Postal Regulatory Commission
Submitted 5/7/2013 11:18:22 AM
Filing ID: 86927
Accepted 5/7/2013

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 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

Public Representative Response to the Ex Parte
Communications of Discover Financial Services

(May 7, 2013)

A. Introduction.

Since the Public Representative last filed comments, Discover Financial Services (DFS), through its counsel, Robert Brinkman, and through the senior manager of its marketing department, Cheryl O' Day, published two *ex parte* communications addressing the merits of the issues in this docket. Identifying himself as Legislative Counsel for the League of Postmasters, Mr. Brinkman authored an article entitled "Who Moved My Cheese?" which appears at pages 9-12 of the May issue of the Postmasters Advocate. The majority of his article challenges this Public Representative's conclusions that Standard Regular letter mail is a monopoly product and is price inelastic. On April 29, 2013, Cheryl O'Day, DFS's Senior Manager, Marketing Operations, sent a letter to the Chairman of the Postal Rate Commission which was copied to the other Commissioners. Ms. O'Day's letter challenges this Public Representative's conclusions that the Discover NSA did not comply with section

3622(c)(10) in Contract Year One and challenges the Commission's apparent agreement with that conclusion in the FY 2012 Annual Compliance Determination.

Both *ex parte* pieces assert that Standard Regular mail 1) is not a monopoly product, 2) that it faces "direct competition, 3) that postage is "by far" the largest cost of using it, 4) that it is price elastic, and 5) the price elasticity of Standard Regular mail "bears no relationship" to DFS's price elasticity.

B. Does Standard Regular Letter Mail Have "Direct Substitutes" or Is It a "Monopoly Product"?

One thing on which the Public Representative and DFS's spokesmen agree is that in evaluating market dominant NSAs, it is crucial to determine whether the product is price elastic or price inelastic.[1] If Standard Regular letter mail is price inelastic for DFS, any across-the-board rebate awarded to DFS will reduce the Postal Service's total revenue.[2]

There is only one supplier of Standard Regular letter mail service, yet Mr. Brinkman's article asserts that it is not a "monopoly product" because it has "direct substitutes." Mr. Brinkman is giving a different meaning to economic terms than the rest of the civilized world gives to them. There are no other suppliers of Standard Regular mail. Private industry cannot offer delivery of hardcopy mail to a targeted list of physical

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[1] Price elasticity is the ratio of a percent change in a product's price divided by the percent change in volume in response to that change in price. If a one-percent reduction in price causes less than a one-percent increase in volume, it is price inelastic. If a one-percent reduction in price causes more than a one-percent increase in volume, it is price elastic. Therefore, discounting inelastic products will decrease the Postal Service's total revenue. See "Analysis of Postal Price Elasticities," May 1, 2013, White Paper of the Office of the Inspector General of the United States Postal Service, Report Number: RARC-WP-13-008 (IG Whitepaper) at 4.

[2] Even though market dominant products are price inelastic, a market dominant NSA that offered discounts *only for volume that exceeds a baseline* could still increase net revenue. An NSA for an inelastic product that offers a discount for *all volume mailed*, such as the DFS NSA, cannot increase net revenue. The basic flaw in the DFS NSA is that it offers a discount on all DFS volume mailed, not on the increment above the baseline. In a nutshell, that is why it does not comply with section 3622(c)(10)(A).

mailboxes. For advertisers who find this form of communication the most effective, they have nowhere else to go but the Postal Service. A "direct competitor," as the rest of the civilized world uses that term, is one who offers to fill the same market need with *the same product*.[3] This is not a semantic quibble, because all products that have direct substitutes are price elastic (their own-price elasticity is above 1.0).

To illustrate how sensitive products that actually have direct substitutes typically are to changes in price, consider an intersection with a gas station on each corner. The gas stations meet the same market need by selling *the same product.* (One gas station's gas is the same as another station's gas, except for the brand.) Because each gas station's product is a direct substitute for the other gas stations' product, a station will capture virtually all of that corner's market if it prices its gas one-or two-percent below the others. The same price sensitivity can be seen in airlines that compete head-to-head by offering flights that leave at the same frequency from the same airport and connect the same city pair. Their products are direct substitutes, differentiated only by brand. If one airline discounts its service by only a few percentage points, it can fill every flight by taking fares from its competitor.[4] Buyers on the spot market for virtually any commodity (crude oil, copper, cotton, cantaloupes) have similarly high price elasticties. If a supplier of a commodity reduces the price of his product only one or two percent below market, he can sell his entire inventory in a matter of minutes.

Demand for products that have only indirect substitutes is much less sensitive to price. How much less depends on how close the indirect substitutes are. Consider the

[3] See, e.g., http://www.centerforadvantage.com/ci/competitiveassessment.htm; https://en.wikipedia.org/wiki/Competition_(economics).

[4] An example of the price sensitivity exhibited by national providers of the *same hard copy advertising product* is provided by the 2006 consent decree that Valassis and New America Marketing had to sign with the Federal Trade Commission. Together, these two companies supply almost the entire market for nationally distributed Free Standing Inserts (FSs). They sought to seize market share from each other by cutting price. Because they offered the same product (but for branding), they competed only on price. Each time one company cut its price, it took market share from the other, until the other met the lower price. This drove profits to zero. They decided to fix a price floor between themselves as the only solution to the problem of the high price elasticity of these direct substitutes.

cab driver who patronized the gas stations discussed earlier. A one-percent discount (3.5 cents a gallon) is enough to make him (and almost every other motorist in the neighborhood) choose the discounted gas over the competing brands. But when the cab driver goes back out onto the street, he will find that his cab services have many indirect substitute services that will fill the same need (getting a prospective fare from the same Point A to Point the same Point B) but they will not fill it in the same way. A potential fare can choose a more expensive alternative (private limo), or less expensive alternatives (subway, bikeshare, walking). The fare will not just think about the price, but about his arthritic knee, how long it will take to hail a cab, how frequently the subway comes, how long it will take to get from Point A to Point B once the ride begins, whether he will be sheltered from the cold, whether he can work on his presentation while he rides, whether he can talk privately with his client, how likely it will be to run into a traffic jam, and whether he can deduct the fare as a business expense, etc. Only after weighing all of these non-price factors will the traveler makes his choice.

These alternative transportation modes are *indirect substitutes* because each offers a unique combination of advantages and disadvantages to the traveler. A one- or two-percent reduction in price by any of the alternatives will not have much of an effect on the decision of the typical traveler as to which one he will choose because he will have to consider all of the non-price factors as well. Offering a discount of one- or two-percent, therefore, will increase the amount of the transportation service sold very little compared to the huge increase in sales it would bring to the gas station on the street corner described earlier.

DFS is in a position analogous to the traveler planning how to get from Point A to Point B. Price is only one of many important factors that determine what mix of advertising media it will choose. As Mr. Brinkman said, DFS chooses among e-mail, search engine, online advertising, social media, telemarketing, point-of-sale, and database marketing, as well as direct marketing. All have different response rates, action rates, amounts purchased per leed, and different loyalty effects. As a result, the price that each media channel charges DFS will have a different effect on DFS's return on investment.[5] The amount of any of these media services that DFS will purchase depends not just on their relative price, but on a half-a-dozen *crucially important non-price considerations*. Because non-price factors are crucial, it is to be expected that DFS's decision to purchase particular amounts of any alternative media channel (including Standard Regular letter mail) will have a price elasticity that is less than 1.0. Contrast this to the role that price plays in the cab driver's decision as to which station he will buy his gas from.

C. Objective Evidence of Price Elasticity.

Should the reader still doubt that Standard Regular letter mail is a monopoly product, that the competition it faces is from indirect substitutes, that the choice among those indirect substitutes depends crucially on a host of important non-price considerations, and that this makes Standard Regular letter mail price inelastic, he should look at the thorough analysis of the price elasticity of market dominant products that the Inspector General of the United States Postal Service has just released.

Christensen and Associates are economic consultants hired by the Inspector General of the United States Postal Service[6] to specifically investigate whether the recent recession, coupled with long-term competition from electronic forms of communication, have altered the price elasticity of market dominant products in general, and Standard Regular mail in particular. These economists are highly respected in the

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[5] Realistic estimates of the **non-price** advantages and disadvantages of purchasing indirect substitutes for Standard Regular letter mail are readily available. According to the Direct Mail Association's recent study, *2012 Response Rate Report*, the widely varying house-list response rates for the substitute media channels that DFS chooses among are as follows: Display Add 0.04%, E-mail 0.12%, Paid Search 0.22%, Direct Mail 3.4%, telephone 12.95%. The Returns on Investment (ROIs), however, follow a very different pattern. For example, for each $1 spent, the return on investment is: E-Mail $28.50, Direct Mail $7, Telephone $1. DFS has to calculate these widely varying benefits and compare them to the widely varying prices it will pay to get these benefits, before it can choose what mix of media channels to buy.

[6] See footnote 2, above.

field of econometric modeling, have long experience analyzing the postal market, and, because they were working for the Inspector General, have no incentive to slant their analysis.

Excerpts from the summary at the beginning of their report follow. (The bolding is mine):

> This paper analyzes the effect of postal price increases on revenue and volume. Opponents of price increases assert that higher prices will drive customers away, reducing revenue and exacerbating the loss of volume to electronic alternatives. Proponents of price increases cite the long history of price increases that led to revenue increases prior to the implementation of a price cap in 2007. The resolution of this dispute lies in the data. **Analysis of the demand for postal products shows that price increases will increase revenues. Recent events such as the Great Recession and the growth of use of the Internet do not change this conclusion**.
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> * * * * *
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> **The demand for the postal products studied is price inelastic. Price increases will increase revenues. Decreases in postal prices, either through price cuts or widespread use of discounting, will reduce Postal Service revenues.**
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> * * * * *
>
> The Great Recession and the availability of electronic alternatives clearly decreased the demand for the postal services examined in this report, as evidenced by a drastic decline in volume over the past 7 years. **However, neither the recession nor any other event since 2008 caused postal price elasticities to increase in any significant way. Postal price elasticities are not in flux. The demand for postal products remains price inelastic.**
>
> Price elasticities generally are higher when competitive alternatives are more readily available. Since electronic alternatives to mail have become increasingly widespread in recent years, one might think that price elasticity estimates that use data from an earlier, less competitive era would understate the price elasticities of mailers today. Christensen

> Associates found, however, that including historical data (from the 1990s, for example) in the econometric demand analysis does not materially affect the estimates of price elasticities.

At page 6 of the IG Whitepaper's Appendix:

> Both research tracks reached the following conclusions:
>
> **The demand for First-Class Mail, Standard Mail, and Periodicals is price inelastic,** and Christensen Associates' estimates are generally in the same range estimated by the Postal Service's 2012 models.
>
> - With the possible exception of Standard ECR, Christensen Associates **found no evidence that the demand for the market dominant products in this study has become more price elastic over time. In fact, one could reasonably conclude that some products have become *less* price elastic in recent years.**
>
> - **The Great Recession (or other recent events) does not seem to have had any discernible effect on price elasticities.**
>
> - **Use of historic data from a time with fewer electronic alternatives in the Postal Service's demand analyses does not lead to underestimates of price elasticities.**
>
> One of the primary purposes of econometric demand models is to determine what factors cause (or do not cause) changes in mail volume. These models show that recent volume declines are the result of the effects of the Great Recession and the long-term trend away from printed communications. **Price increases are not the cause of the Postal Service's volume losses. Mailers are not more sensitive to price increases than in the past.**
>
> Based on the econometric evidence, raising the price level for First-Class Mail, Standard Mail, and Periodicals above the rate of inflation will increase the gross revenues of the Postal Service. However, it is important to note that each price elasticity estimate applies to an aggregate classification of mail. It may be the case that market segments within an aggregate classification examined in this report are price elastic.

> **However, this implies that the remaining market segments within that classification are more inelastic than the overall econometric estimates.**
>
> **Widespread discounting among these market dominant products that lowers price levels will reduce revenue. Such indiscriminant use of discounting, therefore, is a counterproductive pricing strategy. Mailers are unlikely to increase volume sufficiently to offset the reductions in price.**

The White Paper thoroughly examined the historical responses of the volume of various market dominant products to changes in own price, the price of competing products, economic cycles, and technological substitutes. In almost every way imaginable, it empirically tests the hypothesis that recent volume declines in those products are being caused by changes in the shape of their respective demand curves (changes in their price elasticity).

The paper concludes that recent volume declines represent a shift of the relevant product demand curves to the left. **This means that the Postal Service's share of the communications market is dwindling for structural reasons, not because its products are becoming more sensitive to price**. In this regard, the IG's While Paper confirms the 2010 findings of Boston Consulting Group that the decline in First-Class transaction mail is due to the inherent cost and process advantages that a financial services corporation captures by integrating its document generation, billing and statement dissemination, and record storage into an all-digital system, rather to any recent trends in the price of First-Class postage.

The IG's White Paper, therefore, provides clear policy guidance on the assumptions that the Postal Service should bring to market dominant NSAs. The Postal Service should assume that an individual mailer of market dominant products has an inelastic demand for such products, unless that mailer provides specific, convincing reasons for believing that it has a sensitivity to discounts that is an exception to the rule. The Postal Service's approach to the DFS NSA, in contrast, tacitly assumes that DFS's elasticity for Standard Regular is several standard deviations above that of other users of Standard Regular mail. This is what one has to believe, in order to believe that DFS would base its entire purchase of Standard Regular mail in a given year ($271 million in Contract Year One) not on its calculation of the marketing effort that will be required to implement its business plans, but on the prospect that if it spends several hundred million dollars on direct mail *that it would otherwise not spend*, it might qualify for a rebate of around 2%.

D. The Mean and the Extreme.

In her letter to the Commissioners, Ms. O'Day passionately asserts that DFS's price elasticity is extremely atypical of other mailers of this market for Standard Regular letter mail, but she offers absolutely no reason that the Commission should think that this is true. She describes DFS's process for making marketing decisions, which involves calculating price and non-price tradeoffs between the full array of indirect substitute media channels discussed above before it decides what media mix it will by.

The trouble with this line of argument is that it makes DFS *similar*, not *dissimilar*, to all other financial services companies in the market for advertising direct mail. Visa, Mastercard, American Express, BankAmerica, Capital One, JP Morgan Chase, Citibank, and HSBC all choose from essentially the same array of indirect substitute media channels. They all have the same list of media suppliers to choose from. They all must calculate the price and non-price tradeoffs before they decide what mix they will buy. There is absolutely nothing that DFS has told the Commission that would indicate that its price elasticity for purchasing advertising mail (First-Class and Standard Regular) can plausibly be thought to be several standard deviations away from the price elasticity of the remaining high-volume users of that mail in the financial services industry (Visa, Mastercard, American Express, BankAmerica, Capital One, JP Morgan Chase, Citibank, and HSBC).

E. Is a Subjective or an Objective Showing of Compliance with Section 3622(c)(10)(A) Required?

At page one of her *ex parte* letter to the Commissioners, Ms. O'Day hopes to take the issue of what DFS's price elasticity really is entirely out of the realm of objective review by asserting that

> we believe that different companies have very different sensitivities to mail an mail rates, and our experience is that those sensitivities change all the time, varying month to month if not week to week.

In other words, the DFS's advertising budget and advertising plans (which would determine its price elasticity of demand for the various media channels that it uses) are evanescent and unknowable. They are a will o' the wisp--little more than a gleam in Ms. O'Day' eye. One gets the impression from reading her letter that she knows more about what she will have for breakfast tomorrow than she knows about his own marketing plans. Can you imagine if Ms. O'Day went to the corporation's budget committee with a pitch like that? Do you think she would come away with budget authority of more than 1 dollar? Yet this is the level of information on which Mr. Brinkman and Ms. O'Day urge the Commission to base its finding that this NSA will increase the Postal Service's net revenue.

If asserting that its marketing plans are an unknowable will o' the wisp is enough to affirmatively demonstrate that the DFS NSA will increase the Postal Service's net revenue, as section 3622(c)(10)(A) requires, what is to stop Visa, Mastercard, American Express, BankAmerica, Capital One, JP Morgan Chase, Citibank, and HSBC from coming in with their similarly-situated NSA proposals? Why will they not be able to claim that their price elasticities for targeted advertising mail are also several standard deviations larger than average, and justify it with the same showing that DFS is insisting on here (that their marketing plans must be presumed to be extraordinarily sensitive to price, yet are unknown and unknowable, even to themselves)? What will have happened to the idea that NSA's have to meet standards? What will happen to the idea that the Commission's duty is to see that statutory standards have meaning? And, most importantly, in light of what we have learned from the Inspector General's White Paper, what will happen to the Postal Service's money?

F. Who Moved My Rebate?

From December 2010 until April of 2011, DFS's Standard Regular mail surged. After April, 2011, it subsided. The DFS NSA took effect after April, 2011, when the surge was over. Only mail sent after April could qualify for a rebate. It would appear to an objective observer that the surge in mail sent by DFS prior to April 2011 was part of a marketing plan that was being implemented regardless of the prospect of rebates. Likewise, it would appear to an objective observer that the subsidence of volume sent by DFS once its mail became potentially eligible for rebates took place for reasons that were independent of the rebate. If rebates were driving these decisions, DFS would have postponed its surge of marketing mail until that mail could have earned a rebate. But, according to Ms. O'Day's *ex parte* letter to the Commissioners, appearances deceive. She says that even through the pre-NSA surge in volume could not qualify for a rebate, the possibility that DFS might later earn rebates on other mail boosted the company's "confidence" sufficiently to cause it to roll out its direct mail marketing initiative at full price, when it had no chance to earn rebates. Letter at 2.

Of course, if the chance to earn rebates has been driving DFS's mailing decisions, DFS would have done the opposite of what it did—it would have held back its roll-out until its Standard Regular mail could qualify for rebates. By floating this implausible interpretation of the evidence, Ms. O'Day is asking the Commission to "take my word for it" no matter how difficult it is to square with the facts.

It is common for the nation's statutes and regulations to include legal standards that require a fact finder to look at the reasons underlying an actor's behavior. An example is our system of tort law under which the reasons or motives underlying an actor's behavior are evaluated by a judge, jury, or regulator. Under tort law, the risk to others caused by a defendant's behavior is evaluated according to the standard of what a "reasonable man would have done under the same circumstances." [7] That an objective standard of review is necessary to allow the tort law system to function is illustrated by the following case.

A young man, driving on an empty country road, crashed his convertible into a widow's pear tree, flattening the tree. He was proving to the girl in the passenger seat that, as an all-star soccer player, he could do anything with his feet that other people could do with their hands. The car flattened the pear tree, he told the judge, not because he was steering with his feet, but because he had to avoid the widow's cat, which had darted in front of the car. Through his attorney, the young man argued that he was exercising the ordinary standard of care, since he could steer with his feet as well as normal people could steer with their hands. The judge, however, didn't see it that way. He said the issue wasn't whether the young man was being careful in his own mind. The issue was whether a "reasonable man in the same situation" would consider such driving careless.

If tort lawsuits had to exonerate all defendants who assert that they were not taking unusual risks in their own mind, our system of negligence law would unravel. There would be no tort system. To function, our system of negligence law has to employ the objective test of what a "reasonable man under the circumstances" would think of the risk being taken. The same is true of applying section 3622(10)(A). If the affirmative showing that an NSA will increase the Postal Service's net revenue can be considered to be met simply because an applicant says "in my own mind, my price elasticity is ten times normal, take my word for it," section 3622(c(10)(A) would, as a practical matter, be repealed. For that statutory standard to have meaning, an *objective* showing that it will increase contribution must be provided.

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[7] See, e.g., http://injury.findlaw.com/accident-injury-law/standards-of-care-and-the-reasonable-person.html

G. The Significance of Non-Postage Costs.

Mr. Brinkman scoffs at the Public Representative's assertion that postage is a "small" part of the total cost of using Standard Regular mail. To an extent, his criticism is justified. In asserting that non-postal costs have an important bearing on the mailer's decision whether, and how much, mail to purchase, I should have been less categorical. I should have said that non-postal costs range from constituting the majority of the costs of sending Standard Regular letter mail to a large minority of those costs, depending on a number of factors.

Further research using media companies who provide worksheets that break out the full costs of Standard Regular letter mailings shows that the range of estimates depends on such things as whether the creative portion of preparing a mailing campaign is professionally done, whether extensive test mailings are done, how sophisticated the mailing lists purchased are, and whether such things as four-color printing and the processing of reply envelopes are included.

According to the websites below,[8] the total cost to design, print, and mail a piece of Standard Regular mail ranges from 40 cents to more than $1 dollar. If enough mail is ordered to sort to 5 digits, postage is 24.7 cents per piece. Under these assumptions, postage as a share of the total cost of the mailing ranges from roughly 25 percent to 60 percent. These websites, however, typically base the cost breakout on mailings of less than 50,000. Postage becomes a larger share of total per piece costs as mailings increase in size above that level. Even for larger mailings, however, the cost of production, printing, and processing hard copy responses remain major considerations in the calculation of what, and how much mail to buy.

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[8] http://www.pbsmartmarketer.com/en/direct-mail-pricing/; http://download.endicia.com/Endicia/PDF/Webinars/Presort+Mail+101+for+Small+Business.pdf; http://www.controlbeaters.com/L5.html#2; http://printinthemix.com/Fastfacts/Show/575; http://www.bplans.com/business_calculators/direct_mail_roi_calculator;

H. Final issue.

Neither Mr. Brinkman nor Ms. O'Day mentions the problem that the amended NSA would breach the firewall that is supposed to exist between market dominant and competitive products. There is an anti-trust principle that prohibits tying the purchase of competitive products to the purchase of monopoly products. To establish a violation, however, it is necessary to show that tying will have a significant adverse market impact. As the Public Representative noted previously,[9] that is not likely here because DFS has assured us that only insignificant volumes of Priority Mail are involved. Nevertheless, approving the amended NSA would set a highly undesirable precedent for future NSAs where the potential impacts of the tying arrangement on competitive markets could be substantial.

Respectfully submitted

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[9] See Public Representative Comments, April 3, 2013, at 12.