

BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON, D.C. 20268-0001

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

Docket No. MC2004-4

RESPONSES OF THE UNITED STATES POSTAL SERVICE WITNESS AYUB  
TO INTERROGATORIES OF THE OFFICE OF THE CONSUMER ADVOCATE  
(OCA/USPS-T1-22-29)  
(August 2, 2004)

The United States Postal Service hereby provides its responses to the following interrogatories: Office of the Consumer Advocate Interrogatories to United States Postal Service Witness Ali Ayub (OCA/USPS-T1-22-29), filed on July 22, 2004.

Each interrogatory is stated verbatim and is followed by the response.

Respectfully submitted,  
UNITED STATES POSTAL SERVICE

By its attorneys:

Daniel J. Foucheaux, Jr.  
Chief Counsel, Ratemaking

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August 2, 2004

**OCA/USPS-T1-22.** Please refer to your testimony at VI. Discount Cap, pages 15-17, and PRC Op. MC2002-2, page 154, footnote 83, which states:

This excludes any potential increased contribution as a result of Capital One responding to the declining block rate structure by increasing its volume of First-Class Mail. The commission is excluding this potential contribution because the record does not provide an adequate basis for evaluating the response of Capital One (and its competitors) to the declining block rates. See Chapter V, Section M, for the analysis leading to this conclusion.

Please expand on your testimony and address the Commission's concern with respect to unknown before rates volumes and the unknown response to discounts.

**RESPONSE:**

Discover's Before Rates First-Class marketing letter volume—the only type of First-Class mail over which Discover appears to have significant discretion over volume—would have to increase by over 75% of current marketing letter volume before the resulting “leakage” from the NSA rate discounts outweighed the ACS cost savings generated by the discounts.

Increases of this magnitude are extremely unlikely. Discover's historical volumes, in contrast to those of Capital One, have been quite stable in recent years. Moreover, the terms of the NSA establishing an annual threshold adjustment and merger adjustments provide structural safeguards against the risk that Discover could obtain volume-related discounts for increases in First-Class mail volume caused by a merger or an organic increase in the scale of Discover's business.

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**OCA/USPS-T1-23.** Please refer to your testimony at VI. Discount Cap, pages 15-17, and PRC Op. MC2002-2, page 154, para. [8025], which states:

Third party mailers will be unharmed by the NSA so long as the dollar amount of the volume discounts the Postal Service makes available to Capital One is not greater than the costs it avoids as a result of the return mail feature of the agreement.

Please explain how the Postal Service has protected third party mailers from harm should the dollar amount of the volume discounts provided to Discover exceed the costs avoided as a result of the return mail feature of the Discover NSA.

**RESPONSE:**

The NSA cannot result in a contribution loss for the Postal Service because the combination of ACS cost savings and the effects of incremental and retained First Class Mail volume, together, exceed any potential exposure (discount on existing volume). However, the risk of not pursuing an NSA is not zero. Ignoring the cost savings on existing volume, the Postal Service loses 13 million pieces in Year 1, and 18 million pieces in Years 2 and 3 of the agreement. The potential exposure to the Postal Service is, at a minimum, identified below.

	<u>YEAR 1</u>	<u>YEAR 2</u>	<u>YEAR 3</u>
Volume	13,000,000	18,000,000	18,000,000
Contribution*	\$0.158	\$0.152	\$0.147
Opportunity Cost	\$2,050,564	\$2,742,385	\$2,641,653

\*MC2004-4 USPST-1-Appendix A page 10 line 9

The chart above illustrates that no NSA, at a minimum, means an opportunity cost of at least \$7.3 million in additional contribution over the term of the NSA that is "lost."

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**OCA/USPS-T1-24.** Please refer to your testimony at Appendix A, page 10, lines (2), (3), (6) and (7) for Year 1, and the accompanying notes.

- (a) For Year 1, please confirm that the “First-Class Operational Letter cost per Piece Before Rates” should be 0.106. If you do not confirm, please explain and provide all calculations.
- (b) For Year 1, please confirm that the “First-Class Operational Letter cost per Piece After Rates” should be 0.106. If you do not confirm, please explain and provide all calculations.
- (c) For Year 1, please confirm that the “First-Class Marketing Letter cost per Piece Before Rates” should be 0.148. If you do not confirm, please explain and provide all calculations.
- (d) For Year 1, please confirm that the “First-Class Marketing Letter cost per Piece After Rates” should be 0.131. If you do not confirm, please explain and provide all calculations.

**RESPONSE:**

(a) Not confirmed. The base cost of \$0.106 does not include the contingency factor, whereas \$0.109 includes the contingency factor of 1.03 from USPS-LR-1/MC2002-2. \$0.109 equals \$0.106 (Current w>Returns Adjusted Total Unit Cost) multiplied by 1.03 (contingency factor contained on page 1 of Appendix A). The inclusion of the contingency factor does not increase the value of the NSA.

(b) Not confirmed. The base cost of \$0.106 does not include the contingency factor, whereas \$0.109 includes the contingency factor of 1.03 from USPS-LR-1/MC2002-2. \$0.109 equals \$0.106 (After Rates w>Returns Adjusted Total Unit Cost) multiplied by 1.03 (contingency factor contained on page 1 of Appendix A).

(c) Not confirmed. The base cost of \$0.148 does not include the contingency factor, whereas \$0.151 does include the contingency factor of 1.03

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from USPS-LR-1/MC2002-2. \$0.151 equals \$0.148 (Current w>Returns Adjusted Total Unit Cost) multiplied by 1.03 (contingency factor contained on page 1 of Appendix A).

(d) Not confirmed. The base cost of \$0.131 does not include the contingency factor, whereas \$0.135 does include the contingency factor of 1.03 from USPS-LR-1/MC2002-2. \$0.135 equals \$0.131 (Current w>Returns Adjusted Total Unit Cost) multiplied by 1.03 (contingency factor contained on page 1 of Appendix A).

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**OCA/USPS-T1-25.** Please refer to your testimony Appendix A, pages 3, 4 and 5.

- (a) Please confirm that the “WEIGHTED AVERAGE/TOTAL” of 313,052,403 and 137,447,635 in column 11 on pages 4 and 5, respectively, sum to 450,500,038, the “Total Pieces” in column (3) on page 3. If you do not confirm, please explain.
- (b) On page 4, please explain how the “WEIGHTED AVERAGE/TOTAL” of 313,052,403 in column 11 was derived. Show all calculations.
- (c) On page 5, please explain how the “WEIGHTED AVERAGE/TOTAL” of 137,447,635 in column 11 was derived. Show all calculations.
- (d) Please confirm that the volumes for the specified Nonautomation Presort Letters and Automation Presort Letters rate categories in column 11 on pages 4 and 5 sum to the volumes of the same Nonautomation Presort Letters and Automation Presort Letters rate categories on page 3, column 1. If you do not confirm, please explain.
- (e) On page 4, please explain how the volumes of Nonautomation Presort Letters and Automation Presort Letters in column 11 were derived. Show all calculations.
- (f) On page 4, please provide all calculations that show the derivation of the percentages in column 12 associated with Nonautomation Presort Letters and Automation Presort Letters.
- (g) On page 5, please explain how the volumes of Nonautomation Presort Letters and Automation Presort Letters in column 11 were derived. Show all calculations.
- (h) On page 5, please provide all calculations that show the derivation of the percentages in column 12 associated with Nonautomation Presort Letters and Automation Presort Letters.

**RESPONSE:**

- (a) Confirmed.
- (b) The total of 313,052,403 is the total sum of the Discover’s statement volume at the different rate categories. These values are the reconciled volume numbers from the USPS Permit system and Discover.

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<u>Rate Category</u>	<u>Volume (column 11)</u>
Nonautomation Presort Letters	11,155,885
Automation Mixed AADC	7,752,541
Automation AADC	15,543,758
Automation 3-Digit	226,048,367
Automation 5-Digit	51,718,335
Automation Carrier Route	833,517
<b>TOTAL</b>	<b>313,052,403</b>

(c) The total 137,447,635 is the total sum of the Discover's marketing volume at the different rate categories. These values are the reconciled volume numbers from the USPS Permit system and Discover.

<u>Rate Category</u>	<u>Volume (column 11)</u>
Nonautomation Presort Letters	54,986
Automation Mixed AADC	1,235,576
Automation AADC	3,554,645
Automation 3-Digit	82,154,566
Automation 5-Digit	49,987,987
Automation Carrier Route	459,875
<b>TOTAL</b>	<b>137,447,635</b>

(d) Confirmed

(e) The volumes of Nonautomation Presort Letter and Automation Presort Letter in column 11 are actual Discover volumes broken into rate categories. The only calculations used were to sum specific rate categories across all permits.

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(f)

<b>Rate Category</b>	<b>Volume /</b>	<b>Total Volume =</b>	<b>Percentage</b>
Nonautomation Presort Letters	11,155,885	313,052,403	3.56%
Automation Mixed AADC	7,752,541	313,052,403	2.48%
Automation AADC	15,543,758	313,052,403	4.97%
Automation 3-Digit	226,048,367	313,052,403	72.21%
Automation 5-Digit	51,718,335	313,052,403	16.52%
Automation Carrier Route	833,517	313,052,403	0.27%
<b>TOTAL</b>	313,052,403	N/A	100.00%

The percentages are calculated by dividing the “Volume” for each rate category column by the “Total Volume”. This is reflected in footnote (12) on page 4 of Appendix A.

(g) Please see answer (e) above.

(h)

<b>Rate Category</b>	<b>Volume /</b>	<b>Total Volume =</b>	<b>Percentage</b>
Nonautomation Presort Letters	54,986	137,447,635	0.04%
Automation Mixed AADC	1,235,576	137,447,635	0.90%
Automation AADC	3,554,645	137,447,635	2.59%
Automation 3-Digit	82,154,566	137,447,635	59.77%
Automation 5-Digit	49,987,987	137,447,635	36.37%
Automation Carrier Route	459,875	137,447,635	0.33%
<b>TOTAL</b>	137,447,635	N/A	100.00%

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**OCA/USPS-T1-26.** Please refer to your testimony Appendix A, pages 4 and 5.

- (a) On page 4, in columns (14) and (16), please confirm that the “Total Unit Cost Estimates, Including Contingency” of 0.109 and 0.109, respectively, are not used anywhere in Appendix A. If you do not confirm, please explain.
- (b) On page 5, in columns (14) and (16), please confirm that the “Total Unit Cost Estimates, Including Contingency” of 0.151 and 0.135, respectively, are not used anywhere in Appendix A. If you do not confirm, please explain.
- (c) Please explain the rationale for calculating, and intended use of, the figures referred to in parts (a) and (b) of this interrogatory.

**RESPONSE:**

- (a) Not confirmed. The “Total Unit Cost Estimates, Including Contingency” of \$0.109 and \$0.109 are used on page 10 of Appendix A at line(s) 2 and 3. The cost is used in calculating the First-Class Statement Letter avg. Contribution Before and After Rates.
- (b) Not confirmed. The “Total Unit Cost Estimates, Including Contingency” of \$0.151 and \$0.135 are used on page 10 of Appendix A at line(s) 6 and 7. The costs are used in calculating the First-Class Marketing Letter avg. Contribution Before and After Rates.
- (c) The contingency factors were applied to the cost estimates following the guidelines used by the Postal Service to account for unanticipated cost increases. The contingency in the NSA as well as the cost inflation adjustment factor are both variables that rise the per piece cost to account for any increase in the base cost. Combined the contingency factor of 3% and the inflation factor of 4% should account for any cost increases.

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**OCA/USPS-T1-27.** Please refer to your testimony at VI. Discount Cap, pages 15-17, and PRC Op. MC2002-2, page 156, para. [8031]. Please confirm that in the case of Capital One, the Commission established an annual stop-loss amount equal to 95 percent of \$14,259 million, based upon an equilibrium annual volume of 1,559,248 thousand. If you do not confirm, please explain.

**RESPONSE:**

In the Capital One case no volume projections were provided for Years 2 and 3 of the agreement. The Commission projected savings of \$14,229 million per year which was the projected savings over the test year and forecasted the exact same savings over the remaining years. The Commission capped the total price incentives at 95% of the projected cost savings over the three years. The volume of 1,559,248, thousand, as presented above, represents the volume Capital One would have had to mail to reach the cap. However this assumes that the ratio of statements and marketing pieces remains constant at higher volumes which may be unrealistic. The higher the proportion of marketing mail the higher the cost savings would be which would in turn increase the cap.

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**OCA/USPS-T1-28.** Please refer to PRC Op. MC2002-2, pages 152-156, and the attachment to this interrogatory.

- (a) Please confirm that in Table 3, the calculated stop-loss estimate for Discover is consistent with the Commission's calculation of the stop-loss estimate with respect to Capital One. If you do not confirm, please explain and provide the correct stop loss estimate. Please show all calculations.
- (b) Please confirm that in Table 3, the stop-loss estimate, if recommended, would limit the total dollar amount of the discounts awarded to Discover to no more than 95 percent of the total dollar amount of savings realized by the Postal Service during the three year period of the Discover NSA. If you do not confirm, please explain.
- (c) Refer to Table 2 in Year 1. Please confirm that the TYBR volume of 497,630,513 would permit Discover to mail 92,630,513 ( $497,630,513 - 405,000,000$ ) additional pieces in Year 1, more than 7.1 ( $92,630,513 / 13,000,000$ ) times Discover's Year 1 estimated volume response of 13 million pieces. If you do not confirm, please explain.
- (d) Refer to Table 2 in Year 2. Please confirm that the TYBR volume of 501,928,341 would permit Discover to mail 96,928,341 ( $501,928,341 - 405,000,000$ ) additional pieces in Year 2, more than 5.3 ( $96,928,341 / 18,000,000$ ) times Discover's Year 2 estimated volume response of 18 million pieces. If you do not confirm, please explain.
- (e) Refer to Table 2 in Year 3. Please confirm that the TYBR volume of 506,540,893 would permit Discover to mail 101,540,893 ( $506,540,893 - 405,000,000$ ) additional pieces in Year 2, more than 5.6 ( $101,540,893 / 18,000,000$ ) times Discover's Year 3 estimated volume response of 18 million pieces. If you do not confirm, please explain.

**DISCOVER NSA  
 Stop Loss Estimate Model**

**TABLE 1  
Year 1 - ACS Related Savings**

[1]	Manual Letter Returns Unit Cost	\$0.55	[1]
[2]	Electronic Letter Returns Unit Cost	\$0.34	[2]
[3]	Discover Return Rate - Solicitation Mail	9.3%	[3]
[4]	Address Change Service (ACS) Success Rate	85%	[4]
[5]	Discover TYBR Customer Mail Volume	295,000,000	[5]
[6]	Discover TYBR Solicitation Mail Volume	156,000,000	[6]
[7]	Solicitation Mail % of TYBR Volume	34.59%	[7]
[8]	Discover ACS Unit Cost Savings	\$0.00568739	[8]
[9]	Discover TYBR Equilibrium Volume	497,630,513	[9]
[10]	Total ACS Test Year Savings	<b>\$2,830,220</b>	[10]

**TABLE 2  
Year 1 - Discount Leakage**

<u>Volume Block</u>	<u>Incremental Volume</u>	<u>Discount</u>	<u>Discount Leakage</u>	<u>Volume B</u>
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[a]	[1]	[b]	[2] = [1b] - [1a]	[3]	[4] = [2] * [3]	[a]	[1]
405,000,000	to	435,000,000	30,000,000	\$0.025	\$750,000	405,000,000	to
435,000,001	to	465,000,000	29,999,999	\$0.030	\$900,000	435,000,001	to
465,000,001	to	490,000,000	24,999,999	\$0.035	\$875,000	465,000,001	to
490,000,001	to	497,630,513	7,630,512	\$0.040	\$305,220	490,000,001	to
515,000,001	to			\$0.045	\$0	515,000,001	to
<b>Total</b>					<b>\$2,830,220</b>		
Difference - ACS Savings and Discount Leakage					\$0.054455		

Attachment to Interrogatory  
OCA/USPS-T1-28  
Page 4 of 5

**TABLE 1 (Years 1-3)**

Notes & Sources

- [1] USPS-T-1 (Ayub), Appendix A, page 1
- [2] USPS-T-1 (Ayub), Appendix A, page 1
- [3] USPS-T-1 (Ayub), Appendix A, page 1
- [4] USPS-T-1 (Ayub), Appendix A, page 1
- [5] USPS-T-1 (Ayub), Appendix A, page 2
- [6] USPS-T-1 (Ayub), Appendix A, page 2
- [7] = [6] / ([5] + [6])
- [8] = ([1] - [2]) \* [3] \* [4] \* [7]
- [9] = Table 2 [1b]
- [10] = [8] \* [9]

**TABLE 2 (Years 1-3)**

Notes and Sources:

- [1] Request, Attachment B
- [3] Request, Attachment B

**DISCOVER NSA  
 Stop Loss Estimate Model**

**TABLE 1  
Year 2 - ACS Related Savings**

Manual Letter Returns Unit Cost	\$0.57	[1]
Electronic Letter Returns Unit Cost	\$0.36	[2]
Discover Return Rate - Solicitation Mail	9.3%	[3]
Address Change Service (ACS) Success Rate	85%	[4]
Discover TYBR Customer Mail Volume	290,000,000	[5]
Discover TYBR Solicitation Mail Volume	156,000,000	[6]
Solicitation Mail % of TYBR Volume	34.98%	[7]
Discover ACS Unit Cost Savings	\$0.00598120	[8]
Discover TYBR Equilibrium Volume	501,928,341	[9]
Total ACS Second Year Savings	<b>\$3,002,134</b>	[10]

**TABLE 2  
Year 2 - Discount Leakage**

<u>Block</u>	<u>Incremental Volume</u>	<u>Discount</u>	<u>Discount Leakage</u>
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**DISCOVER NSA  
 Stop Loss Estimate Mod**

**TABLE 1  
Year 3 - ACS Related Savi**

Manual Letter Returns Unit Cost	[1]
Electronic Letter Returns Unit Cos	[2]
Discover Return Rate - Solicitator	[3]
Address Change Service (ACS) S	[4]
Discover TYBR Customer Mail Vo	[5]
Discover TYBR Solicitation Mail V	[6]
Solicitation Mail % of TYBR Volum	[7]
Discover ACS Unit Cost Savings	[8]
Discover TYBR Equilibrium Volum	[9]
Total ACS Third Year Savings	[10]

**TABLE 2  
Year 3 - Discount Leaka**

<u>Volume Block</u>	<u>Incremental Volume</u>
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	[2] = [1b] - [1a]	[3]	[4] = [2] * [3]
[b]			
435,000,000	30,000,000	\$0.025	\$750,000
465,000,000	29,999,999	\$0.030	\$900,000
490,000,000	24,999,999	\$0.035	\$875,000
<b>501,928,341</b>	11,928,340	\$0.040	\$477,134
		\$0.045	\$0

**Total** **\$3,002,134**

Difference - ACS Savings and Discount Leakage \$0.0060996

	[1]	[b]	[2] = [1b] - [1a]
[a]			
405,000,000	to	435,000,000	30,000,000
435,000,001	to	465,000,000	29,999,999
465,000,001	to	490,000,000	24,999,999
490,000,001	to	<b>506,540,893</b>	16,540,892
515,000,001	to		

**Total**

Difference - ACS Savings and Dis

lel

ngs

\$0.60

st \$0.37

n Mail 9.3%

Success Rate 85%

Volume 285,000,000

Volume 156,000,000

ne 35.37%

\$0.00629097

ne 506,540,893

**\$3,186,636**

ge

Discount

Discount  
Leakage

[3]            [4] = [2] \* [3]

\$0.025        \$750,000

\$0.030        \$900,000

\$0.035        \$875,000

\$0.040        \$661,636

\$0.045        \$0

**\$3,186,636**

Discount Leakage    \$0.0199391

**DISCOVER NSA**

**TABLE 3**  
**Calculation of Total Stop Loss Estimate**

	<u>Volume</u> [1]	<u>Discount Leakage</u> [2]	<u>Return Cost Savings</u> [3]
Year 1	497,630,513	\$2,830,220	\$2,830,220
Year 2	501,928,341	\$3,002,134	\$3,002,134
Year 3	506,540,893	\$3,186,636	\$3,186,636
			<u>\$9,018,990</u>
Passthrough Percent			95%
<b>TOTAL STOP LOSS ESTIMATE</b>			<b>\$8,568,040</b>

Notes and Sources

- [1] & [2] TABLE 2, for the year indicated
- [3] TABLE 1, for the year indicated

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**RESPONSE:**

- (a) Not confirmed. Using the approach forwarded in PRC Op. MC2002-2, page 156 para. [8031] of limiting price incentives to 95% of cost savings over the term of the agreement the “stop loss” I calculate to be at \$7,606,602 which is 95% of the total ACS Savings of \$8,006,949 (Appendix A page 11 at line 2).
- (b) Not confirmed. The “stop-loss” cap on the 95% cap on the total dollar value of the price incentives is based only on the quantified savings to the Postal Service. As described in my testimony the Postal Service believes the savings represented are a conservative estimate. Furthermore the “stop-loss” cap does not account for the contribution earned from increased or retained volume due to the price incentives.
- (c) If Discover’s TYBR forecast was 497,630,513 this would represent a volume response of 7.1 times greater than Discover’s projected TYAR forecast of an additional 13,000,000 marketing pieces. In addition the ACS cost-saving projected would be lower.
- (d) Confirmed if TYBR forecast was 501,928,341.
- (e) Confirmed if TYBR forecast was 506,540,893.

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**OCA/USPS-T1-29.** Please refer to your testimony at Appendix A, page 1. Please confirm that the Discover's first-year ACS unit cost saving for solicitation mail is \$0.00568739 [ $(\$0.55 - 0.34) * 0.093 * 0.85 * 0.054823$ ], where  $(\$0.55 - 0.34)$  represents the difference between manual return unit costs and electronic return unit costs, 0.09 represents Discover's physical return rate, 0.85 represents the ACS success rate, and 0.3459 represents the ratio of Discover's TYBR solicitation mail volume to the sum of Discover's TYBR customer mail and solicitation mail volume. If you do not confirm, please explain.

**RESPONSE:**

Not confirmed. The calculation presented above does not calculate savings per total marketing piece. The chart below provides the Postal Service valuation of what the savings per total marketing pieces would be given Discover TYBR forecast for Year 1:

(1)	156,000,000	TYBR Marketing Volume
(2)	9.30%	Return Rate
(3)	14,508,000	Return Volume (1)*(2)
(4)	85.00%	ACS Success Rate
(5)	12,331,800	Number of physical returns eliminated
(6)	\$2,589,678	ACS Savings $(\$0.55 - \$0.34) * (5)$
(7)	\$0.0166	Savings per marketing pieces (6) / (1)

It is important to note that even at higher or lower marketing volume levels that the savings of \$0.019 cents does not change.

## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

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Brian M. Reimer

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August 2, 2004