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POSTAL REGULATORY COMMISSION
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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

Clarification of Public Representative Analysis in Response to Reply Comments

(February 23, 2011)

The Postal Service filed reply comments in this docket on February 11, 2011.[1] At page 3, addressing the comments of the Public Representative, it observes that

> the table on page 16 of the PR's comments, while it may serve to illustrate his argument, cannot be taken to provide coherent estimates of the value of the agreement. In calculating the contribution, the PR assumes one value for incremental volume, which he uses to calculate incremental discount, then uses this discount to calculate a second—and different—incremental volume estimate. Presumably, there is some incremental volume estimate that satisfies his purpose, but the PR hasn't found it here.

The table was an abridged presentation of calculations that distinguished between the increment of mail that DFS would have to send in order to qualify for the rebate, and the increment of mail that could reasonably have been considered a response to a discount of the size awarded. The growth in volume that could reasonably have been a response to the discount was identified by using the average elasticity for the relevant class of mail, taken from the Postal Service's demand models. The calculation was demonstrated in detail in workpapers that the Public Representative provided to the

[1] Response of the United States Postal Service to Comments of the Public Representative, February 11, 2011.

Postal Service at its request.[2] Increments of volume that cannot reasonably be considered to have been prompted by a discount of the size awarded should be considered the "anyhow" portion of volume growth.

The Postal Service has demonstrated difficulty in distinguishing between incentivized volume and volume growth from other causes that nevertheless qualifies for a discount. This, of course, is the core issue in designing NSAs. If average elasticities for a product are not employed in evaluating how much volume growth can reasonably be attributed to the discount, there is really no objective, verifiable way to demonstrate that an NSA would satisfy the statutory requirement of section 3622(c)(10) for volume-based NSAs that they increase "the overall contribution to the institutional costs of the Postal Service."

If the price terms in a volume-based NSA are not based directly on an average elasticity for the targeted product, the NSA should at least be supported by a cogent discussion of how much the NSA participant's elasticity is thought to deviate from the average elasticity for that product, and why it is thought to deviate from it to the degree assumed. If there is no objective benchmarking of any kind underlying volume-based NSAs, there is simply no way that a party that is not privy to the business plans of the NSA candidate (i.e., the Postal Service, the Commission, or the public) can know whether the NSA will increase or reduce "the overall contribution to the institutional costs of the Postal Service." The statutory requirement that NSAs be approved only if they can be shown to increase contribution would be transformed into a requirement that NSAs be approved "as long as it cannot reasonably be determined whether the NSA will or will not increase contribution."

Discovery Financial Services also filed comments in reply to the Public Representative. [3] In them, at page 5, DFS noted that "there is an enormous amount of money to be made for the Postal Service from NSAs, if the process [is] functioning properly." There is also an enormous amount of money to be lost by the Postal Service

[2] Notice of Filing of Workpapers, February 8, 2011; PR Workpapers R2011 3.xlsx.

[3] Reply Comments of Discover Financial Services, February 11, 2011.

from market dominant NSAs as well, if market dominant NSAs become commonplace throughout the Postal Service without any objective benchmarking of the NSA candidate's expected response to discounts.[4]

This particular NSA is a case in point. According to Andrew Davison, Senior Vice-President of *Compremedia*, which tracks the credit card direct mail industry, 1.4 billion new credit cards solicitations were received by American consumers in the fourth quarter of calendar 2010, which was up from 575 million for the same quarter of 2009.[5] That is an annual rate of growth in credit card solicitations of 243 percent. He adds that "there is a sense of optimism around the credit card industry which is spreading." Under the terms of this NSA, Discover would qualify for over $ 2 million dollars of rebates if it increased its Standard mailings in 2011 by only 23 percent over current volumes. In other words, it could qualify for those rebates by increasing its Standard mailings at less than one-tenth the rate that the credit card industry as a whole has been increasing its solicitations. Unless Discover's business plans are extremely atypical of the credit card industry as a whole, the odds seem high that Discover will have qualified for this rebate for its mailings in 2011 regardless of the discount.

If this is a correct reading of the risk that the Postal Service will have given away $2 million in free money to Discover at the conclusion of calendar 2011, consider the consequences to the Postal Service's net revenue if the Discover NSA's terms were to be replicated throughout the credit card industry in functionally equivalent NSAs. This demonstrates the importance of the Commission insisting that the Postal Service make a plausible case that a proposed market dominant NSA will increase its net revenue, rather than taking the approach that Discover seems to advocate—that the NSA should

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[4] In its initial comments, the Public Representative noted that volume-based discounts for market dominant products that can reasonably be expected to increase net contribution are rare things indeed, considering that market dominant products (specifically First-Class and Standard) are highly price inelastic, by the Postal Service's own calculation. This means that by definition, such products yield less total revenue if prices are reduced. As long as a volume-based discount for a market dominant product applies to the entire volume of that product sent by an NSA participant, as it does in this NSA, there is little reason to believe this economic law of gravity will be repealed.

[5] See interview of Mr. Davison published on February 8, 2011, on ChiefMarketer.com.

be approved as long as no one can reasonably predict whether it will make or lose money for the Postal Service.

Respectfully submitted,

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