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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

DISCOVER FINANCIAL SERVICES NSA — Docket No. MC2015-3

DISCOVER FINANCIAL SERVICES NSA — Docket No. R2015-2

RESPONSE OF THE UNITED STATES POSTAL SERVICE TO COMMENTS OF THE PUBLIC REPRESENTATIVE
(November 21, 2014)

On November 17, 2014, the Public Representative ("PR") filed comments ("Comments") in this docket in response to Postal Regulatory Commission ("Commission") Order No. 2231 filed on October 29, 2014. The United States Postal Service ("Postal Service") hereby submits its response to certain issues raised by the PR in those comments.[1]

Although the Postal Service understands the PR's perspective, we respectfully disagree with his characterization of this Negotiated Service Agreement ("NSA") and its potential value to the Postal Service. The Postal Service has provided an analysis and estimates to support its good faith belief that this NSA will improve our net financial position by increasing the overall contribution to institutional costs. Assuming the Commission elects to approve this NSA, the passage of time will provide definitive information Discover's past performance,[2] and its stated intentions during the course of

[1] In this pleading, the Postal Service has not attempted to respond to all of the PR's comments or those filed on November 17, 2014 by Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Rather, we have focused on the PR's characterizations of the purpose and effect of the NSA with Discover Financial Services ("Discover"), as it embodies the agreement between the parties arrived at through negotiations.
[2] Statement of Harit Talwar, Discover Financial Service Executive Vice President, President – U.S. Cards and Chief Marketing Officer, Docket Nos. MC2015-3, R2015-3,(Oct.28, 2014) at 6 &19 (Hereafter "Talwar Statement").

negotiations and its subsequent statements filed with the Commission[3] Substantially reinforce the Postal Service's conclusions.

The Postal Service affirms its belief that (i) Discover will act in good faith and honor its contractual obligations under this NSA and (ii) the NSA will increase the overall contribution to the Postal Service's institutional costs. The Postal Service also reaffirms its assertion that this NSA (a) conforms to the policies embodied in the Postal Accountability and Enhancement Act of 2006; (b) meets the statutory standards supporting the desirability of this special classification;[4] (c) has the potential to enhance the Postal Service's long-term financial position; and (d) will not cause unreasonable harm to the marketplace.

At various points in his comments, the PR criticizes the Commission and the Postal Service for poor judgment. The PR also asserts that this NSA does not meet the requirements of 39 USC 3622(c)(10). In essence, the PR thinks this NSA should be disapproved by the Commission because of a perceived lack of "actionable evidence",[5] incomplete information and non-existent methodology. We respectfully disagree. With our initial submission and our subsequent response to questions posed by the Commission,[6] the Postal Service provided detailed information and financial projections based on our long-established and long-utilized methodology.

With respect to 39 USC 3622(c)(10), in establishing a modern system for regulating rates and classes for market-dominant products, the Commission takes into account

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[3] Comments of Discover Financial Services, Docket Nos. MC2015-3, R2015-3, (Nov. 17, 2014), at 1, 2, 4-6.
[4] 39 USC 3622((c)(10).
[5] This term is undefined. Public Representative Comments, Docket Nos. MC2015-3, R2015-3 (Nov. 17, 2014), at 1 (Hereafter, "Comments").
[6] Notice of the USPS of Filing Request to Add Discover Financial Services Negotiated Service Agreement to the Market-Dominant Product List, Docket Nos. MC2015-3, R2015-3 (Oct. 27, 2014); *see also* Responses of the USPS to Chairman's Information Request No. 1, Questions 1-12, Docket Nos. MC2015-3, R2015-3 (Nov.13, 2014).

> “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 . . . *improve the net financial position of the Postal Service through* reducing Postal Service costs or *increasing the overall contribution* to the institutional costs of the Postal Service; . . . and (B) do not cause unreasonable harm to the marketplace.” [Emphasis added]

This NSA adheres to that tenet as the structure of this NSA is explicitly designed to improve the Postal Service’s overall net financial position by growing overall contribution through increasing Standard Mail revenue and volume to offset declining First Class Mail. Instead of seeing potentially hundreds of millions in business revenue diverted to digital channels, the Postal Service is attempting, not only to retain the business of one of its largest mailers, but to grow its total net contribution. As the PR correctly cited, the Direct Marketing Association’s 2014 Statistical Fact Book is one the leading industry resources utilized by marketers. However, the PR incorrectly characterized the Credit Card sector as “stable from 2011 to 2013 as compared with 2008 to 2010”.[7] A simple review of the yearly figures in the chart he provided in his comments shows variance and fluctuation, not stability. This instability is an indicator of volatility of market behavior in the credit card sector.[8] This type of behavior reflects risk. This NSA is designed to minimize risk in an unstable market environment. As the PR noted, the Postal Service is acting logically by trading risk for certainty.

Apart from his incorrect assumption that the NSA will lose money, the PR contends that this NSA is flawed because he thinks it is similar to the prior NSA with Discover.

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[7] Comments at15.

[8] Albert Bollard, Robert Mau and Ido Segev, *The future of credit card distribution*, *McKinsey on Payments*, McKinsey & Company, 28-33 (Sep. 2013), *available at* http://www.google.com/url?url=http://www.mckinsey.com/~/media/mckinsey/dotcom/client_service/financial%2520services/latest%2520thinking/payments/mop18_the_future_of_credit_card_distribution.ashx&rct=j&frm=1&q=&esrc=s&sa=U&ei=5FhvVO_0CZamyATm94BQ&ved=0CBQQFjAA&usg=AFQjCNGPHb7YSA_PinZoU1ZsXl0CUy6gTw.

While this NSA does extend rebates to Discover, this NSA is not a replica. This NSA is an evolution which reflects changing business needs of both parties. Just as Discover's business is constantly evolving to meet changing market needs, our NSA has evolved. That there are some similarities is natural -- the parties are the same, the framework of PAEA remains unchanged, and the Postal Service must still strike a balance between meeting a key customer's needs, the needs of other similarly situated mailers in the marketplace and its own needs. This NSA reflects that balance and enables the Postal Service to not only maintain and increase the value of Discover's total business with the Postal Service, but also to increase overall contribution.

Under this NSA, Discover would qualify for revenue rebates if, and only if, DFS Eligible Mail *both* (i) meets or exceeds specified annual revenue thresholds *and* (ii) exceeds the aggregate total volume for DFS Eligible Mail. Furthermore, if Discover does not meet the Annual Revenue Growth Thresholds in each year of the NSA, it is obligated to pay the Postal Service a nonperformance penalty of ten percent (10%) of the difference between the Annual Revenue Growth Threshold and the annual revenue actually generated by DFS Eligible Mail in a particular Agreement Year. [9]

In addition to new provisions designed to strengthen the overall contract,[10] this NSA includes provisions regarding (1) termination (tying continuation of the NSA to annual revenue and volume commitments; allowing the Postal Service to terminate the NSA if DFS fails to meet the annual Tier 1 revenue growth threshold; and allowing the Postal Service to terminate the NSA if Discover fails to cure a material breach within thirty (30) calendar days after receiving written notice); (2) sale (requiring downward adjustment of

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[9] As the PR acknowledges, absent payment of rebates, the penalty alone would cause the NSA to meet the contribution requirement of section 3622(c)(10).

[10] The NSA includes provisions regarding dispute resolution, remedies, sovereign acts, and general provisions(including but not limited to choice of law; consent to jurisdiction; force majeure; assignment; amendment; waivers; invalidity; relationship; trademarks; and survival).

Baseline Volume and Baseline Revenue thresholds equal to the corresponding total DFS Eligible Mail volume lost in the year preceding the Sale); and (3) acquisition or merger provisions (requiring upward adjustment of the Baseline Volume and Baseline Revenue Thresholds to account for increased mailing activity that would qualify as DFS Eligible Mail).

Furthermore, as Discover has to not only maintain the revenue and volume thresholds[11] for this NSA, it must exceed them and create more net contribution year over year. This structure was not chosen by the Postal Service in a vacuum. It was the result of lengthy negotiations which began before, and continued after, the prior NSA terminated. The contract, taken as a whole, is beneficial to both the Postal Service and Discover. If this were not so, neither party would have elected to pursue a new NSA.

The Postal Service negotiated and evaluated this NSA based on its best business judgment of Discover's future behavior, given current trends, understanding of Discover's business, and expectations of market and economic conditions, and will evaluate actual results based on these same factors. The Postal Service will perform the same kind of analysis with regard to other mailers who would like to enter into a similar agreement; the fact that no mechanical model can be substituted for this analysis is not a reason either to doubt the judgment of the Postal Service or to reject this agreement.

While the PR acknowledges the perils of diversion of mail volumes to alternative communications media, the particular status of Discover among similar mailers and the apparent benefits of Discover's past mailing record, and the potential benefits of agreements with particular mailers to contribute to the Postal Service's financial

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[11] The thresholds were based on the Year 3 volumes and revenues generated as a result of the prior NSA.

condition, he accuses the Postal Service of presenting the Commission with a "false choice." He proposes two alternatives. The Commission could hold the review of this NSA in abeyance, pending a rulemaking to develop an alternative methodology. Or, it could conditionally approve the NSA and order the Postal Service to petition for a rulemaking. If limited to these two outcomes, the Postal Service would prefer the second. Delaying the benefits to the Postal Service and Discover from the NSA, while the Commission engages in what would surely be a protracted and potentially contentious rulemaking proceeding, would be an extremely unwise business choice in today's economic environment, and in light of the considerations outlined in the Discover CMO's statement. Given the new information injected here in that statement, and Discover's own comments, the Postal Service would strongly advocate a third option. Approve the NSA as negotiated and structured. Wait for real evidence of the merits of the deal in the event rebates are provided If that evidence does prove that this NSA failed to provide any financial benefits, the Postal service would have no incentive to continue it, and, under the terms of the contract, it could terminate.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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