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UNITED STATES OF AMERICA
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

Public Representative Comments

(April 3, 2013)

I. BACKGROUND

The Commission approved the original NSA in this docket on March 15, 2011.[1] That agreement defined the revenue from First-Class and Standard Regular letters mailed by Discover Financial Services (DFS) from February 2010 through January 2011 as a baseline. It paid rebates to DFS if its aggregate spending on First-Class and Standard Regular letters exceeded that baseline by the following percentages:

Year 1 Revenue Threshold	Baseline plus 10%
Year 2 Revenue Threshold	Baseline plus 15%
Year 3 Revenue Threshold	Baseline plus 20%

[1] See Order No. 694.

If DFS's spending on First-Class letters fell below the previous year's level, the revenue threshold in a contract year would be adjusted upward by $1.65 for every dollar of the First-Class revenue shortfall. The original agreement would have penalized DFS for failing to meet the adjusted revenue threshold in Contract Year One by ten percent of the shortfall.

On November 15, 2012, the Postal Service and DFS agreed that the penalty for failing to meet the adjusted revenue threshold in Contract Year Three of the NSA would be the same as the penalty in Contract Years One and Two. On March 8, 2013, the Postal Service notified the Commission that it has amended that agreement.[2] The amendment allows DFS to treat the volume of "expedited" mail that it substitutes for "a small portion of DFS Eligible First-Class Mail volume mail" as though such volume were DFS Eligible First-Class Volume. Under the amended NSA, the Postal Service would calculate the postage revenue that such expedited mail volume would have earned had it been mailed DFS Eligible First-Class, and add that amount to the revenue threshold that triggers rebates or penalties under the Discover NSA. It attributes the need for this revision to "DFS' unforeseen business decision" to distribute a new credit card to purchasers via Priority Mail rather than First-Class Mail. See Attachment to Letter. The Postal Service asserts that the Priority Mail that it would count toward the adjusted threshold in Contract Year Three would be less than one percent of its eligible First-Class mail. Letter at 1.

The Commission issued Order No. 1676 on March 14, 2013, serving notice of the amendment to the Discover NSA, setting a schedule for comments, and appointing me as Public Representative.

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[2] Letter of Brandy A. Osimokun to Shoshana Grove, Secretary of the Postal Regulatory Commission, dated March 20, 2013 (Letter).

II. POSTURE OF THE PROCEEDING

The posture of this NSA is anything but straightforward. Section 3622(c)(10)(A) requires that the Postal Service affirmatively show that the NSA agreement, as amended, will either "improve the net financial position of the Postal Service" or "enhance" the Postal Service's operational performance. At the same time, section 3622(c)(10)(B) requires that the Postal Service show that it "will not cause unreasonable harm to the marketplace."

The Postal Service must make the affirmative and negative showings described above with respect to the amended NSA as a whole, and the Commission must judge the amended NSA as a whole against these statutory standards. The Commission is not free to decide that the amendment, in isolation, meets these statutory standards. The amendment, by itself, cannot be reasonably thought to be a "special classification" within the meaning of section 3622(c)(10), or to constitute a bargain that includes the essential elements of a contract under contract law. The consistency of the amended clause with section 3622(c)(10) cannot be evaluated apart from its effect on the agreement as a whole.

The Commission has already found that in Contract Year One, the original NSA reduced DFS's net contribution to the Postal Service by over $ 4 million, making it "inconsistent with section 3622(c)(10)." FY 2012 Annual Compliance Determination (ACD) at 158. Because it could not plausibly find that the original NSA would increase contribution, the Commission approved it on the only other statutory ground available--that it would enhance the Postal Service's operations, by enhancing management's "knowledge of potential tools to slow the overall declining trend for First-Class Mail volume." Id. In its ACD, the Commission noted that the Postal Service's FY 2012 Annual Compliance Report makes no mention of any insight that this NSA has given management into how it might stem the causes of First-Class Mail's volume decline. Therefore, the Commission concludes, the Discover NSA did not comply with section

3622(c)(10) in Contract Year One.[3] The Commission's decision to approve or reject this amended NSA must be based on its finding that the amended NSA is, or is not, likely to bring this NSA into compliance with section 3622(c)(10) in Contract Year Three. As described below, the amendment will move the Discover NSA further from compliance with section 3622(c)(10) and, therefore, the amended NSA agreement should be rejected.

III. THE PURPOSE OF AMENDING THE DISCOVER NSA

DFS asserts that the Priority Mail volumes that are the subject of the amendment would be less than one percent of the Contract Year Three's baseline First-Class volume if they were counted in its stead.[4] This effect seems too small to worry about at first blush. But, as DFS itself explains, its purpose is to significantly shift the balance of risk that was struck in the original NSA. Id. at 3. For reasons explained below, the amendment will increase the probability that DFS will meet the Contract Year Three revenue threshold qualifying it for rebates on all of its First-Class and Standard Regular letter mail. That, in turn, increases the probability that the Postal Service will have to pay millions of dollars in rebates to DFS for volume growth that was unrelated to those rebates. For this reason, the amended Discover NSA is even more likely than the original Discover NSA to reduce DFS's net contribution to the Postal Service. For that reason, the amended Discover NSA should be rejected as less likely to comply with section 3622(c)(10) than the unamended Discover NSA.

This conclusion might seem counterintuitive. Priority Mail has a per-piece contribution of $1.69 while First-Class letter mail has a per-piece contribution of $0.24.

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[3] In the FY 2012 ACD, the Commission appears to have deferred taking remedial steps to bring the Discover NSA into compliance with section 3622(c)(10) in the hope that the net contribution outcome will be reversed in Contract Year Two.

[4] Comments of Discover Financial Services, March 26, 2013, at 1.

It would seem that any time Priority Mail can be substituted for First-Class Mail, it would benefit the Postal Service. That intuition, however, is not relevant here because a desire to avoid the penalties contained in the Discover NSA are not what made DFS decide to use Priority Mail to distribute its new credit card.

DFS does not assert that it decided to use Priority Mail rather than First-Class to distribute its new credit card to avoid the penalty that is contained in the NSA, and it would not be credible if it had. The additional cost to DFS of substituting Priority Mail for First-Class is so high, and the benefit to DFS's position in the NSA so meager, that it would be irrational for DFS to base its decision to use Priority Mail on the benefit that it would gain as a party to an amended NSA.

The average postage expense per piece for the least expensive variant of commercial Priority Mail ($4.99) is roughly 15 times that of Presort First-Class ($0.36). Applied to one percent of DFS's eligible First-Class letter volume[5] yields a mailing cost of $11.4 million if Priority Mail is used, compared with $1.9 million if First-Class Mail had been used.[6] If DFS's motive for using Priority Mail to distribute its new credit card was to insure against incurring a penalty under the NSA, it could do that by mailing an additional 16 million Standard Regular letters at a cost of $3.1 million.[7] Mailing these additional Standard Regular letters would reduce the risk of incurring the slight penalties under the original NSA to the same degree as the Priority Mail option, but at roughly one fourth of the cost. If DFS is economically rational, its motive for paying such a high premium for using Priority Mail has to be unrelated to the risks and rewards built into the original NSA. Accordingly, its decision to go ahead with its plan to use Priority Mail should not be affected by any changes made to the original NSA.

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[5] The most recent figure for eligible First-Class letter volume available is 228,516,630 in Contract Year One. One percent of that is 2.29 million pieces.

[6] See average revenue per piece for First-Class Presort letters of $0.36 in FY 2012 Annual Compliance Determination, page 81, Table VII-1.

[7] See average revenue per piece for Standard Regular letters of $0.1956 in FY 2012 Annual Compliance Determination, page 106, Table VII-16.

DFS's attempt to tie its decision to use Priority Mail to distribute its new credit card to the original Discover NSA is artificial. DFS points out that its Priority Mail strategy would help the Postal Service achieve the same broad goal of the original NSA, which is to increase DFS's net contribution to the Postal Service. It argues that it would be unfair not to reward it and amend the NSA to reduce its risk of incurring a penalty. Otherwise, it says, the increase in net contribution caused by its decision to use Priority Mail would be a "windfall" to the Postal Service.[8]

AS explained above, and further explained below, the benefits and risks under the original NSA are already skewed heavily in favor of DFS. In Contract Year One of the agreement, DFS received over $5 million in rebates for doing what it, and the entire financial services industry was doing in 2011—restoring its direct mail credit card solicitations to pre-recession levels in response to a rebounding national economy. This is the real meaning of the term "windfall." Approving the amended NSA would simply remove a pothole in DFS's road to a securing a windfall of the same kind in Contract Year Three that it got in Contract Year One.[9] Approving the amended NSA based on the notion that it is required to be "fair" to DFS is ironic in the extreme.

IV. REASONS THAT THE DISCOVER NSA AWARDS A WINDFALL

The Discover NSA consists of a "carrot" and a "stick." The carrot is the rebate to DFS for mail that exceeds the revenue threshold; the stick is the penalty that DFS would pay if its revenue falls short of the threshold. The carrot involves a major risk to the Postal Service--the risk that it will give rebates to DFS in a given contract year for mailing Standard Regular letters that it would have mailed without rebates. The only risk that the stick imposes on DFS is that in any contract year, a last minute need would arise to change its plans for using direct mail in a way that caused revenues to fall

[8] Comments of Discover Financial Services, March 26, 2013, at 4.

[9] Data is not yet in on whether DFS

below the threshold, thereby incurring a penalty. The justification for the penalty clause is that it gives the NSA the appearance of offsetting the risk to the Postal Service that it will give rebates to DFS for mail it would have sent without rebates.

A. Contract Terms under the Agreement.

There are several reasons why the risks involved in the Discover NSA are allocated almost entirely to the Postal Service. The first is way that the contract is drafted. It allows either party to opt out of the agreement three months before any contract year commences. This puts DFS in the driver's seat. Typical retail direct mail marketing campaigns have minimum lead times of between six months to a year.[10] Therefore, in any given contract year, DFS will have had to plan its direct mail campaign well in advance of the NSA's opt-out date. If its marketing plan meets the NSA revenue threshold that year, it will stay in the NSA. If its plan does not meet that threshold, it will opt out, without penalty. Therefore, the only risk that DFS runs is that a need to cancel its already-formulated marketing plan will emerge suddenly before the beginning of a contract year, after the opt-out date has passed.

Since DFS is in a position to know what its internally-developed marketing plan is in any given year, and the Postal Service is not, the Postal Service assumes the risk that it will misestimate what DFS would have mailed without the incentive of a rebate, and will pay rebates for mail that DFS would have mailed anyhow. The risk that DFS will incur a penalty is not comparable because it knows well ahead of time how much it will mail under its marketing plan, and can opt in or out, accordingly. The amendment that would count some Priority Mail volumes when computing the adjusted revenue thresholds would merely reduce what is an almost negligible risk to DFS that it will incur

[10] This lead time is necessary because corporations typically need to line up annual budget authority for marketing campaigns, to design and produce the content of the advertising. Campaigns that use multiple media channels need additional time to make coordinated buys of airtime, periodical ad pages, and print shop capacity.

a penalty due to a last-minute change in its marketing plans. Approving the amended NSA would simply shift the balance of risk even more heavily against the Postal Service.

B. Economics of the Agreement.

In addition to the structure of the NSA agreement, the economics of the agreement stack the cards heavily against the Postal Service. This NSA was structured in denial of economic fundamentals. As the Public Representative explained in his comments in the initial phase of this docket, the volumes of mail categories that this NSA is trying to stimulate with rebates (First-Class and Standard letters) are price inelastic. First-Class letters as a whole have an elasticity of -0.392. Standard Regular letters as a whole have an elasticity of -0.437. Both elasticities are well below -1.0. This means that they are insensitive to modest price reductions. In percentage terms, modest price decreases applied to these categories will cause them to lose more in revenue than they will gain in volume. Their insensitivity to small price reductions reflects the fact that they are monopoly products without direct substitutes, and the fact that postage costs make up only a small portion of the total cost of producing and mailing these products.

The essence of the original NSA is that it tries to tie DFS's demand for high-margin First-Class letters to its demand for low-margin Standard letters. Trying to tie DFS's demand for these two products together by minor manipulations of their relative price, however, flies in the face of economic reality.[11] The only portion of the market for letter mail in which First-Class and Standard letters are substitutes is for advertising. That source of overlapping demand is irrelevant to analyzing this NSA because DFS

[11] The amended NSA would be even more unrealistic in its economic assumptions, because it would presume that demand for Standard advertising letter mail, First-Class transaction mail, and Priority Mail could be tied together (the price of one incentivizing demand for the other)as though all three were close substitutes.

has expressly disclaimed further interest in using First-Class Mail to advertise for credit card customers. DFS now uses First-Class only for bill and statements, and then only where the law requires it.

With no plausible source of overlapping demand, offering a small change in price for Standard Mail is very unlikely to influence the amount of First-Class Mail that DFS purchases. Nevertheless, the underlying premise of this NSA is that giving DFS a chance to win a very small rebate for Standard letter mail will provide an effective incentive to use First-Class Mail more than it otherwise would. Clearly, the trends observed in DFS's use of First-Class are determined by its need to mail transaction mail, and the trends observed in its use of Standard letter mail are determined by its marketing initiatives. Marketing initiatives in the financial services industry have lead times of six months to several years. Because DFS's decision to go ahead with a marketing initiative is made at least six months in advance of roll out, and is determined by demographic trends and economic cycles, it has almost nothing to do with the small rebates in the price of Standard letters relative to First-Class letters that are available under this NSA. This is particularly true because the size of the rebate is unknown until well after the credit card solicitations have been mailed.[12]

Rebates cannot reasonably be expected to drive volumes where the categories of mail purchased have small price elasticities, the rebates are a small percentage of the total price, and to qualify for them, a bulk mailer must adjust his entire purchase of a mail category in order to qualify for those rebates. When the original Discover NSA was reviewed, the Public Representative noted that when small marginal discounts such as those provided for in this NSA, are applied to large volumes (hundreds of millions of pieces in the case of this NSA), very high elasticities are required to incentivize enough

[12] The size of the rebate depends on the rate of inflation and the timing of cap-based rate cases that reflect that inflation. Consequently, the size of the rebate is unknown until the contract year after the advertising has been mailed.

volume for net contribution to be positive.[13] In its initial review of the Discover NSA, the Commission agreed, noting that the Discover NSA would increase the net contribution to institutional costs only if the rebates were applied to the **increment** of mail needed to meet the NSA-defined revenue threshold, rather than to all of DFS's First-Class and Standard letter mail.[14]

It is easy to demonstrate that DFS is not basing its decision to buy hundreds of millions of pieces of First-Class and Standard mail on the small rebates offered by the Discover NSA, and, instead, is awarding rebates for "anyhow" volume. This can be done by estimating what price elasticities would be necessary for these rebates to have caused all of the increases in volume of these categories in Contract Year One relative to the base period used by the Postal Service in its forecasts. The Commission has estimated that DFS's price elasticity for First-Class letter mail would have had to be **ten times as high as the average user of First-Class letter mail**, and its price elasticity for Standard mail would have had to be **forty-two times higher than the average user of Standard letter mail**.[15] These outlandish elasticities demonstrate that the growth in DFS's Contract Year One volumes relative to the Postal Service's FY 2010 baseline were not caused by the rebates it received at the conclusion of Contract Year One, but were caused, instead, by DFS's already-formulated marketing plan. That marketing plan was its response to the marketing efforts of its competition in the financial services industry, and its response to the phase of the economic cycle that it expected to prevail in that year.[16]

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[13] See Comments of the Public Representative in Response to Order No. 654, February 7, 2011, at 13.

[14] Even then, the Commission, concluded, the NSA would increase net contribution only if the Postal Service's volume forecast for the eligible categories were accepted. The Commission noted that actual volume trends for credit card solicitations were starkly at odds with the Postal Service's volume projections. See Order No. 694 at 14-15.

[15] FY 2012 Annual Compliance Determination at 157-58.

[16] The growth in DFS's eligible volume in Contract Year One relative to FY 2010 cannot be attributed to the NSA's rebates because those volumes were responding to the nation's economic cycle. When the terms of the original Discover NSA were drawn up (February 2011), direct mail from the

V. CONCLUSION

The legality of the Discover NSA is already on shaky ground. The Commission's FY 2012 Annual Compliance Determination has already found the original NSA is not consistent with the section 3622(c)(10)(A)(i) requirement that it will increase net contribution. The Commission also found that no showing has been made that it satisfies the only other available ground for approval--that it improves the Postal Service's operational performance.[17] The amended Discover NSA would put the agreement on even more fragile legal ground, because it would graft onto the NSA a completely unrelated business initiative to distribute a new credit card via Priority Mail. In doing so, the amended agreement would simply make it more likely that DFS, in Contract Year Three, will qualify for millions of dollars in rebates for the Standard Regular direct mail credit card solicitations that it planned to mail regardless of rebates. The amended NSA is, therefore, more likely than the original NSA to conflict with the section 3622(c)(10)(A)(i) requirement that it be shown to increase net contribution. For that reason, the amended NSA should be rejected.

VI. OTHER ISSUES

A. Conflating Market Dominant and Competitive Contribution.

financial services industry was rebounding dramatically from the recession lows of 2009 and leading industry consultants were forecasting that the rebound would continue through Contract Year One. The Postal Service was either unaware of these industry trends, or chose to disregard them in making its estimate of the effect of the NSA on volumes and revenues. See Clarification of Public Representative in Response to Reply Comments, February 23, 2011, at 3.

[17] See section 3622(c)(10)(A)(ii).

By characterizing this amendment as "minor," and not submitting it formally to the Commission for approval, the Postal Service apparently hoped that its amended NSA would receive light regulatory scrutiny for its compliance with section 3622(c)(10). As the Commission well knows, the viability of the PAEA depends on maintaining the integrity of the wall that it erects between the marketing and pricing of Market Dominant services and the marketing and pricing of competitive services. This wall is the mechanism that prevents the Postal Service from using its market power over Market Dominant products as leverage to gain an advantage in competitive markets.

This amendment breaches that wall by using one set of rebates to simultaneously incentivize the purchase by DFS of Market Dominant (Presort First-Class) and competitive services (Priority Mail). If the volumes of Priority Mail involved in the amended NSA constituted a significant share of the market for 2-day parcel-shaped mail, it would raise serious issues regarding a monopolist improperly using preferential prices for Market Dominant products to gain a competitive advantage in the market for the delivery of 2-day parcels. That could constitute an illegal tying arrangement under Section One of the Sherman Act [see Northern Pacific Railroad v. United States, 356 U.S.1 (1958)], and violate section 3622(c)(10)(B) [that an NSA be shown not to cause unreasonable harm to the marketplace]. Even at the relatively small volumes of Priority Mail that this amendment purports to involve, it conflicts with the most basic safeguard against misuse of monopoly power in the PAEA. The Commission has yet to ascertain whether there is a compelling business need to breach this wall, which it should do before it approves even a minor breach.

B. The Need to Calculate the Effects of NSAs Using Commission-Approved Methodologies.

In its order that originally approved this NSA, the Commission observed that the NSA as drafted was flawed because it was based on Postal Service forecasts of baseline volume (what volumes would have been without rebates) for Eligible First-

Class and Standard letters that avoids using the Commission's approved method of forecasting the impact of discounts on volume, i.e., avoids basing the forecast on the average price elasticities of the affected services. The Commission criticizes the Postal Service for not offering any other objective, qualitative analysis to take its place. The Commission noted that the Postal Service's forecast of baseline volume in this NSA even avoids any explanation of how the Postal Service combined or weighted the list of qualitative factors that it purports to have considered in making those forecasts. Order No. 694 at 13.

The Commission said that it could not endorse baseline volume projections based on such a subjective, non-analytical approach. It observed that "it is incumbent upon the Postal Service to develop a quantitative approach that incorporates the factors it is using to estimate volumes." Id. at 14. To remedy this deficiency, the Commission included, as one of the yearly reporting requirements for this NSA, "a *detailed discussion* of how the Postal Service believes DFS's own-price elasticities differ from the average elatsiticities of workshared First-Class and Standard Regular Mail." (emphasis supplied) Id. at 23.

The Postal Service's Data Report on the first contract year of this NSA brushed this reporting requirement aside, stating[18]

> The Postal Service can not quantify how DFS' own-price elasticities differ from the average elasticities of work shared First-Class Mail and Standard Regular Mail. The Postal Service does not measure how elasticities differ by customer. Obviously, the large groupings for which we have measures of elasticity are a composite of many customers; each of which may react to price changes differently.

The Postal Service so far has disregarded the italicized language in Order No. 694 quoted above. That language asks for a *detailed discussion* of how the

[18] Discover Financial Services Negotiated Service Agreement Data Collection Report (April 1, 2011 – March 31, 2012), Postal Service Response to Item 9.

Postal Service believes Discover's own-price elasticity for these services differs from the market's average own-price elasticities for these services.

Whether the Postal Service is using a formal model, or an informal, judgmental approach to forecast Discover's response to price rebates, if it identifies a specific number of incremental pieces that Discover will purchase in response to a specific price change, the Postal Service is, inescapably, assuming that Discover has a particular own-price elasticity for that service.

The Commission, in Item 9 of its Data Collection Report, directs the Postal Service to acknowledge, in quantitative terms, how far the own-price elasticity that it has assumed for Discover deviates from the market average, and explain in detail why it believes it deviates to the extent that it does. The fact that the Postal Service didn't use a formal model to estimate Discover's own price elasticity for the affected services is no excuse not to provide such a discussion in its answer to Item 9.

If the Commission decides to approve the amended NSA, it should condition its approval on good faith attempt by the Postal Service to answer Item 9 of the required data report. A good faith answer would have to acknowledge the extent to which the own-price elasticities that the Postal Service implicitly assumes for Discover differ from the relevant market averages, and provide a detailed discussion as to why they differ to that degree, in compliance with Order No.694.

Respectfully submitted

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