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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

RATE AND SERVICE CHANGES TO IMPLEMENT FUNCTIONALLY EQUIVALENT NEGOTIATED SERVICE AGREEMENT WITH BRADFORD GROUP	Docket No. MC2007–4

REPLY BRIEF OF THE UNITED STATES POSTAL SERVICE

UNITED STATES POSTAL SERVICE

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. THERE IS SUFFICIENT RECORD EVIDENCE IN SUPPORT OF THE PROPOSED NSA, AND NO INTERVENOR HAS MADE A COMPELLING ARGUMENT AGAINST THE POSTAL SERVICE'S FINANCIAL MODEL 1

A. The OCA's Criticisms of the Estimated Financial Benefit to the Postal Service Are Not Supported on the Record 1

1. The OCA's attempt to utilize the PAEA to defeat this NSA should be rejected 2

2. The OCA's concerns over non-price exogenous factors are without merit and are based on a flawed understanding of the Postal Service's financial model 4

3. The Bradford Group NSA features several provisions which mitigate the risk of misestimating volumes and the effects of unforeseen events 6

B. ACMA's Concern Over the Use of LR-22 Does Not Counsel Against This NSA 7

III. CONCLUSION 8

I. INTRODUCTION

The United States Postal Service hereby submits its Reply Brief in this proceeding. This Reply Brief primarily responds to the Initial Brief filed by the Office of the Consumer Advocate, the only party who opposes the Bradford Group Negotiated Service Agreement (NSA). The argument put forth by the American Catalog Mailers Association (ACMA) is also addressed briefly in Section II.B.[1] In short, the OCA's arguments against the Bradford Group NSA are not supported by the record evidence, and should be rejected because the OCA seeks to substitute its own business judgment for that of the Postal Service and its co-proponent. The Postal Service respectfully urges the Commission to reject the OCA's unsupported arguments and approve the Postal Service's request to implement the Bradford Group NSA.

II. THERE IS SUFFICIENT RECORD EVIDENCE IN SUPPORT OF THE PROPOSED NSA, AND NO INTERVENOR HAS MADE A COMPELLING ARGUMENT AGAINST THE POSTAL SERVICE'S FINANCIAL MODEL

A. The OCA's Criticisms of the Estimated Financial Benefit to the Postal Service Are Not Supported on the Record

The Office of the Consumer Advocate (OCA), as the only intervenor who opposes this NSA, offers a familiar argument in its Initial Brief. Rather than submitting testimony of its own to try to demonstrate, on the record, how the Postal Service's financial model (in the OCA's view) improperly estimates the financial benefit from this

[1] The only other party to file an Initial Brief, the American Catalog Mailers Association (ACMA), is solely concerned with the precedential value of the use of LR-22 in the Postal Service's financial model. *See* ACMA Initial Brief at 2 ("ACMA does not question the terms of the Bradford Group NSA.").

NSA, the OCA relies upon a flawed argument pertaining to non-price exogenous factors in its Initial Brief. The OCA seems to argue that the Postal Service should control for every non-price exogenous factor imaginable in its financial model (presumably, up to and including "Acts of God"), but at the same time the OCA has not offered any means of doing so on the record. The OCA essentially argues that the Bradford Group NSA should be rejected simply because the Postal Service cannot *guarantee* that non-price exogenous factors will not occur in the future. This line of thinking is wholly unrealistic, as it ignores the Postal Service's ability to make rational business judgments in response to changing economic conditions, and turns a blind eye to the multiple risk-mitigation features inherent in the Bradford Group NSA contract language.[2]

1. The OCA's attempt to utilize the PAEA to defeat this NSA should be rejected.

Despite the fact that the Bradford Group NSA was submitted under the Postal Reorganization Act (PRA), the OCA argues in its Initial Brief that this NSA should meet a higher standard under the Postal Accountability and Enhancement Act (PAEA).[3] The OCA arrives at this point by drawing upon the Opinion and Recommended Decision in the Bank of America NSA (Docket No. MC2007-1), in which the Commission concluded that:[4]

> [T]he enunciated policies and objectives of [the PAEA] are both material and relevant, and that they should be applied under the aegis of "such other factors as the Commission deems appropriate." §§ 3622(b)(9) and 3632(c)(6).

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[2] In fact, it is perhaps telling that the OCA offers no criticism of the risk-mitigation contract provisions in its Initial Brief.
[3] *See* OCA Initial Brief at 1-4.
[4] PRC Op. and Rec. Dec., MC2007-1, at 52.

From this, the OCA concludes that the Bradford Group *must* "improve the net financial position of the Postal Service" in order to be approved.

While the Commission has expressed its view that it may properly consider the PAEA as one of many "factors as the Commission deems appropriate," the OCA takes quite a leap in arguing that the Bradford Group NSA must be held to a new *requirement* under the PAEA, when this docket was clearly initiated under the PRA.[5] In addition, as several parties pointed out in Docket No. RM2007-1, nothing in the PAEA or the Commission's rules support the OCA's view that the PAEA imposes a higher standard for NSAs.[6] Moreover, the OCA seems to claim in its Initial Brief that the PAEA language is a well-developed statutory test, when in reality the parameters of § 3622(c)(10)(A) have not yet been fully explored on the record in this, or any prior, docket. Surely, there will be adequate time and opportunities for parties to debate and litigate the scope of the new rules for NSAs under the PAEA. However, the OCA's attempt to interject a new PAEA "statutory test" at this point in the proceedings, and when this case was submitted under the PRA, should be rejected.

This is not to say, however, that the policies behind the PAEA should be ignored. Rather, they can be considered as one of any number of "factors as the Commission

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[5] *See* OCA Initial Brief at 14 ("Unlike the Bookspan NSA, however, the Bradford Group NSA must be considered under the new statutory tests of the PAEA."); 39 U.S.C. § 3622(c)(10)(A)

[6] *See* Reply Comments of the United States Postal Service in Response to Order No. 26 (October 9, 2007) at 17-20; Reply Comments of Time Warner Inc. in Response to Initial Comments on Commission Order No. 26 (October 9, 2007) at 25-27; Reply Comments of Advo, Inc. in Response to Proposed Regulations Establishing a System of Ratemaking (October 9, 2007) at 5-8; Direct Marketing Association, Inc. Reply Comments Pursuant to PRC Order No. 26 (October 9, 2007) at 1-3.

deems appropriate." The Commission emphasized upon issuing regulations establishing a system of ratemaking (Docket No. RM2007-1):

> [t]he statute seeks to provide the Postal Service with greater pricing flexibility for negotiated service agreements coupled with enhanced transparency and accountability. Requiring a specific formula or model for evaluating agreements is contrary to that intent." Order No. 43 at ¶ 2194.

And as the Bradford Group points out in its Initial Brief, the pricing flexibility afforded by the PAEA actually weighs in favor of approving this NSA. This argument can be found on pages 7-10 of the Bradford Group's Initial Brief, and need not be reiterated here. But introducing a new requirement to this proceeding, which has thus far not been a part of the instant litigation, would not be appropriate.

2. The OCA's concerns over non-price exogenous factors are without merit and are based on a flawed understanding of the Postal Service's financial model.

The vast majority of the OCA's Initial Brief is concerned with the effect of non-price exogenous factors on the Postal Service's financial model and the estimated financial benefit to the Postal Service.[7] The OCA first asserts that the Postal Service has not controlled for the effects of non-price exogenous factors because it did not obtain or develop an elasticity of demand from the Bradford Group.[8] This criticism, however, ignores the fact that there is no assurance on the record that any estimate of customer-specific elasticity in this case would be reliable. As witness Parr's states, "Given that I have three years of data for Bradford Group with only one price change during those years, the development of an own-price elasticity specific to the Bradford

[7] *See* OCA Initial Brief at 4-13.
[8] *Id.* at 5.

Group would result in an unreliable estimate."[9] The OCA has offered no record evidence to demonstrate that such an estimate would in fact be reliable, yet is willing to point out that the absence of such an estimate is a flaw in the Postal Service's financial model because it would help control for non-price exogenous factors.[10]

Unsatisfied with the absence of an unreliable elasticity estimate, the OCA next turns to the Postal Service's "Value to Volume Sensitivity Matrix, Based on Year 1" (Appendix C, Table 1), to attempt to demonstrate the effect of non-price exogenous factors in the absence of customer-specific elasticity. The OCA alters the Postal Service's Sensitivity Matrix by assuming all changes are caused by non-price exogenous factors rather than the discounts from the NSA.[11] In doing so, the OCA attempts to show that the financial benefit of the proposed NSA is much smaller than the Postal Service's model demonstrates.[12]

However, the OCA's argument with respect to non-price exogenous factors is based on a fundamental misunderstanding of the Postal Service's financial model. As explained by witness Parr: [13]

> [T]he methodology used to develop "OCA Exhibit 1" is conceptually flawed. Following long-standing PRC rate-litigation procedures, the financial model contained in my Appendix A is designed to use a before-rates and after-rates forecast which differ only by the volume effect of the proposed price change (in this case, the discounts on offer). Under these procedures, all other factors are assumed to be identical in the before-rates and after-rates forecasts. In a case

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[9] Tr. 2/22 (OCA/USPS-T1-4).
[10] It is important to note that even with a precise and reliable estimate of customer-specific elasticity, non-price exogenous factors could still have an effect, yet would be controlled for (as they are in this case) by risk-mitigation provisions in the contract.
[11] *See* OCA Initial Brief at 7 ("OCA Exhibit 1").
[12] *Id.*
[13] Tr. 2/73-74 (OCA/USPS-T1-43(f)).

> where the assumed change due to price is zero, therefore, the before-rates and after-rates forecasts should be identical, and any assumed difference in a nonprice factor should be represented as an identical change to both the before rates forecast and the after-rates forecast.

In essence, the OCA's manipulation of the Postal Service's Sensitivity Matrix is flawed because it inserts an assumption (about non-price exogenous factors) which is in direct conflict with a fundamental assumption in the Postal Service's financial model; a financial model which has been approved in prior NSAs. Curiously, the OCA was unwilling to put forth such an argument in testimony, and subject it to scrutiny from the co-proponents and other intervenors in this docket. Nevertheless, the record evidence shows that the OCA's attempt to demonstrate its point on brief should be rejected, because it is based on a flawed understanding of the Postal Service's financial model.

3. The Bradford Group NSA features several provisions which mitigate the risk of misestimating volumes and the effects of unforeseen events.

It is important to again emphasize that the Bradford Group NSA contains several risk mitigation provisions, because the OCA's Initial Brief gives these provisions short shrift. The risk mitigation provisions in the Bradford Group NSA are summarized on pages 7-8 of the Postal Service's Initial Brief, and need not be repeated in full here. But the importance of these provisions cannot be forgotten. The volume commitments require the Bradford Group to increase its mail volume before any discounts are paid out. In addition, the adjustment mechanisms allow the agreement to be adjusted in response to a change in circumstances from year to year. Finally, the automatic termination and unconditional withdrawal provisions grant the Postal Service protection from a variety of unforeseen events that may occur in the Bradford Group's business, the mailing industry, and the economy as a whole, all of which may affect the Bradford

Group's volumes. Thus, the OCA's speculative concerns about the supposed prevalence of non-price exogenous factors, and the OCA's claims that these factors are not "controlled for" in the proposed NSA should be rejected because of the presence of multiple risk mitigation provisions.

B. ACMA's Concern Over the Use of LR-22 Does Not Counsel Against This NSA

The American Catalog Mailers Association (ACMA) argues in its Initial Brief that the Postal Service's use of LR-22 rather than LR-15 in its financial model should not become binding precedent for future NSAs. ACMA is quick to point out however, that they do not oppose the terms of the Bradford Group NSA.[14] ACMA's critique of the Postal Service's cost methodology, while a minor one, nevertheless should be ignored by the Commission.

As the record evidence demonstrates, LR-22 encompasses the full range of costs, whereas LR-15 only includes the mail processing costs for some categories of mail, and only the mail processing and delivery costs for others.[15] Essentially, ACMA is arguing to *exclude* entire categories of cost, which would significantly inflate the estimated contribution gain from this NSA. Thus the Postal Service has taken a more conservative (and proper) approach when calculating costs and contribution in its financial model. ACMA's argument aims to keep the door open on a different costing approach for future NSAs (even if it means neglecting entire categories of cost), while

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[14] *See* ACMA Initial Brief at 2 ("ACMA does not question the terms of the Bradford Group NSA.").
[15] Tr. 2/48-49 (OCA/USPS-T1-27).

not taking issue with the NSA at hand.[16] Therefore, ACMA's argument should be ignored because it has no bearing on the outcome of the instant docket.

III. CONCLUSION

The OCA, the only party that opposes the Bradford Group NSA, attempts in its Initial Brief to impose a new requirement that the Postal Service must predict the future with certainty, and guarantee that non-price exogenous factors will never affect this NSA. The OCA's argument ignores the multiple risk-mitigation features in the contract, as well as the Postal Service's ability to make rational business decisions in the face of unforeseen events or changing circumstances. Certainly, the OCA's view does not afford the Postal Service any pricing flexibility as Congress intended under the PAEA, much less the ability to utilize basic business judgment under the PRA.

For the reasons set forth above, and in the Postal Service's Initial Brief, the Postal Service respectfully urges the Commission to recommend the proposed NSA and adopt the classification language and rates set forth in Attachments A and B to the Postal Service's Request.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

[16] In essence, ACMA does not challenge the size of Bradford Group's "slice of the pie," how it was cut, or how it was served. ACMA simply yearns for a larger pie to slice next time.

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