

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

_____ ) Discover NSA ) _____ )	Docket MC 2011-19
_____ ) Discover NSA ) _____ )	Docket R 2011-3

**Reply Comments of Discover Financial Services  
February 11, 2011**

Discover Financial Services (“DFS”) files these Reply Comments in response to the Comments of the Public Representative filed on February 7, 2011. After reading the Public Representative’s Comments, DFS realized that the Public Representative has not fully understood that the purpose of this NSA is to compensate the postal system for the loss of DFS’s First Class statement mail, which is in the process of diverting to electronic delivery. DFS thus believes that these Reply Comments are necessary to correct any false impression that the Public Representative’s Comments may have inadvertently created.

**I. The NSA**

In 2006 Congress passed the PAEA which replaced the old cost-of-service ratemaking system with an *incentive-based* ratemaking system, based on a value-based pricing philosophy. The change is fundamental. The Public Representative says

that this NSA has “cobbled together” an amorphous set of benchmarks, rebates, penalties, and contingencies” such that the value is uncertain. To the contrary, the NSA is a narrowly targeted, finely honed instrument that focuses on DFS’s total letter mail postal contribution<sup>1</sup> and is designed to *create incentives* to maintain or increase that contribution, despite the diversion of DFS’s First Class statement mail to electronic delivery.<sup>2</sup>

Key to the NSA is recognizing that DFS’s statement mail, like the statement mail of most other large companies, is leaving the postal system for electronic delivery alternatives. In recognition of this fact, the NSA is designed to compensate the postal system for the ongoing loss of DFS’s First Class statement mail by creating an incentive system that incents DFS to either slow the electronic diversion of its First Class statement mail, or increase its Standard Mail spend by a dollar amount sufficient to maintain or grow the overall contribution (not mere spend) of DFS’s mail. If the Postal Service maintains a steady overall contribution from DFS, the postal system and the public benefit more than if the postal system had lost substantial contribution due to the electronic diversion of DFS’s First Class statement mail.

This NSA focuses on total postal spend. Its proposition is simple. If DFS grows its total dollar spend by 10% in the first year, it will continue to pay full postage but earn a rebate on whatever First Class and Standard Mail rate increases occur that year. DFS can meet this goal by either slowing its First Class diversion or increasing its Standard Mail growth. The incentive is larger for First Class than it is for standard (75%

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<sup>1</sup> The NSA is limited to First Class and Standard letters.

<sup>2</sup> The Public Representative focuses several times on First Class advertising mail in his comments, assuming it is relevant to the NSA. That assumption has little or nothing to do with this NSA. DFS no longer extensively uses First Class for marketing or advertising purposes.

to 37.5%) in order to make it easier for DFS to earn a rebate by slowing First Class diversion than by increasing Standard Mail growth. Likewise, in the second and third year, the NSA creates incentives for DFS to earn rebates by increasing its contribution growth by 5%. Moreover, this contribution growth is a “net” contribution that is adjusted for the loss of contribution that will occur due to the electronic diversion of DFS’s statement mail. This is because there is a threshold adjustment that requires that an additional spend of \$1.65 for Standard Mail be added for every \$1.00 decrease in First Class Mail spend from DFS. Since the marketplace for statement mail is changing from mail to electronic delivery, the threshold increase for DFS could be significant.

Many have asked what could be done to either stem the loss of First Class mail, or to increase the growth of other mail to compensate for the loss of contribution. This NSA is an innovative and creative attempt to answer that question. In perfect harmony with the philosophy of an incentive-based ratemaking system, it does so by creating incentives for DFS to change its behavior. Moreover, since postage usually represents the majority of the cost of producing and distributing a mail piece, the incentives are significant, and should change behavior.<sup>3</sup>

## **II. The Public Representative’s Criticisms of the Contract.**

This NSA is a contract. *Critically*, the contract is the result of a negotiating process between two parties in which both parties have balanced a variety of interests, benefits, and risks to arrive at a “bargain,” to use the traditional term from legal contract theory. Throughout this “bargaining” process, both parties consider a variety of

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<sup>3</sup> The Public Representative’s assumption that “postage accounts for only a small portion of the price of producing and sending a mail piece” is incorrect. Public Representative’s Comments at 8.

tradeoffs of interests, benefits, and risks. Each party makes offers and counter offers that are specific balances of the various elements that the party has decided are acceptable. The process ends when both parties reach a “meeting of the minds” as to the balances of the elements, or when they realize that no deal is going to be reached.

Much of the substance of the Public Representative’s Comments boils down to a critique of the various balances of elements in the contract. It is clear from the Public Representatives comments that had he been a negotiator for either DFS or the Postal Service, the contract would have turned out differently. That is fair. There is a wide variety of balances of interests, benefits, and risks that are possible during negotiations. Some of those balances might have resulted in reaching an agreement. Others surely would not have.

But this contract is the balancing of interests that came together to form the bargain *in this instance*, and it is the balance that is before the Commission. DFS respectfully suggests that the Commission should not critique the balancing of interests in the contract or change any provisions of the contract, for that would rebalance all the interests, benefits, and risks and upset the bargain. Rather, the Commissions should determine if the contract is legal under the PAEA. That means determining that it is more probable than not that the Postal Service will make money under the contract,<sup>4</sup> and that the contract will not result in unreasonable harm to the marketplace. 39 U.S.C.3622. If the contract will make more money for the Postal Service, the public is better off.

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<sup>4</sup> Or that the contract will enhance the performance of mail preparation, processing, transportation, or other functions.

### **III. The NSA Process.**

If the NSA process is to work well, and this surely was a prime concern of Congress when it passed the PAEA, mailers need to know with certainty that when they negotiate with the Postal Service for an NSA, they will not have to renegotiate with the public representative, any other party, or with the Commission. Mailers need to know that the Commission will straightforwardly and rapidly approve any NSA that was negotiated, so long as the deal more likely than not will put the Postal Service in a better final position, and will not reasonably disrupt the marketplace. No other concerns should be relevant.<sup>5</sup>

The marketplace that mailers operate within is a marketplace that changes by the hour, by the day, by the week, and by the month. These contracts and this approval process need to fit within that reality. There is an enormous amount of money to be made for the Postal Service from NSAs, if the process functioning properly. The Commission needs to get the NSA process working again, and the Postal Service needs to start tapping that money.

### **IV. Disruption of the Marketplace.**

In terms of unreasonable disruption of the marketplace, this NSA deals with overall postage revenue for a financial services company, and gives it certain rebates if certain goals are met. The size of the potential rebates is very small compared to the size of the company, its competitors, and the marketplace. It is difficult to see how such

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<sup>5</sup> Obviously the contract cannot unduly or unreasonably discriminate among users of the mail, nor grant any undue or unreasonable preference. 30 U.S.C. § 403.

relatively small rebates could possibly disrupt the marketplace, much less unreasonably so.

Further, a functionally equivalent NSA should be, as it was with prior financial service NSAs, more than adequate to take into account any effect on the marketplace. DFS should know, for it was the first company to take advantage of a functionally equivalent NSA, from which no disruption of the marketplace occurred. Tools were made available by the Postal Service for all to use. Some companies used them. Some did not.

The functionally equivalent provision was put into the law to provide that if there were any competitive advantage to an NSA, or that if any NSA would have a significant effect on a company, a functionally equivalent opportunity would be made readily available for the NSA contractee's competitors. Importantly, such a contract has to be available on "public and reasonable terms" to similarly situated mailers. It does not have to be made available on terms identical to the original contract. 39 U.S. C. § 3622 (10). If this were not so, then Section 3622(10) would say that the contract had to be made available on "public and identical" terms. Thus, the opportunity does not have to be a "mirror" contract, but rather a functionally equivalent one containing the essence of the deal, but allowing the parameters to vary to meet the needs of the mailer and to assure that the Postal Service makes a profit.

There has been no suggestion by any competitor that this NSA gives DFS any great competitive advantage, or has any negative effect on any marketplace, much less an unreasonable one.

## Conclusion

This NSA was negotiated and written as businesses would do so—focused on revenue and the bottom line, and achieving a fruitful bargain for both sides. Individual tradeoffs were made by both sides, as is normal in the negotiating process, and an acceptable combination was found. That balance should not be rebalanced by the Commission because it would destroy the integrity of the bargain.

The NSA is an innovative and creative approach that does not fit into any of the boxes of the old NSAs. That is good, not bad. The Commission should approve the DFS NSA as soon as possible, and encourage the Postal Service to do more.

Thank you for considering our views.

Respectfully submitted,

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