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ORDER NO. 2410

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners: Robert G. Taub, Acting Chairman;
Tony Hammond, Vice Chairman;
Mark Acton;
Ruth Y. Goldway; and
Nanci E. Langley

Market Dominant Product Prices
First-Class Mail & Standard Mail
Discover Financial Services

Docket No. MC2015-3

Market Dominant Product Prices
Discover Financial Services (MC2015-3)
Negotiated Service Agreement

Docket No. R2015-2

ORDER REJECTING THE POSTAL SERVICE'S REQUEST TO ADD DISCOVER NEGOTIATED SERVICE AGREEMENT TO THE MARKET DOMINANT PRODUCT LIST

Washington, DC 20268-0001

March 24, 2015

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ORDER REJECTING THE POSTAL SERVICE'S REQUEST TO ADD DISCOVER NEGOTIATED SERVICE AGREEMENT TO THE MARKET DOMINANT PRODUCT LIST

(Issued March 24, 2015)

I. INTRODUCTION

The Postal Service seeks to add a new negotiated service agreement[1] (NSA) with Discover Financial Services (Discover) to the market dominant product list.[2] The

[1] An NSA is "a written contract, to be in effect for a defined period of time, between the Postal Service and a mailer, that provides for customer-specific rates or fees and/or terms of service in accordance with the terms and conditions of the contract." 39 C.F.R. § 3001.5(r); *see also* 39 C.F.R. § 3010.6. In an NSA, a mailer often receives a discount (or rebate) designed to encourage higher mail volumes and contribution.

[2] Notice of the United States Postal Service of Filing Request to Add Discover Financial Services Negotiated Service Agreement to the Market-Dominant Product List, October 27, 2014 (Request).

Commission is unable to approve the Request because the Postal Service has not demonstrated that the Discover NSA complies with the applicable statutory and regulatory requirements.

Under the applicable statutory and regulatory requirements, the Commission cannot approve an NSA for a market dominant product if the Postal Service fails to demonstrate the NSA will either: (1) improve the net financial position of the Postal Service through reducing costs or increasing the overall contribution to institutional costs; or (2) enhance the performance of mail preparation, processing, transportation, or other functions. 39 U.S.C. § 3622(c)(10); *see also* 39 C.F.R. § 3010.40(a). The Postal Service maintains the Discover NSA will improve its net financial position through increasing contribution to institutional costs.

The Commission, however, cannot conclude that the agreement is likely to improve the Postal Service's net financial position after evaluating it using the accepted methodology. Acknowledging this difficulty, the Postal Service suggests an alternative approach for use in reviewing this NSA. Yet its alternative approach is improperly based on subjective intuition rather than the objective evidence necessary to support its claims.

This is the first NSA the Commission has been unable to approve, and it is not a decision the Commission takes lightly. The Commission is not insensitive to the financial challenges faced by the Postal Service. Although the Postal Accountability and Enhancement Act (PAEA) granted new flexibility to the Postal Service in setting postal prices, it also made clear that only NSAs that improve the net financial position of the Postal Service or enhance the performance of certain postal operations may be approved.[3] These statutory limitations protect the public and other mailers. Otherwise, NSAs that do not improve the financial position would cause decreases in contribution

[3] The Postal Service does not claim that the Discover NSA enhances the performance of postal operations.

from volume-based discounts that would exacerbate the Postal Service's already challenging financial circumstances.

Accordingly, the PAEA does not grant the Commission the discretion to approve the Postal Service's Request, when, as in this case, the Postal Service fails to demonstrate that the Discover NSA complies with the applicable statutory and regulatory requirements.

II. BACKGROUND

A. Procedural History

Pursuant to 39 U.S.C. §§ 3622 and 3642, and 39 C.F.R. parts 3010 and 3020, the Postal Service filed a formal request to add the Discover NSA (or the Agreement) to the market dominant product list.[4] Request at 1. In Order No. 2231, the Commission gave notice of the two dockets, appointed a Public Representative, and provided the public with an opportunity to comment.[5] To provide the Postal Service an opportunity to submit additional information to support its Request and possibly permit the Commission to approve the Agreement under applicable statutory and regulatory requirements, the Chairman issued an information request seeking clarification of various elements related to the Discover NSA.[6] The Responses to CHIR No. 1 did not provide the Commission with a basis to approve the Agreement, and the Commission issued an additional, more detailed information request designed to provide the Postal

[4] In support of its Request, the Postal Service filed a copy of the Board of Governors' Resolution No. 14-07, authorizing a negotiated service agreement with Discover; a copy of the contract; proposed descriptive language changes to the Mail Classification Schedule; a proposed data collection plan; a statement of supporting justification as required by 39 C.F.R. § 3020.32, which the Postal Service also asserts satisfies the requirements of 39 C.F.R. § 3010.42(b)-(e); and a financial model.

[5] Notice and Order Concerning Addition of Discover Financial Services Agreement to the Market-Dominant Product List, October 29, 2014 (Order No. 2231).

[6] Chairman's Information Request No. 1, November 6, 2014 (CHIR No. 1); *see also* Responses of the United States Postal Service to Chairman's Information Request No. 1, Questions 1-12, November 13, 2014 (Responses to CHIR No. 1).

Service another opportunity to submit the necessary information required under the applicable statutory and regulatory framework.[7]

B. Postal Service's Request

The Postal Service believes the Discover NSA conforms to the policies of the PAEA and meets the statutory standards supporting the desirability of special classifications under 39 U.S.C. § 3622(c)(10). Request at 3. The Postal Service considers Discover to be one of its largest customers, generating over $300 million in annual mail revenue. *Id.* at 4.

Description of the NSA. The Postal Service indicates the NSA is designed to increase the total aggregate contribution the Postal Service receives from mail eligible pursuant to its agreement with Discover. *Id.* at 5. The Postal Service indicates the NSA consists of the following key components:

- Discover must meet or exceed annual revenue growth thresholds (*i.e.,* 3-6 percent above the baseline) to qualify for specific rebate percentages under a tiered structure. The baseline revenue amount to calculate the annual growth thresholds is $304,053,073.
- Discover must also meet or exceed a baseline volume amount annually (1,256,212,059 pieces in the first year, subsequent contract years' eligible volumes depend on volumes in prior years) in order to qualify for a rebate.
- The NSA provides for a tiered rebate structure for a portion of the postage paid for eligible mail if such mail (1) meets or exceeds specified annual revenue thresholds, and (2) exceeds the aggregate total baseline volume for mail eligible

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[7] Commission Information Request No. 1, December 12, 2014 (CIR No. 1); *see also* Responses of the United States Postal Service to Commission's Information Request No. 1, Questions 1-18, December 19, 2014 (Responses to CIR No. 1); Notice of Filing of USPS-MC2015-3/NP1 and Application for Nonpublic Treatment, December 19, 2014.

under the Agreement. The tier 1 and 2 rebates are 2.25 percent and 2.5 percent, respectively.

- If Discover does not meet the annual revenue growth thresholds provided for in the NSA, Discover must pay the Postal Service a nonperformance penalty of 10 percent of the difference between the annual revenue growth threshold and the annual revenue actually generated by Discover for mail eligible under the Agreement.

Id. at 5-13.

The Agreement's effective date is one business day following the day on which the Commission issues all necessary regulatory approval. *Id.* at 1. The Agreement also contains an implementation date (December 1, 2014, or on a date mutually agreed upon by the Postal Service and Discover), and will expire three years from the implementation date, unless otherwise terminated pursuant to the provisions of the agreement. *Id.* at 1; *id.* Attachment B at 6. The Agreement contains a termination clause, granting either the Postal Service or Discover the right to terminate the Agreement for convenience prior to the last 90 days of each agreement year, without penalty. *Id.*

Similarly situated mailers. With respect to potential similarly situated mailers, the Postal Service declares it is ready to negotiate and implement functionally equivalent agreements with such mailers. *Id.* Attachment E at 4. It believes that in assessing the desirability of a similar agreement, the defining characteristics of Discover are its size, its large aggregate Standard Mail and First-Class Mail postage, its expanding Standard Mail advertising volume, and its declining First-Class Mail billing and statement volume. Request at 13.

C. Comments

Comments were filed by Discover,[8] Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (together, Valpak),[9] and the Public Representative.[10] Discover[11] and the Postal Service[12] filed reply comments. In brief:

- The Postal Service and Discover, the parties to the Agreement, separately filed comments and/or reply comments in support of the proposed NSA.
- Valpak, a direct marketing company, filed comments urging the Commission to reject the proposed NSA on the basis that it fails to meet the applicable statutory requirements.
- The Public Representative commented that the Postal Service has offered no actionable evidence that the proposed NSA will meet statutory and regulatory requirements for market dominant NSAs.[13] He urged the Commission to hold the

[8] Preliminary Comments of Discover Financial Services, November 13, 2014 (Discover Preliminary Comments); Comments of Discover Financial Services, November 17, 2014 (Discover Comments). In addition, Discover filed a Statement of Harit Talwar, which the Commission treats as initial comments. Statement of Harit Talwar, October 28, 2014 (Talwar Statement). Discover also filed a notice of filing. Notice of Filing of Statement of Harit Talwar Chief Marketing Officer of Discover Financial Services, October 28, 2014.

[9] Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Discover Financial Services Negotiated Service Agreement, November 17, 2014 (Valpak Comments).

[10] Public Representative Comments, November 17, 2014 (PR Comments).

[11] Reply Comments of Discover Financial Services, November 21, 2014 (Discover Reply Comments). Discover also filed a motion for acceptance of its reply comments. Motion for Acceptance of Discover Reply Comments, November 21, 2014 (Discover Motion). The Discover Motion is granted.

[12] Response of the United States Postal Service to Comments of the Public Representative, November 21, 2014 (Postal Service Reply Comments). The Postal Service also filed a motion for acceptance of its reply comments. Motion of the United States Postal Service for Leave to File Response to Comments of the Public Representative, November 21, 2014 (Postal Service Motion). The Postal Service Motion is granted.

[13] The Public Representative is designated by the Commission, pursuant to 39 U.S.C. § 505, to represent the interests of the general public independently from the Commission.

proceeding in abeyance until a meaningful understanding of the impact of the Agreement is developed.[14]

The comments received by the Commission are summarized in Appendix A and addressed in the relevant sections of the Commission's analysis.

III. PRELIMINARY MATTERS

The Commission has reviewed the Request, the Agreement, the financial analyses, the Postal Service's responses to CHIR No. 1 and CIR No. 1, and all initial and reply comments filed in this docket. The Commission cannot approve the Request because the Postal Service did not demonstrate that the Discover NSA complies with the applicable statutory and regulatory requirements.

Product list assignment. The Commission's initial statutory responsibilities in this docket require it to determine whether the proposed Discover NSA should be assigned to the market dominant product list or the competitive product list. 39 U.S.C. § 3642. In making this determination, the Commission must consider whether "the Postal Service exercises sufficient market power that it can effectively set the price of such product substantially above costs, raise prices significantly, decrease quality, or decrease output, without risk of losing a significant level of business to other firms offering similar products." 39 U.S.C. § 3642(b)(1). If it meets these requirements, the product will be categorized as market dominant; the competitive product category consists of all other products.

No commenter opposes the proposed classification of the Discover NSA as market dominant. Having considered the statutory requirements discussed above and the support offered by the Postal Service, the Commission finds, for purposes of this

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[14] The Public Representative's comments were filed *before* the responses to CIR No. 1 were due.

proceeding, that the Discover NSA product could properly be classified as a market dominant product.

Provisions applicable to market dominant products. Next, the applicable statutory and regulatory provisions require that the proposed market dominant NSA must either: (1) improve the net financial position of the Postal Service through reducing costs or increasing the overall contribution to institutional costs; or (2) enhance the performance of operational functions. *See* 39 U.S.C. § 3622(c)(10)(A); 39 C.F.R. § 3010.40(a). This requirement is discussed in Section IV of this Order.

Finally, a proposed NSA "may not cause unreasonable harm to the marketplace" and "must be available on public and reasonable terms to similarly situated mailers." 39 C.F.R. § 3010.40(b), (c); *see also* 39 U.S.C. § 3622(c)(10)(B). Because the Commission is unable to conclude the Discover NSA improves the net financial position of the Postal Service, this Order does not address these requirements.

IV. COMMISSION'S FINANCIAL ANALYSIS

The primary issue is whether the Agreement's volume-based discount would create more contribution toward paying for the institutional costs of the Postal Service than would be received in the absence of the Agreement. In its analysis of this issue, the Commission needs to evaluate how much additional volume Discover will send due to the discount. With respect to that analysis, the key issue is the importance of Discover's elasticity (or price sensitivity).

Elasticity is a general economic term used to describe the relationship between two variables. In this Order, it is used exclusively to refer to price elasticity, which is a measure of the volume response to a price change.[15] Roughly speaking, elasticity is the percentage change in quantity divided by the percentage change in price. *Id*. Thus,

[15] Docket No. RM2010-9, Notice of Proposed Rulemaking Concerning Methods to Estimate Volume Changes Caused by Pricing Incentive Programs, June 8, 2010, at 4 (Order No. 469).

if the elasticity, price change, and volume (either before or after the price change) are known, the volume change associated with the price change can be determined. *Id.*

The Postal Service asserts that elasticity cannot capture the effects of the Discover NSA. *See* Responses to CHIR No. 1, questions 3, 9; Responses to CIR No. 1, questions 12, 13. Notwithstanding its assertion, elasticity is a mathematical relationship that by definition captures price effects.

In support of its position that the Agreement would create more contribution than would be received in the absence of the Agreement, the Postal Service does not rely on the methodological principles that have been previously approved by the Commission. Request at 5, 13-15. Instead, the Postal Service proposes an alternative approach, which relies on its estimates of before-rates volume. However, the Commission is concerned by the fact that the Postal Service's estimates are unsupported.

In many past proposals for volume-based incentives, volumes in excess of a specified threshold were eligible for discounts.[16] In general, the Commission is concerned that inaccuracies in the Postal Service's estimate could cause the value of discounts to be awarded to volume that would have been mailed regardless of the discounts to exceed contribution from new volume sent in response to the discounts. In this case, once the specified threshold is reached, all volumes, not just those in excess of the threshold, are discounted. This means that by design, the majority of discounts awarded by the Discover NSA would be for mail that would be sent without the discount.

That is not to say the Postal Service is prohibited from giving discounts on volume that would have been mailed regardless of the discount. However, if the Postal Service provides discounts for these volumes *in excess of new contribution from volume growth due to the discounts*, the resulting contribution to the Postal Service would be *less* than the contribution it would have received without the NSA. Such a result would

[16] *See, e.g.,* Docket Nos. MC2011-19 and R2011-3, Order Adding Discover Financial Services 1 Negotiated Service Agreement to the Market Dominant Product List, March 15, 2011 (Order No. 694).

not be in accord with applicable statutory and regulatory provisions. *See* 39 U.S.C. § 3622(c)(10)(A); 39 C.F.R. § 3010.40(a).

In the sections that follow, the Commission first discusses how the Postal Service has not demonstrated that the Discover NSA will improve its net finances. Second, the Commission discusses the Postal Service's alternative approach and why the Commission cannot accept such approach as consistent with statutory and regulatory requirements. Third and finally, the Commission discusses the Postal Service's failure to provide any potential alternative or additional rationales under which the Commission could approve the NSA.

A. The Postal Service has not Demonstrated the NSA will Improve Net Finances

As stated above, a proposed market dominant NSA must either: (1) improve the net financial position of the Postal Service through reducing costs or increasing the overall contribution to institutional costs; or (2) enhance the performance of operational functions. *See supra* III; 39 U.S.C. § 3622(c)(10)(A); 39 C.F.R. § 3010.40(a). The Postal Service contends the Discover NSA will improve its net financial position through increasing contribution to institutional costs. Request at 5.

Below, the Commission first explains how under the accepted methodology, the Discover NSA will result in a net loss. Second, the Commission discusses the rationale underlying the accepted methodology. *See also infra* Appendix B. Third, the Commission responds to the Postal Service's and Discover's criticisms of the accepted methodology.

1. Accepted Methodology Shows the NSA will Result in Net Loss

The Postal Service calculates the net benefit from the Discover NSA, using the accepted methodology, as *negative* $6,180,863 in the first year of the Agreement. Request, DFS NSA Financials (Attachment F), tab "5_Commission's Methodology"; *see* *also* Responses to CHIR No. 1, question 3. The Postal Service further estimates the Agreement will have a negative $18 million net financial impact over its three-year term. Responses to CHIR No. 1, question 3; Excel file "CHIR No.1_QU3b."

The Postal Service's estimate assumes Discover will just meet the Agreement's volume threshold, making it eligible for a discount. *Id*. If Discover's volume exceeds the threshold by 10 percent, the Agreement is expected to have a negative net financial impact of more than $20 million over the three-year term. *Id.* The only scenario within the proposal that provides a positive impact on net contribution is if Discover misses the Agreement's volume threshold and pays a penalty per the Agreement. *Id.*; *see also* Request, Attachment B at 4.

In that scenario, the Agreement would have a net financial benefit of $7.6 million. PR Comments at 3. However, the Commission finds that it is unlikely that Discover will pay a penalty under the Agreement given the Postal Service's claims that the "projected after-rates volumes are the negotiated minimum volumes required to achieve the threshold and represent the annualized projected growth to which Discover was…comfortable committing."[17] Responses to CIR No. 1, question 6.

[17] In addition, the Agreement contains a termination provision, which allows either party to terminate the Agreement "for convenience" prior to the last 90 days of the each contract year. *See* Request, Attachment B at 6.

Table IV-1 shows the contribution at the volume ranges described above.

Table IV-1: Anticipated Effect of Discover NSA

	Volume 10% Lower Than Estimate	Postal Service Estimate	Volume 10% Higher Than Estimate
Year 1	$2,101,676	$(6,181,368)	$(6,799,505)
Year 2	$2,888,317	$(6,168,739)	$(6,785,613)
Year 3	$2,635,597	$(6,306,561)	$(6,937,217)
Total	**$7,625,590**	**$(18,656,669)**	**$(20,522,336)**

Sources: Responses to CHIR No. 1, question 3; Excel file “CHIR No.1_QU3b”; and PR Comments at 3.

The Commission has analyzed the Postal Service’s workpapers and agrees with the Postal Service’s calculations, using the accepted methodology. *See* Request, Excel file “DFS NSA Financials (Attachment F),” tab “5_Commission’s Methodology”; Responses CHIR No. 1, question 3, Excel file “CHIR No.1_QU3b.”

2. Explanation of Accepted Methodology

The current accepted methodology for evaluating NSAs is designed to use the mailer’s price elasticity to estimate the new mail volume generated by the discount provided pursuant to the Agreement.[18] This methodology has been employed by the Commission for over a decade.[19] The methodology provides an independent and empirical analysis of the range of profitability to the Postal Service attributable to NSA

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[18] *See* Docket No. RM2010-9, Order Terminating Proceeding, May 27, 2011, at 1 (Order No. 738).

[19] *See, e.g.*, Docket No. MC2004-3, Opinion and Further Recommended Decision, April 21, 2006.

discounts, and relies on auditable inputs and assumptions. As an objective assessment tool, it can be used to evaluate an agreement prospectively (such as in the instant case) or it can be used to evaluate the impact of an NSA retrospectively (as the Commission does routinely in its annual compliance determination).

The key feature of the accepted methodology is the use of mailer-specific mail characteristics including unit costs, unit revenues, and price elasticities. The reliance on price elasticities has been adopted by the Commission as an "accepted analytical principle"[20] to be used in the Postal Service's periodic reports to the Commission.[21] 39 C.F.R. § 3050.1(a); *accord* 39 C.F.R. § 3050.10.

The Commission uses the methodology as a tool to ensure that the Postal Service does not lose contribution as a result of entering into an NSA. Preventing this outcome is crucial given the Postal Service's current financial difficulties. When the Postal Service is not operating at a profit and does not have retained earnings, the burden of recovering decreased contribution resulting from such an NSA could fall on mailers not party to the Agreement.

The foundation of the accepted methodology is straightforward. If a volume discount or rebate is offered to a mailer, there are two possible reasons for changes in the mailer's volume:

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[20] An analytical principle is "a particular economic, mathematical, or statistical theory, precept, or assumption" relied on to develop reportable data. 39 C.F.R. § 3050.1(c). A methodology can be generally defined as a combination of analytical principles and "quantification techniques" defined as "any data entry or manipulation technique whose validity does not require the acceptance of a particular economic, mathematical, or statistical theory, precept, or assumption. A change in quantification technique should not change the output of the analysis in which it is employed." 39 C.F.R. § 3050.1(f). While there are minor differences in the quantification techniques used by the accepted methodology and the Postal Service's alternative approach, the use of price elasticities is the only difference of consequence.

[21] The accepted analytical principle is defined as "'the analytical principle that the financial impact of price incentives to increase mail volume or to shift mail volume between products should be based on the Postal Service's best estimate of the price elasticity of the discounted product.'" Order No. 469 at 4 citing Docket No. RM2008-4, Notice of Proposed Rulemaking Prescribing Form and Content of Periodic Reports, August 22, 2008, at 9, and 2007 Annual Compliance Determination, March 27, 2008, at 127.

- The volume change could be the reaction of the mailer to the discounted price. In economic terms, this would be depicted as a move along the mailer's demand curve. This mathematical relationship is called "price elasticity."
- The volume change could be a result of factors *other than price* that cause a shift in the mailer's demand curve.

The distinction between the two reasons is critical for the Commission's analysis. Contribution from increased volume mailed in response to a discounted price improves the Postal Service's financial position because it is contribution the Postal Service would not have received without providing the discount. However, if factors other than price cause an increase in volume, then any discount or rebate resulting from the additional volume provides no additional benefit to the Postal Service because those mailpieces would have been mailed regardless of the rebate or discount offered. In fact, a discount or rebate that does not incentivize new volume would decrease overall contribution by the amount of the discount or rebate.

The mechanics of this methodology are described in Appendix B.

3. Postal Service's and Discover's Criticisms of Accepted Methodology

The Postal Service and Discover argue against using the accepted methodology.[22] *See also infra* IV.B. First, the Postal Service argues against use of the accepted methodology because a mailer-specific elasticity is not used. Second, Discover argues the accepted methodology understates the incentive of the discount. As discussed below, the Commission does not find these arguments persuasive.

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[22] The Postal Service contends models "are not particularly useful when applied to individual mailers." Responses to CIR No. 1, question 12. Discover argues "no quantitative analysis can fully capture the effect of this NSA on [its] decision making…." Discover Reply Comments at 2.

a. Mailer-specific elasticity not used

The Postal Service argues that by having to rely on the subclass elasticity when a mailer-specific elasticity is not available, the accepted methodology fails to take into account how a particular mailer will react to the marginal discount provided. *See* Responses to CHIR No. 1, question 3. The Postal Service contends it is unable to derive a mailer-specific elasticity for Discover and asserts it would be unfeasible to collect mailer-specific data that would enable it to isolate the effect of non-price variables from the effect of price changes. Responses to CIR No. 1, question 15.

The Commission recognizes the elasticity of individual mailers may differ from that of the subclass as a whole; however, the accepted methodology uses subclass elasticities because they are the only elasticity estimates provided by the Postal Service at this time.[23] On multiple occasions, the Commission has recommended that the Postal Service attempt to verify estimates provided by an NSA partner by developing industry-specific elasticities of demand.[24] The Postal Service, however, has not followed this recommendation.

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[23] Subclass elasticities are prepared by the Postal Service and filed with the Commission every January. *See, e.g.*, Market Dominant Products, FY 2014: USPS Demand Equation Estimation and Volume Forecasting Methodologies, January 20, 2015, available at *www.prc.gov*.

[24] *See* Docket No. MC2007-5, Opinion and Recommended Decision, May 29, 2008, at 24-25 ("Even if the Postal Service can[]not construct an own price elasticity specific to Life Line, the Postal Service should consider attempting to verify data presented by a potential NSA partner through an industry elasticity of demand or even using the subclass elasticity of demand. While a mailer-specific own price elasticity is not required for approval of an NSA, its absence means that the Postal Service should more thoroughly exercise due diligence in negotiating and evaluating proposed NSAs."); Docket No. MC2007-4, Opinion and Recommended Decision, April 18, 2008, at 29 ("Nonetheless, the Postal Service should also consider attempting to verify data presented through an industry elasticity of demand or even using the subclass elasticity of demand to help independently analyze any point estimates provided by an NSA partner. The Commission agrees with OCA that deriving a customer-specific elasticity of demand for Bradford would be very helpful in evaluating the information provided in this case. While a mailer-specific own price elasticity is not required for approval of an NSA, its absence means that the Postal Service should more thoroughly exercise due diligence in negotiating and evaluating proposed NSAs."); *see also* Order No. 694 at 14 n.19; Docket No. MC2004-3, Opinion and Further Recommended Decision, April 21, 2006, at 36-37.

In addition, the Commission considered the possibility that Discover's elasticities may deviate from subclass elasticities used in the accepted methodology. The Commission asked the Postal Service to explain why Discover has a higher price elasticity (in absolute terms) than the mailers within its subclass. CIR No. 1, question 15. The Postal Service responded that, in essence, Discover has a higher elasticity "[b]ecause of its digital experience, expertise, and success in the area of marketing, Standard Mail is not a monopoly product for Discover." Responses to CIR No. 1, question 15. In contrast, the Postal Service asserted that Standard Mail mailers with significantly below-average elasticities are mailers in "those industries which do not do a significant portion of their advertising through alternative media." *Id.*

The Postal Service has not provided any quantitative or qualitative evidence to corroborate its assertion that Discover's digital expertise results in a higher elasticity for Discover than the subclass. The Commission concludes the evidence on the record does not support elasticities for Discover that are high enough in absolute terms to project a positive net financial impact using the accepted methodology.

b. Incentive understated

Discover argues that the accepted methodology is not applicable to this Agreement because its individual marketing decisions about marketing channels are not made "at the margin" where marginal discounts incentivize the mailing of additional pieces. Discover Comments at 11. Discover further argues that the marginal discounts used in the accepted methodology do not accurately capture the substantial incentives the NSA provides. *Id.* Instead, Discover asserts, the proposed discount will incentivize Discover at the inception of a campaign, when Discover's individual marketing teams make decisions among marketing channels. *Id.* at 10.

Discover argues that to achieve the volume and revenue growth thresholds set forth in the NSA, it has a $12.6 million incentive (the combination of avoiding a $4.5 million penalty and qualifying for an $8.1 million rebate) that translates to a 22.3 percent incentive. *Id.* at 12. It provides an analysis that shows a positive net value to the Postal Service under a variety of before-rates volume scenarios. *See* Library Reference DFS-LR-1, November 17, 2014. The price elasticities implied by Discover's calculations generally fall between the subclass elasticity used in the accepted methodology and those implied by the Postal Service's estimate of Discover's volume response to the marginal change in price.

The Commission, however, does not find the analysis provided by Discover persuasive. The results anticipated by Discover are largely driven by the assumption that the penalty acts as a price incentive at the margin, and by the treatment of the discount as a price change that applies only to incremental volume. There are two reasons why, in this case, it is not appropriate to include the penalty as part of the price incentive that drives incremental volume.

First, Discover knew about the penalty for failing to reach the threshold when it agreed to the NSA. If Discover's analysis indicated that the discounts alone would be insufficient to justify the necessary volume increase, it could avoid the penalty by simply rejecting the proposed terms of the Agreement. Second, once the Agreement is in effect, Discover has the right to terminate the Agreement for convenience prior to the last 90 days of each Agreement year to avoid paying the penalty. Whereas the only way for Discover to obtain the discounts would be to meet the volume threshold, it has two ways to avoid the penalty without meeting the threshold. These opportunities to avoid the penalty without reaching the threshold weaken its incentivizing effect, and consequently it should not be considered equivalent to the discounts as Discover has done in its analysis.

Conceptually, the treatment of the discount as applying only to the incremental volume sent in response to the incentive is not irrational. Economic theory holds that changes in the price influence the quantity demanded. The relevant price change is the marginal price (*i.e.,* the price of the last unit purchased). While the Agreement provides for a uniform percentage discount on all of Discover's mail volumes, conditioning the entire discount on achieving the threshold effectively means that the 1,256,212,059th piece sent by Discover would have a price of approximately negative $8 million. Thus, the marginal discount is not effectively uniform for all possible volumes. Instead, there is effectively a large discount (and therefore a large incentive) at the threshold, and a much smaller discount at volumes above the threshold. The analysis in Discover's library reference attempts to capture this effect by essentially treating the discount as applying exclusively to incremental volume rather than to all pieces.

Discover's analysis demonstrates that the incentive to reach the threshold can potentially result in a larger volume response than the 2.5 percent marginal discount would otherwise indicate. It nevertheless remains dependent on assumptions about both the before- and after-rates volumes, which drive both the estimated impact on the Postal Service's finances and the implied elasticities. The assumptions used in Discover's analysis are unsupported and cannot be relied upon.

For example, in Discover's scenario with no First-Class Mail growth, Discover's range of before-rates volume for Discover's First-Class Mail is 201,009,500 to 234,232,722 pieces. *See* Library Reference DFS-LR-1, November 17, 2014. As Discover's First-Class Mail volume was 209,081,196 in 2014, most of the scenarios presented would require that Discover grow its volume significantly in the absence of any discount. Notice, Excel file "DFS NSA Financial (Attachment F)." The scenarios purported to demonstrate implied price elasticities closest to the average for Standard Mail Regular all assume First-Class Mail before-rates volumes greater than Discover's 2014 volume. This seems unlikely, as Discover does not expect to mail more First-Class Mail volume even with the discount. Discover Preliminary Comments at 5.

Crucially, all of the scenarios evaluated by Discover assume the after-rates volume forecast by the Postal Service is accurate. The Postal Service forecasts that, in year 1 and year 3, Discover will send *one piece* of mail above the threshold. This assumption virtually guarantees that the analysis will show an improvement in the net financial position of the Postal Service, because the very large discount for reaching the threshold acts as a price incentive at the margin. In contrast, if the actual volume sent by Discover under the NSA exceeds the threshold by more than one piece, the marginal price incentive no longer includes this large discount. As the actual volume sent under the NSA increases beyond the threshold, it becomes increasingly difficult to conclude that the large discount paid for crossing the threshold affected the actual volume sent because it no longer represents a change in price at the margin.

4. Summary

Under the accepted methodology, the Postal Service estimates the Discover NSA will have a negative $18 million net financial impact over its three-year term. Responses to CHIR No. 1, question 3; Excel file "CHIR No.1_QU3b." Next, the Commission reviews the Postal Service's alternative approach to estimating the Agreement's net financial impact and explains why the approach is inconsistent with statutory and regulatory requirements.

B. Review of Postal Service's Alternative Approach

Under applicable regulations, the Postal Service is not limited to demonstrating the net financial benefit of an NSA using Commission-accepted analytical principles.[25] In this case, the Postal Service proposes to rely upon an alternative approach to demonstrate compliance with section 3622(c)(10)(A) and 39 C.F.R. § 3010.40(a). *See* 39 C.F.R. § 3010.42(f)(5). First, the Commission summarizes the Postal Service's alternative approach, which it terms its "net value method" or "quantitative analytical methodology." Second, the Commission explains why it cannot accept the Postal Service's alterative approach due to the lack of actionable evidence presented. Third, the Commission discusses how it is unable to validate the Postal Service's approach.

1. Summary of Postal Service's Alternative Approach

The Postal Service labels the manner in which it calculates the net financial benefit of the Discover NSA as the "net value method" or "quantitative analytical methodology."[26] Responses to CIR No. 1, question 5. The Postal Service's calculation derives from the following steps:

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[25] Generally speaking, a change to an accepted analytical principle must be "preapproved" by the Commission. *See* 39 C.F.R. § 3050.11. Section 3010.42(f)(5), which allows the Postal Service to propose its own methodology, is unique to NSAs. *See* Docket No. RM2013-2, Order No. 1786, Order Adopting Final Rules for Determining and Applying the Maximum Amount of Rate Adjustments, July 23, 2013, at 23 (finding that "although in many cases, the Commission's accepted analytical principles will provide the best available model for evaluating the net financial impact of a market dominant negotiated service agreement, part 3010 should not unnecessarily limit the Postal Service's ability to supplement its filing with an alternative analysis of the net financial impact.").

The Commission has also sought input from the Postal Service and the public regarding new methods to estimate volume changes resulting from pricing incentives. In 2010, the Commission initiated a rulemaking to consider changing this accepted analytical principle. Order No. 469 at 1. During that rulemaking proceeding, the Commission evaluated comments from interested persons including the Postal Service. Order No. 738 at 4-10. The Commission concluded that the alternative methods suggested by the commenters did not "offer a demonstrable improvement over the current method." *Id.* at 1. The Commission decided to retain the elasticity-based accepted analytical principle for evaluating the financial effects of price incentives to increase mail. *Id.* at 16.

[26] The Public Representative calls the Postal Service's approach a "guess." PR Comments at 10.

Step 1. “Actual volumes mailed above the Before Rates trend are calculated.” *Id.* In this step, the Postal Service estimates the *anticipated* increase in mail volume due to the discounts offered in the Agreement. This incremental volume is calculated by subtracting the “before rates” volume (*i.e.,* Discover’s anticipated mail volume without any discounts) from the “after rates” volume (*i.e.,* Discover’s anticipated mail volume with the discounts offered in the Agreement).

Step 2. “Contribution on these volumes is determined based on the published contribution per mail category.” *Id.* In this step, the Postal Service takes its estimate of the incremental volume (*i.e.,* the increase in volume due to the discount) and multiplies that by the corresponding unit contribution.[27]

Steps 3 and 4. “Any rebate paid to the mailer is deducted from this calculation” and “[t]he result is the Net Value of the NSA year.” *Id.* Here, the Postal Service subtracts the estimated rebate paid to Discover pursuant to the Agreement from its estimate of contribution from incremental volume spurred by the discount.

Following these steps, the Postal Service calculates the net value of the NSA as $23,536,897 in the first year of the contract. Request, DFS NSA Financials (Attachment F), tab “4_Value.” Using its analysis, it calculates the net value of the NSA over the three-year term as $91,441,679. *Id.*

As explained in detail below, the Commission cannot accept the Postal Service’s alternative approach as a viable methodology through which to review the net financial benefit of the NSA.

[27] The Postal Service calculates Discover’s unit contribution for each class by adjusting FY 2013 unit contributions per mail category for inflation. It then calculates a weighted-average unit contribution for Discover’s First-Class Mail and Standard Mail based on Discover’s FY 2014 volume distribution.

2. The Commission Cannot Accept the Postal Service's Alternative Approach

The Commission has consistently required that the Postal Service demonstrate that a volume-based rate discount has a reasonable likelihood of resulting in a net increase in contribution above what the contribution would have been absent the discount. In this case, the accuracy of the Postal Service's approach depends on the accuracy of its before-rates and after-rates estimates. The Postal Service has failed to provide the Commission with the evidence required for it to evaluate the reasonableness of the Postal Service's approach.

First, the Postal Service's estimation of "before rates" volume is just that, an estimate. As an initial matter, the Postal Service did not provide information about this analysis as part of its Request as required by 39 C.F.R. § 3010.42(f)(5). Then, in Response to CHIR No. 1, the Postal Service explains that "absent company specific elasticities, [it relies] on marketing intelligence, customer-specific information furnished to us by the customer (as in the case of Discover), and past history (again provided by Discover in relation to [its] prior NSA)." Responses to CHIR No. 1, question 3 (footnote omitted).

Later, in its Response to CIR No. 1, the Postal Service discloses that Discover did not provide it with volume projections absent the Agreement (*i.e.,* what it would mail if the status quo were maintained). It states, "[i]n the absence of an NSA, it would be difficult for any NSA partner to predict volumes." Responses to CIR No. 1, question 7. The Postal Service explains it arrives at the "before rates" volume using "an analysis of company and related industry-specific historical volume trends extrapolated over the period of the NSA." *Id*.

This analysis consisted of an Excel spreadsheet intended to demonstrate the industry-volume trend analysis the Postal Service relied upon to estimate its before-rates volumes. *See* Library Reference USPS-MC2015-3/NP1. The Postal Service did not provide the source of the data or explain how these data were used to project

Discover's before-rates volumes. In addition, the numbers within the spreadsheet are hard-coded,[28] which make it impossible for the Commission to determine whether the Postal Service performed an objective analysis rather than applied subjective intuition.

Moreover, the spreadsheet and other supporting information lack any explanation of the "analysis of company and related industry-specific historical volume trends" or how these data were used to project Discover's before-rates volumes, in violation of 39 C.F.R. § 3010.42(f)(5)(i). *See* Responses to CIR No. 1, question 7. Without such key analysis demonstrating a relationship between the trend analysis and the estimate, it is not possible for the Commission to conduct any sort of objective and independent evaluation of the appropriateness of the Postal Service's assumptions.

Second, the Postal Service's estimation of "after rates" volume is simply "the annualized projected growth to which Discover was comfortable committing." Responses to CIR No. 1, question 6. The record demonstrates the Postal Service has done nothing to verify independently the accuracy of the mailer-provided estimates to determine if the volume response implied is reasonable in relationship to the size of the discount. It is at this point in the analysis of an NSA, that the concept of elasticity (*i.e.,* the mathematical relationship between volume and price) provides an objective, quantitative means of evaluating the reasonableness of the projected volume response.

In sum, the Postal Service's calculation of the net benefit of the Agreement is based on a number that neither the Postal Service can justify nor the Commission can verify, subtracted from a number Discover gave to the Postal Service. Without acceptable objective data, the Commission must conclude that the Postal Service's analysis relies on subjective intuition. Consequently, the Commission is unable to evaluate the reasonableness of the Postal Service's forecasting method or find it

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[28] As used here, the term "hard-coded" means that the cells contain numbers only, as opposed to formulas or links. When the purported results of an analysis are hard-coded in a spreadsheet, it is not possible to determine how the results are produced, without additional clarification or explanation.

creditable under 39 C.F.R. §§ 3010.40, 3010.42(f)(5), and 3010.44. As a result, the Postal Service's analysis is insufficient to support its Request.

3. The Commission is Unable to Validate the Postal Service's Approach

Although the Postal Service was unable to provide the Commission with quantitative evidence to support the use of its alternative approach, the Commission nonetheless undertook an evaluation of the Postal Service's desired methodology. Ultimately, the Commission is unable to validate the Postal Service's approach.

First, the elasticities implied by the Postal Service's approach are unjustified. Second, two aspects of the Agreement's design make the chances of it increasing contribution nearly impossible to meet. Third, the proposed Discover NSA is substantially similar to previous NSAs, which the Commission previously has found to have failed to provide the Postal Service with a net financial benefit. These issues are discussed in greater detail below.

a. Elasticities implied by alternative approach are unjustified

The elasticities implied by the Postal Service's alternative approach are shown in Table IV-2. As explained above, whenever there is a proposed price change and estimates for before-rate and after-rate volumes, an elasticity can always be calculated.

Table IV-2: Implied Discover Elasticity – Proposed Discover NSA

	Subclass Elasticity	Discover's Implied Elasticity		
		Year 1	Year 2	Year 3
Standard Mail (Regular)	-0.482	-9.40	-13.10	-16.37
First-Class Mail (Workshared)	-0.305	-6.29	-8.57	-10.34

Source: Market Dominant Products, FY 2014: USPS Demand Equation Estimation and Volume Forecasting Methodologies, January 20, 2015, available at *www.prc.gov*; Responses to CHIR No. 1, question 9.

In order to have the kind of demand response that the Postal Service's approach assumes, the elasticities of Discover's First-Class and Standard Mail would have to be more than 20 times higher (in absolute terms) than the average elasticity for comparable First-Class Mail and Standard Mail. The Postal Service offers no quantitative evidence to justify such a sizable demand difference between Discover and other mailers of First-Class and Standard Mail.

In addition to the issues associated with the methodology the Postal Service used to forecast its before-rates and after-rates estimates, the resulting estimates it provides are problematic. The following two examples illustrate: (1) the inconsistency among the estimates filed in this docket; and (2) the inconsistency between estimates in this docket and the estimates provided in Docket No. R2013-11.

First, the Postal Service estimates that absent the implementation of the Agreement, Discover's volumes will continue to decline during contract year 2 despite a real price decrease of 4.3 percent due to the anticipated exigent surcharge removal. Responses to CIR No. 1, question 11. At the same time, the Postal Service expects that the 2.5 percent price decrease will incentivize over 255 million pieces of Standard Mail in contract year 2. *Id.* As the Public Representative notes, the Postal Service's expectation that a 2.5 percent price decrease will lead to increased volume is inconsistent with its expectation that volume would decrease despite a 4.3 percent price decrease. PR Comments at 13.

The Postal Service states that absent the Agreement, Discover indicated it would shift its marketing dollars from mail to digital alternatives. Responses to CIR No. 1, question 11. It argues that it is unclear whether the removal of the 4.3 percent exigent surcharge would have any effect on Discover's decision. *Id.* It further argues that there is no causal connection between the anticipated 4.3 percent price decrease and Discover's decision to shift marketing dollars absent the agreement. *Id.*

The Commission finds the Postal Service's rationale unconvincing. If Discover were to substantially increase its mail volume in response to a 2.5 percent price decrease as the Postal Service contends, it is unlikely, absent compelling evidence, that Discover would not also increase its mail volume in response to a 4.3 percent price decrease.

Second, the Postal Service's estimate of incremental volume in this docket is inconsistent with its earlier estimate of mailers' response to a 1.6 percent price decrease forecasted in Docket No. R2013-11. The Public Representative comments that in this docket the Postal Service estimates that providing Discover a 2.5 percent price decrease in contract year 2 will incentivize more than 300 million pieces of additional Standard Mail, an increase of 41 percent. PR Comments at 13. However, in Docket No. R2013-11, the Postal Service used its roll forward model to estimate that increasing prices for all Standard Mail mailers by 1.6 percent would decrease volume by 462 million pieces, a 0.56 percent decrease in volume. *Id*. at 17.

It seems improbable that one mailer's response to a price change would be of similar magnitude as the response of the entire class to a slightly smaller price change. When analyzed together, these two results imply that Discover represents a hugely disproportionate share of all price sensitivity among users of Standard Mail, and that all other Standard Mail users collectively exhibit far less sensitivity to price. The Postal

Service has presented no evidence to support this conclusion and absent such evidence, the Commission is unable to substantiate these claims.

Nevertheless, the Postal Service and Discover argue that the Agreement affects Discover in a different way than a regular 2.5 percent decrease. Responses to CIR No. 1, question 11; Discover Comments at 12. The Postal Service also contends that there is no inconsistency between the positions taken in Docket No. R2013-11 and the instant docket. Responses to CIR No. 1, question 12. It argues that although models may be useful for estimating volume changes resulting from proposed price increases on an aggregate basis, they are not particularly useful when applied to individual mailers. *Id.* The Postal Service further argues that it is inaccurate to say that a 2.5 percent price decrease would incentivize spending by Discover that would result in 300 million mailpieces. *Id.* It believes it is "more accurate to say that giving Discover a 2.5 percent rebate if it (i) meets or exceeds the specified annual revenue thresholds and (ii) exceeds the aggregate total volume for DFS Eligible Mail would preserve Discover's current aggregate mail spend and increase its contribution necessary to qualify for the negotiated rebate levels." *Id.*

Discover makes a similar argument – that the Agreement's effect is more than simply the effect of a 2.5 percent discount. Discover Comments at 12. To illustrate, Discover argues, "sometimes even a very small change in price can make a big difference, if the other factors that we consider have aligned themselves in a certain way." Talwar Statement at 20. Discover further argues that the Agreement would change "the normal order of business," and preclude a shift of marketing funds from mail to digital channels. Discover Reply Comments at 3.

The Commission does not find this argument and reasoning persuasive. Whether Discover would increase its mail volume in response to the discount is not in question. At issue is the magnitude of the change in volume the Postal Service can expect in response to a 2.5 percent discount. While Discover presents an analysis demonstrating its view of why it expects to respond with greater volume increases than the marginal discount would otherwise suggest, questions remain about the validity of the underlying assumptions. *See supra* IV.A.3.b. Moreover, neither the Postal Service nor Discover attempted to explain how price interacts with the other factors it considers. Consequently, the Postal Service has failed to provide the Commission with the necessary information for it to conclude that the Agreement will have the effect the Postal Service claims.

b. Agreement's design makes chances of it increasing contribution nearly impossible

Two aspects of the structure of the Agreement make the chances that it will increase contribution to the Postal Service nearly impossible. First, the Agreement provides rebates on First-Class Mail. Second, the Agreement provides rebates on all mail volume, including pieces below the threshold. These issues are discussed, in turn, below.

Rebates on First-Class Mail. The Agreement includes discounts on First-Class Mail. First-Class Mail has a relatively low elasticity, which typically means that a discount offered on First-Class Mail will produce a small volume response. On this point, Discover comments:

> Some might try to criticize this NSA for including First Class, suggesting that Discover and the Postal Service should have negotiated this NSA in a different way, e.g., limiting it only to declining block discounts in Standard Mail, and urge the Commission to reject it on such grounds. That criticism really boils down to someone not liking a square peg, and suggesting that the crafters of the peg should have made it a round peg. Discover and Postal Service negotiated this NSA to meet the needs of *both* Discover and Postal Service, and not the needs of anyone else and doing so is not only perfectly acceptable under the law, but it also is the point of having an NSA.

Discover Preliminary Comments at 2 (emphasis in original). Discover also argues that First-Class Mail's inclusion in the Agreement is actually a benefit to the Postal Service. *Id.* at 4. Discover argues that this benefit is two-fold.

First, Discover argues that any decrease in First-Class Mail revenue must be offset by an increase in Standard Mail revenue in order for it to qualify for rebates under the Agreement. *Id.* at 4-5. However, contribution per piece is much higher for First-Class Mail than for Standard Mail. Consequently, although Discover may "make-up" revenue lost from First-Class Mail, it does not necessarily increase contribution to the Postal Service.

Second, Discover argues that because any rebate "will be based on Discover's total mail spend, that means that there is an incentive in place to increase First Class revenues." *Id.* at 5. Discover goes on to explain, "[T]here are some very creative marketers at Discover, and this incentive could focus them on developing new, ingenious ways to use First Class for marketing purposes." *Id.* However, Discover undercuts its own argument by stating that it does "not anticipate that this will occur." *Id.*

Rebates on all volume. The Discover NSA also provides Discover with rebates for all volume mailed, if a revenue threshold is reached. When an agreement offers a rebate for all volume mailed, by its design, a discount will be given on volume that would have been mailed without the rebate. Discounts on this volume represent lost contribution that must be offset by new contribution generated by new volumes sent in response to the discount. Thus, generally speaking, the greater this volume is, the less likely the agreement will increase net contribution. Based on the Postal Service's before-rates volume forecast, in the first year of the Agreement discounts would be paid on 1.013 billion pieces of volume that would have been mailed absent the discount.

While rebates on all mail volume are not prohibited by any statute or regulation, such rebates make the Agreement more risky for the Postal Service. When discounts are given on mail volume that would have been mailed without the Agreement, the Postal Service may obtain less contribution than would have been received in the absence of the Agreement.

c. Discover NSA is similar to other NSAs, which have failed to provide the Postal Service with a net financial benefit

The Discover NSA is similar to other NSAs, which have failed to provide the Postal Service with a net financial benefit. First, the Postal Service does not have a strong record of accurately forecasting NSA volumes. Second, the prior Discover NSA, which is substantially similar to the NSA in the instant docket, resulted in a net loss for the Postal Service. These issues are discussed in detail below.

Postal Service's record of forecasting NSA volumes. The Postal Service does not have a strong track record of accurately forecasting NSA volumes. The Public Representative compared the actual reported volumes from previously approved and implemented market dominant NSAs with the Postal Service's forecasts. PR Comments at 12. He found that the Postal Service has been off by 7.7 percent on average in the first year of a contract, by 14.0 percent on average in the second year, and by 24.2 percent on average in the third year. *Id*. Excel file "Appendix A – History of Postal Service NSA Projections and Results."

The Commission has reviewed the Public Representative's calculations and concurs with his results. The Commission concludes that the inability of the Postal Service to accurately forecast mailer response to discounts in prior market dominant NSAs casts doubt on the reliability of the forecasts in this case.

Prior Discover NSA resulted in net loss for the Postal Service. The Commission approved the prior Discover NSA (Prior NSA) on March 15, 2011. Order No. 694. The Prior NSA was substantially similar to the proposed Discover NSA (*i.e.,* Discover received rebates for all volume mailed, provided that a revenue threshold was reached).

See id. at 2-4. Using the accepted methodology, the estimated decrease in contribution to the Postal Service is shown in Table IV-3.

Table IV-3: Effect of Prior NSA

	Increase in Contribution from Incentivized Volume	Rebates Paid	Net Benefit to the Postal Service
Year 1	$1.3 million	$5.6 million	- $4.3 million
Year 2	$2.4 million	$9.2 million	- $6.8 million
Year 3	$4.4 million	$18.5 million	- $14.1 million
Total			**- $25.2 million**

Source: Docket No. ACR2014, Library Reference USPS-FY14-30, Excel file "ACR_NSA_FY14.Rev.2.20.15," tab "5_PRC Methodology"; Docket No. ACR2013, *Annual Compliance Determination*, March 28, 2014, at 62-69 (FY 2013 ACD); Docket No. ACR2012, *Annual Compliance Determination,* March 28, 2013, at 153-58 (FY 2012 ACD).

The Postal Service estimated the net benefit of the Prior NSA differently from the accepted methodology used by the Commission. The Postal Service's estimates, however, were not based on any quantitative factors. In addition, the Postal Service's estimates implied elasticities that were far outside the expected value, as shown in Table IV-4.

Table IV-4: Implied Discover Elasticity – Prior NSA

	Implied Discover Elasticity (Year 1)	Multiple of Subclass Average	Implied Discover Elasticity (Year 2)	Multiple of Subclass Average	Implied Discover Elasticity (Year 3)	Multiple of Subclass Average
Standard Mail (Regular)	-18.5	42x	-5.03	11x	-4.42	8x
First-Class Mail (Workshared)	-3.8	10x	-3.33	10x	-2.45	9x

Source: USPS-FY14-30, Excel file “ACR_NSA_FY14.Rev.2.20.15,” tab “5_PRC Methodology”; FY 2013 ACD at 67; FY 2012 ACD at 157-58.

When approving the Prior NSA, the Commission expressed reservations about the qualitative methods used by the Postal Service to estimate what the net contribution from Discover’s mail would be absent the NSA. *See* Order No. 694 at 13. At that time, the Commission noted that “[i]t is incumbent upon the Postal Service to develop a quantitative approach that incorporates the factors it is using to estimate volumes.” *Id.* at 14. Using the elasticity-based accepted analytical principle, the Commission concluded that the Prior NSA was unlikely to improve the Postal Service’s net financial position. *Id.* However, recognizing that “[t]he context of the Postal Service’s proposal is important,” the Commission authorized the Prior NSA to proceed, stating “allowing this negotiated service agreement to proceed will allow management to enhance its knowledge of potential tools to slow the overall declining trend for First-Class Mail volume.” *Id.* at 15.

In the FY 2013 ACD, after the Commission found that the Prior NSA resulted in a net loss of almost $11.2 million to the Postal Service during the first two contract years, it directed the Postal Service to provide “a detailed analysis of the lessons learned from the [Prior] NSA.” FY 2013 ACD at 62, 68, Table IV-5. The Commission asked the Postal Service a similar question in CHIR No. 1.

In response to that request, the Postal Service stated that it learned that the Prior NSA achieved its goals of maintaining Discover's contribution from First-Class Mail and Standard Mail, gaining a net increase in contribution of nearly $71 million over three years. Responses to CHIR No. 1, question 2. The Postal Service also stated that it "learned that a mailer's behavior is highly affected by the behavior of the mailer's customers, particularly with respect to the acceptance of electronic statements from financial entities." *Id.* It also concluded that future NSAs should "be structured to provide for overall net increases in contribution regardless of the actions taken by a mailer in response to market conditions and/or market response to any one product subset of that mailer's mail volume." *Id.*

The Commission based its approval of the Prior NSA, in part, on the premise that the Postal Service would use the experience as an opportunity to observe and attempt to measure the specific factors affecting Discover's mailing behavior. These data could then be used by the Postal Service to develop and refine new potential methods for evaluating the financial impact of volume discounts based on quantitative inputs.

Based on the Postal Service's statement of what it learned from the Prior NSA, it does not appear to have availed itself of this opportunity. While the Commission does not rely solely on this matter to reject the instant Discover NSA, this, among other reasons explained throughout this Order, calls into question the Postal Service's estimates of the value of the Discover NSA.

4. Summary

The Postal Service has failed to demonstrate why its proposed approach is either more accurate or more reliable than the accepted methodology. Without such a demonstration, the Commission cannot accept or rely upon the proposed new methodology in this case. Next, the Commission discusses the Postal Service's inability to provide potential alternative or additional rationales under which the Agreement could be approved.

C. Postal Service has Excluded Other Potential, Legal Justifications

Although the Postal Service sought approval of the Discover NSA on the basis that it would improve its net financial position through increasing contribution to institutional costs, the Postal Service may also seek approval of an NSA on the basis that it would improve its net financial position through reducing costs or that it will enhance the performance of operational functions. *See* Request at 5; *see also* 39 U.S.C. § 3622(c)(10)(A)(i), (ii); 39 C.F.R. § 3010.40(a)(1), (2). Although the Postal Service failed to demonstrate that the Discover NSA would improve its net financial position through increasing contribution, the Commission proactively solicited potential additional rationales under which the Discover NSA could be approved under existing statutory and regulatory requirements.

Accordingly, the Chairman, and ultimately the Commission, issued 19 information requests, designed to prompt the Postal Service to fully explore and explain potential benefits of the Discover NSA which might meet Commission scrutiny under existing statutory provisions, particularly 39 U.S.C. § 3622(c)(10)(A)(i) and (ii). *See* CHIR No. 1; CIR No. 1. Eventually, the Commission proffered to the Postal Service no fewer than seven possible rationales under which the Discover NSA could be approved. Each was rejected by the Postal Service. These potential rationales, and the Postal Service's responses to them, are outlined below.

1. The Commission encouraged the Postal Service to consider whether the Discover NSA would enhance the performance of mail preparation, processing, transportation, or other functions of the Postal Service (or put another way, could the Agreement be approved under 39 U.S.C. § 3622(c)(10)(A)(ii)). *See* CHIR No. 1, question 4; *see also* CIR No. 1, question 1. The Postal Service stated that it did not anticipate that the Discover NSA would enhance the performance of mail preparation, processing, transportation, or other functions of the Postal Service.

See Responses to CHIR No. 1, question 4; *see also* Responses to CIR No. 1, question 2.

2. The Commission prompted the Postal Service to consider whether the Discover NSA would reduce its costs. *See* CIR No. 1, question 1. The Postal Service responded that it "hereby confirms that we anticipate the Agreement will have no effect on costs to the Postal Service." Responses to CIR No. 1, question 1 (footnote omitted).

Next, the Commission pressed the Postal Service to consider ways in which the financial benefits of the NSA with respect to contribution may have been initially understated by the Postal Service.

3. The Commission asked the Postal Service whether the Discover NSA would induce other financial service mailers to increase volume. *See* CIR No. 1, question 3.

4. The Commission also asked the Postal Service whether, as a result of the Discover NSA, mail volume from a mail category with a relatively low cost coverage would migrate to a mail category with relatively higher cost coverage. *See id.* question 9.

5. The Commission asked the Postal Service to consider whether, as a result of the Discover NSA, Discover would increase its "prospecting volume" (*i.e.,* mail sent to prospective customers, with the expectation that some prospects will become customers, leading to subsequent additional volume). *See id.* question 10.

6. The Commission sought insight from the Postal Service as to how the minimization of risk may improve the net financial benefit to the Postal Service. *See id.* question 18.

The Postal Service discounted each of the Commission's inquiries. *See* Responses to CIR No. 1, questions 3, 9, 10, and 18; *see* Responses to CHIR No. 1, question 2.

Finally, the Commission prompted the Postal Service to strengthen the basis for the Postal Service's stated financial benefits.

7. The Commission suggested that the Postal Service may be able to use Discover's historical volume data to estimate the own-price elasticities for Discover. *See* CIR No. 1, question 13. Although the Postal Service attempted to calculate these elasticities, it rejected this method, stating, "[i]n the Postal Service's view, it would be misleading to provide such an estimate, since it would not reflect the decision-making process that led to the agreement with Discover." *See* Responses to CIR No. 1, question 13.

Ultimately, the Postal Service's inability to provide potential alternative or additional rationales under which the Discover NSA could be approved leaves the Commission with no choice but to find that the Discover NSA cannot be approved because the Postal Service has failed to demonstrate that the Discover NSA complies with applicable statutory and regulatory requirements.

V. CONCLUSION

Under current statutory and regulatory requirements, the Commission does not have discretion to approve an NSA for a market dominant product without a showing by the Postal Service that the NSA will either: (1) improve the net financial position of the Postal Service through reducing costs or increasing the overall contribution to institutional costs; or (2) enhance the performance of mail preparation, processing, transportation, or other functions. 39 U.S.C. § 3622(c)(10); *see also* 39 C.F.R. § 3010.40(a).

Based on the accepted methodology, the Commission cannot find that the agreement is likely to improve the net financial position of the Postal Service. Although the Postal Service does suggest an alternative approach for the Commission to use in reviewing this NSA, the Commission finds that this approach is based on subjective intuition rather than the objective evidence necessary to meet statutory and regulatory requirements. Given this and the other issues with the approach discussed above, the Postal Service has failed to demonstrate why its proposed approach is either more accurate or more reliable than the accepted methodology. Without such a determination, the Commission cannot find the approach credible or rely upon it in this case. Finally, in exploring other opportunities to justify approval of the Agreement under alternative acceptable statutory authority, the Postal Service did not provide the Commission with any support for these alternatives.

The Commission notes that although the PAEA granted flexibility to the Postal Service in setting postal prices, the law also made it clear that market dominant NSAs can only be approved if they improve the net financial position of the Postal Service through reducing costs or increasing overall contribution to institutional costs or enhancing the performance of mail preparation, processing, transportation, or other functions. This statutory responsibility leaves the Commission with no choice but to find that the Discover NSA cannot be approved because the Postal Service fails to demonstrate that the Discover NSA complies with applicable statutory and regulatory requirements.

VI. ORDERING PARAGRAPHS

It is ordered:

The Request to Add Discover Financial Services Negotiated Service Agreement to the Market Dominant Product List is denied because the Postal Service did not demonstrate that the Discover NSA complies with applicable statutory and regulatory requirements.

By the Commission.

Shoshana M. Grove
Secretary

APPENDIX A: SUMMARY OF INITIAL AND REPLY COMMENTS

Four commenters provided initial and/or reply comments to the Commission: Discover, Valpak, the Postal Service, and the Public Representative. Following is a summary of these comments.

I. INITIAL COMMENTS

Discover, Valpak, and the Public Representative filed comments.

A. Discover

1. Statement of Harit Talwar

On October 28, 2014, Discover filed a document titled “Statement of Harit Talwar.” Harit Talwar is the Executive Vice President, President – U.S. Cards and the Chief Marketing Officer of Discover. Talwar Statement at 1. Mr. Talwar submits his statement in order to “show the Commission and its staff how Discover markets, so that they can appreciate why this NSA is important for helping mail maintain its market position among the various marketing channels that Discover uses.” *Id.* at 2 (footnote omitted).

Mr. Talwar states that but for the proposed NSA, Discover “would be moving more dollars out of mail and into our digital channels next year and the years after, and the Postal Service would be losing revenue and contribution each year.” *Id.* at 4-5. He asserts that “Discover did in fact mail more over the term of our previous NSA, then we would have without that contract.” *Id.* at 6.

Mr. Talwar's statement then goes on to provide (1) an overview of Discover's targeted marketing channels[1] and (2) the process that its marketing teams use to allocate its marketing budget among the different targeted channels, including a list of its "Key Performance Indicators."[2] *Id.* at 6-20. He explains that:

> Given the fact that our decisions involve consideration of various Key Performance Indicators that cannot be reasonably isolated, it is not realistic to think that anyone could produce a reliable, across-the-board prediction of our use of the mail based on postage price alone, holding all our other factors equal. Indeed the very notion of holding our Key Performance Indicators unchanged flies in the face of how we market. Key Performance Indicators always change and are interrelated to each other and interact with price, which is one of the indicators.

Id. at 19-20.

2. Preliminary Comments

On November 13, 2014, Discover submitted preliminary comments "for the purpose of clarifying several matters undergirding the NSA brought before the Commission." Discover Preliminary Comments at 1. Discover begins by stating that it "*does not* expect its First-Class behavior and volumes to be influenced in any significant way by the Negotiated Service Agreement…" *Id.* at 1 (emphasis in original). Discover defends the inclusion of First-Class Mail within the NSA, stating that such inclusion met the needs of both it and the Postal Service. *Id.* at 1-3. The comments also emphasized its position that the Postal Service is facing increasing competition from digital

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[1] Discover uses the following targeted marketing channels: email, pop-ups, paid search, banner ads, social media, Discover website, mobile web, mobile apps, and direct mail. *Id.* at 7.

[2] The "Key Performance Indicators" for acquisition marketing (*i.e.,* marketing to non-customers in the hope of acquiring them as new customers) are: program budget, goal of the campaign, message of the campaign, target audience of the campaign, customer and post booking performance (sales, payment, profitability of new customer (return on assets or return on shareholder equity)), channel performance (enrollment rates, channel costs/pricing/cost per account), channel specific characteristics (scalability, operational flexibility/speed to market), riskiness, and measurability. *Id.* at 17.

communication competitors. *Id.* at 4. The comments also touched on issues related to Discover's CAPS account, use of Full Service IMb mail, and the NSA's effective and implementation dates. *Id.* at 5-6.

3. Comments

On November 17, 2014, Discover submitted its comments. Discover noted that the Commission has discretion about how to judge the NSA, needing to find only that the NSA improves the net financial position of the Postal Service. Discover Comments at 2. Discover argues that, as a direct bank, it is on the cutting edge of digital marketing, and that it is changing its use of mail and its relationship with the Postal Service. *Id.* at 3-7. Discover argues that if it were to shift its marketing dollars out of mail and into digital channels, the consequences "could be severe for the Postal Service." *Id.* at 6. Discover also comments that the NSA is exactly the type of response to the "digital age" that the PAEA intended to encourage. *Id.* at 7-10.

Discover further argues that the Commission's accepted methodology should not apply, principally because the method was created for a declining block discount structure, and secondly, because Discover's individual marketing decisions are made at the inception of a campaign and because price interacts with other variables to "yield a unique solution that makes precisely isolating the effect of price unrealistic." *Id.* at 10-11. Discover argues that the use of marginal discounts "do not accurately capture the substantial incentives the NSA provides to achieve the volume and revenue growth thresholds to qualify for the 2.5 percent rebate." *Id.* at 12 (footnote omitted).

Discover argues that, in actuality,

> Discover has a $12.6 million incentive (the combination of avoiding a $4.5 million penalty and qualifying for an $8.1 million rebate) for Discover to increase its Year 1 volume from the Before-Rates to After-Rates volume. This translates not into a 2.5 percent marginal discount, but rather a 22.3 percent incentive on incremental pieces to grow

> volume. Based upon this more accurate calculation of the incentive to grow volume, the implied absolute values of elasticity of Discover's mail, while still higher than those used in the Commission's accepted methodology, is less than one.

Id. at 12-13.

B. Valpak

Valpak urges the Commission to reject the Discover NSA because the proposed NSA clearly fails to meet the requirements of the PAEA. Valpak Comments at 1-3. Valpak asserts that "[t]he Postal Service's claim that the Discover NSA will result in nearly $1 billion in total revenue, providing $91.4 million in a net contribution over the three-year term, is fanciful." *Id.* at 2.

After criticizing the Postal Service for not following the Commission's rules, Valpak attacks the Postal Service for "defending its speculation about unprecedentedly high elasticities for a single large mailer" while earlier in the year "excoriat[ing] mailers for failing to accept Postal Service evidence of the low elasticity of demand…." *Id.* at 2-3. Valpak concludes that "[n]ot having objective, independently verifiable data to support the Postal Service's assertions, the Commission must conclude that the proposed Discover NSA will result in a net financial loss to the Postal Service." *Id.* at 3.

Valpak further comments that the Commission's approval of this NSA would constitute avoidance of its statutory duties. *Id.* Valpak states that "[t]he Commission was created for a time such as this, to block illegal proposals and to prevent the Postal Service from abusing its monopoly." *Id.* at 4 (footnote omitted).

C. Public Representative

The Public Representative urges the Commission to hold the proceeding in abeyance until a meaningful understanding to the impact of the agreement is developed.[3] As a first step, the Public Representative analyzes the net financial impact to the Postal Service pursuant to the Commission's approved methodology. PR Comments at 3-4. The Public Representative states:

> [T]he DFS NSA is projected to lose upwards of $18 million in contribution over the life of the agreement, using the Commission's methodology. This result, in a sense, is predetermined by the nature of the agreement and the methodology…[The Commission] methodology is intended to assess the marginal response to price incentives…. The contract provides rebates across all volume, not just to encourage the contract partner to maximize volume by extending the demand curve…. The rebate is estimated to be given to 1.012 billion pieces before the contract partner is incentivized by the discount to add volume.

Id. at 4.

Next, the Public Representative argues that the Postal Service fails to demonstrate that the NSA improves its net financial position. *Id.* at 6-8. In particular, he notes that this NSA is similar to the prior Discover NSA, which provided rebates for all volume mailed so long as a revenue threshold is met. *Id.* at 8. He notes that the Commission concluded in the FY 2013 ACD that "in contract year 2 [of the prior Discover NSA] the rebate was greater than the contribution incentivized by the Agreement. As implemented by the Postal Service, the NSA is inconsistent with section 3622(c)(10)." *Id.* at 9 (footnote omitted).

Next, the Public Representative argues that the Postal Service has not met its burden of proof with respect to the Agreement. *Id.* at 10-17. He states:

> …The Postal Service has the responsibility of providing the Commission and stakeholders with the information needed to ensure transparency and accountability and that the agreement conforms to the requirements of the law. The Postal Service has made little, if any attempt to meet this

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[3] The Public Representative's comments were filed *before* the responses to CIR No. 1 were due.

> burden. Instead, the Postal Service has provided an alternative "black box" statement of the value of the agreement.
>
> To be clear, the statements the Postal Service has provided regarding its valuation of the agreement do not amount to a methodology. A methodology is "a set or system of methods, principles, and rules for regulating a given discipline." In this instance, the given discipline is: the analysis of mailer response to price changes. The Postal Service has not provided an alternative methodology because it has offered no set, or system, or methods, or principle, or rules concerning how mailer response should be measured. The unsupported statement that without the agreement, DFS will mail 201,009,000 pieces of First-Class Mail without the agreement and 232,631,418 with the agreement is not a methodological analysis; it is a guess. A methodology creates transparency, allows for discussion, and creates a basis from which to make adjustments. A methodology allows for accountability.
>
> Because the Postal Service offers no methodology to support its assertions, these assertions cannot be evaluated or assessed. When the Postal Service's estimates turn out to be incorrect, stakeholders cannot evaluate the underlying methodology and assess why the error occurred. Potentially more important, because the Postal Service does not have a methodology to understand how mailers respond to individualized price changes it cannot use its experience to improve its own understanding of such agreements.

Id. at 10-11.

The Public Representative also comments that while "[t]he Postal Service states that the Commission's method doesn't capture reality…[its] track record of predicting mailers['] volumes shows that those predictions cannot be used to predict the effects of agreements. *Id.* at 12. The Public Representative observes that "[n]o sound methodology would produce a 5 percent volume decrease with a 4.3 percent price decrease [referring to the price decrease as a result of the removal of the exigent surcharge], but a 31 percent volume increase with a 2.5 percent price decrease." *Id.* at 13; *see also id.* at 16-17.

Finally, the Public Representative argues that it is unclear from the record whether the Discover NSA will benefit the public. *Id.* at 19-21. He posits that the costs of an NSA that causes a negative net financial impact on the Postal Service will ultimately be borne by mailers in the form of reduced service and increased rates. He reiterates that the balance of information in the record does not support implementation of the NSA. *Id.* at 21.

II. REPLY COMMENTS

Discover and the Postal Service filed reply comments.

A. Discover

In its reply comments, Discover maintains that the failure of the NSA to “pass the Panzar test” is “both unsurprising and completely irrelevant” because the test “was not developed for agreements of its type.” Discover Reply Comments at 1. Discover argues that “because the test was developed for an agreement with declining block rates and without penalties” it is unsurprising that the Discover NSA, which has neither declining block rates nor penalties, does not pass. *Id.* Discover further argues that, as demonstrated in its earlier-filed library reference, the Discover NSA “provides a net financial benefit to the [Postal] Service as shown by a test properly modified to reflect the actual circumstances of the agreement.” *Id.* (footnote omitted).

Discover submits that several facts provide the Commission “sufficient grounds upon which to approve this NSA under both the spirit and the letter of the PAEA.” *Id.* at 3. Specifically, Discover points to: (1) the Statement of Harit Talwar, which explains that “the marketing decisions of Discover’s teams are integrated decisions using more than two score of interrelated and interdependent criteria, only one of which is price”; (2) that the majority of its new accounts are now acquired through digital channels and that notwithstanding the proposed NSA, Discover would move marketing funds from mail to digital. *Id.* at 2-3.

Discover also states that it disagrees with the Public Representative's conclusion that the record in the case does not support the belief that revenue from Discover will decline. *Id.* at 3. Discover contends that the statements of its Chief Marketing Officer, which conclude that the Postal Service's revenue from it will decline but for the Agreement, should be given "considerable weight." *Id.* at 3-4.

Discover suggests the Commission should use a two-step process in this case. *Id.* at 4. First, the Commission should "use the alternate test that [Discover] provided in [its] Comments and Library Reference." *Id.* at 4. Discover avers that "[as it has] shown with the modified test, this NSA provides a net financial benefit to the [Postal] Service across a wide range of 'before rates' volumes estimates…." *Id.* Second, the Commission should "take into account the full impact on the Postal Service's finances of the risk of a future Discover decision [to] shift millions, perhaps hundreds of millions over time, of marketing dollars from mail to digital." *Id.* at 5.

B. Postal Service

On November 21, 2014, the Postal Service submitted its response to certain issued raised in the Public Representative's comments. The Postal Service states:

> 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 the NSA should be disapproved by the Commission because of a perceived lack of "actionable evidence[,]" incomplete information and non-existent methodology. We respectfully disagree. With our initial submission and our subsequent response to questions posed by the Commission, the Postal Service provided detailed information and financial projections based on our long-established and long-utilized methodology.

Postal Service Response at 2 (footnote omitted).

The Postal Service also objects to the Public Representative's contention "that this NSA is flawed because…it is similar to the prior NSA with Discover." *Id.* at 3. The Postal Service states that the Discover NSA "is an evolution which reflects changing business needs of both parties." *Id.* at 4. The Postal Service emphasizes that it "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." *Id.* at 5. The Postal Service argues that "the fact no mechanical model can be substituted for this analysis is not a reason to doubt the judgment of the Postal Service or to reject this agreement." *Id.*

APPENDIX B: ACCEPTED METHODOLOGY

The accepted methodology quantifies the volume increase that can be attributed to the discount, and distinguishes it from changes in volume that are due to other factors. The model works in the following manner:

First, the price elasticity is used to draw a demand curve through the point defined by the after rates volume and the discounted rate. The price elasticity used may be a mailer-specific elasticity (*e.g.*, Discover), or a proxy for the mailer-specific elasticity. In general, the subclass elasticity is used.[1] The subclass elasticity is developed by the Postal Service and is filed with the Commission every January. The Commission does not preapprove any methodological changes, and the Postal Service routinely makes "tweaks" to the way it calculates the subclass elasticity every year.

Second, new contribution is computed based on volume growth that can be attributed to the discounted price.

Third, and finally, the total net value of the agreement to the Postal Service is calculated by subtracting all the discounts or rebates earned by the mailer from the new contribution.

To evaluate an agreement prospectively, a range of likely outcomes is used to construct a range of after-rates volumes. The mailer's demand elasticity,[2] or if not available, the subclass elasticity that corresponds to the type of mail subject to the agreement, is used to construct the mailer's demand curve. Then for any after-rates

[1] Under the statute that preceded the PAEA (the Postal Reorganization Act), subclasses were defined subsets of classes of mail. The Postal Service has not yet modified its demand model (which is the source of its elasticity estimates) to align with products instead of subclasses. *See* Market Dominant Products, FY 2014: USPS Demand Equation Estimation and Volume Forecasting Methodologies, January 20, 2015, available at *www.prc.gov*; *see also* Docket No. RM2014-5, Order No. 2117, Notice and Order Scheduling Technical Conference, July 9, 2014, at 4.

[2] Elasticity is a measure of the volume response to a price change.

volume (Q_d in the figure below), the before-rates volume can be identified by moving down the demand curve to the discounted price (to Q_f).

The formula for calculating the before-rates volume with the own price elasticity is:

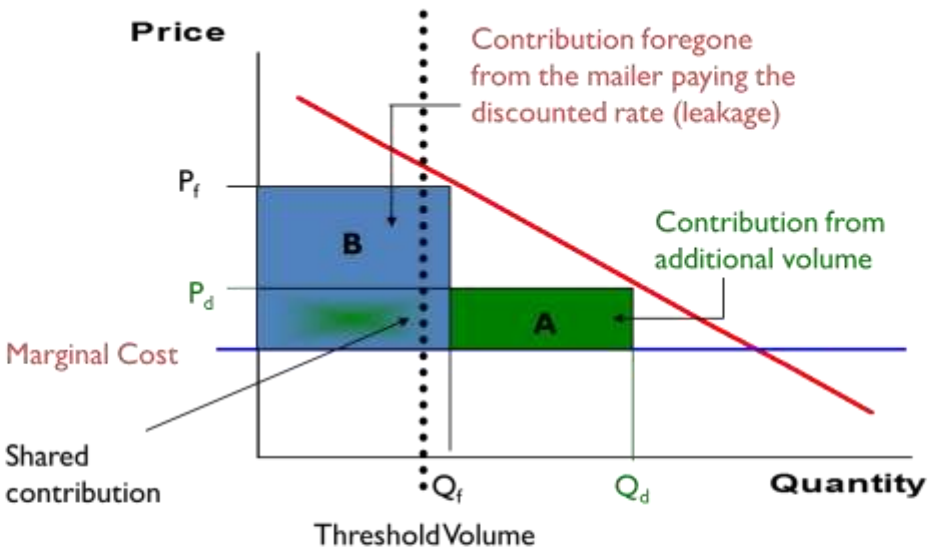
$$V_b = V_a \left[\frac{P_O}{P_d} \right]^{E_p}$$

Where V_a is the after-rates volume, P_o is the original price, P_d is the discounted price of the last mailed piece, and E_p is the own price elasticity.[3]

Once the before-rates volumes are known, the new contribution due to the discount or rebate is calculated as the discounted price (P_d) multiplied by the incremental volume due to the discount (Q_d minus Q_f). In the figure below, Rectangle A represents contribution from new volume ((Q_d minus Q_f) multiplied by (P_d minus the marginal cost)). Rectangle B represents contribution the Postal Service lost by providing a discount (Q_f multiplied by (P_f –P_d)).

[3] Since Docket No. R80-1, the Postal Service has used log-log or constant-elasticity demand equations to estimate elasticities and forecast volumes. The constant-elasticity demand equation evaluated at the initial (undiscounted) price p_0, assuming all other variables, such as income and population, held constant, is: $Q_0 = ap_0^e$; where Q_0 is the initial quantity (or before rates volume), and e is the constant own-price elasticity of demand. Similarly, the constant-elasticity demand equation evaluated at the discounted rate p_d is: $Q_1 = ap_d^e$; where Q_1 is the new quantity (or after rates volume). The ratio of Q_0/Q_1 can be expressed as: $\frac{Q_0}{Q_1} = \frac{ap_0^e}{ap_d^e} = \frac{p_0^e}{p_d^e} = \left(\frac{p_0}{p_d}\right)^e$; Therefore, $Q_0 = Q_1\left(\frac{p_0}{p_d}\right)^e$

To determine the net effect on the Postal Service, rebates or discounts paid (Rectangle B) are deducted from new contribution (Rectangle A). If new contribution (Rectangle A) is greater than contribution forgone from the mailer paying a discounted price (Rectangle B), then the net effect is positive. Otherwise, the agreement fails to provide a net benefit to the Postal Service.



Compare Area A to Area B to determine if contribution to Postal Service is positive.