the previous year. If at the end of the first or second years, the actual volume is 12% or more above the prior year's commitment, the following year's commitment will be revised to be the average of the prior year's actual volume and the following year's original

commitment. If at the end of the first or second years, the actual volume is 5 percent or more below the prior year's commitment, the following year's commitment will be decreased by the percentage difference between the prior year's actual volume and the prior year's original commitment. In any event, the volume commitments will never be less than 90 million pieces.

[3036] She also highlights the two termination clauses of the Agreement: One provides both parties with an unconditional right to terminate the Agreement without penalty to the other party upon 30 days notice. The other automatically terminates the Agreement if Bookspan's Standard Mail letter solicitation volume exceeds 150,000,000.

[3037] Finally, Bookspan would have to pay a one-time transaction penalty fee of \$200,000 if 73 million pieces of eligible mail are not sent during the first year of the Agreement.

[3038] *Financial impact.* Witness Yorgey highlights how this NSA may affect Postal Service finances. She identifies four items: (1) contribution from additional volumes of Standard Mail letters in response to the rate incentive; (2) net contribution gain from conversion of Standard Mail solicitation flats to letters; (3) expected discount exposure; and (4) total incremental discounts.

[3039] She estimates the impact of the contribution from additional mail volume to be approximately \$3.3 million in new contributions for the duration of the Agreement, and estimates the impact of the conversion to be approximately \$5.1 million in new contributions for the duration of the Agreement. She estimates the impact of the expected discount exposure to be zero because the declining block rates apply only to volumes that are above before-rates forecasted volume. She estimates the total incremental discounts to cost \$0.96 million. Accordingly, she estimates that the total financial impact over the three-year period of the NSA to be a net benefit to the Postal Service of \$7.4 million. This net benefit calculation was later increased to \$7.7 million in response to POIR No. 1. Tr. 2/110.

[3040] *Postal Service's evaluation of before-rates volume forecasts.* In evaluating Bookspan's before-rates volume forecasts, witness Yorgey uses company-specific

research, volume trend analysis, and an analysis of the market rate environment. With respect to company-specific research, she notes that data are limited because Bookspan is a privately held company and is not subject to many Securities and Exchange Commission reporting requirements. Her sources were general research about the book industry, past financial transactions and statements by Bookspan's parent companies, and discussions with Bookspan. She believes this information gives the Postal Service the ability to make informed inferences regarding Bookspan's marketing strategies and its potential growth over the next several years. Her findings suggest that the profitability and future growth prospects for Bookspan may be limited due to negative market trends, and it is unlikely that Bookspan's mail volume could increase significantly absent the proposed NSA. She believes that this adds credibility to the before-rates volume forecasts provided by Bookspan.

[3041] With respect to volume trends, Bookspan provided the Postal Service with counts of its Standard Mail letter and flat solicitation volumes for calendar years 2002 through 2004 which were reconciled with Postal Service permit data. She believes that these data show that Bookspan's Standard Mail letter and flat solicitation volumes through 2003 trended substantially downward. Witness Yorgey interprets the data to continue that downward trend for Standard Mail flats in 2004, with a deviation from that trend for Standard Mail letters in 2004 due to new legislation limiting telephone solicitation and a resulting reallocation of Bookspan's marketing budget. She does not believe that this deviation will have a materially lasting effect on Bookspan's Standard Mail letter-sized solicitation volume. Instead, she expects the downward trend of almost 8 percent per year from the two previous years to continue absent an incentive to increase solicitation of customers.

[3042] With respect to the market environment, witness Yorgey notes that the book market is highly fragmented across a wide variety of products. In the Postal Service's analysis, she notes that she removed commercial publications and textbooks because Bookspan does not compete in those market segments. She believes that Bookspan's competitors are brick and mortar bookstores, general retail merchandisers, mail order

booksellers, and internet booksellers, although Bookspan is unique in its reliance on the mail for almost all aspects of its business. Witness Yorgey points out that the market for book club and mail order book sales has been steadily declining over the past 10 years. She explains that with limited growth potential, retailers are increasingly competing for market share, rather than relying on increasing market size, and that online retailers and general merchandisers are increasing market share at the expense of mail order clubs.

[3043] *Postal Service's evaluation of after-rates volume forecasts.* Witness Yorgey believes that Bookspan is in the best position to provide accurate after-rates volume forecasts and that the forecasts presented by Bookspan are reasonable and can be relied upon to support the Agreement. She explains that Bookspan's forecasts are also consistent with the Postal Service's independent analysis. To test Bookspan's conversion of flats to letters, she conducted a sensitivity analysis of differing percentages of conversion. She believes that the data shows that Bookspan's solicitation flat mail volume has been declining at percentage rates higher than the decline of its total solicitation volume, implying a slight migration from flat-sized volume to letter-sized volume. She expects this to continue and be accelerated by the proposed NSA's discounts on letters. She presents data showing that even if Bookspan were to convert all of its solicitation flats to letters, the proposed Agreement would provide an increase in contribution of approximately \$7.2 million. She also believes that a net loss to the Postal Service could occur only under the most extreme misestimation assumptions.

[3044] Witness Yorgey testifies that the NSA should provide the Postal Service with an increase in net contribution, with very limited risk due to the risk mitigation factors.

[3045] *Other impacts of the proposed NSA.* In accordance with the Commission's rules, Witness Yorgey examines the effects of the proposed Agreement on the competitors of the NSA partner, competitors of the Postal Service, and mail users. With respect to the effects of the proposed Agreement on competitors of Bookspan, she believes that Bookspan is unique in its use of the mail as a primary means of marketing, but still competes with booksellers that do not rely to such a large degree on mail. In terms of total advertising dollars spent by competitors, she believes that the \$0.36 million

incentive that Bookspan might earn is not large enough to have a substantial impact on the industry.²⁷ She points out that competitors who rely on other forms of advertising already have the ability to negotiate price terms with their suppliers. Thus, she believes, this NSA may serve to rectify a competitive disadvantage that currently exists for Bookspan. Furthermore, any competitors of Bookspan may negotiate a functionally equivalent agreement. Accordingly, she concludes that the NSA's effect on Bookspan's competitors is not expected to be significant, and the NSA may bring the benefits of increased competition in the marketplace.

[3046] With respect to effects of the proposed Agreement on competitors of the Postal Service, she found that competitors are not affected by this Agreement due to Bookspan's unique reliance on the Postal Service as a marketing channel and use of the mail as a fulfillment medium. Witness Yorgey expects impact on mail users to be minimal. She considers the net contribution of \$7.7 million from this NSA small enough to have little measurable value to any other specific mailers.

[3047] *Consistency with the rate classification criteria of the Act.* Witness Yorgey analyzes the criteria of title 39, section 3623(c) and 3622(b) and believes that the proposed Agreement satisfies those criteria. First, she believes that by negotiating directly with individual customers, it may be possible to more accurately present prices that represent the value that the user places on the service being provided (pricing criteria 2) for mail classifications that are desirable to the mailer and the Postal Service (classification criteria 5). Further, she determines that the customer-specific rates offered to Bookspan more than cover the costs associated with Bookspan's mail (pricing criteria 3). She points out that the classifications and prices presented in the Agreement benefit the affected general public (pricing criteria 4), through additional information regarding book purchase options. In line with pricing criteria 7, witness Yorgey explains that the proposed declining block rate structure is relatively simple and maintains a transparent, identifiable relationship between volume levels and applicable rates and

²⁷ The \$0.36 million is based upon Bookspan's projected after-rates volume forecast. *Id.* at 108.

fees. She believes that pricing criteria 5 does not come into play because Bookspan has available alternatives such as print advertising. She also recognizes that while the proposal does not specifically create new workshare categories, it provides the incentives for low-cost Standard Mail letters consistent with pricing criteria 6.

[3048] She believes that the proposed Agreement meets the relevant classification criteria. The classification is desirable from the point of view of the consumer and the Postal Service, she argues, because it includes prices that reflect relative value and provides classifications that do not require extremely high degrees of reliability and speed satisfying classification criteria 2, 3 and 4. Further, she argues that the rates are fair and equitable because the proposal reflects balanced consideration of the applicable criteria, directly affected customers are served by the proposal, no customer is harmed, and the incentive-based pricing structure is consistent with the structures employed by other media to promote additional usage.

2. Cross-examination

[3049] Valpak explored witness Yorgey's testimony calculating the potential increase in contribution from Bookspan converting flats to letters. Valpak questioned witness Yorgey's use of average costs over all the different letter rate categories that Bookspan uses. Similarly, Valpak questioned witness Yorgey's use of average costs over all the different flat rate categories that Bookspan uses. Valpak's examination, through the aid of an examination exhibit,²⁸ highlighted the fact that when the average letter and flat cost and revenues are disaggregated down to specific products that Bookspan uses, the proposed Bookspan NSA could result in a decrease in contribution if the Agreement encourages certain flat mailpieces to convert to certain letters products. Specifically, Valpak's cross-examination stressed the fact that if ECR basic flats were to

²⁸ *Id.* at 193 (Valpak XE-1).

convert to nonauto basic letters, the Postal Service would lose the 8 cent contribution from the ECR flats while only gaining a unit contribution from the nonauto basic letter of about 6.6 cents (assuming a 2 cent discount under the Agreement).²⁹ Valpak's cross-examination notes that, since there is no knowledge or evidence as to which pieces will convert from flats to letters, all the converting flat pieces could result in 56 million mailpieces shifting from ECR flats with an 8 cent contribution to nonauto basic letters with a lower, 6.6 cent contribution.

²⁹ Such a discount could rise to 3 cents if Bookspan meets certain volume threshold requirements specified in the Agreement.

E. Proposed DMCS Provisions

[3050] The Postal Service proposes adding a new Domestic Mail Classification Schedule (DMCS) section 620, to specify the general parameters of the Bookspan NSA. Request at Attachment A. The Postal Service submitted an amendment to this proposed language on October 18, 2005. This includes language clarifying eligible standard mail under the Bookspan NSA and functionally equivalent NSAs. The Commission issued Notice of Inquiry No. 1 seeking comments on these topics and the responses are discussed in section IV.F. of this Opinion.

[3051] The Postal Service also proposes the addition of three new rate schedules to the DMCS: 620A, 620B, and 620C. Rate Schedule 620A specifies the volume block incremental discounts in year one of the Agreement. Rate Schedule 620B specifies the volume block incremental discounts in year two of the Agreement. Rate Schedule 620C specifies the volume block incremental discounts in year three of the Agreement. See Request at Attachment A.

IV. FINDINGS AND CONCLUSIONS

A. Overview

[4001] The Commission set out the general requirements for NSAs in Docket No. MC2002-2 (the Capital One Case). It determined that the Postal Reorganization Act permits the Postal Service to contract with individual mailers if (1) the contract is reviewed in a public proceeding³⁰ and satisfies the substantive criteria of the Act; (2) the proposed rate and service changes will work to the mutual benefit of mail users and the postal system as a whole; and (3) the rate-and-service package is offered to other potential users willing to meet the same conditions of service.³¹ The Commission's rules further elaborate on these principles. Rule 190 of the Commission's Rules of Practice states, "it shall be the policy of the Commission to recommend Negotiated Service Agreements that are consistent with the statutory criteria, and benefit the Postal Service, without causing unreasonable harm to the marketplace." 39 C.F.R. § 3001.190(b).

[4002] Sections B and C of the Commission's Findings and Conclusions address the legal challenges to the proposed Agreement. Those sections focus on whether the Agreement comports with the Act and the reasonable justifications proposed for affording Bookspan preferential treatment. Sections D, E, F, and G discuss specific aspects of the Agreement. In Section D, the Commission conducts a thorough financial analysis of the Agreement. Section E concentrates on the mailpieces that are eligible for a discount under the NSA. Section F discusses changes to DMCS provisions, and Section G addresses the proposed Data Collection Plan.

³⁰ Here, there is no dispute that the proposed Bookspan NSA was heard under the formal public hearing requirements of the Administrative Procedure Act. See 39 U.S.C. § 3624.

³¹ PRC Op. MC2002-2, ¶ 3013; *accord* PRC Report to the Congress, February 11, 2002, at 1, 14-15. As DFS notes, the Commission promulgated rules in February of 2004 to ensure that the first and third elements of this test will be met. See DFS Brief at 2 (citing PRC Order No. 1391, February 18, 2004 and PRC Order No. 1439, May 26, 2005).

B. Substantive Statutory Criteria

[4003] Under Chapter 36 of the Act, the Postal Service is required to submit a request for a change in rates or fees to the Postal Rate Commission, which is required to issue a recommended decision on the request for the consideration of the Governors. The Commission's recommended decision is required to include a statement "specifically responsive to the criteria established under §§ 3622 or 3623, as the case may be" in its evaluation of the pending proposal. 39 U.S.C. § 3624(d). Under section 3622(b), the Commission's recommended decision must also be made "in accordance with the policies of this title[.]" In this case, the proponents assert that the proposed NSA meets the criteria of both sections 3622 and 3623. These requirements are analyzed below.

1. Undue or Unreasonable Discrimination or Preferences

[4004] Pursuant to 39 U.S.C. § 3622(b)(1) and § 3623(c)(1), every request predicated on an NSA is required to consider the fairness and equity of the Agreement in regard to other users of the mail and the fairness and equity of the Agreement in regard to the competitors of the parties to the Agreement. Additionally, § 3622(b)(4) requires the Commission to consider the effect of the proposed rates on the general public, business mail users, and enterprises in the private sector. As part of these statutorily mandated considerations, the Commission must determine that the Agreement complies with the requirements found in section 403(c) of the Act. Section 403(c) provides:

In providing services and in establishing classifications, rates, and fees under this title, the Postal Service shall not, except as specifically authorized by 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. § 403(c).

[4005] It should be noted that the statute does not ban all discrimination or preferences, only “undue or unreasonable” ones, as Bookspan points out.³² Several participants³³ imply in their arguments that the Commission has interpreted this provision to limit NSAs based on volume discounts to only those that exhibit cost justifications. The participants cite the PRC Report to the Congress in February 2002 where the Commission stated that “[n]egotiated rates — unaccompanied by a change in service conditions that provides a cost justification — are a problematic approach... .” PRC Report to the Congress at 13. This Congressional submission, however, is not a bar to NSAs. It merely highlights the fact that without cost savings to the Postal Service, the benefits that the Postal Service is to receive under a proposed NSA should be carefully examined due to additional issues — not present in NSAs that have a cost savings element — that potentially may arise in such agreements. Such issues need to be analyzed on a case-by-case basis.

[4006] Participants cite to three Commission Opinions and Recommended Decisions that they believe limit volume discounts to only those situations where costs savings exist. In the Capital One Case, the Commission held that the Capital One NSA did not run afoul of the anti-discrimination provision of section 403(c) because of the “significant cost-saving opportunities that the terms of the Postal Service-Capital One NSA make available to the Postal Service[.]” PRC Op. MC2002-2, ¶ 3030. The Commission did not hold that cost-savings opportunities are required. Rather, it stated

³² Bookspan Brief at 11; *see also* PRC Op. MC2002-2 ¶ 3026. Valpak cites *United Parcel Service v. United States Postal Service*, 604 F.2d 1370, 1377 (3d Cir. 1979) (*UPS Case*), in support of its proposition that “[i]n the absence of such measurable cost differences, the Bookspan discounts cannot meet the test of 39 U.S.C. § 403(c)[.]” Valpak Brief at 38, n.32. The *UPS Case*, however, had nothing to do with allowing the Postal Service to treat mailers differently due to differences in costs. It was a case dealing with the Postal Service’s failure to seek a recommended decision from the Commission before proceeding with an experimental rate and classification. *UPS Case* at 1371. The court did analyze part of § 403(c) in its decision; however, it used the language of § 403(c) to show that the Postal Service’s definition of “change” in “rate” or “mail classification” was impermissibly narrow. *Id.* at 1375, 1378. The court was careful and explicitly stated that “we need not, and do not, decide that a test plan could never be instituted because of the operation of § 403(c)[.]” *Id.* at 1377-78.

³³ NAA and NNA Brief at 6-9, 13; Valpak Brief at 34-40.

that “preferences for mailers” must “have a reasonable justification.” *Ibid.*³⁴ This part of the opinion did not equate “reasonable” with “cost,” as NAA and NNA argue, but rather identified one instance of a “reasonable justification” that was applicable in that case. There may be other reasonable justifications.³⁵ The Commission will not foreclose innovation by interpreting “reasonable justification” so narrowly. Indeed, restricting NSAs to those having a cost savings element, as Bookspan notes, might effectively limit NSAs to only inefficient mailers and punish those mailers who are already employing efficient mailing practices. The Act does not demand such an absurd result. As the Postal Service correctly notes, declining block rates — without associated cost savings — can be approved under the Act if such agreements provide additional net revenue above and beyond the amounts that would have been generated in the absence of the declining block rates.³⁶

[4007] Participants also cite to prior Commission decisions in omnibus rate proceedings that rejected earlier proposals of volume-based discounts to support their argument that NSAs need to be restricted to those involving cost savings. In Docket No. R87-1, the Commission refused to recommend volume discounts for Express Mail service; in Docket No. R90-1, the Commission rejected a similar proposed discount for

³⁴ See also, e.g., *National Easter Seal Society v. United States Postal Service*, 656 F.2d 754, 762: (“But, absent some reasonable ground for differential treatment, section 403(c) forbids discriminatory phasing of discounts to only one class of mailers.”)

³⁵ For example, OCA suggests that the Postal Service consider alternatives to NSAs. Specifically, it suggests the Service consider a method called monopolistic screening or second-degree price discrimination. OCA Brief at 6, 39-42. OCA did not submit evidence on this topic during the proceeding and presented it only in its brief. The Commission will not consider whether OCA’s alternative proposal is a reasonable justification since it is not based on a developed factual predicate. Nonetheless, the Commission believes that the Postal Service should consider all alternatives which could result in higher net revenues for the Postal Service.

³⁶ Meeting the burden of proof on this increase in volume and net revenue under a particular set of facts is another matter, however. This problem is analyzed in more detail in section IV.D.

the same service.³⁷ In the Capital One Case, the Commission found that in these two omnibus rate proceedings “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*.”³⁸ Participants highlight the terms “cost difference” in that sentence, but fail to take notice of the fact that the sentence also notes that “other empirical justification” may exist to support volume-based discounts. Such other empirical justification could result in NSAs that do not have measurable cost differences if the NSA meets those requirements outlined above.

[4008] Bookspan and Time Warner cite *UPS Worldwide Forwarding, Inc. v. United States Postal Service*, 66 F.3d 621, 635 (3d Cir. 1995) (*UPS Worldwide*), in support of their argument that volume discounts are a legal and appropriate method of contracting with customers. In that case dealing with the Postal Service's products in the international mail arena, Bookspan and Time Warner correctly point out that the court determined that International Customized Mail (ICM) agreements based solely on volume discounts were permissible under § 403(c). The court found two reasons for determining that the discounts would not cause any undue or unreasonable discrimination or preferences to harm competition. First, it noted that the regulation promulgating the ICM program requires the Postal Service to “make every ICM service agreement available to similarly situated customers under substantially similar circumstances and conditions.” *Id.* at 635 (quoting 58 F.R. 29782). Second, the court found that the ability of “similarly situated” customers to seek ICMs would be facilitated

³⁷ PRC Op. R87-1, March 4, 1988, ¶ 6020 (in denying volume discounts for Express Mail, the Commission did not find that cost savings were necessary; rather it found 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.”); PRC Op. R90-1, January 4, 1991, ¶ 6535 (in denying volume discounts, again, the Commission did not find that cost savings were necessary; rather it stated that the Postal Service would have to show that volume discounts comply with the prohibitions of undue or unreasonable discrimination and preferences “before discounts with no basis in a cost difference could be approved”).

³⁸ PRC Op. MC2002-2, ¶ 3031 (emphasis added).

because the regulation also requires the Postal Service to publish detailed information on each ICM agreement and allows the public, including competitors and other mailers to verify the terms and conditions of each ICM. *Ibid.* The Bookspan NSA and the Commission's rules include both of these safeguards. By the very nature of Commission rule 193(b) and the Commission's public proceedings, the NSAs become publicly available and published.³⁹ Accordingly, the Bookspan NSA satisfies the conditions of *UPS Worldwide*.

[4009] Bookspan and Time Warner cite other ratemaking agencies' legal interpretations and corresponding case law in support of their positions that other agencies with ratemaking responsibilities subject to "no undue discrimination" provisions allow rate discounts for certain mailers in arrangements similar to NSA agreements without cost savings initiatives.⁴⁰ Specifically, they point to decisions and policy statements by the Interstate Commerce Commission (ICC), the Federal Energy Regulatory Commission (FERC), and the Federal Communications Commission (FCC).

[4010] In the context of ICC ratemaking, the D.C. Circuit found that the contractual agreement at issue satisfied the no undue discrimination statutory provisions since "current law no longer considers contract rates to be *per se* violations of the common carrier duty of nondiscrimination" provided that procedural mechanisms existed for filing private contracts. *Sea-Land Service, Inc. v. ICC*, 738 F.2d 1311, 1316-18 (D.C. Cir. 1984) (*Sea-Land*).⁴¹ The court recognized that *Armour Packing Co. v. United States*, 209 U.S. 56 (1908), did not hold that separate contract rates were unlawful *per se* and

³⁹ 39 C.F.R. § 3001.193(b) (requiring the Postal Service to furnish a copy of the proposed NSA to the Commission); 39 U.S.C. § 3624. Section 3624 requires the Commission to issue its recommended decision only after "the opportunity for a hearing on the record under sections 556 and 557 of title 5." *Ibid.*

⁴⁰ Bookspan Brief at 13-14; Time Warner Brief at 2, 5-7.

⁴¹ NAA and NNA also cite *Sea-Land* and *UPS Worldwide* for the propositions that common carriers and the Postal Service may offer individual contract rates consistent with the principle of nondiscrimination only if they make the Agreement available to similarly situated customers under similar circumstances and conditions. NAA and NNA Brief at 13. The Commission's rules on functional equivalency make sure that similarly situated customers are able to obtain similar agreements and, therefore, satisfies this aspect of § 403(c).

that post-1978, the ICC “has held that contract rates are not inherently discriminatory, provided that the carrier offering them makes them available to all similarly situated shippers of like commodities.” *Sea-Land*, 738 F.2d at 1316 (citing *Change of Policy, Railroad Contract Rates*, Ex Parte No. 358-F (I.C.C. Nov. 9, 1978)). As noted above, the Commission also has such safeguards in place for similarly situated mailers with its functional equivalency regulations, and acts as a check against permitting the Postal Service to engage in undue or unreasonable discrimination or preferences.⁴²

[4011] Time Warner also cites *In the Matter of AT&T Communications; Revisions to Tariff*, FCC. No. 12, 4 FCC. Rec. 4932 (April 18, 1989),⁴³ *rev'd sub nom., MCI Telecommunications Corp. v. FCC*, 917 F.2d 30 D.C. Cir. (1990) (*MCI*). This FCC decision was overturned on appeal and remanded to the FCC for further proceedings. The reviewing court noted the test for determining whether the tariff violated the FCC’s anti-unjust or unreasonable discrimination provisions. *MCI*, 917 F.2d at 39. That test entails a three-step inquiry: “(1) whether the services are ‘like’; (2) if they are ‘like,’ whether there is a price difference; and (3) if there is a difference, whether it is reasonable.” *Ibid*. If any of the following are found: the services are not “like,” there is no price difference, or the difference is reasonable, then the tariff does not violate the FCC’s anti-discrimination provisions.⁴⁴ The first two elements of this test are not applicable to the Commission’s considerations of NSAs to date since so far, NSAs do not offer different mailing services than those already available under the DMCS. However, the third part of this test is similar to the review the Commission undertakes when it

⁴² See 39 C.F.R. § 3001.196.

⁴³ Time Warner Brief at 2.

⁴⁴ On remand, the FCC determined that Tariff 12 options were not “like,” and as a result, did not need to reach the question of whether the differences were reasonable under the third part of the test. *In the Matter of AT&T Communications; Revisions to Tariff*, FCC. No. 12, 6 FCC. Rec. 7039 (Nov. 22, 1991). Accordingly, the FCC’s analysis in this regard is of limited applicability to the proposed NSA before the Commission.

considers potential NSAs, except the Commission frames the determination slightly differently — whether the preferences in the NSA rates have a reasonable justification.⁴⁵

[4012] In the context of energy ratemaking, FERC has examined incentive rates that are less than the applicable ceiling rates for oil and natural gas pipelines.⁴⁶ FERC has held that these rate incentives are allowed under the applicable nondiscrimination statutory provisions so long as similarly situated customers are also allowed to take advantage of such rates. If evidence of discrimination did exist, however, FERC considers it important that other procedures, such as the filing of complaints, allow the FERC to review the appropriateness of the incentive rates in particular situations.⁴⁷ These FERC procedures underscore the importance of the Commission's functional equivalency procedures under 39 U.S.C. § 3001.196 as well as the statutory complaint procedures under chapter 36 that allow mailers to have their objections considered by the Commission if they feel they have been unfairly treated or discriminated against by the Postal Service.

[4013] In this analysis of other ratemaking bodies, it is important to note the distinctions between the Postal Service and the entities whose rates are regulated by the FERC, the ICC, and the FCC. Such differences are key to understanding the appropriate level of review and risk tolerance of each ratemaking agency. First, as noted in the Capital One Case, communications carriers, pipelines, and railroads are all profit maximizing entities.⁴⁸ In the case of a “for profit” corporation, one of the overarching

⁴⁵ See PRC Op. MC2002-2, ¶ 3031.

⁴⁶ See *Explorer Pipeline Co.*, 71 FERC ¶ 61,416 (1995); *Williams Pipe Line Co.*, 80 FERC ¶ 61,402 (1997) (*Williams*); *ANR Pipeline Co.*, 85 FERC ¶ 61,333 (1998) (*ANR*).

⁴⁷ *ANR, supra*, “ANR's proposal is consistent with existing regulations, and ANR is bound to comply with Commission regulations regarding undue preference and discrimination. *Should any party believe ANR has violated those regulations in specific discount transactions they can protest the discount report or file a complaint under the Commission's complaint procedures.*” (emphasis added); see also, *Williams, supra*, “TRMI has presented no evidence to support its claim of discrimination, and therefore that claim will be rejected... .”

⁴⁸ PRC Op. MC2002-2, ¶ 5079.

goals is to maximize profits for their shareholders.⁴⁹ The shareholders, not the regulators or the other customers, determine the level of risk and potential return that they are willing to tolerate with respect to incentives for certain discount tariffs. If the shareholders are not satisfied with the benefits received by these discounts, they can replace the current directors with others of greater abilities or those more closely aligned with shareholder risk tolerances. If too many poor choices are made, the entities could go out of business and the shareholders would lose their entire investment. In other words, the shareholders serve as a check and balance against offering rates or tariffs that are too low.

[4014] Unlike these entities, the Postal Service is not a “for profit” entity and does not obtain funds through investment choices of shareholders. Any downsides to poor decisions are borne by the other customers who must make up for any possible shortfalls. Moreover, unlike the for profit entities’ shareholders, the Postal Service’s customers and the public do not have the power to remove directors or management who make poor decisions that ultimately effect their tariff rates.⁵⁰

[4015] Second, unlike the entities regulated by the other ratemaking agencies mentioned above, the Postal Service has a statutory monopoly over certain mail-related services. Since no direct competition exists for these services, the statutory monopoly results in many customers being captive; that is, they are without the ability to take their business elsewhere if they are not satisfied with the Postal Service’s prices or service.⁵¹ These significant differences force the Commission to fulfill its duty to the public by adherence to a higher level of scrutiny for individualized rates than the ICC, the FCC, and the FERC who allow, in certain circumstances, “fil[ing of] an incentive rate that is

⁴⁹ Other for profit entities, such as LLPs or LLCs, have analogous investor/management relationships.

⁵⁰ These tariff rates are analogous to the returns on investment that the shareholders would receive if the Postal Service were a for profit entity since instead of any upside or downside resulting in dividends, it would directly translate into higher or lower tariffs.

⁵¹ These captive customers would have to absorb higher rates and fees if individualized agreements fail to produce a positive return on investment.

less than the applicable ceiling, [with] no further regulatory action... .”⁵² These differences result in a lower risk tolerance for the Postal Service than may be acceptable for a business that exists completely in the private sector.

[4016] NAA and NNA argue that the Agreement is unreasonably discriminatory and violates § 403(c) because it is specifically tailored to Bookspan.⁵³ As DMA correctly notes, NSAs are supposed to be tailored to the needs of a particular mailer and that if a set of mailing requirements are applicable to a large group of mailers, it should be proposed as a niche classification or rate design available to an entire subclass.⁵⁴ Since the essential features of the NSA are available to other similarly situated mailers, the Agreement does not run afoul of § 403(c) simply because it is tailored to a specific mailer.

[4017] NAA and NNA’s concern that only mailers larger than Bookspan can obtain functionally equivalent agreements is unfounded. First, all functionally equivalent NSAs previously considered by the Commission involved a baseline agreement for volumes larger than the proposed functionally equivalent agreements.⁵⁵ Second, as the Commission has noted in prior cases, the complaint procedures of chapter 36 are available to applicants for NSAs comparable to baseline agreements who feel that they have been unfairly rejected by the Postal Service.⁵⁶ Third, the proposed DMCS language dealing with functionally equivalent NSAs uses the language “similar or greater multiplier effect.” NAA and NNA’s interpretation of that phrase to mean “larger” would inappropriately read the word “similar” out of the provision. Moreover, the Commission’s proposed revisions to the DMCS language related to functionally equivalent NSAs do not

⁵² *Williams, supra.*

⁵³ NAA and NNA Brief at 16-18.

⁵⁴ DMA Reply Brief at 5-6.

⁵⁵ See Dockets No. MC2002-2 (baseline); MC2004-3 (functional equivalent); MC2004-4 (functional equivalent); MC2005-2 (functional equivalent).

⁵⁶ PRC Op. MC2002-2, ¶ 7022.

impose any sort of volume, revenue, or other minimum mailer size thresholds with respect to potential functionally equivalent NSAs, and the Commission does not consider such conditions to be necessary for a mailer to qualify for a functionally equivalent agreement.

[4018] In sum, there is no bar to potential NSAs that do not have a cost savings element so long as the essential features of the NSA are available to other similarly situated mailers and there is a reasonable justification for the Agreement. Here, the non-cost based proposed “reasonable justifications” for finding this Agreement does not run afoul of § 403(c) are the “multiplier effect” and the contractual risk mitigation mechanisms which are discussed in section C, “Proposed Justifications for Preferential Treatment.” Since these provide reasonable justification, the Agreement is not unduly or unreasonably discriminatory.

2. Other Fairness, Equity, and Competitor Considerations

[4019] In addition to the explicit requirements of § 403(c), the Commission independently considers whether the proposed Agreement meets the fairness and equity provisions of § 3622(b)(1) and § 3623(c)(1).

[4020] Except for the § 403(c) issue discussed above, the briefs filed by the participants and the Commission’s independent inquiry in the matter do not provide any argument that the NSA is either not fair or not equitable in regard to other users of the mail, or in regard to the competitors of the parties to the Agreement.⁵⁷ Time Warner argues that mutual gains in efficiency for the Postal Service and mailers, in any form, including NSAs, actually enhances competition and contributes to a fairer competitive

⁵⁷ As part of its broader argument that allowing the mail eligible for a discount to contain inserts from strategic business alliances could reduce Postal Service revenues, OCA argues that there is a risk of substantial competitive harm as a result of the NSA provision allowing Bookspan to include inserts of its strategic business alliances in eligible mailings. This issue is addressed in section IV.E.3.

market.⁵⁸ A fair competitive market, Time Warner argues, would not deny the public the variety of price and quality options that the ability to negotiate customized agreements would provide. The Commission strives to help promote fair competition for the Postal Service and its non-regulated competitors so long as there is no undue discrimination, cross-subsidy, or other violations of the Act.

[4021] The Commission finds that the Agreement will benefit other users of the mail by increasing contribution to the Postal Service without an unreasonable likelihood of having an adverse effect on the rates of other mailers. Further, there is no indication that the Bookspan NSA rates will cause any competitive harm to other users of the mail, especially given the ability of similarly situated mailers to obtain functionally equivalent agreements.

3. Other Factors of the Act

[4022] Under statutory criteria § 3623(c)(5), the Commission is to consider the desirability of the classification change from both the point of view of the user and the Postal Service. The Commission finds that the Postal Service would not be receiving the benefits of the Agreement, the arguable increased contribution analyzed below, and the resulting increased multiplier effect, unless it is able to tailor rates and classifications to the specific characteristics and circumstances of its relationship with Bookspan. Bookspan would also not be receiving the benefit of lower postage costs for Standard Mail letter solicitations if not for the Agreement and its special business relationship with the Postal Service. Thus, the NSA classification is highly desirable from the point of view of both the user and the Postal Service. The same relationship also increases the value of service to the user of this special classification, which weighs in favor of criteria § 3623(c)(2).

⁵⁸ Time Warner Brief at 7.

[4023] Under statutory criteria 3622(b)(3), the Commission must be satisfied that the Agreement covers its indirect and direct attributable costs and provides a reasonable contribution to other Postal Service costs. As discussed in more detail in section IV.D., Financial Analysis, the Commission finds that the testimony and evidence, including Bookspan's multiplier effect, support a finding that the Agreement meets the standard.⁵⁹

⁵⁹ Valpak argues that there is a prospect of "some Bookspan letter mail (Nonauto 3/5 Digit letters) receiving a discount which exceeded the product's contribution to institutional costs" in violation of § 3622(b)(3). Valpak Brief at 29. The Commission does not and has not demanded that every mailpiece cover its own attributable costs to satisfy the requirements of § 3622(b)(3). Instead, a particular rate and classification must produce enough revenue to cover attributable costs on a subclass-by-subclass basis, which Valpak does not argue is failing to occur here. Accordingly, the Agreement does not run afoul of the § 3622(b)(3) requirements on this basis.

C. Proposed Justifications for Preferential Treatment

[4024] For the first time, the Postal Service does not propose a cost based justification for a proposed NSA. Instead, it puts forward other proposed “reasonable justifications” for finding this Agreement does not run afoul of § 403(c).⁶⁰ These factors are the contractual risk mitigation mechanisms and the “multiplier effect.” The Commission considers each proposed justification below.

1. Contractual Protective Mechanisms

a. Overview

[4025] In its reply brief, the Postal Service seems to argue that the risk reduction provisions of the NSA are a “rational” justification for affording Bookspan preferential treatment.⁶¹ It contends that “in lieu of the unrelated ACS [Address Correction Service] cost savings that exist in the prior NSAs, the Bookspan NSA contains numerous novel provisions that address the issue of risk directly, rather than in the indirect way the cost savings ended up being used to address risk in the Capital One NSA and its progeny.” *Id.* at 8. Each protective mechanism is addressed in turn below.

⁶⁰ A different reasonable justification for satisfying the requirement of § 403(c) is found in the alternative model discussed in the Bank One reconsideration decision. PRC Op. and Further Recommended Decision, MC2004-3, ¶¶ 5017-38.

⁶¹ Postal Service Reply Brief at 7. Section II of the Brief is titled “There is sufficient empirical justification for the declining block rates.” *Ibid.* Section II.A. is titled “Novel Features of this NSA Mitigate the Risks of Misestimation of Volumes.” *Ibid.* Accordingly, it is unclear if the Postal Service is arguing that the risk mitigation mechanisms are an empirical, rational justification for affording preferential treatment. For purposes of completeness, the Commission addresses this argument.

b. Volume Commitments

[4026] The volume commitment levels are a novel concept which allows Bookspan to earn discounts for Standard Mail letter volumes that exceed specific volume thresholds, but the discounts do not become payable until Bookspan reaches a higher volume commitment level.⁶² This will help protect the Postal Service by insuring that Bookspan meets a higher volume level than would otherwise need to be met in order for discounts to become payable. This mechanism reduces the risk of discount leakage from variations in before-rates forecasts. The Commission finds the volume commitment concept to be an appropriate risk mitigation provision.

c. Volume Commitment Adjustments

[4027] To further protect the Postal Service against discount leakage, there is a volume commitment adjustment mechanism in the NSA. The volume commitment adjustments provide that if at the end of either the first or second years, the actual volume is 12% or more above the prior year's actual volume, the following year's commitment will be revised to be the average of the prior year's actual volume and the following year's original commitment. This mechanism reduces the risk of discount leakage from more significant variations in forecasted volumes. The Commission finds the volume adjustment mechanism to be an appropriate risk mitigation provision for this NSA.⁶³

⁶² If Bookspan never reaches the volume commitment levels, it will not be paid any discounts for that year of the Agreement.

⁶³ Shorter duration NSA are also more desirable due to the uncertainty around predicting future mail volumes of a given mailer. Estimating future mail volumes of a given mailer one year in the future is very difficult and such difficulty substantially increases when a contract requires the prediction of mail volumes 3 years in the future.

d. Automatic Termination

[4028] This contractual provision automatically terminates the Agreement and all discounts cease if Bookspan's standard mail letter solicitation volume exceeds 150 million pieces. Witness Plunkett believes that this provision protects the Postal Service in the event that there is an anomalous and unanticipated change in the business climate that renders the intended outcome of the negotiations invalid. Tr. 2/314. In essence, this "acts in a way that is similar to the caps that have been applied in the other NSAs." Tr. 2/313. He testifies that a fair description of this provision would be "a warning bell of changed circumstances," rather than a financial protection to the Postal Service. Tr. 2/315-16. The Commission finds the automatic termination provision to be an appropriate mechanism for dealing with changed circumstances even though, as noted by Witness Plunkett, it is not designed as a financial protection.⁶⁴

e. Unconditional Withdrawal

[4029] This contractual provision gives both parties the unconditional right to terminate the Agreement without penalty upon 30 days notice. The Commission finds this protection to be of paramount importance in hedging against unforeseen problems or significant errors in volume estimates. It allows the Postal Service to terminate the Agreement if it later determines that circumstances have changed in a way such that the Agreement no longer is in the Postal Service's best interest. Unanticipated complications are the most difficult to hedge against and this provision allows the Postal Service some protection from such issues. Accordingly, the Commission finds the unconditional withdrawal contractual protection to be appropriate and desirable for this NSA. The Commission trusts that the Postal Service will not hesitate to utilize this provision prudently if the data reports indicate that under the Panzar test, discussed

⁶⁴ See Tr. 3/313 ("It's not necessarily designed to protect the Postal Service financially.").

below, the Bookspan actual volumes reach a point where the data show that the NSA decreases the Postal Service's net contribution.⁶⁵

f. Analysis of Contractual Protections

[4030] Overall, the contractual protective mechanisms negotiated by the Postal Service are a vast improvement over those the Commission examined in the Capital One NSA. The Commission applauds the Postal Service and Bookspan for their innovation and ingenuity in that regard. These protective mechanisms will help mitigate the risk of loss to the Postal Service.

[4031] Nonetheless, these mechanisms are not an adequate justification for providing preferential treatment to certain mailers. In the Capital One NSA case, the Commission noted the problem of unreasonable discrimination would arise "if the Service were to negotiate "discounted" rates — unaccompanied by a change in service conditions that provided cost or revenue justification." PRC Op. MC2002-2, ¶ 3004. A rational justification for preferential treatment must provide for a reduction in the Postal Service's cost or increase the Service's revenues.⁶⁶ The protective mechanisms in this proposal are designed to prevent revenues from decreasing below unacceptable levels, but they do not stand on their own as a revenue increasing mechanism or cost savings element. Mitigating risk, without more, does not rise to the level of a rational justification for an Agreement. Accordingly, the Commission does not find the contractual protective

⁶⁵ If circumstances warrant yet the Postal Service is not able to exercise its option to withdraw, the Commission may be less likely to recommend including such a provision in future NSAs in lieu of more rigid protective mechanisms.

⁶⁶ In the Capital One Case, for example, the rational justification accepted by the Commission was "Capital One's agreement to take measures that will avoid the potential costs of physical return [of mail in the ACS System]." PRC Op. MC2002-2, ¶ 3031. Unlike the Capital One NSA, there is no cost savings element in this proposed NSA. The Commission notes that if the alternative approach was properly applied to designing this NSA, as outlined in the Bank One reconsideration decision, that would provide a rational justification for providing preferential treatment under § 403(c).

mechanisms discussed above to be a rational justification for preferential treatment under section 403(c).

2. Multiplier Effect

[4032] The Postal Service argues the presence of the multiplier effect is a rational justification for the Commission recommending preferential treatment here. Indeed, the Postal Service believes that the multiplier effect goes to the heart of this Agreement. Witness Plunkett testifies that the multiplier effect is “a key condition of the agreement” and he “would not recommend an NSA like the Bookspan NSA if there were no multiplier effect.”⁶⁷ NAA and NNA argue that the multiplier effect is not a sufficient distinguishing principle to meet section 403(c) requirements of nondiscrimination, and therefore does not provide a legally sufficient rationale for singling out one mailer for special treatment.⁶⁸

[4033] NAA and NNA note that “almost *any* mailer could claim, with some reason, that it might mail larger volumes if it were to receive a discount. And some of those mailers reasonably could maintain that some of their additional mail could in turn generate still more volume from other mailers.” NAA and NNA Initial Brief at 5. (Emphasis in original.) As an example, NAA and NNA point out that “a promotion for a weekly newspaper can generate a subscriber, which in turn can generate many weekly newspaper mailings, as well as invoices and payments. Promotional inserts in First Class mail billing envelopes also may generate multiple shipments, invoices, and payments.” *Id.* at 11-12. To justify preferential treatment, a multiplier effect must be sufficiently clear and substantial as to warrant disparate treatment. In Notice of Inquiry No. 1, the Commission proposed to include such clear and substantial justification in the DMCS language. None of the participants objected or commented negatively on these provisions which were based on testimony and discovery from Postal Service witnesses.

⁶⁷ Tr. 2/217, 234, 259, 338.

⁶⁸ NAA and NNA Brief at 10-18.

[4034] The language offered by the Commission would replace the general language “as specified by the Postal Service” with the following quantification of multiplier effect requirements:

For a mailer to have a similar or greater multiplier effect, at least six times per year, that mailer must send a continuing series of marketing mail, 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 use at least one other subclass for merchandise fulfillment.⁶⁹

NOI No. 1 at 7. NAA and NNA argue that the detailed requirements suggested by the Commission are arbitrary. They contend that “[t]here is no basis in the record for drawing eligibility lines at any particular level.”⁷⁰ Similarly, Valpak argues that because the Postal Service did not quantify the multiplier effect, it cannot serve as a basis for this NSA.⁷¹

[4035] NAA’s, NNA’s, and Valpak’s arguments are not persuasive. Potential NSAs are reviewed by the Commission on a case-by-case basis. Here, the Commission’s main focus is on the multiplier effect exhibited by Bookspan and whether it meets the rational justification test.⁷² There is support for Bookspan’s multiplier effect in the record. The uncontested testimony of Witness Posch shows that on average, a successfully recruited member will generate between 50 and 60 mail pieces over the course of one year. See Tr. 4/449e, 454. As the Postal Service notes, the evidence shows that it is “a

⁶⁹ Although this language is found in the proposed DMCS as a requirement for “Other Mailers,” as this is a proposal for a new baseline agreement, Bookspan must also meet these criteria for the Agreement to pass muster under § 403(c).

⁷⁰ NAA and NNA Brief at 15.

⁷¹ Valpak Brief at 32-33;

⁷² As Bookspan correctly notes, to avoid stifling innovation, “the Commission should not impose an unreasonably high burden on Bookspan and the Postal Service to completely define the scope and nature of [functionally equivalent] agreements with heretofore unidentified postal customers. Those agreements can and should be evaluated, if they materialize, on their own merits.” Bookspan Brief at 27-28. Of course, some consideration of the parameters of potential functional equivalent agreements is necessary to determine if similarly situated mailers are harmed by the proposed NSA, but each agreement must be evaluated on its own merits.

direct result of Bookspan doing business as it does. It is axiomatic that the more book club members Bookspan obtains, the greater the multiplier effect for the Postal Service.” Postal Service Reply Brief at 13; see *also* Tr. 3/449d-f, 454. Since an increase in solicitations will produce an increase in recruited members for Bookspan, the multiplier effect is proportionately larger.

[4036] An important factor in the analysis of a multiplier effect’s appropriateness for purposes of § 403(c) is the expected increase in net revenue to the Postal Service of an NSA partner’s “use [of] at least one other subclass for merchandise fulfillment.” If a potential NSA partner’s merchandise fulfillment were through a subclass that provided a minimal or *de minimus* contribution per piece, the Commission would be less likely to find that a multiplier effect satisfies the rationale justification requirement. Yet where, as with Bookspan, if the multiplier effect’s merchandise fulfillment subclass (such as Bound Printed Matter) has a comfortable contribution per piece, it helps support a finding that Bookspan’s multiplier effect is likely to appreciably increase the Postal Service’s net revenue and therefore satisfies the rationale justification requirement.

[4037] There is no precise quantification of how much net revenue is necessary to constitute a rational justification and pass muster under § 403(c) as each proposal must be analyzed on a case by case basis. The rational justification requirement remains essential, however, notwithstanding the Postal Service’s litigation strategy choice not to rely on the quantitative aspects of the multiplier effect as part of the financial analysis of the NSA.⁷³

[4038] The functionally equivalent multiplier effect described in the DMCS is not arbitrary. It was extrapolated from witness testimony and is logically related to the multiplier effect that Bookspan exhibits. The witnesses were not merely “mention[ing] a particular number, without more” in an attempt to define similar multiplier effects, as NAA

⁷³ Compare Valpak Brief at 13-16 with Postal Service Reply Brief at 13. The financial analysis of this NSA is found in section IV.D. The Postal Service chose not to quantify the financial benefits of the multiplier effect as part of its direct case. It is nevertheless a “key condition” to this NSA, and the “key condition” for satisfying the requirements of § 403(c).

and NNA suggest,⁷⁴ rather the witnesses based their analysis of necessary conditions for the multiplier effect on discussions with Bookspan about its particular multiplier effect and mailing practices.⁷⁵

[4039] The main goal of DMCS language relating to the multiplier effect is to “allow potential NSA partners to know in advance and have a better idea at the outset whether they might qualify for a functionally equivalent NSA... .”⁷⁶ It is not to set sufficient conditions for functional equivalency.⁷⁷ If similarly situated mailers believe they are being treated unfairly by these criteria in violation of § 403(c), they may file a complaint with the Commission to obtain relief.

[4040] Valpak expresses concern that “[i]f 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.”⁷⁸ Fortunately, the current law is well-suited to prevent such a result. Each new NSA must receive Commission review, and among other statutory criteria, the pricing discretion of the Postal Service to give preferential treatment to certain mailers is limited by 403(c) which, as discussed above, imposes a rational justification requirement for preferential pricing. Any proposed NSA that comes before the Commission for approval will, like the Bookspan Agreement, be analyzed for compliance with these criteria, on a case-by-case basis.

⁷⁴ NAA and NNA Brief at 15 n.14.

⁷⁵ Tr. 2/32, 34, 337-38.

⁷⁶ NOI No. 1 at 10.

⁷⁷ See *also* section F, DMCS Provisions.

⁷⁸ Valpak Brief at 39. Valpak expands upon this floodgates argument by pointing out that if extra volume in response to marginal discounts were to become the only prerequisite for a functionally equivalent NSA, it would be difficult to distinguish between similarly situated mailers and those who are not. *Ibid.*

D. Financial Analysis

1. Accuracy of Cost Estimates

[4041] The accuracy of the cost estimates used by the Postal Service in determining the financial benefits of the Bookspan NSA were questioned by the participants on several grounds. The Commission shares many of these concerns and believes that the Postal Service did not appropriately estimate costs. Nonetheless, the Commission believes that the adjusted costs it derives below salvages the Postal Service's cost estimates enough to make them usable in this case.

[4042] The Commission's Rules require that Requests for baseline NSAs include:

such information and data and such statements of reasons and bases as are necessary and appropriate fully to inform the Commission and the parties of the nature, scope, significance, and impact of the proposed changes or adjustments ... and to show that the changes or adjustments are in the public interest and in accordance with the policies and applicable criteria of the Act.

39 C.F.R. 3001.193(e)(1). Specifically, the Postal Service is required to include a financial analysis that "utilize[s] mailer-specific costs ... and provides the basis used to determine such costs."⁷⁹ The Rule also provides, however, that:

[i]f mailer-specific costs ... are not available, the bases of the costs ... that are proposed shall be provided, including a discussion of the suitability of the proposed costs ... as a proxy for mailer-specific costs.

Id. at § 3001.193(e)(1). In this case, the Postal Service has submitted subclass average cost data under the Postal Service's methodology as a proxy for mailer specific cost data for all letters and flats in the Standard Mail rate categories adjusted only for Bookspan's

⁷⁹ *Id.* at § 3001.193(e)(1)(iv).

specific mailing profile by rate category and presort tier. Several participants argue that the Postal Service has not provided a satisfactory rationale on the suitability of the proposed use of subclass average costs as a proxy for Bookspan specific costs in this case, and accordingly, the Commission should reject the Agreement.⁸⁰

[4043] As noted above, the use of proxies for mailer-specific costs is allowed by the Commission's rules. Nonetheless, the use of proxies is not a free pass to disregard mailer specific costs. Those proxies must be as close as practicable to mailer specific costs and be accompanied by a satisfactory rationale as to why the proxy is a reasonable substitute.

[4044] The Commission has stated that “[it] expects the Postal Service to know and understand mailer-specific costs where they have a bearing on a request. This is all part of analyzing the financial aspects of any proposed Agreement.”⁸¹ The Commission thought this additional detail was reasonable given that an NSA provides participating mailers with benefits that are not available to other mailers in general and that such a “requirement to substantiate a request for a Negotiated Service Agreement is part of the cost of receiving those benefits.” *Id.* at 32. In this case, Witness Yorgey notes that “[a]s 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.”⁸² The mere fact that in the past, the Commission has recommended NSAs on the basis of a given proxy for mailer specific costs does not make such a proxy sufficient in every case. Each situation must be weighed on its own merits and each proxy evaluated relative to the factors that influence that specific NSA partner's actual costs. The mere absence of more detailed information is not sufficient to create an inference that the proxy used is adequate under the circumstances.

⁸⁰ Valpak Brief at 16, 19-21, 29; NAA and NNA Brief at 19-21; APWU Brief at 4-10.

⁸¹ Docket No. RM2003-5, Order No. 1391 at 34, February 11, 2004.

⁸² Tr. 2/93.

[4045] The Commission's decision to accept average costs in the Capital One Case was based upon an analysis that supported and justified using average costs as a proxy. For electronic return costs, the Commission analyzed an argument that including a lower cost for forwards, on average, underestimated the cost of electronic returns, the result of which would be that the Postal Service's estimate of cost savings from substituting electronic for physical returns was too high. This contention was tempered by a rebuttal argument that certain returns also incurred that higher cost. The Commission found both the argument and rebuttal argument to have merit, but "does not find that either of these factors is significant enough to make the proxy unusable, and their impact is moderated because to some extent they offset." PRC Op. MC2002-2, ¶ 6026. With respect to physical return costs, the Commission found that "there is little cause to believe that the proxy is so inaccurate as to be unusable." *Id.* at ¶ 6019 (footnote omitted).

[4046] In the current Bookspan case, such an analysis does not apply. Average costs do not easily translate into Bookspan specific costs. This problem is highlighted with respect to Standard Mail non-letters. In fact, comparing systemwide average revenue to Bookspan specific revenue for flats indicates that the costs of handling Bookspan's flats may in fact be quite different than that systemwide average cost assumed by Witness Yorgey.⁸³ Cross-examination of Witness Yorgey supports this conclusion:

To the extent that the rates applicable to pieces above and below the breakpoint and for differing levels of dropship activity reflect underlying cost differences, it is reasonable to assume that the fact that Bookspan's mail exhibits lower unit revenues than do the national averages, there are also lower costs that have not been adequately reflected in the unit costs that were used as proxies for Bookspan's unit costs.

Tr. 2/95. The record contains further support for Bookspan specific unit costs for non-letters being lower than average. Witness Posch testifies that Bookspan's mailing

⁸³ See Valpak Brief at 19-20; NAA and NNA Brief at 20-21.

practices already exhibit good address hygiene. Tr. 3/449h-j; see also Tr. 2/114-22, 278. This supports a conclusion that Bookspan's costs for flats are lower than the subclass-average flats costs. By assuming subclass-average flats costs, the Postal Service overestimates the financial benefit of Bookspan converting flat mailings to letters. The record is simply devoid of information on the degree of the overstatement. This overstatement coupled with the Postal Service's failure to perform a simple sensitivity analysis on cost changes magnifies the Commission's concern and emphasizes the need to obtain more reliable cost data.

[4047] Another problem is that the cost data are known to be flawed with respect to allocations between nonautomated and automated presort categories of Standard Mail letters yet the Postal Service has not attempted to account for these changes. As highlighted by APWU, these flaws were pointed out to the Postal Service in Docket No. R2005-1 and acknowledged, yet the Postal Service fails to adjust or make an allowance for the flaws with respect to its analysis in the Bookspan case.⁸⁴

[4048] Witness Yorgey testifies that the unit costs per rate category for both Standard Mail letters and Standard Mail flats are based on the USPS Docket No. R2005-1 Test Year 2006.⁸⁵ In R2005-1, the Postal Service acknowledged that the cost estimates for standard letters were flawed. In response to APWU/USPS-T2-1, which points out these flaws, Witness Yorgey admits that "no adjustments were made" to the flawed data but does not explain why no adjustment was warranted. Tr. 2/58. Similarly, the Postal Service acknowledged that in R2005-1 the cost estimates for Standard Mail flats are likely inflated by an inexplicably high reported cost for flats processing, but fails to attempt to explain why no adjustment was necessary for such admitted flaws in this case.

[4049] As Valpak correctly notes, more detailed costs, based on cost-causing characteristics of the way individual mailings are prepared and entered, are available for

⁸⁴ APWU Brief at 6.

⁸⁵ See USPS-T-2 at Appendix A 1-9.

Periodicals.⁸⁶ Valpak argues, “[i]t is clear that mailer-specific costs not only are possible, but also that the Postal Service is in a position to develop such estimates.”⁸⁷ If similar more detailed cost information is available to the Postal Service to design rates for Standard Mail, such data would be more likely to approximate actual mailer specific costs and foster understanding of costs imposed on the Postal Service by specific mailings. This would not only be of great benefit in evaluation of NSAs – for both the Postal Service and the Commission – but would lead to more accurate rate setting in general.⁸⁸ It would give the Commission more confidence in the Postal Service’s calculations and allow the Commission to recommend NSAs that it might otherwise be unable to recommend due to less reliable volume and revenue estimates. The Postal Service should take steps to obtain better cost estimates for the categories of Standard Mail.

[4050] The Commission recognizes that an effective methodology to obtain mailer specific costs cannot be designed and implemented overnight. However, the Commission expects that over time and with NSA experience and data, the Postal Service will work toward mailer specific costs. In the very first NSA Opinion and Recommended Decision, the Commission stated, “the Commission anticipates that future proposals of a similar nature will incorporate improvements [in cost estimates] as the Postal Service gains experience in mailer-specific agreements.” PRC Op. MC2002-2, ¶¶ 6019, 6053. Today, several years and five NSA cases later, the Postal Service still has not presented any evidence that it is working towards more accurate cost estimates for specific mailers and attempting to get away from using average costs

⁸⁶ See Docket No. C2004-1.

⁸⁷ Valpak Brief at 20 n.21.

⁸⁸ This could also quell concerns that the Postal Service “can easily present a ‘showing’ of a net profit [for a particular NSA] by selecting a proxy [for costs] that leads to the desired result.” NAA and NNA Brief at 20 n.20.

as a proxy. In fact, as the OCA and APWU correctly note, witness Yorgey did not even do a sensitivity analysis to determine the effects of inaccurate cost estimates.⁸⁹

[4051] If the Postal Service shows efforts toward obtaining cost estimates that are more accurate than subclass-wide average costs, the Commission would be less critical of average costs or another methodology presented as a proxy for the required mailer-specific costs. But the Commission cannot endorse the Postal Service's failure to attempt to determine accurate, detailed costs based on cost-causing characteristics. At a minimum, it should adjust Bookspan's costs to fit Bookspan's specific dropshipment profile.

[4052] To make this adjustment, unit costs for each dropship level within a presort category are developed so that the differences between each level reflect the dropship unit cost savings from Docket No. R2005-1, USPS-LR-K-113, and the weighted average cost of each presort tier (using FY 2004 Billing Determinants as weights) is equal to those provided in the Response to POIR No. 1, Question 2. Tr. 2/96-97. The resulting unit costs can then be applied to the detailed breakdown of Brookspan's volume provided in the Response to POIR No. 1, Question 3a, Attachment 3.⁹⁰ Tr. 2/91-92. This additional step provides a more appropriate proxy for Bookspan specific costs since it is more accurately approaches Bookspan's specific mailing profile.

[4053] The Commission's adjustments to the costs proposed by the Postal Service also have an impact on the Postal Service's estimated increase in net contribution for the Agreement.⁹¹ The estimated impact of the contribution from additional mail volume remains at approximately \$3.6 million in new contributions for the duration of the Agreement, while the estimated impact of the conversion changes from approximately \$5 million to approximately \$5.3 million for the duration of the Agreement. The

⁸⁹ Tr. 2/60; *see also* APWU Brief at 8-9; OCA Reply Brief at 7-8.

⁹⁰ These calculations are presented in PRC-LR-1 at 7-8.

⁹¹ This calculation is made under the assumption that the Postal Service's volume estimates are accurate. The accuracy of the Postal Service's volume estimates is discussed at great length in section IV.D.2.b.

estimated impact of revenue leakage (or exposure) is estimated to remain at zero because the declining block rates apply only to volumes that are above before-rates forecasted volume. The estimated total incremental discounts remains at \$0.96 million. Accordingly, the revised Postal Service estimate of the total financial impact over the three-year period of the NSA adjusted using the Commission's costs is expected to result in a net benefit to the Postal Service of approximately \$7.9 million from approximately \$7.7 million.

2. Accuracy of Volume Estimates

[4054] In this case, the overall reliability and accuracy of the volume estimates is extremely important. The Bookspan NSA depends heavily on the accuracy of the point estimates of volume devised by the potential NSA partner in the first instance.

[4055] In particular, it is necessary to examine the estimates that have been presented regarding Bookspan's proposed solicitation mail volumes with and without the NSA. The purpose of the Agreement is to increase the volume of Standard Mail letters which will generate additional contribution to the Postal Service. If the estimates are too low, that is, if the discounts are paid on mail that would have been mailed without the discount, then the NSA will not only fail to add to the Postal Service's net revenue, it could reduce contribution because some of that volume would have been mailed regardless of the NSA at the non-discounted rate.

a. Bookspan's Elasticity of Demand and Its Relevance

[4056] Commission Rule 193(e)(1)(v) requires that Requests for baseline NSAs:

Utilize ... elasticity factors for that year, and provide the bases used to determine such volumes and elasticity factors. If ... elasticity factors are not available, the bases of ... elasticity factors that are proposed shall be

provided, including a discussion of the suitability of the proposed ... elasticity factors as a proxy for ... elasticity factors.

39 C.F.R. § 3001.193(e)(1)(v). Elasticity factors help the Commission create and test models for determining how the mailer is expected to react to certain discounts. It also can provide insight into projected before-rates volumes given a specific after rate volume.⁹² Here, no elasticity factors were presented. The proponents instead identified the following as affecting demand: differences in postage, cost of paper, list costs and rental terms, and expected response rates. Tr. 3/376-87.

[4057] OCA argues that the volume forecasts used to create the volume commitments and discount thresholds in this NSA are implausible. As support for its position, OCA points to what it categorizes as “bizarre,” “implausible,” and “nonsensical” demand curves created by the volume forecasts presented in this case.⁹³ In essence, OCA argues that the resulting demand curve means the volume estimates cannot be believed or relied upon because of extreme differences between the response to price increases versus price decreases.⁹⁴

[4058] OCA points to the volume data submitted by the proponents in this case based upon differing assumptions and attempts to draw a demand curve from those plot points.⁹⁵ OCA argues that this curve is implausible because 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. This creates a “kink” in the demand curve. OCA finds it illogical that one would find modest volume responses to omnibus rate case increases yet “explosive” volume responses to modest price decreases from NSAs. OCA argues that instead, one would expect the proposed NSA discounts to produce a

⁹² See discussion on Bank One reconsideration, MC2004-3, ¶¶ 5031-33.

⁹³ OCA Brief at 19, 21.

⁹⁴ OCA Brief at 2, 7, 14.

⁹⁵ See Bookspan Brief at 14 (citing Tr. 4/515; 3/424-25; 3/385; 5/537-48; 5/549-50; USPS-T-2, Appendix A, at 3).

volume response of 3.7 million letter shaped pieces, rather than the projected 27 million pieces. OCA runs a similar analysis for known average revenue per piece and forecast volumes for year 2 of the Agreement and obtains a similar result.

[4059] The year 2 demand curve, based on Witness Epp's estimates, shows a ten million piece increase for a 10.1 percent decrease in postage and has a three million piece decrease for a 5.4 percent increase in postage. Accordingly, OCA argues that "one can place no faith in witness Epp's volume forecasts." OCA Brief at 21.

[4060] Bookspan responds that OCA's analysis is flawed. First, it argues that "basic" economic textbooks show that even in pure economic theory, there is no general rule about the relationship between price and elasticity, and accordingly, there is no theoretical basis for OCA's expectation of a proportionate response to a discount and rate increase. The Postal Service illustrates this by way of a real world example of disproportionate department store shopping due to coupon discounts. Postal Service Reply Brief at 11 n. 25.

[4061] Second, Bookspan argues that OCA's graph points are flawed because they use average revenue per piece as a proxy for "price" at the margin (\$.194). Yet under the NSA, Bookspan will be paying a discounted price of \$0.178 since it will be above the discount threshold. Indeed, the only elasticities of demand that appear in the record support using the discounted price of \$0.178. Bookspan submits that plotting a curve based on these corrections yields a plausible demand curve.⁹⁶

[4062] Third, both Bookspan and the Postal Service argue that plotting a demand curve in this case is not meaningful because points developed for that graph are based on "unrealistic assumptions." Witness Epp testifies:

OCA incorrectly assumes that there exists a direct relationship, and therefore a quantifiable elasticity of mail volume in relation to postage. As I explained in my testimony, and during the hearing, postage paid for letters is only one of the factors that drive letter mail volume. It is an important

⁹⁶ See Tr. 5/584-87.

factor, and that is why we have negotiated this NSA, but it is still only one. Other factors include (but are not necessarily limited to) the cost of books and paper, royalty rates, list costs, rental terms, other media costs, and marketing goals.

The existence of the NSA itself factors into marketing budgeting and planning. To reap the benefits of the NSA will requires changes in our marketing mix, so I would plan to shift money from other channels in order to achieve the commitment goals set by the NSA. Also, as a result of obtaining the NSA, corporate strategy may direct higher marketing goals in terms of new member growth which may result in an increase in the overall marketing budget.

Tr. 5/528-29. See also Tr. 3/376-83 (discussing how Bookspan makes marketing decisions). Thus, Bookspan views postage as only one of the variables in Bookspan's total marginal cost for its marketing campaigns.

[4063] Fourth, Bookspan argues that there is nothing implausible about believing that Bookspan's incremental expenditures would not be limited by the value of the discount it receives. This is because, Bookspan argues, decisions on postage are not limited by postage but rather by the expected profitability of its mail campaigns relative to its other advertising choices. *Id.* at 379-383.

[4064] The Commission finds that elasticity of demand is relevant to this case despite Bookspan's argument that OCA's effort is not "meaningful" and that it is "flawed." The Commission's concern is not that the data may be flawed, but rather why a similar analysis was never done by the Postal Service in the first place in this case. The Postal Service recently recognized the importance of an analysis based upon the demand function in the Bank One Case.⁹⁷ In fact, in his Revised Declaration, Mr. Plunkett describes the derivation of a demand function specific to marketing mail for Bank One.⁹⁸ Mr. Plunkett notes that a demand function can be used "as an exploratory tool to identify

⁹⁷ See section IV.D.2.a.

⁹⁸ Tr. 2/84-86.

the potentially important predictors of marketing mail demand.” Plunkett Declaration at 32.

[4065] Witness Yorgey notes such an analysis may not be completely accurate especially in cases where non-economic variables dominate. Nonetheless, it would provide an additional starting point for analysis. At a minimum, elasticity analysis provides some form of a more independent verification.⁹⁹ Even accepting the flaws in OCA’s proposed demand functions, it is the sort of analysis that the Postal Service should have done in this case prior to agreeing to enter into an agreement. *Ibid.* Or, in the alternative, the Postal Service could have used the subclass average elasticities from the last rate case as default values. The Commission has much less confidence in data that are provided merely to support litigation as opposed to data actually used by the Postal Service in deciding whether or not to enter into such an agreement. The demand curves plotted by OCA highlight the problems inherent in using point volume estimates devised by the potential NSA partner. They also underscore why using the Bank One reconsideration model could streamline and simplify the litigation of future NSAs.

b. Reliability of Volume Estimates

[4066] With respect to the reliability of the before- and after-rates volume estimates in this case, as with all cases designed under the point volume estimate model, there are two main issues. The first is the underlying reliability of those point estimates, which, as noted above, are based on point volume forecasts from Bookspan. The second issue is the Postal Service’s due diligence in verifying those point volume estimates.

⁹⁹ See 39 C.F.R. § 3001.193(e)(1) (requiring that the analysis “be prepared in sufficient details to allow independent replication.”)

(1) Reliability of Bookspan's Volume Estimates

[4067] Witness Epp submitted testimony providing his estimate of the before-rates forecast by taking the last four years of Bookspan's historic volumes, adjusting them to correspond with the Postal Service's fiscal years, and then verifying them against Postal Service permit data. Tr. 3/382.¹⁰⁰ Witness Epp notes that while the Postal Service may project its future mail volumes based on its historic experience, Bookspan cannot forecast total numbers of mailpieces independently from its planning of other direct marketing campaigns. Witness Epp testifies that because its decision making process is dependant on operational campaigns, it cannot offer a mail forecast with great precision more than a few months in advance. Nonetheless, to support this Agreement, he develops the best possible three year before-rate and after-rate mail volume forecasts based on information Bookspan presently possesses. These numbers are as follows:

Table 4-1
Bookspan's Forecasted Solicitation Volumes

	FY 2006	FY 2007	FY 2008
Before Rate			
New Membership Std letter-size	78,000,000	75,000,000	75,000,000
New Membership Std flat-size	137,000,000	129,000,000	130,000,000
Total	215,000,000	204,000,000	205,000,000
After Rate			
New Membership Std letter-size	105,000,000	105,000,000	107,000,000
New Membership Std flat-size	120,000,000	110,000,000	110,000,000
Total	225,000,000	215,000,000	217,000,000

¹⁰⁰ The historical volumes FY2005 were added during the pendency of the case as they became available.

[4068] To arrive at these numbers, Witness Epp uses past and present marketing budgets, together with Bookspan's best estimate of future cost increases as well as expected growth in profitability.

[4069] OCA argues that the volume estimates are not credible because Bookspan's mailing and marketing plans change on a monthly basis,¹⁰¹ based upon the corporate budgeting process, the projected profitability of individual campaigns, the choice of lists, and corporate strategy.¹⁰² OCA contends it is pure speculation for Witness Epp to make an accurate estimate three years in advance with so many unknown variables completely independent of prices that could affect its mailing practices.

[4070] OCA also takes issue with the fact that although Witness Epp testified as to the factors that dictate Bookspan's marketing efforts (and, as a result, solicitation mail volumes), his results do not allow independent replication or verification of those mail volumes.

[4071] Bookspan and the Postal Service argue that in the real world there is no model or spreadsheet which allows one to input the marketing budgets and the other factors discussed above and come up with mail volumes. This is especially true for Bookspan which doesn't plan mail volumes, but instead uses the mail as a means for executing its planned promotional campaigns. Tr. 3/379-83. Bookspan argues that there is nothing in the record to question Witness Epp's credibility and OCA's brief points to nothing in the record that provides a basis for such doubt.

¹⁰¹ Tr. 3/382 ("In general, campaign plans are reviewed and re-planned on a monthly basis... . Another way of saying this is that with each monthly financial forecast, our forward-looking marketing budget ... is subject to adjustment.").

¹⁰² OCA notes that Witness Epp cited an important a recent corporate strategy change that directly effects the estimates and historical volumes used in creating this NSA, the decision to focus on internal (which usually result in letter mailings) rather than external lists (which usually result in flat mailings). OCA Reply Brief at 3 (citing Tr. 3/441).

[4072] Bookspan and OCA agree that three-year volume estimates cannot be made with any level of precision. The difficulty for the Commission is how to evaluate the risks inherent in a three-year NSA without robust volume estimates. As the Commission recently noted, “[t]he actual and projected volume information presented by Bank One [the NSA counterparty] is an appropriate starting point in the Commission’s analysis. However, it is well recognized that potential Negotiated Service Agreement partners will face a strong temptation to provide estimates that tend to support generous agreements.” PRC Order No. 1450 at 16 (citing MC2002-2 Tr. 8/1651, PRC Op. MC2002-2, ¶ 5094). Observations such as these underscore the inherent problems with unquestioning reliance on point volume estimates devised by the potential NSA partner as justification for the proposed Agreement. By using the alternative approach outlined in the Bank One reconsideration decision to create its NSAs, the Postal Service, the potential NSA partner, the mailing community, and the Commission would be able to avoid these issues since the alternative approach ensures that all participants’ interests are aligned and all proponents have a significant financial disincentive to incorrectly estimate volume ranges.

[4073] Here, however, due to the inherent bias in using point volume estimates devised by the potential NSA partner in the first instance, it is vastly more important for the Commission to consider the Postal Service’s independent analysis of the Bookspan before- and after-rates volume projections.

(2) Independent Postal Service Analysis of Volume Estimates

[4074] An appropriate starting point for examining the adequacy of the Postal Service’s independent analysis of Bookspan’s point volume estimates is the Revised Plunkett Declaration of May 18, 2005, provided to the Commission two months before the Request was filed. The Plunkett Declaration, submitted in the Bank One case, sets forth the various ways that the Postal Service supposedly evaluates point volume

estimates devised by a potential NSA partner in the first instance.¹⁰³ The Commission recently discussed its confidence in the methodology used in the Plunkett Declaration with respect to point volume estimates devised by a potential NSA partner:

Mr. Plunkett's declaration is notable. It indicates real progress in the Postal Service's procedures to ascertain the mailing characteristics of its Negotiated Service Agreement partners. There appears to be a significant improvement over the level of analysis presented in the Capital One docket, the case considering the first proposed Negotiated Service Agreement. In the Capital One case, Mr. Plunkett was asked if the Postal Service independently estimated Capital One's volume estimates. He began his response by stating: 'The Postal Service did not develop a parallel estimate of Capital One's mail volume using distinct data sources or methodologies.' Docket No. MC2002-2, Tr. 4/762, 765-6. This introductory statement cemented the Commission's belief that more needed to be done.

PRC Order No. 1450 (January 6, 2006) at 17 (citing PRC Order No. 1443 (August 23, 2005) at 7).

[4075] Accordingly, the Plunkett Declaration may be used as a starting point for determining if the Postal Service's analysis and evaluation of its NSA partner's volume estimates are reasonable. Facts and circumstances of a particular case and a potential NSA partner may dictate that more or less analysis be done before seeking approval. However, in cases based upon point volume estimates devised by the potential NSA partner in the first instance, if the Postal Service is deviating from the techniques described in the Plunkett Declaration to adapt it to the facts and circumstances of a particular case, it should have rational reasons for doing so and share those reasons with the Commission.

[4076] With respect to the Plunkett Declaration, the Commission recently noted that:

¹⁰³ Although the Plunkett Declaration was submitted in MC2004-3, it was not received into evidence in that case. See Order No. 1450 (January 6, 2006).

Presentation of an analysis based on Mr. Plunkett's review procedures outlined in his declaration potentially could improve the confidence level of partner supplied estimates, and could facilitate the Commission's future consideration of Negotiated Service Agreements.

Ibid. Another methodology also may be used such as the simpler, less costly, and more predictable alternative approach discussed in the Bank One reconsideration decision.

[4077] The Plunkett declaration notes that "the first step in evaluating volume forecast of a company such as Bank One is to analyze its volume trends" through a "trend analysis" where, based on historical volumes, "we extrapolate the ... mailing history in a linear fashion into the future." Plunkett indicates that "the trend analysis is intended to provide only a starting framework for understanding the mailing profile of our partner and a useful cross-check of the company's short-term forecasts." Plunkett Declaration at 7-8; Tr. 2/84.

[4078] Here, witness Yorgey did a trend analysis for Bookspan's Standard Mail letters and flats as well as a combined trend analysis for the total solicitation Standard Mail volume based upon yearly, monthly, and quarterly volumes. Tr. 2/84-85, 87. As discussed in section IV.D.2.a.1), she testifies that the trend showed that Bookspan's Standard Mail letters and flats were trending "substantially downward." USPS-T-2 at 8. Witness Yorgey did not run any kind of regressions to identify any correlation between different categories of Bookspan's mail. Tr. 2/85.

[4079] The next step outlined in Plunkett's declaration is the derivation of a demand function specific to marketing mail based upon economic variables. Plunkett Declaration at 9-11; Tr. 2/84. Once the demand function is created, the Postal Service can use it "as an exploratory tool to identify the potentially important predictors of marketing mail demand" and compare the results of this model with the volume forecasts provided by the potential NSA partner. Plunkett Declaration at 11; Tr. 2/84.

[4080] Witness Yorgey did not independently derive a demand function like the one outlined in the Plunkett Declaration. She did not attempt to derive a Bookspan specific elasticity or use the default subclass average elasticity as part of her analysis. Witness

Yorgey felt that economic variables are less likely to have an impact on marketing mail demand in the direct mail book club industry which would make this “formulaic approach impractical.” She further explains that because Bookspan is a privately held entity it would be impossible to perform an analysis as comprehensive as the one described in the Plunkett Declaration. Tr. 2/85-86; see *also* section IV.D.1.

[4081] In the next section of his declaration, Plunkett describes the development of a demand function for total marketing mail based on the total number of accounts. Plunkett Declaration at 13. This was done for Bank One, because it was believed that the total number of accounts was directly related to the volume of mail sent to existing accounts and those sent to acquire new accounts. This allowed the development of “a second independent checkpoint” to verify the NSA partner’s volume forecasts. Plunkett Declaration at 13-14; Tr. 2/84.

[4082] In the Postal Service’s review of the potential Agreement with Bookspan, it did not attempt to derive a demand function – or even an elasticity estimate – specific to solicitation mail volume based on the number of memberships or any other similar measure. Tr. 2/261. Witness Plunkett did not believe such an analysis was necessary since he expected that marketing volume would be positively correlated with growth or negatively correlated with a decline in the number of customers. *Ibid.*

[4083] OCA argues that the Postal Service has not convincingly explained why it believes the Bookspan volume estimates.¹⁰⁴ First, OCA examines the trend analyses prepared by Witness Yorgey. OCA submits that, in fact, they do not indicate a downward trend but rather fluctuations in the low 80 million range.¹⁰⁵ OCA also takes issue with the fact that “[o]ver the course of approximately two months witness Yorgey substantially changed the projections, updating the projections based on the availability of new

¹⁰⁴ OCA Brief at 21-32.

¹⁰⁵ OCA seemingly accepts Bookspan and the Postal Service’s explanation that the historical volume increase for FY2004 is based on a one time influx of funds from telemarketing to direct mail marketing due to the federal government’s enforcement of the “Do Not Call” registry. See USPS-T-2 at 8.

data.”¹⁰⁶ As a result, the Year 1 annual projections changed by around 13 percent, with similar changes to the Year 1 quarterly projections. Further, OCA observes that when compared to Witness Epp’s projections, Witness Yorgey’s trend analysis projections produce estimates significantly higher. *Ibid.*

[4084] Bookspan and the Postal Service readily acknowledge that Yorgey’s trend analysis is inaccurate because it fails to take into the consideration relevant non-economic factors. They submit that if those factors are considered, witness Epp’s projections are reasonable.

[4085] OCA also criticizes the Postal Service’s failure to analyze the market environment. OCA notes that the Postal Service states that it likes to “consult numerous independent sources” when evaluating volumes of prospective NSA partners, but did not do any of that here since Bookspan is a unique privately held company and there are no independent sources for the Postal Service to look at.¹⁰⁷ OCA argues that the Commission was troubled by questions of reliability of volume estimates in the Capital One line of cases and the Bookspan NSA should be rejected because the Postal Service has done even less to evaluate the reliability of its partners point volume estimates.¹⁰⁸

[4086] If OCA were arguing that there were data that the Postal Service should have consulted but did not, that would be a matter of great concern to the Commission. But as Bookspan and the Postal Service point out, the Postal Service cannot look at independent sources because they do not exist. Bookspan should not be penalized because it is privately held, its industry is small, and it does not foster the types of independent publications and forecasts that other industries may have. For every NSA,

¹⁰⁶ OCA Brief at 25 (citing Attachment to Response of USPS to POIR No. 1, Q. (1)(a), revised October 18, 2005, at Attachment 1)

¹⁰⁷ Tr. 2/233. This includes SEC filings, stock analysts reports, trade association publications, company reports, company press releases, competitor information, macroeconomic forecasts as well as the consultation of outside experts.

¹⁰⁸ Bookspan Brief at 32-34.

the Postal Service need only do the amount of due diligence that is appropriate for that industry.

[4087] Nonetheless, the Commission cannot find the volume point estimates reasonable under the circumstances.¹⁰⁹ It is imprudent for the Postal Service to rely upon the volume point estimates provided by the potential NSA partner. An independent analysis must be done. Here, the only independent analysis that the Postal Service did was a cursory trend analysis, and that analysis, as OCA notes, produced estimates that were significantly higher than those forecasted under the Agreement. This should have raised red flags and caused the Postal Service to look closer at the point estimates. Yet rather than continue independently investigating, the Postal Service accepted Bookspan's estimates. This does not satisfy the Commission that the Postal Service has done appropriate due diligence in this circumstance. Differences in point estimate analysis deserve a hard look, certainly something more independent than just "discussions with Bookspan." Tr. 2/85. The Postal Service should not have readily accepted that Bookspan's solicitation mail volume was expected to continue to decline because it is in a declining market environment since other factors, as shown by the Do Not Call list in 2004, affect solicitation mail marketing budgets.

[4088] As the Commission has stressed, the focus of analyzing these agreements should shift away from these inherently inaccurate point volume estimates and toward a more meaningful and thorough evaluation. Accordingly, the Commission believes it is appropriate to examine the likelihood that the Postal Service will incur a loss under the Bookspan NSA with respect to Standard Mail letters over the entire range of possible outcomes under the Agreement, not merely estimated point volumes. To do so, the Commission applies the Panzar analysis to the proposed Bookspan NSA.

¹⁰⁹ Much of the confusion, uncertainty and litigation surrounding volume estimates could have been avoided if the alternative approach outlined in the Bank One reconsideration decision had been available here to structure and support the Bookspan NSA. However, that analysis had not yet been surfaced by the Commission.

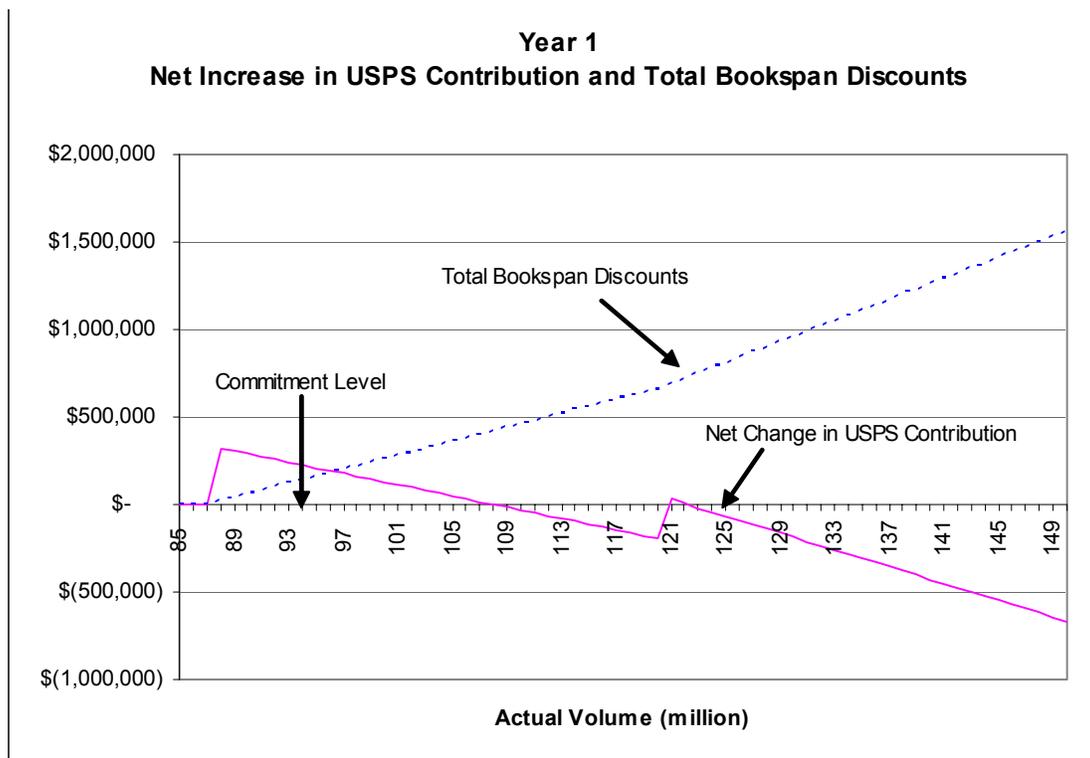
3. Application of Panzar Analysis

[4089] The Commission must be satisfied there is “reasonable assurance that the Postal Service will not lose money on this NSA.” See PRC Op. MC2002-2, ¶ 8013. The Panzar analysis is a way the Commission quantifies the standard with respect to mail volumes of potential NSA partners.¹¹⁰ It is rooted in the Commission’s first Opinion and Recommended Decision in Captial One. In that case, the Commission found, based in part on the testimony of Witness Panzar, that “[t]he impact of the tariff on postal net revenue has two parts.” PRC Op. MC2002-2, ¶ 5012. The first is the increase in net revenue that results from the increase in volume.¹¹¹ This is the increase from new mail volume, or “new contribution.” The second part of the impact is a decrease in net revenue. This decrease in net revenue constitutes discounts on volume that the potential NSA partner would have demanded at the higher rate if there were no discounts. If the new contribution produced by the response to the lower second block rate exceeds the loss of net revenue, the Postal Service overall net revenue will increase at that after-rates volume. See *id.* at ¶ 5013. If not, then the Postal Service will lose net revenue at that after-rates volume. This analysis is repeated for the entire range of possible after-rates volume outcomes to determine the points that would result in an increase in net revenue and those that would result in a decrease in net revenue.

¹¹⁰ The Panzar analysis is not to be confused with the alternative approach model for designing declining block NSAs suggested by the Commission in its Opinion and Further Recommended Decision in MC2004-3, paras. 5001-38. The former is an analysis for evaluating the risk of loss, while the latter is a model for negotiating NSAs that uses the Panzar analysis in their design. See also *id.* at ¶¶ 5010-17. The Panzar analysis is also discussed in MC2004-3 at 5014.

¹¹¹ Given the demand curve is known or can be adequately approximated.

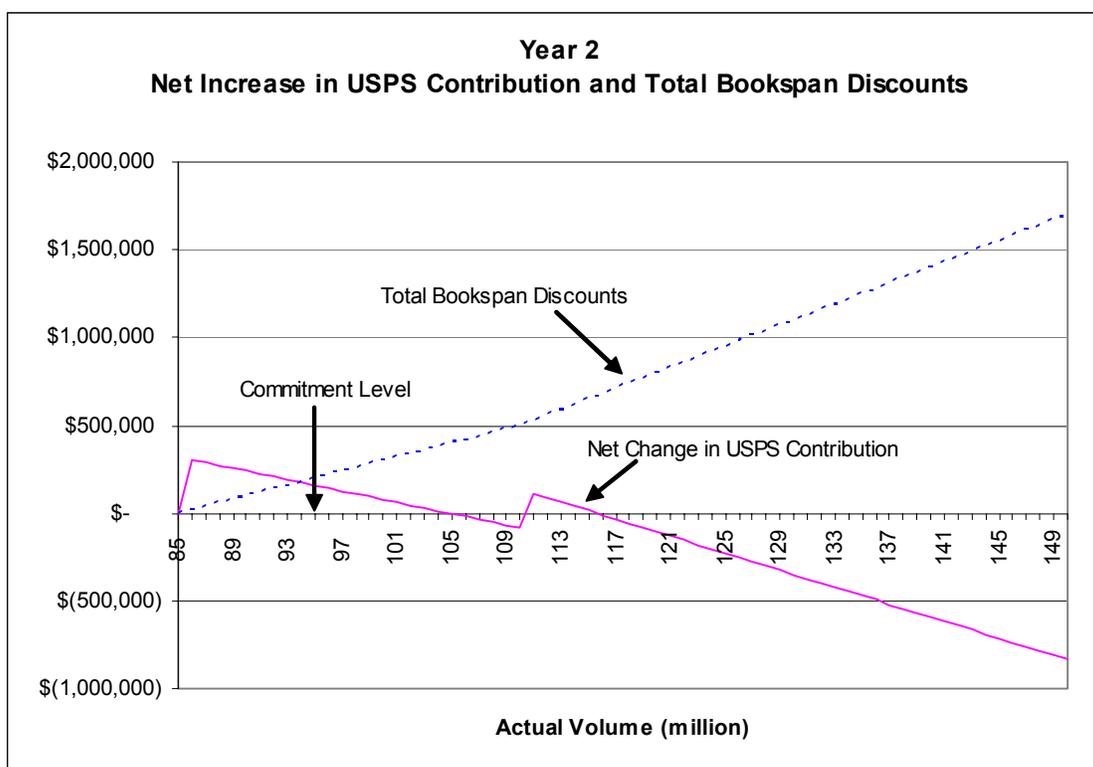
[4090] In this case, taking into account the adjustments to the proxy for Bookspan specific costs discussed in section IV.D.1,¹¹² under the Panzar analysis the impact of varying volume levels are shown in the following graphs.¹¹³



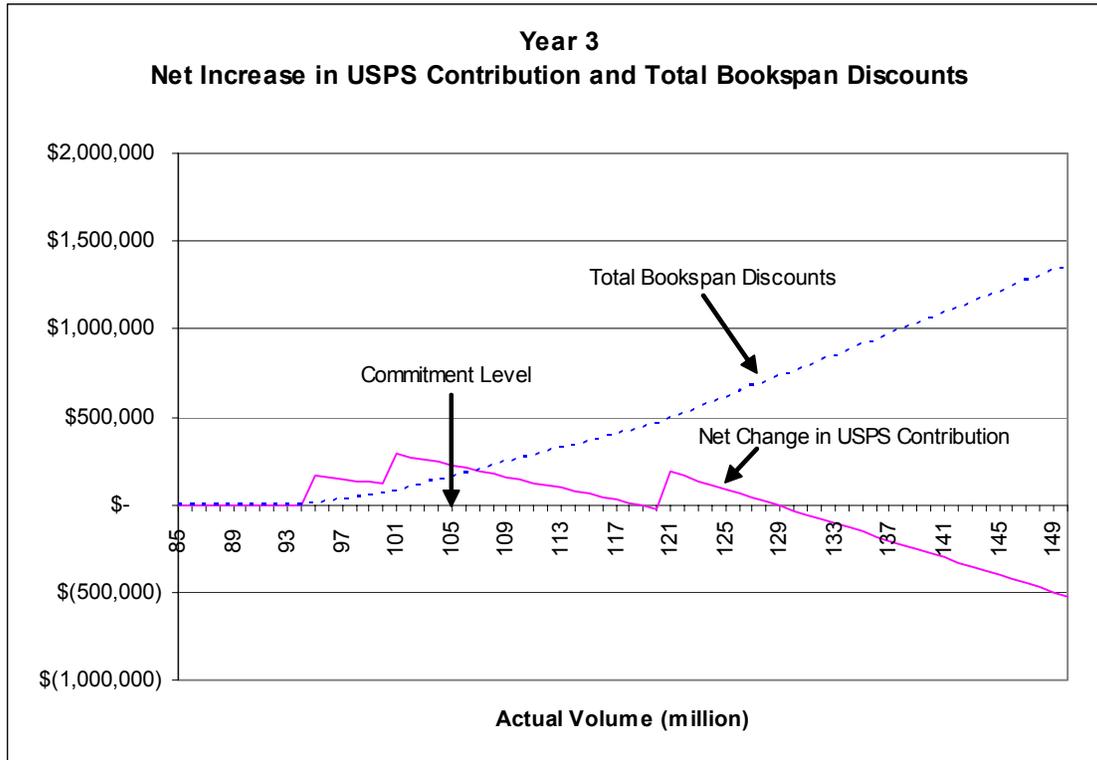
¹¹² For this analysis, the weighted elasticity of Regular and ECR subclasses is used by default since no other elasticity was proposed by any of the participants. The elasticity for the Regular subclass in Docket No. 2005-1 was 0.2671 and the elasticity for the ECR subclass was 1.0926. Bookspan’s base year letter volumes from Witness Yorgey’s response to Presiding Officer’s Information Request No. 3 were used to develop the weighted average elasticity of -0.3284. See Tr. 5/547. This was derived as follows: $((-0.2671 \times 87.0 \text{ million}) + (-1.0926 \times 7.0 \text{ million})) / 94 \text{ million} = -0.3284$.

¹¹³ Due to the commitment levels in the Bookspan NSA and the fact that discounts are not paid unless those commitment levels are reached, the Commission has less confidence in outcome of the Panzar test for those values that are below the commitment levels (94 million pieces in the first year, 95 million pieces in the second year, and 105 million pieces in the third year). Nonetheless, the Commission is confident that the Postal Service will not lose Standard Mail contribution if Bookspan does not reach the commitment level since the Agreement does not allow any discounts to become payable to Bookspan if the commitment level is not reached.

[4091] For year one of the Agreement, if the total Standard Mail letter solicitations mailed by Bookspan is up to 109 million or between 120 million and 123 million mailpieces, the Panzar test demonstrates that the Postal Service will not lose Standard Mail contribution on this NSA for that year. If, however, the total Standard Mail solicitation letters volume for Bookspan is between 109 million and 120 million or greater than 123 million pieces, the Panzar test shows that the Postal Service will lose Standard Mail contribution for year one of this NSA.



[4092] For year two of the Agreement, if the total Standard Mail letter solicitations mailed by Bookspan is up to 105 million or between 111 million and 115 million mailpieces, the Panzar test demonstrates that the Postal Service will not lose Standard Mail contribution for that year. If, however, the total Standard Mail solicitation letters volume for Bookspan is between 105 million and 111 million or greater than 115 million pieces, the Panzar test shows that the Postal Service will lose Standard Mail contribution for year two of this NSA.



[4093] For year three of the Agreement, if the total Standard Mail letter solicitations mailed by Bookspan is up to 118 million or between 121 million and 128 million mailpieces, the Panzar test demonstrates that the Postal Service will not lose Standard Mail contribution in the final year. If, however, the total Standard Mail solicitation letters volume for Bookspan is between 118 million and 121 million or greater than 128 million pieces, the Panzar test shows that the Postal Service will lose Standard Mail contribution for year three of this NSA.

4. Conversion of Flats to Letters

[4094] The Postal Service relies upon increased contribution from flats “migrating” or converting to letters.¹¹⁴ It asserts that approximately \$5 million of the projected \$8.6 million increase in gross contribution due to this NSA as quantified in the Postal Service’s financial analysis is derived from the conversion of flats to letters.¹¹⁵ NAA and NNA argue that this benefit is illusory because it is not required by the Agreement, it is instead only “encouraged.”¹¹⁶ However, a financial benefit should be counted in the Commission analysis if it is intended and the record supports its occurrence as a result of the Agreement. Whether it is required or just encouraged does not prevent recognition by the Commission.

[4095] Valpak challenges the Postal Service’s calculation of this \$5 million benefit from the conversion of flats to letters. It argues that the Postal Service should have disaggregated the unit costs and revenues for each mail product (e.g., for letters, nonauto basic, auto 3-digit, etc.) used by Bookspan rather than using averages for flats and letters as a whole for its analysis. Valpak argues that looking at disaggregated data in this manner is appropriate because there are variations in unit contributions between flats prepared differently. Indeed, Witness Yorgey testifies that for 99 percent of Bookspan’s flat mail, the Postal Service either loses just less than one cent per piece or gains 8 cents per piece. Tr. 2/182, 193. Valpak then attempts to explore which flat-sized

¹¹⁴ Valpak takes issue with the term “migrating” as it believes the term is not factually correct. Valpak interprets migrating to only apply when a decrease in flat volume is offset by an increase in letter volume. It thinks the term converting more accurately describes the phenomenon discussed here. For the sake of clarity, the term converting will be used in this opinion.

¹¹⁵ Tr. 2/186. These calculations are changed to \$5.3 million of the projected \$8.9 million increase in gross contribution due to this NSA when using the Commission’s adjusted costs.

¹¹⁶ NAA and NNA Brief at 19.

mail product would be converting, but the Postal Service admits this is unknown and unexplored.¹¹⁷

[4096] Valpak contends that this is a significant problem. If, for example, ECR Basic Flats convert to ECR Nonauto Basic Letters, the Postal Service would lose either 1.4 cents per piece or 2.4 cents per piece depending on whether the letter-sized piece qualifies for a 2.0 cent or 3.0 cent discount under the NSA. Valpak notes that, if the Postal Service suffers a reduced contribution of 1.4 cents per piece on 56 million pieces, the Service would incur a loss of \$784,000 from the conversion rather than the \$5 million increase in gross contribution estimated by the Postal Service.¹¹⁸ Valpak's argument is tempered somewhat by the Commission's revisions to the cost estimates.¹¹⁹

[4097] The Postal Service argues that the chance of Valpak's scenario is extremely remote and that "... almost every other conversion scenario yields positive contribution" Postal Service Reply Brief at 15. It believes that it is reasonable and fully supported by the record for Witness Yorgey to use weighted average costs by shape and to assume that the shift in volume from flats to letters will be in a distribution that essentially mirrors the current mailing profile. It notes that the ECR Basic rate is only available to mail packaged with 10 or more pieces to a given carrier route, and as witness Epp testifies, Bookspan makes its marketing decisions based upon expected profitability of marketing campaigns, not by carrier route. Tr. 3/381.

¹¹⁷ Implicit in Witness Yorgey's calculations of averages is the assumption that converting flats will have the distribution of all Bookspan flats, and they will convert to letters with the distribution of all Bookspan letters.

¹¹⁸ This is the total number of pieces estimated to convert for all years of the Agreement (17 million in year one of the Agreement, 19 million in year two, and 20 million in year three). Tr. 2/129-30.

¹¹⁹ Under the Commission's revised costs, if all of the anticipated conversion were ECR flats to ECR letters, the Postal Service would lose only \$41 thousand on that conversion in year one of the Agreement. PRC-LR-1 at 10.

[4098] It also notes that the data collection plan will provide a public report of letter and flat mail volume by rate category so this type of activity can be monitored. However, the data collection plan does not alleviate this concern. No data are being collected on mail that would have been sent as flats that is instead sent as letters.

[4099] The issues raised by Valpak are troubling. It would have been prudent for the Postal Service to attempt to look at Bookspan's historical mail product to mail product conversion rates and see if there were any correlation or pattern to help predict future flat to letter conversions. It also would have been prudent to raise the issue with Bookspan to determine if anomalies or other issues would cause the historical data to be an unreasonable indicator of future results. However, none of this was done and the Commission is left without solid support for the use of averages.

[4100] Despite the Postal Service's failure to explore the issue more thoroughly, Witness Epp's testimony on how Bookspan makes marketing decisions supports the Postal Service's argument that the conversion will not be all ECR flats to ECR letters. Without such a conversion, it is highly unlikely that the Postal Service will lose contribution as a result of converting mailpieces. Instead, the record indicates that there is a great likelihood that the conversion will significantly increase the Postal Service's net contribution.¹²⁰ Accordingly, the Commission finds that the financial analysis supports the conversion of flats to letters portion of the Agreement as beneficial to the Postal Service and other mailers.

5. Conclusion

[4101] The Commission finds that, after the adjustments and revisions to the financial analysis noted above are taken into consideration, the financial risk of this Agreement is endurable under the totality of the circumstances. The Commission

¹²⁰ See PRC-LR-1 at 10 for an analysis of the financial effects of volume shifts assuming different subclass compositions of the converting volumes.

improves the cost estimates to make them more accurate. The Commission could not find the proponents' point volume estimates to be reliable and usable, and this might have been fatal to the Agreement had it not been for other factors in this case to make the overall risk of loss to the Postal Service tolerable. Analyzing the results of the Panzar test demonstrates that over the three years of the Agreement, there is a range of values where the NSA will result in the Postal Service having an increased contribution, especially in the third year.¹²¹ There is also the possibility that the Postal Service's net contribution from Standard Mail may decrease as a result of this NSA. Any such shortfall would have to be made up by other mailers. This is of substantial concern to the Commission. Nonetheless, the Panzar test does not tell the whole story here since it does not take into account the potential benefits from the conversion of flats to letters¹²² or the positive benefits from Bookspan's unique multiplier effect. Adding these additional factors to the Panzar analysis satisfies the Commission that the negative outcomes discussed above are mitigated sufficiently to place the total risk of loss at an acceptable level. The Commission also finds important its confidence in the Postal Service's determination to prudently apply the 30-day cancellation provision to terminate the Agreement if data show that under the Panzar test, Bookspan's actual volumes reach a point where the NSA will result in a decrease in the Postal Service's net contribution.

¹²¹ This increase in potentially positive outcomes is due to the addition of the one-cent discount tier and the higher thresholds for the two- and three-cent tiers..

¹²² The financial analysis of the Agreement with respect to flats converting to letters is discussed in section IV.D.4.

E. Mail Eligible for a Discount under this NSA

[4102] The characteristics of the mailpieces eligible for a discount under this NSA are important criteria in the Commission's analysis of this NSA. The criteria can be broken down into three main categories: (1) subclasses of mail: Standard Mail Regular and ECR; (2) types of mail: new member solicitations; and (3) additional inserts from strategic business alliances.

1. Standard Mail Regular and ECR

[4103] The proponents seek to have the Commission recommend that the declining block discounts in the proposed Bookspan NSA apply to both Standard Mail Regular letters and Standard Mail ECR letters. Several participants dispute whether mail eligible for a discount under this proposal should include Standard Mail ECR letters. NAA argues that due process rights were violated since potentially interested parties were not put on notice that this proposal applied to Standard Mail ECR letters.¹²³

a. Due Process Considerations

[4104] The scope of this proposal, as set forth in the proposed DMCS language submitted by the Postal Service stated that "Eligible Standard Mail under this section is defined as letter shaped pieces sent by Bookspan for the purpose of soliciting book club membership" ¹²⁴ This provision does not explicitly state whether ECR letters are to be included. However, NAA argues that section 620.23 of the proposed DMCS clarifies that the Agreement applies only to Regular letters by virtue of its cross-reference to Rate Schedule 321A and 321B which deal only with Standard Mail Regular Presort and

¹²³ NAA Response to NOI No. 1, November 14, 2005, at 2-5.

¹²⁴ Request, Attachment A, Proposed Section 620.11.

Automation categories. NAA contends that section 620.23's lack of reference to Rate Schedules 322 which deals with rates for Standard ECR mail shows that the Agreement only applies to Standard Mail Regular. Support in the record for this interpretation is also found in the testimony of Witness Plunkett.¹²⁵

[4105] The Postal Service and Bookspan never address this inconsistency until in response to Presiding Officer's Information Request No. 3, the Postal Service states that "it was and remains the intention of the proponents that eligible mail ... include both Standard Mail Regular and Standard Mail ECR."¹²⁶ Accordingly, it is now certain that the intention of the contracting parties was to include both Regular and ECR. Nonetheless, the Commission must address NAA's due process concerns to determine if the Commission can lawfully recommend the proposal for Regular and ECR or whether procedural due process forces it to limit any recommendation to only Standard Mail Regular letters.

[4106] Due process requires that potential participants to agency proceedings be given notice of such proceedings.¹²⁷ Such notice must inform potential participants that proceedings have been instituted, and it must also contain information with sufficient detail to allow the preparation and presentation of objections.¹²⁸ Moreover, the Administrative Procedure Act's notice requirements provide that participants be informed

¹²⁵ On cross-examination, Witness Plunkett was asked, "[a]nd does your reference to standard mail in line five include reference to both standard regular and standard ACR[sic]?" As part of his response, witness Plunkett states: "Of course our agreement with Bookspan is standard mail regular." Tr. 2/293-94. Later, in a discussion about DMCS functionally equivalent language, witness Plunkett states: "I'm not sure there would be any standard mail ECR customers that would in any way fall under this category. I can't say that absolutely, but. . . ." Although witness Plunkett was not prepared to commit to a change, he stated that he could not think of a reason why the Postal Service would strongly object to including the word "regular" in the functional equivalency language. *Id.* at 326.

¹²⁶ Postal Service Response to Presiding Officer's Information Request No. 3, Question 2, November 9, 2005; Tr. 5/534.

¹²⁷ *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950).

¹²⁸ *Memphis Light, Gas & Water Div. v. Craft*, 436 U.S. 1 (1978); *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976) ("The fundamental requirement of due process is the opportunity to be heard at a meaningful time and in a meaningful manner.").

of “the matters of fact and law asserted.”¹²⁹ Under that statute, an agency can decide issues where those adversely affected (1) had notice and (2) had an opportunity to contest.¹³⁰ Courts have also held that notice under Section 554 “is sufficient as long as the party to an administrative proceeding is reasonably apprised of the issues in controversy and is not misled.”¹³¹

[4107] The initial notice of this NSA was docketed on July 19, 2005, and published in the Federal Register on July 25, 2005.¹³² The notice stated that the “discount [was proposed to be] available to qualifying Standard Mail letter pieces.”¹³³ In the description of the Agreement, the notice used the term “Standard Mail letter” several times. Nowhere did the notice mention any subset of Standard Mail letters. A close examination of several of the documents referenced in the notice, specifically, the spreadsheets supporting Witness Yorgey’s testimony, mention both ECR and Regular.¹³⁴ Accordingly, although it may not have been perfectly unclear from the outset that the proponents intention was to have the Agreement apply to both ECR and Regular (for the reasons articulated by NAA), a review of the notice indicates that potential participants were reasonably apprised of this potential grey area, and could raise the issue whether the proposed NSA offered discounts for both ECR and Regular.¹³⁵

¹²⁹ 5 U.S.C. § 554(b).

¹³⁰ *NLRB v. Blake Construction Co.*, 663 F.2d 272, 279 (D.C.Cir.1981).

¹³¹ *Rapp v. Office of Thrift Supervision*, 52 F.3d 1510, 1519-20 (10th Cir. 1995); see also *Boston Carrier v. ICC*, 746 F.2d 1555, 1560 (D.C. Cir. 1984) (“The Commission is not burdened with the obligation to give every applicant a complete bill of particulars as to every allegation that carrier will confront. The agency need not anticipate every charge that will be made.”).

¹³² Order No. 1441 (July 19, 2005); 70 F.R. 42602 (July 25, 2005).

¹³³ Order No. 1441 (July 19, 2005) at 3.

¹³⁴ *Id.* at 3 (citing USPS-T-2 at Appendix A at 3-6 at Tr. 2/50).

¹³⁵ In any event, given the responses to Notice of Inquiry No.1 and Presiding Officer’s Information Request No. 3, it is now crystal clear that the proponents’ intention is to have the NSA cover both ECR and Regular Standard Mail letters.

[4108] Even if notice is initially inadequate courts will not vacate an agency decision if it is clear from the record that the parties clearly understood the facts and legal theories relied upon and also contested them at the hearing.¹³⁶ NAA was clearly aware of the issue of Regular versus ECR. It actively participated at the hearing and asked questions as to the scope of potential functional equivalent agreements, which also bear on the scope of the current proposed baseline agreement.¹³⁷ It is difficult for NAA to substantiate a claim that it was surprised or unprepared to contest the issue when it helped bring the issue to light at the hearing. Further, NAA points to no potential intervenor that was denied an opportunity to contest the proponent's view of the facts because it had not been notified earlier and more formally of this issue.¹³⁸ The Commission finds that because potential participants were reasonably apprised that both Standard ECR and Regular could be eligible and as the issue was actually contested by NAA, the requirements of due process have been satisfied with respect to this issue.

b. Subclasses Eligible for a Discount

[4109] After resolving the due process issue and finding that the Commission does not need to limit the Agreement to Regular letters for due process and notice concerns, the Commission must next decide if the scope of the Agreement should be limited to Regular letters for reasons other than due process concerns. NAA's arguments in this respect are the same as mentioned above with respect to its due process concerns, namely, the cross-reference in the proposed DMCS language to only Standard Mail

¹³⁶ "Even where the record contains evidence supporting a remedial order, the court will not grant enforcement in the absence of either a supporting allegation in the complaint *or a meaningful opportunity to litigate the underlying issue in the hearing itself.*" *Blake Construction*, 663 F.2d at 279 (citations omitted) (emphasis added).

¹³⁷ Tr. 2/325 ("I noticed that the proposed language refers to standard mail letter solicitations I don't see the word 'regular' in the DMCS section. Is it your intent to limit functionally equivalent NSAs to standard regular solicitations?").

¹³⁸ *Boston Carrier v. ICC*, 746 F.2d 1555, 1559-60 (D.C. Cir. 1984).

Regular Rate Schedules 321A and 321B. If the Commission finds that the Agreement as written does not meet the conditions of the statute, it can, and should, condition its recommendation on correcting offending provisions or adding additional safeguards until the Agreement comes into compliance with the Act.¹³⁹ It can also condition its recommendation upon the insertion or editing of language in proposed DMCS language to clarify the intended rate and classification changes.¹⁴⁰ Additionally, the Commission's decision itself can clarify the effect of the Agreement on rate and classification changes, since recommended decisions on such changes are part of the Commission's primary responsibilities.¹⁴¹ The latter is one of the purposes of this section of this Opinion – to clarify the extent of mail eligible for a discount under this proposed NSA.

[4110] None of the participants have raised any meritorious reasons for limiting the Agreement to only Regular letters and the Commission does not independently find any. Indeed the record does not support such a limitation because all the data supporting the Agreement submitted by the proponents include both ECR and Regular.¹⁴² Accordingly, the Commission recommends that the Agreement cover both Standard Mail ECR and Regular letters as clarified by the proponents.

2. New Member Solicitations Only

[4111] The type of Standard Mail Regular and ECR letters eligible for a discount was not contested in the briefs, but it was raised by Notice of Inquiry No. 1 and needs to be analyzed by the Commission here for completeness. The DMCS language originally

¹³⁹ See e.g., PRC Op. MC2002-2 at paras. 8008-8023.

¹⁴⁰ See NOI No. 1.

¹⁴¹ *United Parcel Service v. U.S. Postal Service*, 604 F.2d 1370, 1381 (3d Cir. 1979) (“it is the Rate Commission which is charged with making recommended decisions on changes in rates and mail classification”).

¹⁴² Tr. 5/534, 527.

proposed by the Postal Service is unclear.¹⁴³ The two issues raised with respect to new member solicitations relate to “perceived inconsistencies in what might be eligible for mailing under the agreement.”¹⁴⁴

[4112] First, the DMCS language as originally proposed in section 620.11 by the Postal Service is unclear as to whether the phrase in the first sentence “purpose of soliciting book club membership” applies only to “persons who are not currently subscribers to the book club or clubs Bookspan is promoting in the mailing or if it also applies to “book club members whose membership is expiring.” In Notice of Inquiry No. 1, the Commission proposed to clarify that all eligible mail must be for the purpose of soliciting book club membership based upon an interrogatory response of witness Plunkett.¹⁴⁵ Bookspan commented that the Commission’s recommended change of an “or” to an “and” prior to “(2)...” was inappropriate because both (1) and (2) need not be met for a mailpiece to qualify. The Commission agrees and accepts Bookspan’s suggestion that the “or” be retained. This change does not affect the Commission’s main purpose in restructuring this sentence to clarify that all eligible mail must be for the “purpose of soliciting book club membership.” All participants either supported this change or chose not to comment. Accordingly, as recommended, the first sentence of section 620.11 will read:

Eligible Standard Mail under this section is defined as Standard Mail letter-shaped pieces sent by Bookspan for the purpose of soliciting book club membership: (1) of persons who are not current subscribers to the book club or clubs Bookspan is promoting in the mailing; or (2) of book club members whose membership is expiring.

¹⁴³ Request at Attachment A § 620.11 (“Eligible Standard Mail under this section is defined as ...[mail sent] for the purpose of soliciting book club membership”).

¹⁴⁴ NOI No. 1 at 2 (November 3, 2005); *see also e.g.*, Tr. 3/420-22; Tr.2/43; Tr. 3/464-65; Tr. 2/65; 3/424-25; Tr. 2/262-65; Tr. 3/427-29.

¹⁴⁵ Tr. 2/264; *see also* NOI No. 1 at 3.

[4113] Second, the DMCS language as originally proposed by the Postal Service is unclear as to when a particular member ceases to be a “current member” and may once again be re-solicited as a “new member” in the sense that that re-solicitation mailpieces will be eligible for a discount under the Agreement. Using interrogatory responses from the proponents’ witnesses, the Commission crafted additional clarifying language and sought comments on such language in Notice of Inquiry No. 1.¹⁴⁶ All participants either supported these changes or did not comment on them. Accordingly, the changes in the DMCS with respect to classifying new member solicitations will be clarified as set forth in Notice of Inquiry No. 1.¹⁴⁷

3. Inserts from Strategic Business Alliances

[4114] The proposed NSA allows Bookspan to place inserts from strategic business alliances in eligible mailpieces and still receive discounts under the NSA. OCA argues¹⁴⁸ that this provision will allow Bookspan to reinvent itself as an “insert business,” i.e., an entity that consolidates and mails other entities advertising mail for a cheaper price due to the discounts allowed under the NSA.¹⁴⁹ OCA is worried that because of Bookspan’s discounts and ability to utilize inserts in its new member solicitation mail, millions of pieces that would have been mailed as free-standing pieces of mail will instead be routed through Bookspan as inserts. If there were any evidence in the record to support OCA’s

¹⁴⁶ NOI No. 1 at 2-6.

¹⁴⁷ In particular, proposed section 620.11 will include a fourth sentence which will read: “Under no circumstances are periodic Current Member club mailings which offer the cycle’s Featured Selection, as well as other club sections and offerings, eligible to be counted and receive discounts under the agreement, even if they contain solicitations to renew membership in that club or to join other clubs.” NOI No. 1 at 3.

¹⁴⁸ OCA Brief at 34-39; OCA Reply Brief at 16-18.

¹⁴⁹ As Bookspan phrased it, “becoming another Valpak.” Bookspan Reply Brief at 9.

theory, it would be cause for concern. As the Commission noted in the Capital One Case:

Reselling: A non-linear tariff that leaves postal customers with dissimilar marginal rates must include enforceable provisions for preventing the customers with the lower marginal rates from reselling postal services to the others. Reselling, if it is permitted, results in an uncontrolled increase in the leakage of net revenue from the Postal Service to the customer receiving an NSA. ... Any NSA that is likely to create discriminatory rates needs to have provisions ... to forestall an increase in the leakage of net revenue. These provisions must reliably prevent reselling in any form....¹⁵⁰

[4115] However, as Bookspan notes, there is no evidence in the record to support a theory of reselling on these facts.¹⁵¹ Mere allegations and “worst case scenario” arguments without evidentiary support generally will not form the basis for rejecting provisions of an NSA. In fact, the evidence shows that inserts diminish Bookspan’s response rates which are “the most important thing for us [Bookspan] to come out of a mailing.” Tr. 4/487-88. Witness Epp testifies that Bookspan seeks the strategic business alliances insert provision to allow it to continue market tests without jeopardizing the eligibility of its solicitation mail for the prospective discount. Tr. 3/465; Tr. 2/159. Direct mail is a tool that Bookspan uses to promote its book selling business, and inserts detract from that business.¹⁵² The evidence shows that it is not in Bookspan’s business interest to open the floodgates on strategic business alliance inserts, and without such an incentive, OCA’s argument here is tempered.

¹⁵⁰ PRC Op. MC2002-2 (May 15, 2003), ¶ 5078 (internal citations omitted).

¹⁵¹ Bookspan Reply Brief at 9.

¹⁵² Tr. 4/487 (“As a mailer or marketer I’d rather not include a third party piece in my mailing because it typically has a negative impact on my response so if I can do, I do without.”); *id.* at 488 (“If the third party piece has a significant impact on your response rate than [sic] you cannot afford to do it, and we wouldn’t do it anymore.”).

[4116] Moreover, the proposed DMCS language¹⁵³ controlling the parameters of eligible mail limits the number of strategic business alliance inserts to two per mailpiece. The Commission finds that this limitation alleviates concerns about third-party inserts turning the NSA on its head and Bookspan into an insert business.

[4117] OCA also raises concerns about its view that there is no provision in the data collection plan to allow the Postal Service to monitor Bookspan's mailing practices for a misuse of strategic business alliance inserts.¹⁵⁴ The Commission finds that OCA's argument has merit and will require the production of additional data to evaluate the impact of potential changes in Bookspan's use of its strategic business alliance insert privileges.¹⁵⁵ If the Postal Service's monitoring of the strategic business alliance inserts results in substantial increases from the current 0.17%¹⁵⁶ ratio of Bookspan Standard Mail new member solicitation mailpieces that include strategic business alliance inserts to those mailpieces that do not include such inserts, the Postal Service should take appropriate action.

[4118] Finally, the existence of the cancellation clause allows the Commission to conclude that the Postal Service has adequate options available to ensure that no adverse action will harm the Postal Service and non-party mailers as a result of this strategic business alliance insert privilege.

¹⁵³ That is, the proposed DMCS language as subsequently amended by the Postal Service on October 18, 2005. Revised Attachment A to Request Containing Proposed DMCS Language at Attachment A at 1. ("Such pieces may include up to two inserts promoting Bookspan's strategic business alliances.").

¹⁵⁴ OCA Brief at 36.

¹⁵⁵ This argument and the details of the additional data collection requirements related to this concern is discussed in the Data Collection portion of this opinion in Section IV.G.

¹⁵⁶ Tr. 3/410.

F. DMCS Provisions

[4119] The Postal Service proposes to add a new Domestic Mail Classification Schedule (DMCS) section 620, to specify the general parameters of the Bookspan NSA. See Request at Attachment A.

[4120] As noted above in section IV.E., “Mail Eligible for a Discount Under the NSA,” as a result of the proponents testimony and interrogatory responses, the Commission issued Notice of Inquiry No. 1 which proposed revised language to clarify several matters. With the exception of the matters discussed in that section, the participants that commented on the revisions were supportive of the changes.

[4121] This is the first time that the Commission has received a proposal for a baseline agreement that includes proposed DMCS language setting guidelines for similarly situated mailers applying for functionally equivalent agreements.¹⁵⁷ The Commission agrees with the Postal Service that it is worthwhile to identify such preliminary parameters in the DMCS in order for potential NSA partners to have a better understanding of whether they could qualify as functionally equivalent. It is important to note, however, that the DMCS guidelines set forth in proposed section 620.12 are not exhaustive.¹⁵⁸ They contain highly important conditions, but the Commission must analyze each agreement on a case-by-case basis to determine if it is functionally equivalent and in accordance with chapter 36 and the Commission’s functionally equivalency regulations.¹⁵⁹ This ensures that mailers are in fact, similarly situated. Further, if potential mailers believe that they have been unfairly treated or discriminated against by the Postal Service with respect to NSAs or otherwise, they may utilize the statutory complaint procedures under chapter 36 that allow mailers to have their objections heard by the Commission. For these reasons, the Commission recommends

¹⁵⁷ See Proposed DMCS Language § 620.12.

¹⁵⁸ See also discussion in section IV.C.2.

¹⁵⁹ See 36 C.F.R. § 3001.196

the addition of DMCS section 620, modified as discussed in Notice of Inquiry No. 1 and as noted in this Opinion.¹⁶⁰

[4122] The Postal Service proposes the addition of three new rate schedules to the DMCS: 620A, 620B, and 620C. Rate Schedule 620A specifies the volume block incremental discounts in year one of the Agreement. Rate Schedule 620B specifies the volume block incremental discounts in year two of the Agreement. Rate Schedule 620C specifies the volume block incremental discounts in year three of the Agreement. See Request at Attachment B. The Commission recommends the addition of Rate Schedules 620A, 620B, and 620C, as proposed by the Postal Service.

¹⁶⁰ The Commission has also made minor technical and typographic error type corrections in the DMCS language originally proposed by the Postal Service that should have no effect on the intended meaning.

G. Data Collection Plan

[4123] The Commission recommends the data collection plan proposed by the Postal Service with modifications suggested in Notice of Inquiry No. 1 and further modified in this opinion. None of participants oppose the Commission's proposed changes discussed in Notice of Inquiry No. 1.¹⁶¹ These proposed modifications make this data collection plan more consistent with the data collection requirements of previously approved NSAs.¹⁶² Each item is numbered to allow the proponents to easily identify each item within the reports. There are two additions to the Data Collection Plan that the Commission is recommending that were not noted in Notice of Inquiry No. 1. The first deals with data collection relating to Bookspan's strategic business alliances in response to OCA's concerns. The second deals with NAA, NNA, Valpak, OCA, and APWU's concerns with the reliability of the after-rates volume estimates. Each Data Collection Plan addition is addressed in turn.

[4124] OCA raises concerns that the data collection plan does not collect sufficient information to monitor Bookspan's mailing practices for a misuse of strategic business alliance inserts.¹⁶³ Witness Yorgey testifies:

As a matter of course, the Postal Service monitors all NSA customer volumes on a monthly basis. Any unusual deviation from normal mailing patterns would trigger an inquiry into the source of the increase. If Bookspan were found to be acting as a presorter, which is contrary to the

¹⁶¹ See Comments of the Newspaper Association of America on Notice of Inquiry No. 1, November 14, 2005; Comments of Bookspan on Notice of Inquiry No. 1 in Regard to Domestic Mail Classification Schedule and Data Collection Plan Language, November 15, 2005; Response of United States Postal Service to Notice of Inquiry No. 1, November 15, 2005; Reply Comments of Bookspan on Notice of Inquiry No. 1, November 21, 2005; Reply of the United States Postal Service to Comments of the Newspaper Association of America on Notice of Inquiry No. 1, November 21, 2005.

¹⁶² See PRC Op. MC2002-2 (May 15, 2003), ¶¶ 9007-29; PRC Op. MC2004-3 (Dec. 17, 2004), ¶¶ 6127-6130; PRC Op. MC2004-4 (Sept. 30, 2004) at 49-51; PRC Op. MC2005-2 (May 20, 2005) at 44-46.

¹⁶³ OCA Brief at 36; OCA Reply Brief at 17.

purpose of the NSA, the Postal Service would consider the appropriate course of action, which could include exercising its unconditional right to terminate the agreement with 30 days' notice.

Tr. 2/65. The Commission finds that, under the circumstances here, witness Yorgey's response provides an incomplete basis for dealing with the situation that concerns OCA. The Commission agrees with the Postal Service that some protection against this scenario already exists. Specifically, in the Postal Service's monthly monitoring activity under the Bookspan NSA, the Postal Service will be scanning for anomalies in volumes and will initiate a more close analysis as to the cause of these anomalies — whether it be that Bookspan is acting as a "presort bureau" or otherwise. Nonetheless, the Commission agrees with OCA that specific data collection on strategic business alliance inserts will prove valuable to the Postal Service and the Commission in the negotiation and review of future NSAs as well as providing key additional information to keep Bookspan from acting as a presort bureau without the Postal Service's knowledge. Accordingly, the Commission recommends that the following provision be added to the data collection plan: "Bookspan and the Postal Service shall provide the Commission with the volume of solicitation Standard Mail letter-size mailpieces that included strategic business alliance inserts on a quarterly basis. This information shall be provided by rate category and by whether the mailpieces included one or two inserts."

[4125] As discussed previously, NAA, NNA, Valpak, OCA, and APWU have significant concerns with the reliability the volume estimates submitted in this case. These concerns, which the Commission shares, cannot be eliminated through additional data collection. However, data collection can help temper the effect of negative outcomes under the Agreement since such provisions allow the mailing public and the Commission to monitor the effectiveness of the NSA. Regular data collection also helps the Postal Service keep a watchful eye to make sure the it is receiving the benefit of its bargain. If the data collection shows that the Agreement shifts so that it is no longer in the best interest of the Postal Service and other nonparty mailers, the Service can and should exercise its right under the Agreement — and its obligation to the mailing

community to act in their collective best interest — to unconditional withdrawal from the Agreement. Accordingly, the Commission recommends that the following provision be added to the data collection plan: “...The Postal Service will provide an evaluation of the effectiveness of the Agreement using the Panzar analysis discussed in this opinion and presented in PRC-LR-1. The analysis will utilize the appropriate average elasticity and cost approved by the Commission in the most recently completed rate case at the time of the report, weighted by Bookspan’s actual volumes under the NSA. It will also use the actual rates paid by Bookspan under the Agreement and those that would have been paid absent the NSA.”

[4126] The data collection and reporting to be required during the NSA are set out below:

1. The volume of solicitation Standard Mail letter-size by rate category in eligible Bookspan accounts; and flat-size mail that would be eligible if mailed as letters, also by rate category. The volumes provided should be comparable to those provided by witness Epp (Bookspan-T-2) in his forecast.
2. The amount of discounts paid to Bookspan for solicitation Standard Mail letter-size by incremental volume block.
3. Monthly estimates of the amount of time spent on compliance activity and a description of the activities performed.
4. A comparison of the estimated mailer-specific costs and revenues with the actual mailer-specific costs and revenues.
5. As part of each data collection plan report, the Postal Service will provide an evaluation of the impact of the Agreement on contribution.
6. The Postal Service will provide an evaluation of the effectiveness of the Agreement using the Panzar analysis discussed in this opinion and presented in PRC-LR-1. The analysis will utilize the appropriate average elasticity and cost approved by the Commission in the most recently completed rate case at the time of the report, weighted by Bookspan’s actual volumes under the NSA. It will also use the actual rates paid by Bookspan under the Agreement and those that would have been paid absent the NSA.
7. In addition, the Postal Service will provide a narrative comparison of Bookspan’s actual volumes by rate category with:

- a. Before-rates forecast
- b. After-rates forecast
- c. Subclass totals
- d. Relevant benchmarks (such as book companies, publishers, negative option customers) based on research using available and/or commissioned sources where possible.

This will include an analysis of any significant exogenous impacts, e.g., Hurricane Katrina.

8. Bookspan and the Postal Service shall provide the Commission with the volume of solicitation Standard Mail letter-size mailpieces that included strategic business alliance inserts on a quarterly basis. This information shall be provided by rate category and by whether the mailpieces included one or two inserts.

An annual report of the data collected and the information analyzed will be provided to the Commission yearly within 120 days of the NSA anniversary date. Items 1 and 3 are to be reported as monthly data for the previous year of the Agreement. Items 7 and 8 shall be provided every six months within 30 days of the ending of that six month period. The Postal Service shall provide the data in a PC-available format.

H. Conclusion

[4127] Having made the above determinations, the Commission has reviewed the evidentiary record pursuant to its statutory obligation under Chapter 36 of Title 39 of the U.S. Code. This includes a review of the testimony of Postal Service witnesses Yorgey and Plunkett, the testimony of Bookspan witnesses Posch and Epp, the designated written cross-examination, the designated responses to Presiding Officer Information Requests, the responses to Notice of Inquiry No. 1, and the briefs filed by the participants. This review leads to the conclusion that the record supports the recommended classification changes and the related discounts set forth in Appendices One and Two of the accompanying Recommended Decision.

UNITED STATES OF AMERICA
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners:

George Omas, Chairman;
Dawn A. Tisdale, Vice Chairman;
Ruth Y. Goldway; and Tony Hammond

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

Docket No. MC2005-3

RECOMMENDED DECISION

(Issued May 10, 2006)

The Commission, having considered the Postal Service Request, has issued its Opinion thereon. Based on that Opinion, which is attached hereto and made a part hereof,

IT IS ORDERED:

1. The Commission's Opinion and Recommended Decision shall be transmitted to the Governors and shall thereby be advised that the proposed discounts (set forth in Appendix One) and the proposed amendments to the Domestic Mail Classification Schedule (set forth in Appendix Two) are in accordance with the policies of Title 39,

United States Code, and the factors set forth in §§ 3622(b) and 3623(c) thereof, and they are hereby recommended to the Governors for approval.

2. Except to the extent granted or otherwise disposed of herein, all pending motions, exceptions, and other outstanding requests filed in Docket No. MC2005-3 hereby are denied.

By the Commission.

(S E A L)

A handwritten signature in cursive script, reading "Steven W. Williams".

Steven W. Williams, Secretary

CONCURRING OPINION OF CHAIRMAN OMAS
AND COMMISSIONER HAMMOND

It is my firm belief that thoughtfully crafted Negotiated Service Agreements hold great promise as significant new sources of Postal Service revenue. Similar to worksharing, Negotiated Service Agreements offer the Postal Service a unique and highly adaptable tool in building mail volume by better serving individual postal customer needs. Each baseline proposal, however, presents its own challenges, and care must be taken to ensure that such customized agreements work to benefit all mailers as a whole.

If an individual mailer is poised to team with the Postal Service in a fashion that grows USPS net revenues, extending that mailer an incentive benefiting both parties is good business practice. When these same incentives are made available to similarly situated mailers, and the terms of the arrangement do no harm to other mailers, we have negotiated a win-win Agreement. A joint engagement of interested mailers, the Postal Service, and the Postal Rate Commission in effectively framing such arrangements bodes well for the future of Negotiated Service Agreements, as well as the longer term viability of the entire postal delivery system.

Worksharing today has matured as a flourishing, commonplace Postal Service practice. A key driver of the worksharing success story has been this Commission's prudent use of efficient component pricing principles in guarding the interests of every mailer. Just as workshare discounts are regularly reviewed by both the Postal Service and the Commission, Negotiated Service Agreements too must be diligently monitored to guarantee positive, profitable outcomes.

The baseline NSA proposal at hand involves special rate incentives designed to generate additional mail volumes through a multiplier effect. That is, mail receiving discounts generates further mailings in other mail classes that afford significant contributions toward institutional costs.

The Commission has established rules applicable to Negotiated Service Agreements directing the Postal Service to identify to the extent possible, specific costs and revenues of the mail for which the Agreement is intended. As described in the Commission's Opinion, the Postal Service in this instance instead assumed subclass average costs and revenues. The rules require, also to the extent possible, elasticity estimates of the mail for which a Negotiated Service Agreement is requested. The scope of Postal Service efforts to independently estimate the elasticity of mailers is a continuing source of contention, and in this case an independent estimate was not presented.

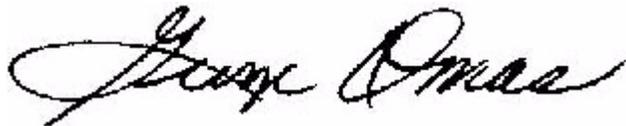
A number of participants challenged these aspects of the Postal Service proposal, expressing concerns that mailers not party to the Agreement would be at unreasonable risk of financial harm due to uncertainties in this area. Although the Commission concluded that in this case the risks to nonparticipating mailers are not unreasonable, matters of this nature do require thorough resolution.

The Postal Service and the mailing community do not favor, nor does the Postal Rate Commission require, the stop-loss cap concept utilized in previously approved Negotiated Service Agreements. Such a component is not proposed in this case. The provision in this Agreement allowing either party to discontinue the NSA with 30 days notice is a critical safeguard mitigating the call for a stop-loss type measure. It is crucial to note that such terms presume that the Postal Service is committed to maintaining a vital role in policing such NSAs going forward.

The development of NSAs is an evolutionary process, perhaps in its infancy still. Congress is clear in its support of Negotiated Service Agreements and I am certain that the future of a truly innovative Postal Service will include NSAs. I am hopeful that the methodology recently presented by the Commission for developing volume discounts in the Bank One reconsideration may provide helpful insight and guidance to both the Postal Service and its mailing partners as they contemplate future NSA proposals. This

Commission will carry on its endeavors to seek new ways to expressly enhance the review of NSAs.

Finally, I encourage the Postal Service to continue its work with the mailing community, and this Commission, in promoting an environment wherein Negotiated Service Agreements can thrive and reach their fullest potential. I remain convinced that we have only begun to explore the tremendous value of NSAs.

A handwritten signature in black ink, reading "George Omas". The signature is written in a cursive, flowing style with a large initial "G".

George Omas, Chairman

A handwritten signature in black ink, reading "Tony Hammond". The signature is written in a cursive, flowing style with a large initial "T".

Tony Hammond, Commissioner

DISSENTING OPINION OF COMMISSIONER GOLDWAY

I am not joining with my fellow Commissioners in favorably recommending that the Postal Service proceed with implementing the Bookspan Negotiated Service Agreement. The majority opinion does include a thoughtful explication of several of the problems that I enumerate below. Unfortunately, I believe those problems and others are of such significance that approval is simply not appropriate under the provisions of Title 39. Further, I am concerned that the Commission's Decision sends confusing signals to the Postal Service and its potential Negotiated Service Agreement partners jeopardizing future agreements.

First, all previous Negotiated Service Agreements, as recommended, protected mailers not party to the Agreement from having to make up contributions lost from unintentionally paying discounts on mail that otherwise would have been mailed at the established rate. The Bookspan Decision provides too little protection.

Second, the Commission's Negotiated Service Agreement rules require rigorous evidentiary presentations for new baseline cases. This allows functionally equivalent requests to be handled more expeditiously. The Commission was encouraged by the Declaration of Michael K. Plunkett presented on reconsideration in the Bank One case that the Postal Service was developing independent tests of mailer-supplied volume estimates. The Postal Service's presentation in Bookspan does not approach the example set in Mr. Plunkett's Declaration. The Commission should be more forceful in signaling the Postal Service to provide more support for and be more forthcoming in its baseline Negotiated Service Agreement requests.

Finally, the Postal Service should be aware of the chilling effect that just one failed Negotiated Service Agreement could have on the entire Negotiated Service Agreement program. I would like the Postal Service to be successful in its Negotiated Service Agreement endeavors. Thus, I believe that the Postal Service needs to place more emphasis on due diligence, and should share the results of these efforts with the Commission when presenting its Negotiated Service Agreement requests.

The volume estimates presented on the record in this case suffer from infirmities similar to those present on the Capital One and Bank One Negotiated Service Agreement records. In those cases, as in the instant case, the Commission could not rely on the mailer-provided volume estimates. The Commission was unable to find that the Postal Service would not be made financially worse off by entering into this Agreement. And the Commission expressed concern that this created unreasonable risk, and that the burden of recovering from this risk would unfairly fall largely on captive monopoly mailers not party to the Agreement. Fortunately, the Capital One and Bank One agreements included cost savings features that could be employed (in the form of stop-loss caps) to counterbalance the risks associated with unreliable volume estimates. This permitted the Commission to issue favorable recommendations. The Bookspan agreement, however, does not offer a comparable method to protect mailers not party to the Agreement. Therefore, I believe this Agreement does not meet one of the essential obligations which the Commission must require of the Postal Service. I cannot and do not recommend that the Postal Service proceed with the Agreement.

The Commission relies heavily on the “multiplier effect” to tip its decision in favor of recommending that the Postal Service proceed with the Agreement. While I do not dispute that Bookspan may exhibit a multiplier effect, the nebulous characterization of the Bookspan multiplier effect presented on the record does not allow me to accord this factor much weight.

First, the economic impact of the multiplier effect is not quantified. Without quantification, it is not possible to determine to what extent, if any, the multiplier effect counterbalances the risks associated with unreliable volume estimates. Second, there is no requirement that Bookspan continue to utilize the Postal Service for its fulfillments. Thus, a substantial component of the multiplier effect could evaporate if Bookspan so chooses. Finally, because the multiplier effect is not relied on by the Postal Service in evaluating the financial impact of the Agreement, and the rationale for limiting functionally equivalent agreements as described in the Domestic Mail Classification

Schedule is not adequately explained, potential similarly situated mailers attempting to obtain comparable agreements may find the application of the multiplier effect requirement arbitrary, and possibly discriminatory in effect.

The Commission also relies heavily on the contract provision which allows the Postal Service to terminate the Agreement with 30 days' notice. The ability to terminate without cause provides the Postal Service with an important safety valve, which offers protection from unexpected results. However, it does little to add protection from the risks identified from unreliable volume estimates. The termination provision assumes that the Postal Service sufficiently monitors the progress of the Agreement, and that the metrics exist to decide when to exercise this provision. Without reliable before-rates volume estimates, the Postal Service lacks the critical information needed as a starting point to evaluate whether or not the Agreement is progressing as planned. The Postal Service may not be able to determine, even after the fact, the point at which the Agreement becomes no longer beneficial.¹ If the Postal Service can not determine this turning point, it can not determine when to exercise the termination provision. Further, the contract provision is not implemented automatically. This allows freedom for an agreement to continue, whether or not it remains beneficial.

Several participants, American Postal Workers Union, AFL-CIO; Newspaper Association of America; National Newspaper Association; Office of the Consumer Advocate; Valpak Direct Marketing Systems, Inc.; and Valpak Dealers' Association, Inc., oppose the implementation of the Bookspan agreement. Arguments were presented questioning the validity of the volume estimates, the use of system-wide versus mailer-specific data, the sufficiency of the cost data, the basis of the multiplier effect, and the absence of a requirement in regard to conversion of solicitation flats to letters. To the extent that each argument is valid, the concerns raised by this group of intervenors

¹ Without mailer-specific inputs, the Panzar test referenced in the Commission's Decision only provides an indication of where the Agreement turns unbeneficial.

further weigh in favor of not recommending that the Postal Service proceed with the Bookspan agreement.



Ruth Y. Goldway, Commissioner

RECOMMENDED CHANGES IN RATE SCHEDULES

The following changes represent the rate schedule recommendations of the Postal Rate Commission in response to the Postal Service's Docket No. MC2005-3 Request. The changes require the addition of three new rate schedules — 620A, 620B, and 620C. The underlined text signifies that the text is new, and shall appear in addition to all other rate schedule text.

BOOKSPAN NSA
RATE SCHEDULE 620A
(FIRST YEAR OF AGREEMENT)

<u>Volume Block¹</u>	<u>Incremental Discounts</u>
<u>87,000,001 to 120,000,000</u>	<u>2.0¢</u>
<u>120,000,001 to 150,000,000</u>	<u>3.0¢</u>

1 Volume block beginning and ending thresholds are subject to adjustment for mergers or acquisitions by adding the new entities' volume in accordance with DMCS § 620.24.

BOOKSPAN NSA
RATE SCHEDULE 620B
(Second Year of Agreement)

Volume Block¹

Incremental Discounts

85,000,001 to 110,000,000

2.0¢

110,000,001 to 150,000,000

3.0¢

1 Volume block beginning and ending thresholds are subject to adjustment for mergers or acquisitions by adding the new entities' volume in accordance with DMCS § 620.24.

BOOKSPAN NSA
RATE SCHEDULE 620C
(Third Year of Agreement)

<u>Volume Block¹</u>	<u>Incremental Discounts</u>
<u>94,000,001 to 100,000,000</u>	<u>1.0¢</u>
<u>100,000,001 to 120,000,000</u>	<u>2.0¢</u>
<u>120,000,001 to 150,000,000</u>	<u>3.0¢</u>

1 Volume block beginning and ending thresholds are subject to adjustment for mergers or acquisitions by adding the new entities' volume in accordance with DMCS § 620.24.

**RECOMMENDED CHANGES IN
DOMESTIC MAIL CLASSIFICATION SCHEDULE**

The following material represents changes to the Domestic Mail Classification Schedule recommended by the Postal Rate Commission in response to the Postal Service's Docket No. MC2005-3 Request. The underlined text signifies that the text is new, and shall appear in addition to all other Domestic Mail Classification Schedule text. Information to be added upon approval by the Board of Governors appears in brackets and is underlined.

**NEGOTIATED SERVICE AGREEMENTS
CLASSIFICATION SCHEDULE**

620 **BOOKSPAN NEGOTIATED SERVICE AGREEMENT**

620.1 **Eligible Standard Mail**

620.11 **Bookspan.** Eligible Standard Mail under this section is defined as Standard Mail letter-shaped pieces sent by Bookspan for the purpose of soliciting book club membership: (1) of persons who are not current subscribers to the book club or clubs Bookspan is promoting in the mailing; or (2) of book club members whose membership is expiring. Such pieces may be sent by Bookspan, by entities in which Bookspan holds controlling shares, or by their vendors on their behalf. Such pieces may include up to two inserts promoting Bookspan's strategic business alliances. Under no circumstances are periodic Current Member club mailings which offer the cycle's Featured Selection, as well as other club selections and offerings, eligible to be counted and receive discounts under the Agreement, even if they contain solicitations to renew membership in that club or to join other clubs.

620.12 **Other Mailers.** Functionally equivalent NSAs, involving declining block rates for Standard Mail letters for the purpose of acquiring customers for programs involving recurring mailings offering merchandise, may be entered into with other customers demonstrating a similar or greater multiplier effect and implemented pursuant to proceedings under Chapter 36 of Title 39, of the United States Code. For a mailer to have a similar or greater multiplier effect, at least six times per year, that mailer must send a continuing series of marketing mail, 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 use at least one other subclass for merchandise fulfillment.

620.2 **Standard Mail Declining Block Rates**

620.21 **Volume Commitments.** The following volume commitments for otherwise eligible letter-shaped Standard Mail pieces must be met before any discounts under this section are payable:

- a. 94 million for the first year of the Agreement;

- b. 95 million for the second year of the Agreement, subject to adjustment as specified below; and.
- c. 105 million for the third year of the Agreement, subject to adjustment as specified below.

If Bookspan does not mail at least 73 million pieces during the first year of this Agreement, it will pay the Postal Service a one-time transaction fee of \$200,000.

620.22 **Volume Commitment Adjustment Mechanism.** At the end of each year of the Agreement other than its final year, the volume commitment for the following year will be adjusted, as follows:

- a. If, at the end of the year, actual volume is 12 percent or more above that year's volume commitment, the following year's commitment will be revised to be the average of the completed year's actual volume and the original volume commitment for the following year.
- b. If, at the end of the year, actual volume is 5 percent or more below that year's volume commitment, the following year's commitment will be decreased by the percentage difference between the completed year's original volume commitment and its actual volume, but in no case to lower than 90 million.

620.23 **Incremental Discounts.** Bookspan's eligible Standard Mail is subject to the otherwise applicable Standard Mail postage in Rate Schedule 321A, 321B, or 322 less the discounts shown in Rate Schedule 620A for the first year of the Agreement, in Rate Schedule 620B for the second year of the Agreement, and in Rate Schedule 620C for the third year of the Agreement, if Bookspan meets the applicable volume commitments specified in 620.21, or as adjusted in accordance with 620.22. Each incremental discount applies only to the incremental volume within each volume block.

620.24 **Volume Block Adjustments for Mergers and Acquisitions.** In the event that Bookspan merges with and/or acquires an entity or entities and/or purchases a portfolio with annual Standard Mail volume in excess of 5 million pieces, the volume blocks will be adjusted to add the volume of Standard Mail sent by the merged or acquired entity during the 12 months preceding the merger, acquisition, or purchase. The adjustment becomes effective for the succeeding fiscal quarter immediately following the date that mail volumes due to the merger, acquisition, or purchase begin to be mailed through the threshold permit accounts.

620.25 **Termination.** The Agreement automatically terminates and eligibility for all discounts under this section ceases if Bookspan's Standard Mail letter solicitation volume exceeds 150,000,000, or if the Agreement is terminated by either party with 30 days' written notice to the other party.

620.4 **Rates**

The rates applicable to this Agreement are set forth in Rate Schedules 620A, 620B, and 620C.

620.5 **Expiration**

The provisions of section 620 expire on [insert date three years from implementation date set by the Board of Governors].

620.6 **Precedence**

To the extent any provision of section 620 is inconsistent with any other provision of the Domestic Mail Classification Schedule, the former shall control.

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