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

Consideration of Worksharing Discount Methodologies	)	Docket RM 2009-3

Comments of
Discover Financial Services
September 8, 2009

Discover Financial Services (DFS) submits these Comments in Response to the Commission's Order on Further Procedural Steps, Order No. 243, issued on July 10, 2009. Comments are due September 11, 2009.

DFS is a financial services company that offers credit card services and other financial service products under the Discover® Card and Discover® brands. It is one of the largest national mailers of First-Class and Standard Mail letters in the United States. DFS's Comments address the costing methodology to be used for Bulk First Class Mail and do not address the relationship of Saturation Mail to High Density Mail.

Summary

DFS' Comments are in three sections. The first section discusses why the PRC should set the attributable cost base for Bulk First Class mail on the actual cost data for Bulk First Class mail. The Second section of DFS' Comments addresses the policy issues raised at pages 4 and 5 of the Postal Regulatory Commission's (PRC) Order 243. The final section addresses several specific points raised by other parties and the

Commission, including 1) why setting the cost basis of Bulk First Class mail at its actual cost level should have no effect on Single Piece First Class mail prices, and 2) why allowing the worksharing requirements of Section 3622(e) to trump accurate cost attribution and market pricing is not appropriate.

I.
The PRC Should Set the Attributable Cost Base For Bulk First Class Mail On the Actual Cost Data.

It is a fundamental principle of business pricing that every business must know its costs on a product by product level and use that information as its starting point for pricing those products. This is the *raison d'etre* for the principle of cost transparency in business and is a prime reason that transparency is one of the core principles of the Postal Accountability and Enhancement Act (PAEA). Indeed, one of the issues Congressman McHugh often discussed during the postal reform debate in Congress was whether the Postal Service or the PRC was using actual cost data to set rates.

Consequently, DFS believes that the PRC should use the actual cost data of a product to set the cost basis of that product under the new statutory regime. Indeed, if the PRC will not use a product's actual cost data, what is the point of having an elaborate and expensive cost tracking system, and having the principle of transparency in the law.

The Postal Service's Cost and Revenue Analysis tells us that the cost of delivering Bulk First Class is: 11.2 cents per piece.[1] To date, the PRC has never sanctioned these costs for use as the cost basis of Bulk First Class mail. It should do

[1] USPS 2008 Public Cost and Revenue Analysis at page 1; PRC Annual Compliance Determination at page 48. That is in sharp contrast to the cost of delivering Single Piece First Class mail which is 25.1

so. Only by using the actual data of Bulk First Class mail costs will the PRC allow the Postal Service to act like a business and allow it to maximize its profits, something even more important now—given the current economic crisis—than it has been in the past.

Previously, the PRC has insisted that the Postal Service use a theoretical construct that was created decades ago before Bulk First Class Mail emerged as a separate product and "real" cost data about the product came into being. Use of that construct—when there was no actual data—once made sense but not anymore. See Comments of the American Bankers Association (ABA) In Response to Notice of Inquiry 3 (NOI 3) in Docket R 2006-1, August 17, 2006; ABA Initial Brief in Docket R 2006-1 at 13-18, December 21, 2006 citing inter alia the factual testimonies of Witnesses Kent ABA-RT-1, Bell NAPM-RT-1, McCormack MMA-RT-1, and Gorham MMA-RT-2.

In using this data to set Bulk First Class prices, the Postal Service should run the cost data through its flow models to break down the data by existing price level and then use that as the cost basis of the prices. Others have also suggested this. See for example the Comments of Mr. Haldi during the August 11, 2009 public forum, Transcript at 98. There are a variety of ways to set the actual cost basis for the different prices levels, and the PRC could call for one more round of comments limited to this narrow issue.

II.
The PRC's Policy Questions.

In response to the policy questions raised by the PRC at pages 4 and 5 of Order 243, DFS suggests that maintaining the traditional link of single piece rates to Bulk First

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cents per piece.

Class mail is arbitrary and captious, in light of the factual evolution of the Bulk First Class Mail market. Moreover, we suggest that while the PAEA does not require any sort of special protection for Single Piece First Class mail, establishing separate classes for Bulk First Class Mail and Single Piece First Class mail with separate caps would be an appropriate action under the present circumstances. Such classes would have to start out with the same quantity of points that have been banked under the current cap in order to be complaint with Section 3622(d).[2]

In terms of defining a "worksharing discount," DFS believes that Section 3622(e) is quite explicit, and that a worksharing discount should be limited to a presorting, prebarcoding, handling, or transportation function that the Postal Service would have to do if the mailer did not.

Finally, DFS can easily envision when a specific price (price is a more accurate term than rate and discount) would reflect avoided cost characteristics, intrinsic cost characteristics, and other factors. In those cases, either option two or three that the PRC spells out at page 5 of Order 243 would be appropriate.[3] Whether option 2 or option 3 would be the better choice would depend upon the circumstances of the market and the price, how much complexity is desirable in the market, and what incentives the Postal Service wished to create and for whom.

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[2] Instead of establishing a separate class of Single Piece First Class mail, it might be better to establish a separate class of First Class Bulk Business Mail and let Single piece First Class Mail remain the sole resident of the traditional First Class.

[3] Option two is to unbundle the price into two components. Option three is to retain the bundle but analytically decompose the price into its worksharing and other components.

III.
Other Matters.

A. Setting Bulk First Class Rates At Actual Cost Levels Should Have No Effect On Single Piece First Class Rates.

There appears to be a hold-over attitude among some in the postal community that Bulk First Class mail and Single Piece First Class Mail are inherently at loggerheads. According to this view, if Bulk First Class Rates go down, Single Piece First Class Rates must go up. DFS does not see why that is true.

Under the old regulatory regime—a closed system where the Postal Service was not to make a profit and should price by factors other than market forces—one rate in a subclass did have to increase if another in the subclass decreased. That, however, is no longer true in the open system created by the PAEA.

In this new and open system, the Postal Service should price each product separately by market forces so that it can not only make a profit, but maximize that profit. Thus, in this new system, no rate should be lowered unless it is going to increase the profits of the Postal Service, or there is some other reason that will lead to higher profitability in the long term. Consequently, lowering Bulk First Class mail rates should only be done if a greater profit would result over the long term. Thus, whatever happens to Bulk First Class Mail, whether prices increase or decrease, and whether they do so by a significant or insignificant amount, there should be no effect on Single Piece First Class mail. Put another way, the products should be priced separately and not be linked.

This principle of individually and separately pricing each product to maximize profit is fundamental to the philosophy of the PAEA and is at the core of the regulatory system embedded in that act. The PRC needs to adopt this principle, if its regulatory activities are to be consistent with the statutory scheme.

B. Allowing The Worksharing Requirements Of Section 3622(E) To Trump Accurate Cost Attribution And Market Pricing Would Be Inconsistent With The PAEA, Inconsistent With The PRC's Finding That Bulk First Class Mail Is A Separate Product, And Negatively Impact The Finances Of The Postal Service.

There has been some suggestion that the PRC should not allow any price difference to exist between Single Piece First Class mail and Bulk First Class Mail that does not reflect avoided cost differences. Such a position is inconsistent *with both* the notion of setting a cost base on the basis of "real" costs *and* the notion of pricing a product according to market forces.

Moreover, the logical result of such a position—that one should not price Bulk First Class mail according to market forces—is inconsistent with the PRC's finding that Bulk First Class mail is a separate product, serves a separate market, and needs to be priced to reflect those separate characteristics. This is a point that even the Public Representative implicitly appears to recognize. PR Comments at 25 (Establishing separate classes for single-piece and presort letters would recognize these distinct product characteristics).

Were the Postal Service to restrict price differences in Single Piece First Class and Bulk First Class Mail to only those supported by avoided costs, the price of Bulk First Class Mail would significantly increase, and those prices would result in a flood of electronic diversion that would negatively impact the Postal Service. For example, were

Bulk First Class mail prices to increase precipitously, DFS would do everything it could to pull its Bulk First Class mail out of the Postal Service and into alternative systems, principally via electronic delivery. Moreover, we believe that virtually every other Bulk First Class mailer would act in a similar fashion. Single Piece First Class mail prices are not an economically viable alternative for DFS to Bulk First Class Mail prices.

Further, we sense that there is a very real possibility that if there were a mass exodus of Bulk First Class mail out of the system, the resultant financial downturn could create a catalyst to trigger additional outflows of other types of mail out of the system. DFS is concerned that in such an atmosphere mailers might well make irrational choices and pick alternatives to mail that were less effective and more expensive.

C. The Theory Of a Reversion Of Bulk First Class Mail to Single Piece First Class Mail Is Not Realistic.

The notion of any substantial portion of Bulk Business Mail reverting to Single Piece First Class mail is not realistic. Just because First Class Single Piece mail was what businesses used to deliver statements before the advent of Bulk First Class mail three decades ago, it does not follow that it is still a viable alternative.

Imagine a federal transportation agency using an analysis that suggests that if gasoline prices go too high, then there would be a massive “reversion” among the American public to horse-drawn transportation because that is the mode of transportation that people used before the advent of the automobile. While some people, somewhere, somehow, would stop using automobiles and start using horses, not many people would do so overall. It no longer is a viable alternative.

So it is with Bulk First Class mail. Were Bulk First Class Rates to go too high (or disappear entirely) some Bulk First Class mailers—somewhere, somehow—would surely revert to Single Piece First Class, but overall very few would do so. Technology has rendered that way of doing business obsolete and as such it is no longer a viable alternative.

D. Chairman Goldway's Question.

During the August 11 public forum, Chairman Goldway asked a question that if one separated Single Piece First Class Mail and Bulk First Class Mail into separate classes, what would be the benchmark for Presort Mail to determine what the appropriate workshare discount is.

If by benchmark, Chairman Goldway meant some rate that had something to do with Single Piece First Class Mail, DFS respectfully suggests that no benchmark would be necessary, for the two should not be linked, as pointed out above. If, however, by benchmark, Chairman Goldway means a base rate from which worksharing discounts would be calculated, we suggest that the PRC and the Postal Service could simply recognize the costs of Bulk First Class Mail at all levels, eliminate all worksharing discounts, and set a series of prices, based on the cost data for the actual level of service that Bulk First Class mail receives. Alternatively, to the degree that the PRC felt it needed to do so for purposes of 3622(e), it could analytically decompose any price into a worksharing component, an intrinsic cost component, and other components, fully taking into account all intrinsic and avoided cost differences.

Since Automation Mixed AADC, Automation AADC, Automation Three Digit, Automation Five Digit and Nonautomation Presort are the traditional rate categories, one should keep those so as not to disrupt the mailing patterns of the thousands of mailers that use those rates, and the processing streams set up both by mailers and the

Postal Service. As time goes on, some of these categories would change, some be eliminated, and new ones be created. Using actual cost data for each category gives the Postal Service a great deal of flexibility in making those changes, flexibility it will need to face a challenging future.

This rate methodology is simple, is based on actual costs, and would allow the Postal Service to maximize its revenues under traditional business principles of pricing to market forces.

E. Mr. Mitchell's question.

Robert Mitchell, filing comments on his own on August 25, 2009 raises some interesting questions that deserve to be addressed on the record:

> One is left with prescriptions that rate increases should always be lower for relatively profitable products, largely to encourage growth, and that lower increases for relatively elastic products are always the more profitable course. But these prescriptions invite questions. If relatively profitable products always receive lower increases, won't their relative profitability erode? Don't firms need their relatively profitable products? Should relatively elastic products always receive lower rate increases, or just until their markups get to a certain level? In other words, where is the stopping point? How does one tell when these prescriptions are making finances worse instead of better? Does the balance ever become just right? Where is the profit maximum position?

Mitchell August 24 Comments at 3-4.

The answer to Mr. Mitchell's question keys on the core principles of the PAEA, which hold that the Postal Service is supposed to act like a business and maximize its profit. In order to act like a business and maximize its profit, the Postal Service must balance in each instance the estimated revenue to be gained through obtaining greater volume growth against the estimated revenue to be lost through obtaining a lower profit per piece. The rates should be set at that point where the Postal Service finds that its profit is maximized. In doing so, it must take into account market and industry conditions, including overall economic conditions and how that impacts various markets.

It must ask questions such as: Are markets mature? Growing? Contracting? What has changed in the markets? What will change? How can the Postal Service anticipate and help that change?

Moreover, the Postal Service needs to consider its own marketing plans, and which markets it wants to incent and how. In terms of NSAs, the Postal Service needs to consider the specific conditions of individual companies, and what products that company needs to use the postal system, as well as what postal products are needed overall in the specific marketplace. Part of that analysis is surely quantitative, but much of it is qualitative. Once that analysis is made, the Postal Service needs to continually reexamine and revaluate, as market conditions change from day to day, month to month. This ongoing process and the flexibility to change lies at the core of the PAEA.

F. The Public Representative's Suggestion.

The Public Representative has suggested establishing separate classes for Single Piece First Class mail and Bulk First Class mail. DFS finds this acceptable. It is time to cost and price each separately, and we see no legal barriers to doing so.

The Public Representative also suggested that the First Class stamp be set at a fractional level. While DFS sees no legal impediment to doing so, and admittedly such a design would solve a lot of problems, we concerned that the public's reaction to such a scheme would not be favorable. Indeed, we are concerned that the public's reaction could negatively impact the Postal Service's reputation and should not be considered without substantial survey and focus group testing.

Conclusion

The PAEA was intended to switch the business model of the Postal Service to a for-profit model that would maximize revenues. For this reason, it gave the PRC final authority over costing and the Postal Service final authority over pricing, including the ability to price to market forces. Only by pricing to market forces, with a product's cost basis tied to its actual costs, is a firm's profit maximized, for only then are the proper pricing signals sent to the market.

To date, the PRC has not allowed the Postal Service to price Bulk First Class Mail by market forces because it has not allowed it to use an accurate cost base. The PRC needs to allow the Postal Service to maximize its Bulk First Class Mail revenue.

Thank you for considering our views.

Respectfully submitted,

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