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

Market Dominant Product Prices First-Class and Standard Mail Discover Financial Services	Docket No. MC2011-19
Market Dominant Product Prices Discover Financial Services (MC2011-19) Negotiated Service Agreement	Docket No. R2011-3

Comments of the Public Representative in Response to Order No. 654

(February 7, 2011)

I. INTRODUCTION

On January 14, 2011, the Postal Service filed a request to add a Discover Financial Services Negotiated Service Agreement (NSA) to the market dominant product list. Order No. 654 appointed the undersigned Public Representative and set a deadline for comments of February 7, 2011.

II. BACKGROUND

The Postal Service may earn more profit from one mailer's overall postage bill than it earns from another mailer's overall postage bill of equal amount because mailers buy different mixes of high-margin and low-margin mail. The proposed Discover Financial Services NSA focuses on this difference as it attempts to slow the general trend away from high-margin mail to low-margin mail. However, it has cobbled together such an amorphous set of benchmarks, rebates, penalties, and contingencies that the value of the NSA to the Postal Service is highly uncertain, the various sources of risk that it will lose money are difficult to assess, and any constraints that the Commission might impose that would reduce those risks are difficult to design.

In the current postal market, there is an arbitrage of advertising letter mail from high-margin bulk First-Class to low-margin Standard letter mail. This NSA seeks to slow this arbitrage by employing a "threshold adjustment" factor. Each dollar of reduced spending by Discover Financial Services (DFS) on automation First-Class letters would be offset by $1.65 added to the overall postage threshold that would qualify DFS for rebates. This NSA offers rebates to DFS that are a fixed percentage of rate increases of unknown size that may occur in future years. The rebate offered for automated First-Class letters would be applied to the entire volume of automated letters sent by the mailer in the future year. The rebate for Standard letters would be applied to the entire volume of Standard letters sent by DFS in the future year. To qualify for these rebates, DFS must spend an overall amount on postage in the future year (its "revenue threshold") that exceeds the amount it spent in the most recent historical year (its "baseline revenue") by a predetermined percent.

If DFS' spending on presorted First-Class letters declines in the future year, the postage threshold that would qualify it for the rebate on its Standard Mail letters would be increased by a predetermined percent (its "revenue threshold adjustment") that is meant to partially offset the decline in spending on presorted First-Class letters. DFS commits to spending the adjusted threshold amount of postage in the future year (its "postage commitment") in the sense that it would pay a penalty for failure to meet its adjusted threshold. The penalty would be calculated as a percent of the gap between DFS' actual spending on postage and the adjusted threshold.

The Postal Service characterizes the five elements of the NSA described above (threshold, threshold adjustment, postage commitment, First-Class rebate, and Standard rebate) as "essential" components of the agreement. It characterizes the "exact values" of these elements as custom-tailored to DFS, based on the Postal Service's evaluation of DFS' "volume and revenue trends, current and future economic conditions, and negotiation between the parties." [1]

There are other important elements of the agreement that the Postal Service does not characterize as "essential." One is an obligation on the mailer's part to apply a full-service Intelligent Mail barcode (IMb) to all DFS mail eligible for rebates. [Article

[1] Notice of the United States Postal Service of Filing of Contract and Supplemental Data and Request to Add Discover Financial Services Negotiated Service Agreement to the Market-Dominant Product List, January 14, 2011 (NSA Notice) at 4.

I.A.] Another is a three-year term for the agreement with escalating postage spending thresholds each year (10 percent over baseline revenue in Year One, 15 percent over baseline in Year Two, and 20 percent over baseline in Year Three). [Article II.B.] Another is a provision that DFS will not incur a penalty for failing to meet its postage commitments in Years Two or Three unless the penalty is mutually negotiated by the parties. [Article II.E.] Under the agreement , either the Postal Service or DFS may unilaterally withdraw from the agreement during the first nine months of any year covered by the agreement. [Article III.F.] Also, under the agreement, the parties agree to agree in the future about DFS' participation in other rebate programs while the NSA is in force. [Article I.D.]

III. OSBERVING THE NON-DISCRIMINATION SAFEGUARDS IN SECTION 3622(c)(10).

The Postal Service comments that "in offering a similar agreement to other customers, [it] will look for all of these characteristics" . . . "large but declining billing and statement volumes, . . . and significant volumes of advertising mail" and customers with "the resources and infrastructure to effect . . . a switch" between statement mail and advertising mail. Id. at 5. The Postal Service observes that "in the negotiation of similar agreements" it will be guided by

- the "design imperative" of this NSA—" to generate additional contribution," and

- "the basic structure of the agreement"—the five NSA elements described above that the Postal Service characterizes as "essential."

Id. at 4-5. Finally, it says that "the negotiation of similar agreements … may, in other NSAs, yield parameters that are substantially different from those in this agreement."

The "parameters" that the Postal Service warns may be substantially different in other, similar, NSAs are

1) the percents by which the threshold postage must increase over baseline postage to qualify for rebates

2) the factor by which thresholds must be increase in order to offset declining First-Class letter volumes

3) the factor by which the penalty for missing the mailer's postage commitment is calculated

4) the percent of future First-Class price increases that would be rebated for qualified presorted First-Class mail

5) the percent of future Standard price increases that would be rebated for qualified Standard letters

The PAEA authorizes the Commission to establish a modern system a rate regulation. Under section 3622(c)(10) that system would permit the Postal Service to charge different prices for the same product if this practice is regularized as a "special classification" and certain safeguards are observed. Section 3622(c)(10) states that in establishing a system of regulation, the Commission shall consider (emphasis added)

> the desirability of special classifications *for both postal users and the Postal Service* in accordance with the policies of this title, including agreements between the Postal Service and postal users, *when available on public and reasonable terms to similarly situated mailers*, that –
>
> (A) either—
>
> (i) improve the net financial position of the Postal Service through . . . increasing the overall contribution to the institutional costs of the Postal Service
>
> . . . and
>
> (B) do not cause unreasonable harm to the market place

The Commission has adopted rules that incorporate by reference the safeguards that Congress contemplated. See 39 CFR 3010.42.

The statutory safeguards are as follows: the Postal Service must show that the terms of the NSA benefit both it and "users of the mail"—users of the mail generally, not just the user awarded the NSA. The terms of the NSA must not create an undue or unreasonable preference [since 39 USC 403(c) applies], and must not unreasonably harm the marketplace (i.e., must not unreasonably distort competition among mailers in the markets in which they participate, such as the market for credit cards services).

Taken together, these statutory safeguards require the Commission to consider both sides of the equation before approving an NSA predicated on contribution gain. The terms of the NSA must serve the Postal Service's interests and the interests of mailers, particularly mailers in competition with each other in a downstream market.

If the Commission concludes that this NSA is likely to increase net contribution to institutional costs, and approves it, there inevitably will be other mailers who send both bulk First-Class and Standard letters that will argue that they are similarly situated and are entitled to the same terms. The Commission will then have to decide what terms of this agreement need to be made available to them. In making that decision, the Commission will need to assure itself that the interests of mailers who compete in downstream markets are as well served as the interests of the Postal Service by NSA proposed here.

The discussion above described five mechanisms built into the proposed NSA (postage thresholds, rebates, or penalties) that the Postal Service wants the Commission to view as "essential" to the agreement. The discussion above also described five "parameters" (ratios or percents) each of which places a value on a corresponding threshold, rebate, or penalty. It is clear from the Postal Service's explanation of the proposed NSA that it wants the Commission to view the five mechanisms that it characterizes as "essential" as those that will define a "functionally equivalent" NSA. It is equally clear that it wants the Commission to view the ratios or percents that place a value on those mechanisms as non-essential to the NSA. If they are viewed as non-essential, those percents and ratios can vary among "similarly situated" mailers without seeming to violate the non-discrimination safeguards of section 3622(c)(10).

Each one of the ratios or percents in the proposed NSA is a price term by another name because each one alters what the mailer must pay in postage as the volume of his mailings changes. If those price terms can be dialed up or down at the option of the Postal Service when negotiating with similarly situated mailers (those who send a large amount of First-Class statement mailings and a large amount of advertising mailings) they will constitute price discrimination, which section 3622(c)(10) forbids.[2] Depending on how unequal they are from one NSA to the next, they could have a profound effect on competition among mailers who compete in the credit card services industry. Therefore, if the Commission approves this NSA, it should make it clear that it is not approving the Postal Service's view of which terms of the NSA are "essential" (which terms define a "functionally equivalent" NSA) and which are not, for purposes of triggering the non-discrimination prohibitions of section 3622(c)(10) and 403(c). This would avoid contention and litigation going forward.

Perhaps the prime example of an NSA provision that should be considered an essential element of agreements of this kind is the threshold adjustment factor. The Postal Service bases the selection of its 1.65 threshold adjustment "parameter" (and all other "parameters" in this NSA) on "DFS' volume and revenue trends, current and future economic conditions, and negotiation between the parties." NSA Notice at 4.

The Postal Service offers no clear link between this amorphous mixture of considerations and the specific 1.65 threshold adjustment factor incorporated into this agreement. By not explaining how it arrived at this specific adjustment factor (or any of this NSA's other "parameters"), the Postal Service has made it difficult for subsequent NSA applicants to claim that they are entitled to the same "parameters" (i.e., indirect price terms). The Postal Service presents its adjustment factor as subjective and ad hoc, but it could just as easily have used an objective, algebraic formula showing how many cents worth of contribution is currently obtained from the average dollar of DFS' bulk letter mail postage (46 cents), how many cents of contribution is lost for the average dollar decline in First-Class letter postage (66 cents), and what percent of the lost First-Class contribution would be recouped by the 1.65 threshold adjustment factor proposed in this NSA (77 cents per piece, which comes to 117 percent).

The following algebraic formula shows what increase in any mailer's spending on Standard letters would be needed to exactly offset the loss of contribution suffered from that mailer's reduced spending on First-Class letters.

Mailer Specific First-Class Unit Contribution	x	Mailer Specific Standard Unit Revenue	+	$ 0.229
Mailer Specific First-Class Unit Revenue		Mailer Specific Standard Unit Contribution		

In the case of DFS, in FY 2010, it would take a threshold adjustment factor of 1.42 to offset each dollar of lost spending on First-Class automation letters. Thus, for this Agreement, the Postal Service has determined that an additional $.23 of revenue should be added to the threshold beyond the Standard Mail required for contribution-neutrality. A formula incorporated into this NSAs of this kind that would make these relationships clear would consist of terms for the mailer's overall spending on bulk letter mail, the shares of overall postage that the mailers spends on First-Class and Standard letters, overall volumes of First-Class and Standard letters, and the shares of overall volume made up of First-Class and Standard letters weighted by the different average unit contributions that First-Class and Standard letters currently exhibit.. If the Postal Service negotiated a threshold adjustment factor designed to offset 125 percent, 100 percent, 75 percent, etc., of the loss of contribution from reductions in the mailer's spending on First-Class postage, the Postal Service could identify in a straightforward manner what percentage offset has been targeted.

By calculating the degree of offset that has been targeted in the threshold adjustment factor in an objective and transparent way, a functionally equivalent NSA could be customized to the circumstances of another applicant, but still be meaningfully compared to this NSA. If the Postal Service were to target a different degree of offset in a subsequent NSA, it should have to clearly and specifically explain exactly why it felt that a different degree of offset was appropriate. An objective, transparent approach to selecting and justifying the threshold adjustment factor would allow the Commission and mailers themselves to evaluate whether the non-discrimination safeguards in section 3622(c)(10) are being honored in future NSAs of this kind.

IV. OBSERVING THE SAFEGUARDS AGAINST LOSS OF NET REVENUE IN SECTION 3622(c)(10)

Section 3622(c)(10)(A) states that in establishing a system of regulation, the Commission shall consider authorizing special classification that "improve the net financial position of the Postal Service through . . . increasing the overall contribution to the institutional costs of the Postal Service." In assessing whether the proposed Discover NSA would satisfy this requirement, the answer is "maybe, under certain circumstances."

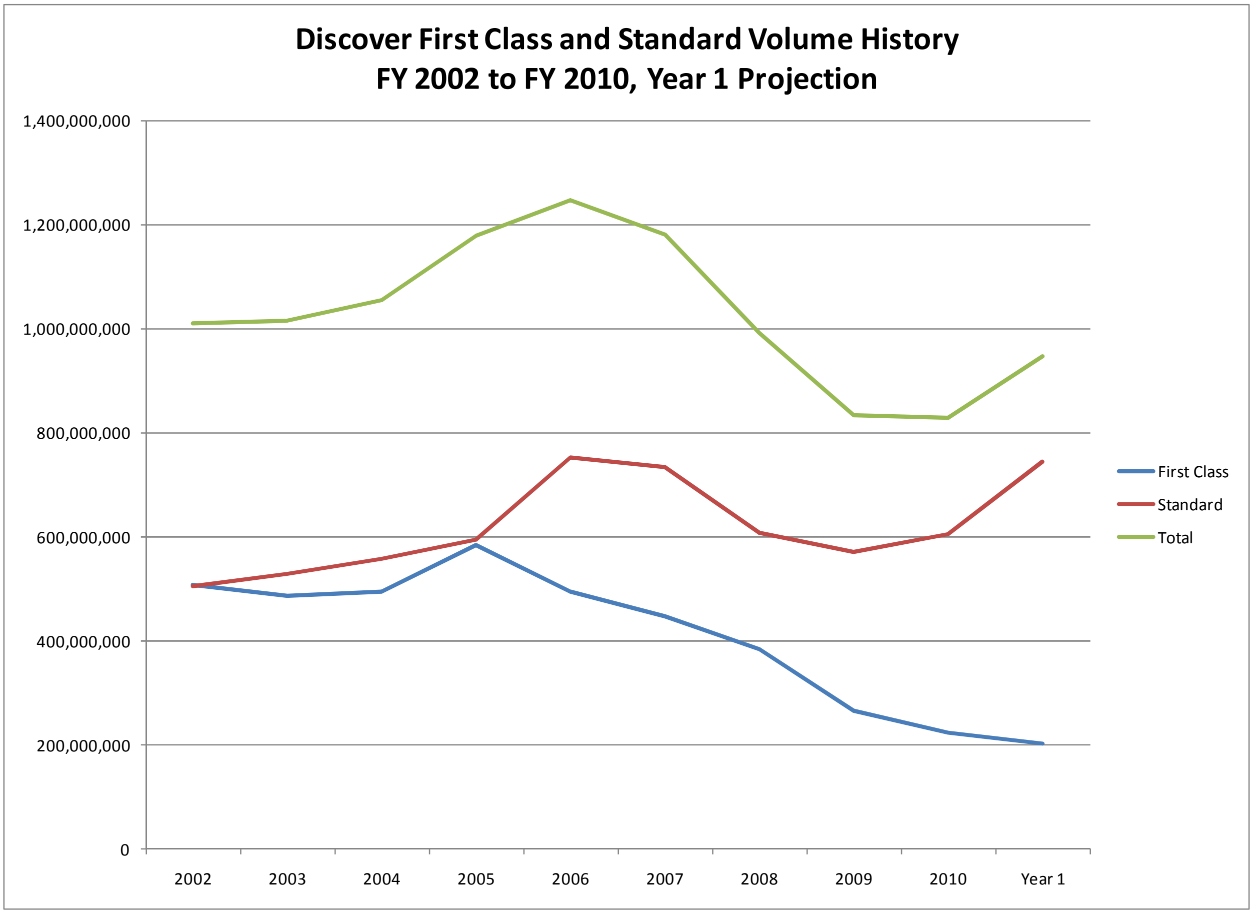
The most common form of Negotiated Service Agreement that offers a price incentive (discount or rebate) in the expectation that it will increase the volume of mail that the mailer purchases (in percent terms) more than it will reduce unit revenues (in percent terms) from those purchases —thus increasing that mailer's contribution to the Postal Service's overhead (assuming that unit costs do not change). For a decrease in price for all pieces to lead to an increase in total revenue, the mailer's volume response to a price reduction (his price elasticity of demand, or volume increase/ price decrease) must be greater than -1.0 in absolute value. According to the Postal Service's demand models (and common economic sense) most of its competitive products have price elasticities whose absolute value is greater -1.0. Such products should be expected to be highly price elastic because they face vigorous competition, and because postage is generally substantial in relation to the value of the item shipped.

For market dominant products, this is generally not true, especially for letter mail. Price elasticities of demand are generally far below -1.0 in absolute value. This is to be expected, since they generally do not face direct competition, and because postage accounts for only a small portion of the price of producing and sending the mailpiece. In its demand models, the Postal Service estimates that the price elasticity of demand for the two kinds of letter mail covered by the Discover NSA is -0.346 for presorted First-Class, and -0.286 for Standard regular. Therefore, for price incentives for market dominant categories of letter mail to increase contribution—be they NSAs or seasonal sales--the Postal Service has to find a First-Class mailers whose price elasticity is roughly triple the average and Standard regular mailers whose price elasticity is roughly four times that of the average just to elicit a breakeven response to a price-reduction incentive.

Given its own price elasticity estimates, the burden of proof should always be on the Postal Service that it has found such atypical users of market dominant letter mail. If it hasn't, the regulatory requirement that deviations from the general price schedule for market dominant letter mail must be shown to be likely to increase overall contribution will not be met. Traditional price elasticity analysis shows that these rebates would not lead to increased contribution from DFS.

The proposed Discover NSA can be analyzed in terms of the marginal effects of its price incentives, applying average own-price elasticities for the products being evaluated, despite the fact that the proposed NSA would offer rebates that apply to the entire volume of the given product purchased by DFS. (The usual approach to volume-incentive NSAs and seasonal sales is to offer declining block rates for added blocks of volume beyond a baseline. Marginal analysis of the behavior of the mailer in response to volume-based price reductions is straightforward for such incentives).

Before discussing the net value of the proposed discounts, it is informative to look at the volume history of Discover. The recent mailing history of DFS is presented in the chart below.



Included in this chart is the projected Agreement Year 1 volume. Following the financial crisis and recession, FY 2009 and FY2010 represented the lowest volume for Discover during this volume period.[3] Discover's First-Class Customer (statement) Mail was 282.9 Million pieces in 2007. It sent over 141 Million pieces of First-Class advertising mail in year 3 of MC2004-4,[4] but has been sending less First-Class advertising mail each year. In FY 2009 and FY 2010, Discover mailed less than 282 Million **total** pieces of First-Class mail, which implies that Discover no longer sends First-Class advertising mail.

[3] Discover.07.DCReport.Complete.pdf, filed February 26, 2008 at 3
[4] From January 2005 to December 2007, Discover was involved in a First Class Volume incentive NSA, MC2004-4.

The chart supports a strong inference, which the Postal Service apparently accepts, that Discover has chosen a strategy of exiting First-Class Mail as a medium for its advertising and continuing to use of Standard Regular mail for that purpose.[5] Therefore, its marginal decisions are essentially how much more Standard Regular advertising mail it should purchase in order to qualify for the rebates being offered. Qualifying for the rebate, however depends on postage spent on both First-Class and Standard, so that the price elasticities of both are relevant.

The Commission's accepted methodology for the analysis of net revenue is outlined in the Commission's MC2004-3 Opinion and Further Recommended Decision. Under that analysis, the effects of price reductions on mailer behavior, contribution depends on three variables

- The Percent Change in Price
- The Own Price Elasticity
- The Unit Contribution of the Incentivized Mail
- The value of the rebate can be calculated assuming an elasticity of -0.346 for automation First-Class, and -0.286 for Standard regular letters. Applying those elasticities shows that there would be little chance that it would increase overall contribution. This is shown by the table below.

Applying the elasticity-based Value model to the NSA, as proposed, the agreement is unlikely to generate new contribution for the Postal Service. The following table uses volume and contribution data provided by the Postal Service in "Discover NSA.xls"

[5] It is important to note that the total projected volumes for the proposed NSA, while higher than FY 2010, are still significantly less than FY 2002- 2008.

R2011-3 USPS Estimated Volumes					
	FY 2010	**Year 1**	**Year 2**	**Year 3**	
First Class Mail	224,761,744	202,285,570	182,057,013	163,851,311	
Standard Mail	604,769,202	745,073,689	816,103,037	873,783,088	
R2011-3 USPS Estimated Contribution					
	FY 2010	**Year 1**	**Year 2**	**Year 3**	
First Class Mail	$0.230	$0.234	$0.235	$0.238	
Standard Mail	$0.090	$0.091	$0.091	$0.091	
USPS Estimated Elasticities					
First Class Mail	-0.346				
Standard Mail	-0.286				
R2011-3 USPS Estimated Discounts					
		Year 1	**Year 2**	**Year 3**	
First Class Mail		$0.005	$0.009	$0.014	
Standard Mail		$0.001	$0.002	$0.004	
Volume Incentivized by by Marginal Discount					
		Year 1	**Year 2**	**Year 3**	
First Class Mail		1,064,092	1,560,563	2,153,687	
Standard Mail		1,612,879	2,876,935	4,715,973	
New Contribution from Incentivized Volume					
		Year 1	**Year 2**	**Year 3**	
First Class Mail		$248,683.029	$367,326.189	$513,488.070	
Standard Mail		$146,116.818	$260,543.708	$429,717.809	
Rebates for Estimated Volumes					
		Year 1	**Year 2**	**Year 3**	
First Class Mail		$1,087,522.926	$1,610,633.572	$2,253,378.239	
Standard Mail		$1,106,987.426	$1,996,877.100	$3,325,036.910	
Net Value of Marginal Discounts					
		Year 1	**Year 2**	**Year 3**	**Total**
First Class Mail		-$838,839.896	-$1,243,307.383	-$1,739,890.169	
Standard Mail		-$960,870.608	-$1,736,333.393	-$2,895,319.101	
Total		-$1,799,710.504	-$2,979,640.775	-$4,635,209.270	-$9,414,560.550

Succinctly, the rebate for the marginal pieces leads to an insignificant amount of new volume. For example, this analysis shows that in Year One, for standard mail, a discount of $.001 for over 745 million pieces incentivizes Discover to send 1.6 Million new pieces.

When small marginal discounts are applied to large volumes, very high elasticities are needed to incentivize enough new volume for net contribution to be positive. The price elasticity necessary to make a rebate of only $.001cent per piece to produce an additional 141 million in Standard volume in Year One is enormous.

The following table shows the price elasticities that would be needed for the Discover NSA to produce any net contribution. In order for the Postal Service to realize a net gain in contribution from the agreement, as proposed, the Own-Price elasticity of First Class and Standard Mail would have to be almost five-fold higher than the average mailer's elasticity for presort First-Class (-0.346), and eight-fold higher than the average mailer's elasticity for Standard Regular (-0.286).

USPS Estimated Elasticities					
First Class Mail	-1.6				
Standard Mail	-2.3				
Volume Incentivized by by Marginal Discount					
		Year 1	**Year 2**	**Year 3**	
First Class Mail		4,873,964	7,105,216	9,724,741	
Standard Mail		12,872,276	22,851,046	37,212,719	
Net Value of Marginal Discounts					
		Year 1	**Year 2**	**Year 3**	**Total**
First Class Mail		$51,544.590	$61,796.563	$65,221.343	
Standard Mail		$59,160.548	$72,581.257	$65,773.291	
Total		$110,705.138	$134,377.820	$130,994.633	$376,077.592

These results reflect the fact that the three variables that determine the value of price reductions in generating contribution-- percent reduction in price, price elasticity, and unit contribution are all very low in this NSA. For Standard mail, for example, the price reduction would be $.001 in Year One, its price elasticity only -0.286, and its unit contribution is only $.09. Not surprisingly, these parameters yield only a small amount of new letter mail, and new contribution of only a few hundred thousand dollars over the life of the NSA. The purpose of the elasticity-based model is to compare the marginal decision to mail with the profitability, to the Postal Service, of that decision. Previous volume-incentive NSAs have not provided discounts to all volume, possibly for the reason discussed above.

If the small incentive provided by the Discover NSA rebate were to yield the positive net contribution of tens of million dollars, as the Postal Service's analysis purports to show, there are really only two plausible explanations. Either DFS has price elasticities for bulk letter mail that can only be described as off the charts, or the incentive effect is illusory, meaning that it is not the small rebate of $.001 that produces 141 million new pieces of Standard mail, but the knowledge or intention of DFS to mail roughly that many new pieces regardless of the rebates.

V. THE EXPLICIT AND IMPLICIT PURPOSE OF THE NSA

As he Postal Service describes it, the purpose of the Discover NSA is to tailor the NSA to the fact that DFS makes "heavy use of both First-Class Mail and Standard Mail" and "has the resources and infrastructure" to "effect . . . the switch" from First-Class to Standard. NSA Notice at 5. Since advertising is the only use of bulk First-Class letter mail that can convert to Standard because of content restrictions, the underlying purpose of the NSA is to slow the migration from the former to the latter. But the elasticities that would accomplish that goal with such small rebates are not real-world elasticities, and all indications are that Discover no longer sends advertising mail by First-Class. Therefore, the actual purpose of the NSA must be something other than that officially described in the Postal Service's Notice.

The Public Representative's best attempt to understand the implicit purpose of this complex NSA, based on its terms, rather than the official description of its purpose. Under the NSA, if the spending threshold is reached, rebates apply to the first and last piece of Discover's entire mailing activity for a given year. Once Discover qualifies for its roughly $ 2 million rebate, there is a dwindling incentive for Discover to increase its volume because the incentive does not grow at the rate that its volume grows. The rebate structure does not continuously incentivize Discover to grow its Standard advertising volume, but, essentially, guarantees that Discover will receive at least $2 million in rebates for a 10% increase in volume, which may already coincide with Discover's advertising plans. This is similar to a two-tiered pricing structure, where Discover pays upfront in exchange for a lower rate across a wide range of volume (in this instance all volume for the next 3 years). The Postal Service has concluded that Discover is rapidly reducing its use of the mail and, apparently, wants to "lock in" Discover's contribution for the next three years (with incentives to increase contribution). For its part, Discover apparently wants to "lock in" a discount in exchange for guaranteeing that it will go ahead with its near-term advertising plans. The benefits to the Postal Service appear to be much more modest than it officially estimates, and the price of insurance that Discover will go ahead with its advertising plans is modest as well. Since there is a mutual right of recision by both parties each year until three months before the agreement applies to the upcoming year, either party has ample time to identify inflation trends that turn unfavorable, or DFS' decides to change its marketing plans. Thus, the NSA appears to be a small risk for a small reward on the part of both parties. The major drawback would seem to be if this NSA were to be replicated throughout the credit card services industry. If so, it could lock the Postal Service into its unfavorable FY 2010 financial position vis a vis such mailers, when that industry is on the rebound.

Year One			
	USPS Assumed Standard Mail Volume Needed to Reach Discount Threshold	**Change in Volume**	**Net Contribution Due to Discount**
	745,073,689		
Before- Rates Volume Estimate			
FY 2010 Volume	604,769,202	140,304,487	$614,816
USPS Low Baseline Estimate	661,214,328	83,859,362	$504,161
USPS High Baseline Estimate	681,373,301	63,700,388	$1,419,549
	USPS Assumed Standard Mail Volume Needed to Reach Discount Threshold - Plus 50 Million Additional Pieces	**Change in Volume**	**Net Contribution Due to Discount**
	795,073,689		
Before- Rates Volume Estimate			
FY 2010 Volume	604,769,202	190,304,487	-$993,062
USPS Low Baseline Estimate	661,214,328	133,859,362	-$437,476
USPS High Baseline Estimate	681,373,301	113,700,388	-$100,053

This agreement is only likely to be profitable under a small range of possible outcomes. The table above shows two volume scenarios, each with three before-rate volume assumptions. The assumptions in the first scenario are contained in the Postal Service spreadsheet “Discover NSA.xls.” If Discover sends exactly one piece more than required to meet the volume threshold in the first year, then the agreement will be profitable if it planned on increasing its FY2010 volume by 60 million pieces before the discount, and 80 million pieces due to the discount. However, if Discover exceeds the discount threshold by 50 million pieces, instead of 1 piece, the agreement will not have a positive impact on Postal Service Finances. As discussed above, the small marginal discount is not sufficient to incentive large amounts of new volume. Further, the 50 Million piece increase in the hypothetical scenario would only increase the discount due to Discover by $74,287, which, given a postage due of over $9.6 Million is unlikely to have a material impact on Discover’s decision to mail the additional 50 million pieces

In order for this agreement to be profitable, the Postal Service has to have correctly estimated both Before Rates and After Rates Standard Mail Volumes to within approximately 20 Million pieces for each of the three contract years. Given the enormous range of possible combinations of First-Class and Standard sufficient to exceed the discount threshold, the likelyhood of the Postal Service correctly estimating future Discover volumes to such degree of precision seems small.

VI. THE ROLE OF "AGREEMENTS TO AGREE" IN THIS NSA

The proposed Discover NSA includes provisions to resolve in the future issues what would be major elements of the current proposed NSA if they had been resolved in the current agreement. One issue that remains unresolved is what penalty, if any, DFS would incur if it fails to meet its postage commitments beyond Year One of the agreement. Article II.E. provides that by the seventh month of Year One, the parties will agree on a penalty if DFS fails to meet its Year Two postage commitment, and by the seventh month of Year Two, the parties will agree on a penalty if DFS fails to meet its Year Three postage commitment.

In contract law, agreements to agree are non-binding (unless they are coupled with additional commitments, such as a commitment to submit to binding arbitration). Since the outcome of the future negotiations concerning the penalty issue is unknown, the agreement to agree on future penalties cannot be considered an operative provision of the proposed NSA. If it were an operative provision, agreements to agree would become an all-purpose tool for evading regulatory scrutiny of any NSA. The Postal Service does not concede that it would be necessity to resubmit the Discover NSA for regulatory approval once a specific penalty for failing to meet DFS' postage commitments in Years Two and Three is agreed to, but it wisely says that it would be willing to do so.[6]

Another issue that remains unresolved is whether DFS mail that is eligible for rebates under the terms of this NSA would also be eligible for rebates under other incentive programs. Article I.D. provides

> DFS shall be eligible to participate in other incentive programs offered by the Postal Service during the term of this Agreement as mutually agreed by the Parties. It is the mutual intent of both parties that the DFS postage

[6] See Response of the United States Postal Service to Chairman's Information Request No. 1, Question 8.

> to be used to calculate thresholds in this Agreement shall be the net of any rebates or other incentives, and that such rebates or incentives shall be realized and applied for accounting purposes under this Agreement to the period in which they were earned.

Presumably, the main candidate for concurrent rebates for DFS eligible mail would be the Postal Service's seasonal sales. It will be difficult enough for the Postal Service, the Commission, or the public to sort out exactly what amount of revenue from DFS was incentivized by the intricate reward and punishment structure of this proposed NSA without having the incentives of a contemporaneous seasonal sale layered on top of the NSA incentives for the same mail. It may not even be possible to calculate threshold postage "net of other rebates or other incentives" earned by the same mail in a timely way, given the considerable lag in the Postal Service's accounting procedure to determine what seasonal sale rebates a participating mailer has qualified for.

If there were overlapping incentive programs covering the same mail it would almost guarantee that the effect of those incentive programs on the Postal Service net institutional cost contribution could not be identified, even though that is a regulatory requirement. It would be an administrative and regulatory briar patch into which the postal community should not be flung. Article I.D. is an agreement to agree in the future about how this NSA would mesh with other incentive programs, such as seasonal sales. It is non-binding, of no effect, and should be excised from this NSA. If the Commission approves this NSA, it should make it clear that an additional round of regulatory approval will be required before mail eligible for rebates under this NSA can be made eligible for other incentive programs as well.

VII. CONCLUSION

The agreement, as proposed, contains many complex and difficult issues. The Postal Service should be commended for a creative attempt to adapt NSAs to current market conditions and including new tracking provisions in the form of iMB requirements. However, is unclear from the Postal Service's proposal that the proposed agreement complies with the net contribution and non-discrimination safeguards of the PAEA. Select issues are:

- The financial risk to the Postal Service is unknown
    - The unit size of the discount is a function of future inflation and rate increases.
    - The aggregate rebate is not capped by volume or dollar amount.
- The agreement offers a financial incentive for Discover to maintain its FY 2010 volume of First-Class Mail, but Discover does not appear to send voluntary solicitation mail via First-Class.
- The agreement represents a trade-off between a guarantee of FY 2010 contribution from Discover mail and the revenue gained by increasing rates as allowed by the CPI cap. It is unclear how valuable this trade-off is to the Postal Service in terms of new volume incentivized by a discount. Discover mailed less volume in FY 2010 than any point since at least FY 2002.
- It is likely that many mailers will be interested in guaranteeing reduced future rate increases in exchange for a commitment to mail FY 2010 volumes, and it is unclear how the Postal Service will comply with its statutory obligation to offer reasonable terms to similarly situated mailers

Respectfully submitted,

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