Postal Regulatory Commission
Submitted 2/4/2008 4:27:21 pm
Filing ID: 58870
Accepted 2/4/2008

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

Rate and Service Changes to Implement Baseline Negotiated Service Agreement With Life Line Screening	)))	Docket No. MC2007-5

INITIAL BRIEF OF THE
OFFICE OF THE CONSUMER ADVOCATE
(February 4, 2008)

The Postal Service has requested Commission approval of a Negotiated Service Agreement ("NSA") with Life Line Screening.[1] The standards for approval of this NSA can be found in the Commission's opinion in the Bank of America NSA. The NSA at issue in this proceeding fails to meet those standards.

I. THE LIFE LINE SCREENING NEGOTIATED SERVICE AGREEMENT MUST SATISFY THE STATUTORY STANDARD TO IMPROVE THE NET FINANCIAL POSITION OF THE POSTAL SERVICE ESTABLISHED IN THE POSTAL ACCOUNTABILITY AND ENHANCEMENT ACT; THAT STANDARD HAS NOT BEEN MET

With enactment of the Postal Accountability and Enhancement Act (PAEA), the Postal Service and Commission entered a new era with respect to the consideration and evaluation of negotiated service agreements. The Life Line Screening ("LLS") negotiated service agreement is the third agreement to be considered subsequent to enactment of the PAEA. The first NSA to which the policies and objectives of the PAEA

[1] *See* "Request of United States Postal Service for a Recommended Decision on Classifications and Rates to Implement a Baseline Negotiated Service Agreement with Life Line Screening," August 8, 2007.

were applied by the Commission was the negotiated service agreement with Bank of America (BAC).

In its recommended decision on the Bank of America NSA, the Commission concluded that:[2]

> [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).

As a "clear Congressional expression of public policy,"[3] the PAEA recognizes the desirability of special classifications that improve the net financial position of the Postal Service or enhance Postal Service operations. More specifically in this regard, negotiated service agreements must:

> (A) either—
> (i) improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service; or
> (ii) enhance the performance of mail preparation, processing, transportation, or other functions;

Applying the first statutory test, the Commission found that the Bank of America NSA would not improve the net financial position of the Postal Service:[4]

> The Commission estimates that the Postal Service will realize less net contribution as a result of entering into this Agreement than it would have without the Agreement.

---

[2] PRC Op. MC2007-1 (Bank of America Opinion and Recommended Decision), at 52.

[3] *Id.*

[4] *Id.*, at 50. However, the Commission observed that, "The net reduction in contribution as a result of proceeding with the Negotiated Service Agreement does not significantly reduce the overall level of contribution provided by BAC's mail." *Id.*, at 42.

In addition, the Commission gave consideration to potential, but unquantified, operational benefits flowing from the NSA, which provided incentives to encourage BAC to improve the processing and quality of its mail, and served to promote use of other advanced mail processing systems. The Commission concluded:[5]

> To the extent that it achieves these objectives, the Agreement should enhance "the degree of preparation of mail for delivery into the postal system performed by the mailer" and have a positive "effect upon reducing costs to the Postal Service." § 3622(b)(6).

These are the only considerations expressed by the Commission that could "help mitigate the adverse financial impact" of the net loss in contribution, and led the Commission to recommend the Bank of America NSA.[6]

Unlike the Bank of America NSA, however, the LLS NSA lacks any incentives designed to cause Life Line Screening to enhance postal operations, in satisfaction of the second statutory test. Consequently, the PAEA's first statutory test, which requires that an NSA improve the net financial position of the Postal Service, is alone applicable to the LLS NSA.

OCA submits that the LLS NSA cannot satisfy the first statutory test, and therefore is not a desirable special classification worthy of recommendation by the Commission. As explained in more detail below, the Postal Service has not demonstrated on this record, and cannot show, that the LLS NSA will improve the net financial position of the Postal Service.

---

[5] *Id.*, at 51.

[6] *Id.*

II. THE POSTAL SERVICE DID NOT AND CANNOT SHOW THAT THE LIFE LINE SCREENING NEGOTIATED SERVICE AGREEMENT WILL IMPROVE THE NET FINANCIAL POSITION OF THE POSTAL SERVICE

As designed, the Postal Service's financial model cannot be used to show that the LLS NSA will improve the net financial position of the Postal Service. The Postal Service's financial model fails to acknowledge or control for the effects of non-price exogenous factors on Life Line Screening's eligible Standard Mail volumes, producing an estimate of the financial value of the agreement that lacks credibility.

A. The Postal Service's Financial Model Does Not Acknowledge, or Control for, the Effect of Non-Price Exogenous Factors in Changing Demand for Standard Mail Letters

The Postal Service presents its financial model for the LLS NSA in Appendix A of the testimony of witness Michelle Yorgey (USPS-T-1).[7] As in all previous NSAs, the Postal Service relies on the point volume estimates provided by the NSA partner, in this case Life Line Screening, to estimate an NSA's financial value. Such reliance is imprudent, absent an independent analysis more sophisticated than the cursory trend analysis and simple internet market research presented in this proceeding.[8] As a mailer responding to economic incentives, Life Line Screening has a natural, and not unanticipated, bias to provide volume estimates producing a favorable financial result. In order to claim discounts on a larger quantity of eligible mail, "it is well recognized that potential Negotiated Service Agreement partners will face a strong temptation to

---

[7] Testimony of witness Yorgey (USPS-T-1), Appendix A.

[8] *See* Testimony of witness Yorgey (USPS-T-1), at 7-9.

provide estimates that tend to support generous agreements."[9] Such estimates might involve a pessimistic (or "low") before-rates volume estimate or an optimistic (or "high") after-rates estimate, or both.

Moreover, Life Line Screening's point volume estimates are affected by non-price exogenous factors including, among others, changes in corporate financial goals or marketing strategies. Such goals and marketing strategies, and the decisions underlying them, are not transparent to the Postal Service. In fact, Life Line Screening's marketing strategy is to seek to continue growing while simultaneously reducing use of the mail.[10] As a result, the effect of these decisions on point volume estimates cannot be determined because they cannot be replicated by the Postal Service or otherwise independently evaluated. This, in turn, prevents the Postal Service from isolating discount-induced volume from volume caused by such exogenous factors inherent in Life Line Screening's point volume estimates. Nevertheless, the Postal Service accepts without change Life Line Screening's point volume estimates by incorporation of such estimates into its financial model.[11]

The Postal Service's financial model for LLS NSA is inherently flawed in another respect. As introduced, the most troubling assumption underlying the model is that the

---

[9] PRC Order No. 1450 at 16 (citing Docket No. MC2002-2, Tr. 8/1651, PRC Op. MC2002-2 (Capital One), para. 5094).

[10] *See* Confidential Responses of Witness Greenberg to Interrogatories of the Office of the Consumer Advocate, OCA/LLS-T1-6 and 8(f), September 25, 2007; Order No. 36, September 14, 2007. Interrogatory 6 was not protected by Order No. 36 and should have been answered publicly. *Id.* at 3: "[A]ny responses or partial responses to these interrogatories that do not require revealing the relationships with specific entities are to be answered publicly . . . ." The response to Interrogatory 8(f) did not reveal "internal communications between management and employees," *id.* at 5, n.6, and should have been filed publicly.

[11] *Compare* testimony of witness Greenberg (LLS-T-1), at 10, and testimony of witness Yorgey (USPS-T-1), Appendix A, page 2.

NSA's price incentives are solely responsible for anyincrease in Life Line Screening's volumes that exceed the before-rates volume forecast during the three-year term of the agreement. Acceptance of this assumption permits the Postal Service to estimate discounts "paid" to Life Line Screening and to calculate the net contribution. However, the Postal Service fails to acknowledge the existence of non-price exogenous factors inherent in Life Line Screening's point volume estimates incorporated into its financial model. Nor does the Postal Service control for the effects of non-price exogenous factors in its model. Instead, the Postal Service simply ignores the existence of non-price exogenous factors *assuming* they will have no effect on the results produced by the financial model—rather than explicitly controlling for their effect in its model.

The traditional economic approach to control for the effect of non-price exogenous factors is through the use of a price elasticity of demand. Only by using such an elasticity specific to the NSA partner can a realistic estimate of the net contribution to the Postal Service be derived for volumes attributable to the NSA's discounted rates, rather than non-price exogenous factors. In this proceeding, however, the Postal Service did not obtain from Life Line Screening, or otherwise rely on, an elasticity of demand specific to Life Line Screening for use in its financial model, as no such elasticity is presented on this record.

Even in the absence of a mailer-specific elasticity of demand, the Postal Service ignores *other options* to control for the effects of non-price exogenous factors in its financial model, such as using the relevant subclass elasticity or, in the case of Life Line Screening, a weighted average elasticity reflecting Life Line Screening's use of the Standard Mail Regular and ECR subclasses. At a minimum, the Postal Service could

have (but did not) calculate the price elasticity of demand implicit in the agreement, based upon the NSA's discounted rates, and Life Line Screening's before-rates and after-rates point volume estimates, as a test of the plausibility of those point volume estimates. Rather, the Postal Service perseveres with its inherently flawed financial model.

The consequence of relying on Life Line Screening's point volume estimates in the financial model, and the Postal Service's inability to verify such estimates, is that all risk of error is borne solely by the Postal Service. Unlike the Postal Service, however, whose expected contribution is entirely dependent upon the entry of discount-induced eligible mail, Life Line Screening is indifferent to the existence of non-price exogenous factors that cause actual volumes to vary from its point volume estimates. Since non-price exogenous factors are always present, and will affect Life Line Screening's mail volumes with or without the NSA, Life Line Screening is ensured a positive financial outcome—or will be at least no worse off—because of the NSA. Life Line Screening will experience a reduction in postage prices for entering additional volumes exceeding the NSA's discount thresholds that are prompted for any reason.

Several scenarios demonstrate the asymmetric nature of the risks and benefits under the LLS NSA. If Life Line Screening is induced by the NSA's price incentives to enter additional mail volume, the added amount of postage paid by Life Line Screening decreases. In this case, Life Line Screening is better off than prior to the NSA and so is the Postal Service,which receives "new" contribution. By contrast, if Life Line Screening's mail volume increases because of non-price exogenous factors, Life Line Screening still earns discounts on its mail. However, the volume increase and resulting

contribution to the Postal Service would have occurred even in the absence of the NSA. In this case the Postal Service is worse off since it "paid" discounts for volumes that would have occurred in any event, i.e., "anyhow" volume.[12]

This analysis forms the basis for the Commission's conclusion that:[13]

> [A]ll risk related to volume forecasts used as the basis for unrestricted volume discounts is borne by the Postal Service and other mailers not party to the agreement.

The Commission's conclusion also makes clear that the Postal Service must not be indifferent to the existence of non-price exogenous factors in its financial model.

B. The Postal Service Can Never Know Whether Volumes in Excess of NSA's Thresholds Are Induced by Discounts or Non-Price Exogenous Factors, Rendering the Risk Mitigation Features of the NSA Irrelevant

The Postal Service will not be able to determine whether any increase in volume occurring during operation of the Life Line Screening NSA (if approved) is caused by discounts, and therefore improves the net financial position of the Postal Service, or by non-price exogenous factors. As explained above, Life Line Screening will pay less postage under the NSA on all of its actualvolumes up to the volume cap of 128 million in Year 1 (and 126 million in Years 2 and 3), whether those actual volumes are induced by the discounts or caused by non-price exogenous factors. However, for the Postal Service to receive an increase in contribution above what would be realized absent the LLS NSA requires that "additional mail volume is caused by the incentive to mail

---

[12] There is another possible outcome that, while important, is not relevant to this discussion: Non-price exogenous factors could cause a decrease in the volume entered by Life Line Screening. In this case, both Life Line Screening and the Postal Service would be worse off. However, the decrease in Life Line Screening's volumes would have occurred even in the absence of the NSA. Nevertheless, the decrease would likely be mitigated somewhat by the NSA's discounted rates.

[13] PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 5007, fn 21.

additional volume (because of the mailer's demand characteristics), and not because of exogenous factors."[14] Under such circumstances, while the Postal Service will earn additional contribution, that contribution will not be "new" to the extent that volume above the discount threshold is caused by non-price exogenous factors.

The Postal Service has long known that, "Once discounts intended to influence mailer behavior are established, it is not possible to 'observe' what mailer behavior would have been without such discounts."[15] The reality of this statement is that no amount of continuous monitoring of actual mail volumes or the use of any data from the NSA's Data Collection Plan (DCP) will permit the Postal Service to determine whether volumes are discount-induced or caused by exogenous factors. Nor can the risk-mitigation features of the NSA contract compensate for the Postal Service's inability to segregate discount-induced volumes from volumes caused by non-price exogenous factors.

While the Postal Service can track actual mail volumes, the Postal Service acknowledged in a recent proceeding that it "will *not* be able to distinguish volume changes caused by the other factors from those generated in response to the discounts."[16] (Emphasis added). In that priorproceeding, t he Postal Service also acknowledged that it does not "possess the data needed to quantify the uncertainty and

---

[14] PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 3006.

[15] Tr. 2/36 (OCA/USPS-T1-16(a)-(b)), citing Docket No. MC2002-2, Tr. 4/767 (Response of Witness Plunkett to POIR No. 2, Question 5).

[16] Docket No. MC2007-4 (herein "Bradford Group NSA"), Tr. 2/26 (OCA/USPS-T1-7(a)); *see also* Tr. 2/54 (OCA/USPS-T1-32).

variability of other non-price outside events for individual mailers (assuming the data for such an analysis exists)."[17]

Moreover, the proposed Data Collection Plan cannot help the Postal Service. In the prior proceeding, the Postal Service observed it was unable retrospectively to use any of the data collected or developed under the proposed DCP to determine whether actual volumes are induced by the NSA's discounts or caused by exogenous factors.[18] Similarly, the Postal Service cannot use any of the data collected or developed in the DCP to determine whether any net contribution received during the pendency of the NSA is the result of the NSA partner's "actual . . . volumes induced by the NSA's discounts rather than volumes caused by all other factors."[19] In the final analysis, the Postal Service concludes that:[20]

> There is no Data Collection Plan that could be created that would allow the Postal Service to distinguish the volumes induced by discounts from volumes caused by all other factors.

Nevertheless, the Postal Service places great confidence in the contractual provisions of the LLS NSA that are proposed to mitigate the Postal Service's financial risk. These risk-mitigating provisions are intended to address the presence of risk by providing mechanisms to adjust for unforeseen circumstances and/or misestimations by either party. One such provision is the NSA's specified volume commitments, which require Life Line Screening to increase its mail volume before any discounts are "paid."

---

17 *Id.*

18 Bradford Group NSA, Tr. 2/31 (OCA/USPS-T1-12(a)).

19 Bradford Group NSA, Tr. 2/31 (OCA/USPS-T1-12(b)).

20 Bradford Group NSA, Tr. 2/32 (OCA/USPS-T1-13).

A second, the "adjustment mechanism," requires increases or decreases in volume thresholds in response to changed circumstances. Lastly, the automatic termination and unconditional withdrawal provisions are presented as a means to protect the Postal Service from non-price exogenous factors, i.e., unforeseen events in Life Line Screening's business, the mailing industry, and the economy as a whole, which may affect Life Line's Screening's actual volumes.

These risk-mitigation provisions are more cosmetic than real. Life Line Screening can still earn discounts on volumes induced by either the NSA's price incentives or non-price exogenous factors before any adjustments, and afterwards—albeit at higher volume levels. And the Postal Service may or may not benefit. Moreover, distinguishing between volumes induced by the discounts and volumes caused by non-price exogenous factors is a prerequisite for exercising the unconditional withdrawal provision of the NSA. As discussed above, the Postal Service's ability to distinguish price-induced volume increases from all other volume increases in "real time" is nonexistent, and therefore precludes it from using this provision of the NSA to adjust for unforeseen circumstances, such as increased volumes caused by exogenous factors, or simple errors in volume estimation.

III. THE POSTAL SERVICE DOES NOT QUANTIFY OR OTHERWISE SHOW THAT LIFE LINE SCREENING'S "MULTIPLIER EFFECT" WILL IMPROVE THE NET FINANCIAL POSITION OF THE POSTAL SERVICE

The Life Line Screening NSA is described as "relatively simple" because it is "designed to provide incentives to Life Line Screening [ ] to increase its use of Standard

Mail letters for selling health care screening services to a nationwide customer base."[21] Based upon the Postal Service's financial model, the sole source of potential additional contribution to the Postal Service that is quantified on this record is the increase in Standard Mail solicitation letter volumes induced by the discounted rates. The LLS NSA does not provide any other quantified or unquantified benefits that would demonstrate an improvement in the net financial position of the Postal Service.

Nevertheless, Life Line Screening offers-up its version of a "multiplier" effect in support of the LLS NSA. Life Line Screening's multiplier effect, presented in the testimony of witness Greenberg (LLS-T-1),[22] is described as a "series of further communications," some by email some by direct mail.[23] However, the financial benefits to the Postal Service of Life Line Screening's multiplier effect are not quantified on this record.

Moreover, the LLS NSA must be considered under the new statutory tests of the PAEA. Under the former Postal Reorganization Act, the Commission established "reasonable likelihood" of a net increase in contribution as the standard for approving NSAs.[24] Consistent with the PAEA, the Commission proposed (and subsequently established) "must improve the net finances of the Postal Service" as the standard for approving NSAs.[25]

---

[21] Testimony of witness Yorgey (USPS-T-1), at 1.

[22] Testimony of witness Greenberg (LLS-T-1), at 4-5.

[23] *Id.*, at 4.

[24] PRC Op. MC2004-3, (Bank One Opinion and Further Recommended Decision), para. 5010.

[25] Docket No. RM2007-1, Order No. 26, "Order Proposing Regulations to Establish a System of Ratemaking," August 15, 2007, at 38.

Given the Postal Service's inherently flawed financial model, the absence of any other quantified benefits to the Postal Service under the LLS NSA, and the requirement that the NSA now" *must* . . . [i]mprove the net financial position of the Postal Service,"[26] the Commission must reject the LLS NSA, as it fails to meet either statutory test established by the PAEA for approval of NSAs.

Respectfully submitted,

Kenneth E. Richardson[27]
Attorney

Emmett Rand Costich
Attorney

901 New York Avenue, N.W.
Washington, D.C. 20268-0001
(202) 789-6833; Fax (202) 789-6891
e-mail: costicher@prc.gov

[26] Docket No. RM2007-1, Order No. 43, "Order Establishing Regulations for Market Dominant and Competitive Products," October 29, 2007, at 127, § 3010.40(a)(1) (emphasis added).

[27] Designated by the Commission to represent the interests of the general public. "Notice and Order in Filing of Request Seeking Recommendation of Baseline Negotiated Service Agreement," August 10, 2007.