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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

RATE AND SERVICES CHANGES TO IMPLEMENT FUNCTIONALLY EQUIVALENT NEGOTIATED SERVICE AGREEMENT WITH DISCOVER FINANCIAL SERVICES, INC.

Docket No. MC2004-4

DIRECT TESTIMONY
OF
ALI AYUB
ON BEHALF OF
UNITED STATES POSTAL SERVICE

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AUTOBIOGRAPHICAL SKETCH

My name is Ali Ayub. I joined the Postal Service in 2001 and am currently an Economist in the Pricing Strategy group. I provided financial analysis support for the Capital One Negotiated Service Agreement (NSA) filing, Docket No. MC2002-2, and was responsible for implementation of the Governors' Decision in that docket. I also developed performance metrics and reporting tools for the Capital One NSA.

I was part of the negotiating team that developed the Discover NSA and am responsible for all financial analysis presented in the Postal Service filing. In addition, I provided negotiation and financial analysis support for the Bank One NSA. This is my first appearance before the Commission.

I earned a Bachelor's Degree in Finance and Information Systems and a Master's of Business Administration (MBA) from the George Washington University with honors. While pursing my MBA, I was also a Chairman's Fellow at the Export–Import Bank (EXIM) of the United States. I am currently a candidate for the Level II portion of the Chartered Financial Analyst (CFA) Examination.

I. PURPOSE AND SCOPE OF TESTIMONY

The purpose of my testimony is to describe and analyze the policy and business considerations that support the Postal Service's negotiated service agreement (NSA) with Discover Financial Services, Inc. (Discover or DFS). The Discover NSA is submitted as functionally equivalent to the Docket No. MC2002-2 baseline NSA with Capital One. Thus, in accordance with 39 C.F.R. § 3001.196, my testimony will include a detailed explanation of how the Discover NSA is functionally equivalent to the baseline agreement, and will describe the differences between the Discover NSA and the baseline agreement. My testimony will also analyze the financial impact of the NSA on the Postal Service over the three year duration of the agreement, the fairness and equity of the NSA in regard to other users of the mail, and the fairness and equity of the NSA in regard to the competitors of the parties to the NSA. Finally, I will explain why functionally equivalent NSAs are important to the business goals of the Postal Service.

My testimony will show that (1) the Discover NSA primarily rests on the same substantive functional elements as the Capital One NSA and provides comparable benefits; (2) Discover is similarly situated to Capital One, and therefore this NSA has a comparable competitive impact; and (3) the Discover NSA conforms to the relevant pricing and classification criteria of the Postal Reorganization Act. My testimony will explain how the Discover NSA will improve the financial position of the Postal Service.

My testimony relies on the concurrently filed testimony of DFS witness Karin Giffney (DFS-T-1), which is similar to the references provided by Capital One in Docket No. MC2002-2. I have reviewed Ms. Giffney's testimony on behalf of the Postal

Service, and affirm that such testimony may be relied upon in presentation of the Postal Service's direct case.

Appendix A to my testimony presents the model that calculates the financial impacts of the NSA. This model reproduces the calculations provided in Attachments (1), (2), and (B) of Witness Crum's testimony (USPS-T-3) in Docket No. MC2002-2. Appendix B explains the similarities and differences of both models. It is important to note that the underlying principles for calculating Postal Service contribution in the new format remain the same. Appendix C contains the proposed Data Collection Plan, which is based on the Data Collection Plan for Docket No. MC2002-2, the baseline docket.

II. THE IMPORTANCE OF NSAs AND FUNCTIONALLY EQUIVALENT AGREEMENTS

A. Background and Strategic Advantages of NSAs

In Docket No. MC2002-2, the Commission found that, when the concepts underlying negotiated pricing and declining block rates are applied fairly, benefits can accrue, not only to the customer and to the Postal Service, but also to all other postal customers. As witness Bizzotto pointed out, the Postal Service considers negotiated pricing a natural extension of its long-standing practice of seeking innovations in pricing. (MC2002-2, USPS-T-1 at 2-5) Used appropriately, negotiated pricing facilitates incentives for additional mail volume that benefit the Postal Service, its business partner, and all users of the Postal Service, through the additional contribution to institutional costs provided by additional volumes. Given the economic pressures

described below, NSAs represent one tool that can help to mitigate the risk that continued erosion of existing First-Class Mail volume will lead to higher-than-necessary rate and fee increases in the future.

In its opinion in Docket No. MC2002-2, the Commission also concluded that the "Postal Service should ensure that '[t]he negotiated rate-and-service package is made available on the same terms to other potential users willing to meet the same conditions of service." PRC Op., Docket No. MC2002-2, ¶ 7004, p. 136. To address this concern in the Capital One case, the Postal Service, Capital One, OCA, and many intervenors entered into a stipulation and agreement that identified the terms and conditions that must be included for an agreement to be considered comparable to Capital One. The Postal Service codified these elements in DMM G911. The Discover NSA meets these criteria and affirms the Postal Service's commitment to extend the Capital One NSA's terms and conditions to other mailers.

B. The Importance Of Functionally Equivalent NSAs to the Postal Service

Functionally equivalent NSAs are important to the Postal Service because they extend the benefits of favorable baseline agreements to similar relationships with other customers. The Commission's procedural framework for functionally equivalent cases promises to ensure that this objective can be achieved efficiently in an expedited proceeding, where controversy and duplication of effort can be minimized. These procedural goals, in turn, support the related objectives of minimizing the transaction costs involved in pursuing NSAs, reinforcing the financial incentives embodied in NSAs, and thereby promoting a viable and productive NSA process.

Expedited litigation and subsequent implementation of the changes proposed in this case would benefit both the Postal Service and DFS under the specific terms of the Discover NSA. If the proposed changes are recommended and approved, the Postal Service would realize immediate benefit from the agreement in terms of ACS savings. If this case, however, were to be litigated as a baseline NSA under the Commission's rules, the protracted proceedings would only delay the Postal Service's ability to capture the ACS savings. From the customer's perspective, furthermore, lengthy litigation would result in higher costs as well as delayed business benefits. For very large mailers, this cost might be easily absorbed within the expected benefit of the NSA, but for smaller mailers this cost can become prohibitive, in effect lowering the customer's valuation of the NSA, perhaps making it economically undesirable. Moreover, lengthy proceedings would add risk that the business environment might change in such a way that neither the Postal Service nor DFS could take advantage of the NSA.

Turning to one specific issue in the baseline agreement case, in Docket No. MC 2002-2, considerable attention was focused on the risks associated with declining block rates. Witness Panzer addressed the technical risks associated with non-linear pricing, and the OCA focused on the risks inherent in providing volume-based incentives in a future period. A number of participants suggested various mechanisms for mitigating these risks, implying that the risk of change might be greater than the risk of doing nothing. Recent volume trends, however, particularly in First-Class Mail, suggest the opposite.

Competition from electronic alternatives, increasing cost pressure on business customers, and a recent period of economic sluggishness have contributed to a

flattening of demand for First-Class Mail over the last several years. At the same time, household growth continues to lead to expansion of the Postal Service's delivery network. While recent productivity gains have been remarkable, there continues to be pressure on the Postal Service to come up with ways to continue to fund its large and growing universal service obligation. In the absence of new ways for the Postal Service to generate additional volumes and revenues, USPS customers will likely be asked to absorb higher price increases in the future. Specifically, Discover has a history of declining First Class Mail volume, and the NSA is expected to help to reverse this trend.

In this environment, the Postal Service considers the ability to negotiate individual price agreements that are consistent with the Act, and to implement them through rate and classification changes, to be of critical importance. Procedures linking favorable baseline agreements with their functionally equivalent offspring will help ensure that the benefits of the baseline agreements can be efficiently extended to similar, but distinct, relationships with other mailers. Promoting functionally equivalent NSAs will also mitigate the concern that a baseline NSA might have adverse competitive impacts.

III. THE DISCOVER NSA IS FUNCTIONALLY EQUIVALENT TO THE CAPITAL ONE NSA

The Discover NSA fully meets the guidelines outlined in the Commission's Order No. 1391 (RM2003-5) for functionally equivalent NSAs. The Discover NSA contains the same functional elements as the Capital One baseline NSA (*i.e.*, declining block rates and address correction elements, Order 1391 at 50), and will produce comparable

benefits for the Postal Service. Any differences between the Discover NSA and the Capital One NSA do not detract from Discover's status as functionally equivalent.

A. The Discover NSA Contains the Same Two Functional Elements as the Capital One NSA

The Discover NSA rests on the same substantive functional elements as the Capital One NSA. First, as in the Capital One agreement, the Postal Service's agreement with Discover calls for the implementation of discounts in the form of declining block rates, according to the schedule outlined below. The discounts are applied only to incremental volume above the negotiated threshold. In other words, no discount would be applied to the first 405 million pieces; a discount of 2.5 cents would be applied to the next 30 million pieces, etc.:

Volume Block	Incremental Discounts
405,000,001 – 435,000,000	2.5¢
435,000,001 – 465,000,000	3.0¢
465,000,001 – 490,000,000	3.5¢
490,000,001 – 515,000,000	4.0¢
515,000,001 – above	4.5¢

Considering these discounts and the testimony of witness Giffney (DFS-T-1) regarding the volume response of Discover to the proposed discount structure, the Postal Service expects Discover's use of First-Class Mail to increase, resulting in additional net contribution to the Postal Service.

Second, as with the Capital One NSA, the Discover agreement contains an address correction element, which creates further cost savings for the Postal Service. Discover has agreed that the Postal Service can convert the physical return of its

undeliverable-as-addressed (UAA) marketing mailpieces into electronic address correction information through the computerized ACS system. It is the same ACS system that was described more fully in the testimony of witness Wilson in Docket No. MC2002-2. (USPS-T-4 at 2-7)

B. The Discover NSA Provides the Postal Service a Comparable Benefit

In discussing the NSA rules governing functionally equivalent agreements, Order No. 1391 stated that the Commission would go beyond an evaluation of the functional elements and examine whether the agreement provides a comparable benefit to the Postal Service. Order 1391 at 51. As an example, the Commission stated that an agreement that is functionally equivalent to Capital One would need to have ACS cost savings. The ACS cost savings that will result from the Discover NSA are significant since over nine percent of its marketing First-Class Mail volume is currently physically returned. (See DFS-T-1 at 9) Also, as in Capital One, the Discover NSA will generate contribution from new First-Class Mail volume. (Appendix A at 1, 10, 11)

C. Other Terms and Conditions of the Discover NSA

The Discover NSA incorporates other terms and conditions found in the Capital One NSA. The agreement waives the seal against postal inspection of mail; requires Discover to prepare mail under applicable standards and to enhance its address management practices; includes a transaction penalty; and contains a provision for Discover to make necessary records and data available to the Postal Service to facilitate and monitor compliance. It also enables the Postal Service to cancel for failure by the mailer to provide accurate data, to present properly prepared and paid mailings,

to comply with a material term of the NSA, or to use the NSA. See Request, Attachment F.

D. New Terms and Conditions in the Discover NSA

By their nature, individual service relationships with the Postal Service reflect the inherent differences among mailers. The ability to develop a customer-specific NSA allows the Postal Service to address these differences directly, and to develop an agreement that best satisfies the needs of an individual customer and the Postal Service. By improving overall revenue contribution to the Postal Service, such agreements in turn benefit all postal customers.

The exact declining block rates in the Discover NSA do not match those in the Capital One NSA, although they are of a similar magnitude. The thresholds, incremental blocks, and starting discounts are unique to the Discover NSA. However, the discount structure remains the same as in the Capital One NSA, and it represents a negotiated agreement between the customer and the Postal Service.

In addition, the Discover NSA incorporates two customer-specific terms and conditions not found in the Capital One NSA: an annual adjustment mechanism to the threshold and a negotiated cap. As explained below, neither term alters the functionally equivalent status of the Discover NSA.

The first customer-specific term is the annual threshold adjustment. In general, NSAs patterned after Capital One are intended to increase First-Class Mail marketing volumes, among other objectives. However, statement volume growth could have the unintended consequence of diminishing the incentives for new marketing mail volume. The annual threshold adjustment protects against this contingency, and also mitigates

against greater discount exposure (leakage), by adjusting the thresholds in the years following the first year of the agreement (the out-years) by the percentage change in the number of credit card accounts. For example, under the Discover mechanism, if the number of accounts were currently at an annual volume level of 10 million pieces, and were to increase to 12 million pieces, there would be a 20 percent adjustment to the volume threshold. In other words, the logical correlation between accounts and statement volume will allow the Postal Service to use the threshold adjustment to mitigate the risk that exogenous factors will result in threshold levels that do not provide the appropriate incentive for marketing mail.

The second customer-specific term is a negotiated cap. The Discover NSA stipulates a discount cap of $13 million over the life of the NSA. This cap is the maximum amount of discounts that the Postal Service will give over the three year agreement. Assuming the discount is spread evenly over the life of the agreement, Discover would have to mail over 532 million pieces per year to reach the $4.33 million cap per year (*i.e.,* $13 million divided by 3), which would represent a 18 percent increase in First-Class Mail from its Year 1 Before Rates (Y1BR) forecast of 451 million pieces.

Discover Witness Giffney describes the DFS rationale for proposing the cap and how it was developed. (DFS-T-1 at 12-13) The Postal Service evaluated the cap proposed by Discover, and agreed that it reinforces the goals of the NSA approach by helping to ensure that functionally equivalent status does not create an unbalanced competitive relationship between the baseline NSA partner and its competitors who may seek functionally equivalent NSAs.

While the Postal Service accepts the logic of this cap as promoting the goals of NSAs, it continues to believe that caps for any purpose will not necessarily benefit either the customer or the Postal Service. Regarding the Capital One type of "stop-loss" cap, it is unlikely the Postal Service's exposure from misestimation could exceed the expected ACS savings from the Discover NSA. Therefore, imposition of a cap, in the context of the Discover NSA, would do nothing to mitigate this specific form of risk.

On the other hand, a "stop-loss" cap could risk the loss of an important opportunity, in the event that contribution which otherwise would have accrued to the Postal Service from the creation of additional First-Class Mail volume does not materialize because of the cap. In this regard, I note that the Commission has affirmed that NSAs ought to result in a net increase in contribution, such that they benefit all users of the Postal Service. Imposition of a stop-loss cap in this instance would work against this aim by potentially arbitrarily limiting such benefits. Moreover, the term "stop-loss" is in itself a misnomer, in that it suggests losses could be incurred. In fact, even at maximum discounts, all NSA volumes would make substantial contribution to institutional costs. Thus, caps of this type would merely reduce potential opportunities to gain additional revenues.

IV. Financial Impacts

A. Value Factors/Elements

As with the Capital One NSA, the Discover NSA has three factors affecting the value: ACS cost savings, new volume contribution, and discount exposure (leakage). The ACS cost savings are the savings that accrue to the Postal Service from eliminating the physical return of First-Class Mail marketing pieces with an electronic return notice.

Rather than having its undeliverable-as-addressed (UAA) marketing pieces physically returned, DFS has agreed to receive most address correction information electronically through the computerized ACS system. This is the same ACS system that was described more fully in the testimony of witness Wilson (USPS-T4) in Docket No. MC2002-2. (MC2002-2, USPS-T-4 at 3-4) Conversion to ACS would save the Postal Service the cost of returning UAA mail through the mail stream to the location where DFS would have processed return mail.

The second stream of value for the Postal Service is the volume contribution from any new volume generated by the NSA. This contribution is calculated using the following inputs: per piece contribution of First-Class Mail, per piece contribution of Standard Mail, and percent of marketing mail converted from Standard to First-Class.

As Discover Witness Giffney explains, the price incentives in the NSA are expected to produce a First-Class Mail volume response of 13 million pieces per year. (DFS-T-1 at 9) The new contribution must offset any substitution leakage that would result from the loss of contribution from Standard Mail pieces which might be converted to incremental First-Class Mail marketing pieces. To be conservative, Discover has estimated that 100 percent of incremental volume would be converted from Standard Mail. (DFS-T-1 at 9). Both the Postal Service and DFS believe that the incremental volumes will exceed the forecast. Id. (See Part C., Conservatism of Assumptions, below.)

The final value determinant is the expected discount exposure. The discount exposure lowers the value of the NSA and is the result of price incentives applied to any volume that would have occurred without a price incentive. As described by witness

Eakin, setting a threshold below forecast volume is economically efficient because it reduces the mailer's marginal price of First-Class Mail relative to other forms of solicitation, and reduces the gap between marginal price and marginal cost of the mailer's First-Class Mail. (MC2002-2,USPS-RT-2 at 4-5, Tr. 10/2069-70).

I estimate the value to the Postal Service of the DFS agreement, when considering all three value drivers, over the three years of the NSA, as follows:

ACS Cost savings:	$8.0 million
Increased contribution (less incremental discounts):	$2.0 million
Discount exposure:	($3.2) million

The agreement therefore would result in net benefit to the Postal Service of $6.8 million over the life of the NSA. A detailed analysis of the financial impact is provided in Appendix A.

B. Financial Model

I believe that the analysis provided in the valuation model of the Discover NSA complies with the guidelines established by the Commission in Rule 193(e). The model follows witness Crum’s methodology in Docket No. MC2002-2, except in instances where a change allows it to conform more closely to the requirements of Rule 193(e). The features of the model are described below; the model is in Appendix A and any changes relative to the Capital One model are discussed in Appendix B.

In order to comply with Rule 193(e)(2), the Postal Service and Discover have provided more data than in Docket No. MC2002-2 in order to present a more representative estimate of the cost and volume effects of the NSA in Years 2 and 3 of

the agreement. (see Appendix B at 2-3) In witness Giffney's testimony, Discover has provided mail volume forecasts in Years 2 and 3 of the agreement, which are minimum forecasts as Ms. Giffney notes. (DFS-T-1 at 8).

In addition, as described in Appendix B, the Postal Service applies a 4 percent annual inflationary cost adjustment factor to estimate unit costs in the each year of the agreement and to account for cost increases since litigation of the Capital One NSA agreement. This cost adjustment factor will provide a better estimate of the value of the NSA in the out-years of the agreement as requested by the Commission.[1] In other respects, the cost assumptions for the DFS mail pieces are based on Docket No. MC2002-2.[2]

C. Conservatism of Estimated Value

The After Rates (AR) forecast provided by DFS is, in the opinion of the Postal Service, a conservative estimate of the potential volume response to the price incentives.

In fact, there are reasons why these forecasts would generally tend toward conservatism. Non-linear pricing of First-Class Mail is relatively new to the Postal Service. Consequently, USPS customers have no direct experience in planning postage expenditures, nor in adjusting budgets when – as may happen if Discover reaches its initial declining block threshold – the cost of customer acquisition declines. If customers use traditional modeling techniques out of necessity, forecasted volume

[1] There remains a possibility of a rate increase during the term of the agreement; such an increase has not been accounted for in the revenue calculations. To the extent that revenues in the out-years have been undercounted, greater credence is lent to the conservatism of any assumption.

[2] Just as in the Capital One case, we did not provide estimates of forwarded mail.

effects are likely to understate the result of sudden and substantial price reductions. Moreover, banks work in a highly regulated and extensively analyzed industry, where public pronouncements can have significant consequences. This is also likely to act as a check against unwarranted optimism in projecting future outcomes.

One of the difficulties that arises in forecasting volumes in Years 1, 2, and 3 of the agreement is that, in complex mailing environments, postage is not the only variable that determines future mailing strategies. The customer and the Postal Service believe – and the universally accepted principles of economics confirm – that, keeping all other business variables constant, lower postage costs will provide an incentive for greater mail volumes. Yet, most companies do not currently forecast the impact of declining postage rates. Thus, it is difficult to predict the full impact on mail volumes. Thus, the point estimates provided are conservative and the Postal Service anticipates that the volume response will be higher.

V. COMPETITIVE IMPACT ANALYSIS

The impact of the Capital One NSA on the competitors of the contracting parties was discussed and evaluated extensively in the baseline proceeding. (MC 2002-2, JCP-T-1 at 11-12 and USPS-RT-2 at 11-14.) In the end, the Commission concluded that the impact on competition would be minor. In this regard, the Commission found it significant that no competitors of Capital One opposed the NSA.

I estimate that the impact on competition of the Discover NSA – which is functionally equivalent to the Capital One NSA – should be even less, since DFS and Capital One are similarly situated, i.e., direct competitors. Incidentally, the pool of competitors who may be disadvantaged because they do not have an NSA decreases

as the number of functionally equivalent agreements increase. For functionally equivalent agreements with direct competitors of the baseline agreement, any industry competitive impacts have been addressed in the baseline filing. More importantly, approving functionally equivalent NSAs provides competitors of Capital One the same incentives to grow their mail volumes. This is not to suggest that postage prices are the sole - or even the primary - dimension along which all competitors in an industry may compete. Indeed, there may be circumstances when it would be impracticable or otherwise inappropriate to provide NSAs to all competitors within an industry.

VI. DISCOUNT CAP

A "stop-loss provision" or discount cap of $40 million over three years was incorporated in the rate and classification changes implementing the Capital One NSA. This was not a condition that was negotiated between the Postal Service and Capital One, but was added by the Commission (PRC Op., MC2002-2, ¶ 5061).

The Commission explained that it instituted the stop-loss provision because of the variability inherent in the volume history of Capital One. The concern over "discount leakage" exceeding cost savings thus influenced the decision to limit the total value of discounts Capital One could earn (PRC Op., MC2002-2, ¶ 8024). In setting the cap, the Commission found that there would be no impact on new volume contribution because the thresholds were above the revised forecast. As I explained above, however, a cap based on either cost savings or exposure (leakage) unnecessarily hinders the ultimate objective of utilizing NSAs as a tool to increase net contribution. Basing the "stop-loss provision" solely on cost savings would tend to limit participation in the NSA process to only large volume mailers who can offer significant cost savings opportunities. This

would place customers who do not impose added costs on the Postal Service at a disadvantage.

More importantly, the stop-loss provision based on the Capital One condition passing through 95 percent of the cost savings (Op. at 156) would foreclose the potential contribution from increased volume. It also would impose a competitive disadvantage for DFS, because its potential cost savings are not nearly as large as the potential cost savings for Capital One, which is a larger originator of First-Class Mail marketing solicitations than DFS. Fears that the customer would have significantly increased mail volumes should be mitigated in the current environment of declining First-Class Mail volumes, and business conditions related specifically to credit card issuers (DFS-T-1 at 6).

The conditions that the Commission cited to support a cap on the discounts do not apply here. The major concern expressed over the course of the Capital One case was that mail volume would have grown in the absence of a discount so that the discounts would exceed the cost savings. By comparison, Discover's volume history is stable, and even if its marketing mail volume were to match its historic high, the Postal Service would receive a positive benefit from the NSA. Specifically, Discover's highest annual marketing mail volume was 209 million pieces in 2001, prior to the most recent rate increase. If Discover, without price incentives, could reach this same level for all three years of the agreement, they would receive $8.7 million in discounts on their before-rates volumes over the term of the agreement (as opposed to the $3.2 million estimate presented above in Financial Impacts, part A). This discount earned by Discover would correlate to exposure for the Postal Service. But, despite the increase

in exposure, the NSA would be contribution-positive because of ACS savings. Under the situation described above, the Postal Service would have underestimated the savings from ACS and, in absolute terms, the savings at 209 million marketing pieces would have been $10.7 million (as opposed to the $8.0 million presented above in Financial Impacts, part A). This means that the NSA would still generate $2.5 million in additional contribution for the Postal Service.

Accordingly, a cap could actually cause harm because it would limit the upside potential of the NSA. As discussed previously, the Discover forecasts are conservative, and it is quite possible that the incremental volume may be higher than predicted. A cap would obviate this possibility.

VII PROPOSED PRICES ARE CONSISTENT WITH THE CRITERIA OF THE ACT

Title 39, Section 3623 requires that the Commission evaluate proposed changes in the classification schedule in accordance with the policies of the Title and the following factors:

1. the establishment and maintenance of a fair and equitable classification system for all mail;
2. the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;
3. the importance of providing classifications with extremely high degrees of reliability and speed of delivery;
4. the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;
5. the desirability of special classifications from the point of view of both the user and of the Postal Service; and
6. such other factors as the Commission may deem appropriate.

Section 3622(b) requires that postal rates and fees reflect the policies of the Postal Reorganization Act, and accord with the following factors:

1. the establishment and maintenance of a fair and equitable schedule;

2. the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to, the collection, mode of transportation, and priority of delivery;
3. the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type;
4. the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters;
5. the available alternative means of sending and receiving letters and other mail matter at reasonable costs;
6. the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service;
7. simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services;
8. the educational, cultural, scientific, and informational value to the recipient of mail matter; and
9. such other factors as the Commission deems appropriate.

The arguments presented by witness Plunkett in the Capital One NSA are also applicable to the Discover NSA:

> …the Postal Service believes that by negotiating directly with individual customers, it may be possible, through negotiated service agreements such as the one submitted here, to more accurately present prices that represent the value that the user places on the service being provided (pricing criterion 2) for mail classifications that are desirable to the mailer and the Postal Service (classification criterion 5). In this case, the Postal Service has directly negotiated with the sender of the mail to arrive at classifications and prices that the Postal Service considers to be fair and equitable (classification criterion 1 and pricing criterion 1). As indicated in the testimony of witness Crum, there can be no doubt that the prices presented in this case will cover the costs of providing the service (price criterion 3). In fact, the address improvement steps that Capital One has agreed to will serve to lower the costs currently borne by other customers (pricing criterion 6). For this reason, the classifications and prices presented in this agreement confer beneficial effects on the general public and other ratepayers (classification criterion 1 and pricing criterion 1). The proposed rates do not have an adverse impact on the rates paid by the general public, or other business mail users (pricing criterion 4). The proposed declining block rate structure is relatively simple and maintains a transparent, identifiable relationship between volume levels

> and applicable rates and fees (pricing criterion 7). (MC2002-2, USPS-T-2, page 9, line 36 – page 10, line 15).

I believe that these pricing and policy issues were comprehensively addressed in the Capital One NSA docket, and that the logic of functional equivalence enables reliance on the findings in that case. In this instance, the close comparability of the structure and elements of the Discover and Capital One NSAs, the similarity of their situations as mailers, and their status as competitors, warrant full reliance on the Commission's findings to justify recommending the proposed changes based on the Discover NSA. Further, the customer-specific rates offered to Discover more than cover the costs associated with Discover's mail, thus meeting pricing criterion #1, concerning fairness and equity, as well as pricing criterion #3, which directly addresses the requirement of covering all costs.

VIII. SUMMARY AND CONCLUSIONS

My testimony has described and discussed the similarities and differences between the Discover NSA and the Capital One NSA. The Discover NSA has the same two substantive functional elements of the Capital One NSA, comparable benefits, other material terms and conditions that were included in the Capital One NSA, and some additional provisions. The new provisions in the Discover NSA reflect the differences between the companies that are inherent in their status as individual mailers. Discover is similarly situated to Capital One, and the fact that it is a direct competitor makes expeditious treatment of this filing under the Commission's specialized procedures especially important.

Accordingly, I conclude that the Discover NSA meets the standards for functional equivalency. The financial model developed to support the Discover NSA is based on the model submitted in Docket MC2002-2, with analytical enhancements as recommended by the Commission in Rule 193(e). The Discover NSA also meets the terms and conditions that must be included for an agreement to be considered comparable to Capital One, as codified in DMM G911.

Finally, based on the Commission's findings and conclusions in its review of the baseline NSA, the Discover NSA meets the criteria outlined for classifications in Title 39, Section 3623 of the Postal Reorganization Act as well as the criteria for postal rates and fees as outlined in Section 3622(b) of the Act.

For these reasons, I conclude that the Commission should recommend the proposed changes as warranted by the projected benefits of the Discover NSA, and as functionally equivalent to the Capital One baseline NSA.

Discover model

Negotiated Service Agreement

Appendix A, page 1

		Year 1	Year 2	Year 3
Return Forecast				
(1)	Statement Mail (Stmt)	0.3%	0.3%	0.3%
(2)	Marketing Mail (Mktg)	9.3%	9.3%	9.3%
(3)	USPS FCM average return rates	1.23%	1.23%	1.23%
Unit cost assumptions				
(4)	Inflation cost adjustment factor	4.0%	4.0%	4.0%
(5)	Manual Letter Returns Unit Cost	$ 0.55	$ 0.57	$ 0.60
(6)	Electronic Letter Returns Unit Cost	$ 0.34	$ 0.36	$ 0.37
(7)	Address Change Service (ACS) Success Rate	85.0%	85.0%	85.0%
(8)	Percent of new marketing mail switched from Standard Mail (SM)	100.0%	100.0%	100.0%
(9)	Contingency Factor	1.03		

(1) DFS MC 2004-4/ DFS-T-1 at page13
(2) DFS MC2004-4/DFS-T-1 at page 14
(3) USPS-LR-1/MC2002-2
(4) USPS MC 2004-4/USPS-T-1 at page 13
(5) USPS-LR-1/MC2002-2 * (1 + (5))
(6) USPS-LR-1/MC2002-2 * (1 + (5))
(7) USPS witness Wilson, T4/MC2002-2
(8) DFS MC2004-4/DFS-T-1 at page 9
(9) USPS-LR-1/MC2002-2

Discover Model
Negotiated Service Agreement
Appendix A, page 2

	2001	2002	2003	Year 1	Year 2	Year 3
(1) Volume calculations						
Before Rates						
Statement mail	309,000,000	333,000,000	313,000,000	295,000,000	290,000,000	285,000,000
Marketing mail letter	209,000,000	196,000,000	138,000,000	156,000,000	156,000,000	156,000,000
Total	**518,000,000**	**529,000,000**	**451,000,000**	**451,000,000**	**446,000,000**	**441,000,000**
After Rates						
Statement mail	309,000,000	333,000,000	313,000,000	295,000,000	291,000,000	287,000,000
Marketing mail letter	209,000,000	196,000,000	138,000,000	169,000,000	174,000,000	174,000,000
Total	**518,000,000**	**529,000,000**	**451,000,000**	**464,000,000**	**465,000,000**	**461,000,000**

(1) DFS MC 2004-4/ DFS-T-1 at page 8- 9

Discover Model

Negotiated Service Agreement
Appendix A, page 3

	(1) Volume	(2) Rates	(3) Revenue
Rate Category			
Single-Piece Letters			
First Ounces, except QBRM	0	0.370	$ -
Qualified Business Reply Mail	-	0.340	-
Additional Ounces	-	0.230	-
Nonmachinable Pieces	0	0.120	-
Single-Piece revenue			-
Revenue Adjustment Factor (a)			1.000
(4) Total Single-Piece Postage Revenue			-
Nonautomated Presorted Letters			
First Ounce	11,210,871	0.352	3,946,227
Additional Ounces	136,361	0.225	30,681
Nonmachinable Pieces	1,110	0.055	61
Heavy Piece Deduction	4,288	(0.041)	(176)
Nonautomated Presorted Revenue			3,976,793
Revenue Adjustment Factor (a)			1.000
(5) Total Nonautomated Presorted Letters Revenue			3,976,793
Automation Presort Letters			
Mixed AADC Letters	8,988,117	0.309	2,777,328
AADC Letters	19,098,403	0.301	5,748,619
3-Digit Letters	308,202,933	0.292	89,995,256
5-Digit Letters	101,706,322	0.278	28,274,358
Additional Ounces	2,410,072	0.225	542,266
Heavy Piece Deduction	176,937	(0.041)	(7,254)
Automation Presort Letter Revenue			127,330,573
Revenue Adjustment Factor (a)			1.000
(6) Total Automation Presort Letters Revenue			127,330,573
Automation Carrier Route Letters			
First Ounce	1,293,392	0.275	355,683
Additional Ounces	-	0.225	-
Heavy Piece Deduction	-	(0.041)	-
Automation Carrier Route Revenue			355,683
Revenue Adjustment Factor (a)			1.000
(7) Automation Carrier Route Letters Revenue			355,683
(8) Total Company Letters Subclass			$ 131,663,049
Total pieces			450,500,038
(9) **Revenue per piece**			**0.292**

(a) Revenue Adjustment Factor not required because customer specific revenue is presented
(1) CBCIS 2003 Discover Volume Data
(2) Rate Schedule
(3) (1) * (2)
(4) Single Piece Revenue * Revenue Adjustment Factor
(5) Nonautomated Presorted Revenue * Revenue Adjustment Factor
(6) Automation Presort Letter Revenue * Revenue Adjustment Factor
(7) Automation Carrier Route Revenue * Revenue Adjustment Factor
(8) (4) + (5) + (6) + (7)
(9) (8) / Total pieces

Discover Model

Negotiated Service Agreement
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	DOCKET NO. R2001-1 PRC FIGURES - NATIONWIDE MAIL MIX									DOCKET NO. R2001-1 PRC FIGURES - DISCOVER MAIL MIX						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Rate Category	TYBR 2003 Total Unit Cost (Dollars)	TYBR 2003 Mail Proc Unit Cost (Dollars)	TYBR 2003 Delivery Unit Cost (Dollars)	TYBR 2003 Other Unit Cost (Dollars)	TYBR 2003 Total Unit Cost (Dollars)	FY 2004 Total Unit Cost Dollars	BY 2000 Mail Volume (Pieces)	FY 2003 Mail Volume (Pieces)	FY 2003 Mail Volume (Percent)	TY 2004 Total Unit Cost (Dollars)	FY 2003 Mail Volume (Pieces)	FY 2003 Mail Volume (Percent)	Current Returns Adjustment Unit Cost (Dollars)	Current w/Rets Adj Total Unit Cost (Dollars)	After Rates Returns Adjustment Unit Cost (Dollars)	After Rates w/Rets Adj Total Unit Cost (Dollars)
FIRST-CLASS MAIL LETTERS																
Nonautomation Presort Letters		0.163	0.063	0.018	0.244	0.254	3,748,977,000	2,673,332,468	5.8%	0.254	11,155,885	3.6%				
Automation Presort Letters																
Automation Mixed AADC		0.055	0.045	0.018	0.118	0.123	2,504,846,824	2,820,696,002	6.1%	0.123	7,752,541	2.5%				
Automation AADC		0.046	0.044	0.018	0.107	0.111	2,680,656,176	2,636,650,800	5.7%	0.111	15,543,758	5.0%				
Automation 3-Digit		0.042	0.043	0.018	0.104	0.108	21,832,339,000	22,571,247,888	48.6%	0.108	226,048,367	72.2%				
Automation 5-Digit		0.032	0.041	0.018	0.091	0.095	12,720,447,000	14,911,024,110	32.1%	0.095	51,718,335	16.5%				
Automation Carrier Route		0.021	0.064	0.018	0.103	0.107	1,075,333,000	802,292,628	1.7%	0.107	833,517	0.3%				
WEIGHTED AVERAGE / TOTAL	**$0.115**	**0.050**	**0.045**	**0.018**	**0.113**	**0.113**	**44,562,599,000**	**46,415,243,896**	**100.0%**	**0.111**	**313,052,403**	**100.0%**	**$ (0.0051)**	**0.106**	**$ (0.0051)**	**0.106**
														(17)		(18)
										Total Unit Cost Estimates, Including Contingency =				**0.109**		**0.109**

(1) Docket No. R2001-1, PRC LR-2, Volume 4, "TYBR", page 3
(2) Docket No. R2001-1, PRC LR-4, "FCLETPRCFA.XLS", page 1
(3) Docket No. R2001-1, PRC LR-7, Page 2
(4) MC2002-2/USPS-T-3, Attachment A, pg. 2
(5) (2) + (3) + (4)
(6) (5) * (1 + inflation cost adjustment factor)
(7) Docket No. R2001, PRC, LR-4, FCM base year volumes from FCM letter model.
(8) Revenue, Pieces, and Weight (RPW) Report.
(9) (8) / [Sum (8)]
(10) Line Item (6), Weighted Average weighted by percentages in (12).
(11) CBCIS 2003 Discover Volume Data
(12) (11) / [Sum (11)]
(13) (Manual Letter Returns Unit Cost * After Rates Statement Mail) * (Statement Mail Return Forecast - USPS FCM Avg. Return Rate) / After Rates Statement Mail
(10) + (13)
(14) ((ACS Success Rate * Electronic Letter Returns Unit Cost + (1 - ACS Success Rate) * Manual Letter Returns Unit Cost) * After Rates Statement Mail * (Statement Mail Return Forecast - USPS FCM Avg. Return Rate))) /
(15) After Rates Statement Mail - USPS FCM Avg. Return Rate * (Manual Letter Returns Unit Cost - Electronics Letter Returns Unit Cost) * ACS Success Rate
(16) (10) + (15)
(17) (14) * Contingency Factor (Assumptions)
(18) (16) * Contingency Factor (Assumptions)

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	DOCKET NO. R2001-1 PRC FIGURES - NATIONWIDE MAIL MIX									DOCKET NO. R2001-1 PRC FIGURES - DISCOVER MAIL MIX						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Rate Category	TYBR 2003 Total Unit Cost (Dollars)	TYBR 2003 Mail Proc Unit Cost (Dollars)	TYBR 2003 Delivery Unit Cost (Dollars)	TYBR 2003 Other Unit Cost (Dollars)	TYBR 2003 Total Unit Cost (Dollars)	FY 2004 Total Unit Cost Dollars	BY 2000 Mail Volume (Pieces)	FY 2003 Mail Volume (Pieces)	FY 2003 Mail Volume (Percent)	TY 2004 Total Unit Cost (Dollars)	FY 2003 Mail Volume (Pieces)	FY 2003 Mail Volume (Percent)	Current Returns Adjustment Unit Cost (Dollars)	Current w/Rets Adj Total Unit Cost (Dollars)	After Rates Returns Adjustment Unit Cost (Dollars)	After Rates w/Rets Adj Total Unit Cost (Dollars)
FIRST-CLASS MAIL LETTERS																
Nonautomation Presort Letters		0.163	0.063	0.018	0.244	0.254	3,748,977,000	2,673,332,468	5.8%	0.254	54,986	0.0%				
Automation Presort Letters																
Automation Mixed AADC		0.055	0.045	0.018	0.118	0.123	2,504,846,824	2,820,696,002	6.1%	0.123	1,235,576	0.9%				
Automation AADC		0.046	0.044	0.018	0.107	0.111	2,680,656,176	2,636,650,800	5.7%	0.111	3,554,645	2.6%				
Automation 3-Digit		0.042	0.043	0.018	0.104	0.108	21,832,339,000	22,571,247,888	48.6%	0.108	82,154,566	59.8%				
Automation 5-Digit		0.032	0.041	0.018	0.091	0.095	12,720,447,000	14,911,024,110	32.1%	0.095	49,987,987	36.4%				
Automation Carrier Route		0.021	0.064	0.018	0.103	0.107	1,075,333,000	802,292,628	1.7%	0.107	459,875	0.3%				
WEIGHTED AVERAGE / TOTAL	**$0.115**	**0.050**	**0.045**	**0.018**	**0.109**	**0.113**	**44,562,599,000**	**46,415,243,896**	**100.0%**	**0.103**	**137,447,635**	**100.0%**	**0.0445**	**0.148**	**0.0280**	**0.131**
														(17)		(18)
										Total Unit Cost Estimates, Including Contingency =				**0.151**		**0.135**

(1) Docket No. R2001-1, PRC LR-2, Volume 4, "TYBR", page 3.
(2) Docket No. R2001-1, PRC LR-4, "FCLETPRCFA.XLS".
(3) Docket No. R2001-1, PRC LR-7, Page 2 .
(4) MC2002-2/USPS-T-3, Attachment A, pg. 2
(5) (2) + (3) + (4)
(6) (5) * (1 + inflation cost adjustment factor)
(7) Docket No. R2001, PRC, LR-4, FCM base year volumes from FCM letter model.
(8) Revenue, Pieces, and Weight (RPW) Report.
(9) (8) / [Sum (8)]
(10) Line Item (6), Weighted Average weighted by percentages in (12).
(11) CBCIS 2003 Discover Volume Data
(12) (11) / [Sum (11)]
(13) (Manual Letter Returns Unit Cost * After Rates Statement Mail) * (Statement Mail Return Forecast - USPS FCM Avg. Return Rate) / After Rates Statement Mail
(14) (10) + (13)
(15) ((ACS Success Rate * Electronic Letter Returns Unit Cost + (1 - ACS Success Rate) * Manual Letter Returns Unit Cost) * After Rates Statement Mail * (Statement Mail Return Forecast - USPS FCM Avg. Return Rate))) / After Rates Statement Mail - USPS FCM Avg. Return Rate * (Manual Letter Returns Unit Cost - Electronics Letter Returns Unit Cost) * ACS Success Rate
(16) (10) + (15)
(17) (14) * Contingency Factor (Assumptions)
(18) (16) * Contingency Factor (Assumptions)

Discover Model

Negotiated Service Agreement
Appendix A, page 6 **Year 1** **Year 2** **Year 3**

Agreement Structure

Year 1			Year 2			Year 3		
Threshold		Discount	Threshold		Discount	Threshold		Discount
405,000,000	435,000,000	$ 0.025	405,000,000	435,000,000	$ 0.025	405,000,000	435,000,000	$ 0.025
435,000,000	465,000,000	$ 0.030	435,000,000	465,000,000	$ 0.030	435,000,000	465,000,000	$ 0.030
465,000,000	490,000,000	$ 0.035	465,000,000	490,000,000	$ 0.035	465,000,000	490,000,000	$ 0.035
490,000,000	515,000,000	$ 0.040	490,000,000	515,000,000	$ 0.040	490,000,000	515,000,000	$ 0.040
515,000,000		$ 0.045	515,000,000		$ 0.045	515,000,000		$ 0.045

Discount on volume above threshold

(1)	Before Rates Forecast	451,000,000	446,000,000	441,000,000
(2)	After Rates Forecast	464,000,000	465,000,000	461,000,000
	Discount in first tier	$ 750,000	$ 750,000	$ 750,000
	Discount in second tier	$ 870,000	$ 900,000	$ 780,000
	Discount in third tier	$ -	$ -	$ -
	Discount in fourth tier	$ -	$ -	$ -
	Discount in fifth tier	$ -	$ -	$ -
(3)	**Discount Earned**	**$ 1,620,000**	**$ 1,650,000**	**$ 1,530,000**

Exposure on volume above threshold

(4)	Threshold	405,000,000	405,000,000	405,000,000
(5)	Before Rates Forecast	451,000,000	446,000,000	441,000,000
(6)	Exposed Pieces	46,000,000	41,000,000	36,000,000
(7)	After Rates Forecast	464,000,000	465,000,000	461,000,000
	Exposure in first tier	$ 750,000	$ 750,000	$ 750,000
	Exposure in second tier	$ 480,000	$ 330,000	$ 180,000
	Exposure in third tier	$ -	$ -	$ -
	Exposure in fourth tier	$ -	$ -	$ -
	Exposure in fifth tier	$ -	$ -	$ -
(8)	**Total Exposure**	**$ 1,230,000**	**$ 1,080,000**	**$ 930,000**

(1) Before Rates Total Volume (Volume calcs)
(2) After Rates Total Volume (Volume calcs)
(3) Sum of discounts earned in first tier to fifth tier
(4) Agreement Structure Beginning Threshold
(5) (1)
(6) Before rates - Threshold: The number of total pieces on which Exposure occurs
(7) (2)
(8) Sum of Exposure in first tier to fifth tier

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Negotiated Service Agreement
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		Year 1	Year 2	Year 3
Return Costs				
	UAA Rate			
(1)	Statement mail	0.3%	0.3%	0.3%
(2)	Marketing mail	9.3%	9.3%	9.3%
Before Rates Forecast				
(3)	Statement mail	295,000,000	290,000,000	285,000,000
(4)	Marketing mail	156,000,000	156,000,000	156,000,000
Return Forecast				
(5)	Statement mail	885,000	870,000	855,000
(6)	Marketing mail	14,508,000	14,508,000	14,508,000
Return Costs				
(7)	Statement mail	$ 487,812	$ 498,726	$ 509,732
(8)	Marketing mail	$ 7,996,810	$ 8,316,682	$ 8,649,349
(9)	Total	$ 8,484,622	$ 8,815,408	$ 9,159,081
After Rates Return Costs				
(10)	Statement mail	$ 487,812	$ 498,726	$ 509,732
(11)	Marketing mail	$ 5,431,795	$ 5,649,067	$ 5,875,030
(12)	Total	$ 5,919,607	$ 6,147,793	$ 6,384,762
(13) Return Cost Savings		**$ 2,565,014**	**$ 2,667,615**	**$ 2,774,320**

(1) DFS MC 2004-4/DFS-T-1 at page13
(2) DFS MC 2004-4/DFS-T-1 at page14
(3) DFS MC 2004-4/ DFS-T-1 at page 8
(4) DFS MC 2004-4/ DFS-T-1 at page 8
(5) (1) * (3)
(6) (2) * (4)
(7) (5) * Manual Letter Returns Unit Cost (Assumptions)
(8) (6) * Manual Letter Returns Unit Cost (Assumptions)
(9) (7) + (8)
(10) (5) * Manual Letter Returns Unit Cost (Assumptions)
(11) ((6) * ACS Success Rate * Electronic Letter Returns Unit Cost) + (1 - ACS Success Rate) * Manual Letter Returns Unit Cost * (6))
(12) (10) + (11)
(13) (9) - (12)

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(1) Standard Mail Regular Revenue per piece

Mail Category	Revenue per piece	Volume	Weighted Avg.
Mixed AADC Auto	$ 0.213	2,717,743	578,336
AADC Auto	$ 0.205	8,952,769	1,830,841
3-Digit Auto	$ 0.183	189,784,945	34,749,623
5-Digit Auto	$ 0.166	203,639,150	33,743,007
Basic Nonauto	$ 0.253	6,053,906	1,534,060
3/5 Digit Nonauto	$ 0.231	2,695,980	623,580
Total Volume		413,844,493	73,059,448
Revenue per piece			**$ 0.177**

(2) Standard Mail ECR Revenue per piece

Mail Category	Revenue per piece	Volume	Weighted Avg.
Basic Nonauto Letters	$ 0.172	2,045,481	351,414
Basic Auto Letters	$ 0.147	14,964,339	2,204,247
Saturation Letters	$ 0.126	24,066	3,032
Total Volume		17,033,886	2,558,693
Revenue per piece			**$ 0.150**

(3) Average Revenue per piece **$ 0.175**

(1) Rate Schedule
(2) Rate Schedule
(3) (Standard Mail Regular Revenue + Standard Mail ECR Revenue) /
(Standard Mail Regular Total Volume + Standard Mail ECR Total Volume)

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Standard Regular Unit Cost

	From Docket No. R2001-1									DISCOVER		
	TYBR 2003 Total Unit Cost (Dollars) (1)	TYBR 2003 Mail Proc Unit Cost (Dollars) (2)	TYBR 2003 Delivery Unit Cost (Dollars) (3)	TYBR 2003 Other Unit Cost (Dollars) (4)	TYBR 2003 Total Unit Cost (Dollars) (5)	FY 2004 Total Unit Cost (Dollars) (6)	BY 2000 Mail Volume (Pieces) (7)	FY 2003 Mail Volume (Pieces) (8)	FY 2003 Mail Volume (Percent) (9)	TY 2004 Total Unit Cost (Dollars) (10)	FY 2003 Mail Volume (Pieces) (11)	FY 2003 Mail Volume (Percent) (12)
LETTERS												
Nonauto Basic		0.130	0.042	0.01	0.18	0.19	1,322,401,662	1,411,242,831	3.2%	0.19	6,053,906	1.5%
Nonauto 3/5-Digit		0.121	0.044	0.01	0.17	0.18	4,476,247,838	2,481,782,907	5.7%	0.18	2,695,980	0.7%
Auto Mixed AADC		0.050	0.039	0.01	0.10	0.10	2,354,963,527	2,687,599,740	6.1%	0.10	2,717,743	0.7%
Auto AADC		0.043	0.038	0.01	0.09	0.09	2,875,476,520	2,848,635,910	6.5%	0.09	8,952,769	2.2%
Auto 3-digit		0.040	0.038	0.01	0.08	0.09	15,600,801,986	17,815,958,778	40.6%	0.09	189,784,945	45.9%
Auto 5-digit		0.031	0.037	0.01	0.07	0.08	11,222,413,732	16,604,952,264	37.9%	0.08	203,639,150	49.2%
Total/average	**0.096**	**0.05**	**0.04**	**0.01**	**0.09**	**0.09**	**37,852,305,265**	**43,850,172,430**	**100.0%**	**0.09**	**413,844,493**	**100.0%**
		(13)										
Company average letter cost 2003		**$ 0.09**										

Standard ECR Unit Cost

	TYBR Unit Costs	
Total ECR letter unit cost	0.080	(14)
Total ECR letter delivery unit cost	0.059	(15)

	TY 2004 Delivery Unit Costs (16)	FY 2003 Mail Volume (17)	FY 2003 Mail Volume (18)
ECR Basic Auto Letters	0.048	14,964,339	87.9%
ECR Basic Letters	0.066	2,045,481	12.0%
ECR High Density Letters	0.049	0	0.0%
ECR Saturation Letters	0.035	24,066	0.1%
Total		17,033,886	

	0.050	(19)
Company Delivery Cost Adjustment	-0.009	(20)
Company ECR total letter unit cost	**0.070**	(21)

(20) **Average Cost per piece** **0.085** (22)

(1) Docket No. R2001-1, LR-J-58, LR58AREG.xls, total unit letter costs
(2) Docket R2001-1, LR-J-60 Revised 11/15/01
(3) Docket R2001-1, LR-J-60 Revised 11/15/01
(4) (1) - average from (2) - average from (3)
(5) (2) + (3) + (4)
(6) (5) * (1 + inflation cost adjustment factor)
(7) Docket No. R2001, PRC, LR-4, SM base year volumes from SM letter model.
(8) Revenue, Pieces, and Weight (RPW) Report.
(9) Each row in (8) divided by total in (8)
(10) (6)
(11) CBCIS 2003 Discover Volume Data
(12) Each row in columnn (11) divided by total in column (11)
(13) Weighted average costs calculated by multiplying column (10) by column (12)
(14) Docket No. R2001-1, LR-J-58, LR58AECR.xls, total TY2003 ECR unit letter costs
(15) Docket No. R2001-1, LR-J-58, LR58AECR.xls, sum of TY2003 ECR unit letter delivery costs (Cost segments 6, 7 and 10) * inflationary cost adjustment factor (Assumptions)
(16) Docket No. R2001-1, LR-J-117, Revised 1/22/02, TY2003 unit delivery costs * inflationary cost adjustment factor (Assumptions)
(17) CBCIS 2003 Discover Volume Data
(18) Percent of volume in each row of (17) divided by total in (17)
(19) Weighted average of the unit costs in (16) weighted by the volume percents in (18)
(20) (15) - (19)
(21) (18) + (20)
(22) ((13 * 11) + (21 * 17)) / (11 + 17)

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		Year 1	(13) Year 2	(14) Year 3
First Class Letter				
(1)	Avg Revenue First-Class Letters	0.292	0.292	0.292
(2)	First-Class Statement Letter cost per Piece Before Rates	0.109	0.113	0.118
(3)	First-Class Statement Letter cost per Piece After Rates	0.109	0.113	0.118
(4)	First-Class Statement Letter avg. Contribution Before Rates	0.183	0.179	0.175
(5)	First-Class Statement Letter avg. Contribution After Rates	0.183	0.179	0.175
(6)	First-Class Marketing Letter cost per Piece Before Rates	0.151	0.157	0.164
(7)	First-Class Marketing Letter cost per Piece After Rates	0.135	0.140	0.146
(8)	First-Class Marketing Letter avg. Contribution Before Rates	0.141	0.135	0.129
(9)	First-Class Marketing Letter avg. Contribution After Rates	0.158	0.152	0.147
Standard Mail				
(10)	Standard Revenue per Piece	0.175	0.175	0.175
(11)	Standard Cost per Piece	0.085	0.088	0.091
(12)	Standard Letter Contribution per Piece	0.091	0.088	0.084

(1) Revenue per piece (FCM rev calc)
(2) CurrentTotal Unit Cost Estimates, Including Contingency (Stmt unit cost)
(3) After Rates Total Unit Cost Estimates, Including Contingency (Stmt unit cost)
(4) (1) - (2)
(5) (1) - (3)
(6) CurrentTotal Unit Cost Estimates, Including Contingency (Mktg unit cost)
(7) After Rates Total Unit Cost Estimates, Including Contingency (Mktg unit cost)
(8) (1) - (6)
(9) (1) - (7)
(10) Average Revenue per Piece (SM rev calcs)
(11) Average Cost per Piece (SM cost calcs)
(12) Standard Revenue - Standard Cost
(13) Year 1 * Inflation cost adjustment factor Year 2 (Assumptions)
(14) Year 2 * Inflation cost adjustment factor Year 3 (Assumptions)

Discover Model
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		Year 1	Year 2	Year 3	Total
ACS Savings					
(1)	Statement Mail	$ -	$ -	$ -	-
(2)	Marketing Mail Letter	$ 2,565,014	$ 2,667,615	$ 2,774,320	**8,006,949**
Contribution from New Volume					
(3)	Statement Mail	$ -	$ 179,079	$ 349,104	**528,184**
(4)	Marketing Mail Letter	$ 867,923	$ 1,165,741	$ 1,065,009	**3,098,673**
(5) Total Exposure		$ 1,230,000	$ 1,080,000	$ 930,000	**3,240,000**
(6) Total Incremental Discounts		$ 390,000	$ 570,000	$ 600,000	**1,560,000**
(7) Total USPS Value		**$ 1,812,938**	**$ 2,362,435**	**$ 2,658,433**	**6,833,806**

(1) Statement Mail Return Costs - Statement Mail After Rates Return Costs (UAA calcs)
(2) Marketing Mail Return Costs -Marketing Mail After Rates Return Costs (UAA calcs)
(3) (Statement Mail After Rates - Statement Mail Before Rates) * FCM Statement Letter avg. Contribution After Rates
(4) (Marketing Mail After Rates - Marketing Mail Before Rates) * FCM Marketing Letter avg. Contribution After Rates
(5) Total Leakage (Disc&Leak)
(6) Discount Earned - Total Leakage (Disc&Leak)
(7) (1) + (2) + (3) + (4) - (5) - (6)

IX. DATA AND APPENDICES

Appendix B

EXPLANATION OF FINANCIAL MODEL

The DFS Model incorporates all of the cost and revenue per piece information into one comprehensive workbook. It serves as a presentation mechanism for the customer-specific revenue and cost calculations. The model was built upon the same revenue and cost assumptions (discount, and exposure (leakage) calculations) as the Capital One NSA. The historical and forecasted volumes are provided by DFS witness Giffney (DFS-T-1). These inputs provide the basis for calculating the value of the NSA.

Assumptions

The assumptions contain the return rates for DFS' mail mix as provided by witness Giffney (DFS-T-1). The inflation cost adjustment factor, a weighted average of inflationary factors, represents the inflationary cost growth projected by the Postal Service. Currently, that factor is 4 percent. The Capital One manual and electronic return unit costs for letters serve as proxies in the DFS Model (USPS-LR-1/MC2002-2). The manual and electronic return unit costs for flats are the adjusted subclass averages. Costs for Years 1, 2, and 3 of the agreement are adjusted by the inflationary cost growth of 4 percent. The Address Change Service (ACS) success rate was explained by USPS witness Wilson (MC2002-2, USPS-T-4 at 7, Line 4) and is assumed to be constant throughout the life of the agreement. The DFS model assumes 100 percent of the incremental mail volume growth to come from migrating Standard Mail to

First-Class Mail for all marketing letters. The contingency is a multiplicative factor applied uniformly to all forecasted postal costs.[1]

Volume Calculations

The Volume Calculations contain DFS' mailing mix, consisting of operational mail and marketing mail letters. The mailing mix for 2001 – 2003 provides a historical view of DFS' past mailing profile. To illustrate the volume response to incentives, DFS witness Giffney (DFS-T-1) has provided the volume forecasts for DFS, both in the absence of an agreement (TYBR) and in the presence of an agreement (TYAR).

First-Class Mail Revenue Calculations

The Rate Category of the model shows the First-Class Mail profile of DFS. It is similar to the profile in the Capital One NSA (MC2002-2, USPS-T-3). It provides a representation of the estimated revenue per piece for DFS marketing and operational mail pieces.

Operational Unit Cost and Marketing Unit Cost

The cost estimates for Operational Unit Cost were built on the same assumptions of the First-Class Mail Presort Letters/Flats Unit Cost Estimate of witness Crum

[1] The contingency is applied to all forecasted postal costs to protect against unforeseen circumstances. It is applied as the very last step in development of the roll-forward costs. It needs to be incorporated in NSA calculations for two reasons. First, the existing rates from which the NSA rates or discounts are being derived include contingency. In the absence of an NSA, the rates that Discover would be paying would have been set so as to recover the contingency. Furthermore, the NSA financial analyses are projections into the future, and the further into the future the projections are made, the more appropriate the application of the contingency.

(MC2002-2, USPS-T-3 Atta2.xls) for the Capital One NSA. Estimates for the DFS NSA differ from those of the Capital One NSA in the Test Year (TY) calculations, the DFS volumes, and the total unit cost (columns 17 and 18). The TYBR 2003 unit cost is based on Docket No. R2001-1, with the weighted distributions calculated from Base Year (BY) 2000 FCM base year volumes from the FCM letter model from Docket No. R2001, PRC, LR-4. The TY 2004 cost estimates were derived by multiplying the TYBR 2003 Total Unit Cost by the inflationary growth rate of 4.0 percent.[2] FY 2003 Mail Volume for DFS was used because it was the latest full year historical volume available. The Total Unit Cost Estimates, including Contingency (Attachment A, page 4, sources 17 and 18) are equal, based on the assumption that the before and after rates forecasts of operational mail remain the same.

The Marketing Unit Cost is built on the same assumptions as the Operational Unit Cost. The major difference is electronic diversion from ACS and the cost differential between manual and electronic returns for UAA mail. Operational mail does not receive the Change Service Requested (CSR) endorsement because it needs to be physically returned to DFS. Marketing mail receives the endorsement, and information is returned from UAA mail electronically 85 percent of the time. This explains why the Total Unit Cost, including Contingency, differs in sources 17 and 18 (Pg. 5); the after-rates unit cost is 1.6 cents less than the before-rates unit cost.

[2] Columns are labeled as "TYBR 2003" in these sheets because those figures are drawn from Docket No. R2001-1, in which FY 2003 was the test year. Columns are labeled as "TY 2004" because FY 2004 is the first of the three years in which the instant NSA is assumed to be in effect. Estimates for the last two years of the agreement, Years 2 and 3, are presented in the subsequent sheets. FY 2004 is not the exclusive "test year" in this proceeding in the sense that FY 2003 was the test year in the Capital One proceeding. It is, rather, one of three relevant years for which estimates are presented and evaluated.

Discount and Exposure

The declining block rate structure for the proposed NSA begins at 405,000,000 pieces, with a discount of 2.5 cents per piece. Exposure (to the Postal Service) measures the discounted revenue associated with declining block rates for mail volume that DFS would have mailed in the absence of the proposed NSA. For each year, DFS' BR Forecast falls within the second tier of the discount structure. Total exposure is therefore calculated by adding the first tier to the second tier. Because the first tier exposure must be maximized before discount calculations apply, the ending threshold is reduced by the beginning threshold (435,000,000 – 405,000,000), and that difference is multiplied by the corresponding discount (2.5 cents). The first tier exposure equals $750,000. The second tier exposure is the remaining volume less the beginning threshold (451,000,000 – 435,000,001), multiplied by the discount (3.0 cents), equaling ($480,000). Thus, the total exposure in this case is $1,230,000 ($750,000+$480,000).

Based on the Y1AR Forecast, DFS could achieve discounts in the first year of the agreement, equaling $1,620,000, using the same formula as exposure. Discounts are given on pieces mailed above the threshold. Double counting of the 46,000,000 (Y1BR – Beginning Threshold: 451,000,000 – 405,000,000) mail pieces occurs in the discount and exposure calculations, because the 46,000,000 pieces are the exposure calculation. The Y1AR of 464,000,000 is made up of the Y1BR plus the 13,000,000 additional marketing pieces. To account for this double counting, the Postal Service subtracts the discount from the exposure, to get the "real" discount calculation of $390,000 (Attachment A, page 11).

UAA Calculations

In lieu of receiving physical returns, DFS will accept electronic diversion of address changes or corrections, as Capital One does. This results in cost savings to the Postal Service by replacing costly physical returns with the less costly transmission of electronic information. The estimated Capital One physical and electronic return unit costs described in USPS-LR-1/MC2002-2 will be used in the DFS model. The total return costs savings vary from the Capital One model because of the different marketing mail volumes, and return rate forecasts (9.3 percent for marketing mail letters).

To calculate the cost savings, multiply the expected volume of Discover's UAA mail times unit costs savings for each piece processed through the ACS times the percentage of Discover's UAA mail that will be processed. The calculation relies upon the evidence in MC2002-2 for 1) the percentage of Discover's UAA mail that will be processed through the ACS system (85%) and 2) the unit savings for each UAA piece processed through the ACS system.

Standard Mail Revenue Calculations and Standard Mail Cost Calculations

The Standard Mail Regular and Enhanced Carrier Route (ECR) Revenues are based on the Standard Mail Regular and ECR Billing Determinants of DFS. The revenue per piece for both Regular and ECR is a weighted average of the revenue per piece and DFS volume. The Standard Regular and ECR unit costs are based on Docket No. R2001-1 for TY 2003 unit costs (Docket No. R2001-1, USPS LR-J-58). These data are based on the USPS version of the cost models, due to the fact that a

PRC-version is not available for some of the data. Specifically, the total unit costs of Standard letters and Standard ECR letters are needed for this analysis. These data are found in the USPS Weight Study (Docket No. R2001-1 USPS LR-J-58), and there is no PRC version of this document. The format for 2004 unit costs follows the First-Class Mail unit cost estimates on pages 4 and 5. This provides the customer-specific revenue and cost data on DFS' Standard Mail.

Contribution Inputs

The Contribution Inputs calculate the contribution per piece of DFS' operational mail and marketing mail letters. This per piece calculation provides the Postal Service with before and after rates revenue, cost, and contribution for First-Class Mail and Standard Mail on a customer-specific basis. It also allows for forecasting future contribution per piece in the out-years of the agreement by allowing the inflationary growth to be multiplied by the cost of each subclass. Unit revenue remains constant over the three-year agreement.

USPS Value

The total USPS value looks at the value determinants, less the discount and exposure associated with the declining block rate structure. "Contribution from New Volume" is any volume above the before rates forecast multiplied by the difference between the First-Class Mail and Standard Mail estimated contributions. This is so because Discover indicates that all of its new First-Class Mail volume will be switched from Standard Mail (100% conversion). (DFS-T-1 at 11).

Appendix C

DISCOVER FINANCIAL SERVICES NSA
PROPOSED DATA COLLECTION PLAN

The Postal Service plans to collect the following data pertaining to the NSA with Discover Financial Services, Inc. (DFS):

1. The volume of First-Class Mail solicitations by rate category in eligible DFS permit accounts;

2. The volume of First-Class Mail customer mail by rate category in eligible DFS permit accounts;

3. The amount of discounts paid to DFS for First-Class Mail by incremental volume block;

4. The volume of First-Class Mail solicitations bearing the ACS endorsement that are physically returned to DFS;

5. The number of electronic address correction notices provided to DFS for forwarded solicitation mailpieces, including the number of notices processed by CFS units and separately for PARS (when fully operational).

6. The number of electronic address correction notices provided to DFS for solicitation mailpieces that would otherwise be physically returned, including the number of notices processed by CFS units and separately for PARS (when fully operational).

7. Monthly estimate of the amount of time spent on compliance activity and a description of the activities performed.

8. For each First-Class Mail solicitation mailing list run against NCOA, DFS will provide NCOA contractor reports that separately identify the number of address records checked and the number of corrections made.

9. For each Change of Address record that is used to forward a piece of DFS solicitation mail through ACS under the Agreement, the Postal Service will provide the date the record was created, its move effective date, whether it was for a family or individual move, and each date that the record was used to forward a mail piece. No other information from the record would be provided.

As part of each data collection plan report, the Postal Service will provide an evaluation of the impact on contribution. It will also provide an assessment of trends of DFS' First-Class Mail volume as compared to overall First-Class Mail volume.

Data collected under the plan shall be reported annually following the end of the fiscal year, with the first report being made available at the end of FY2004. The Postal Service shall provide the data in a PC-available format.