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UNITED STATES OF AMERICA
POSTAL RATE COMMISSION

Before:

Chairman Omas,
Vice Chairman Tisdale,
Commissioner Goldway, and
Commissioner Hammond

Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Bank One Corporation

Docket No. MC2004-3

OPINION AND

FURTHER RECOMMENDED DECISION

Washington, DC 20268-0001
April 21, 2006

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I. SUMMARY

[1001] On February 16, 2005, the Governors allowed the recommended decision of the Commission to approve a Negotiated Service Agreement with Bank One Corporation to take effect, but returned the decision to the Commission for reconsideration. The Governors ask the Commission to reassess its decision to include a "stop-loss cap" that limits the total discounts available to Bank One during the course of the agreement. Further, they request that if the Commission concludes that the stop-loss cap remains necessary, that the Commission "clarify and explain further the thoughts in its Opinion and Concurring Opinion regarding the potential for uncapped NSAs of this type."[1]

[1002] After reconsideration, the Commission recommends no changes to the Bank One Negotiated Service Agreement. The Commission shares the Governors' desire to facilitate the development of beneficial Negotiated Service Agreements. To further that goal, the Commission provides for the consideration of the Governors and all interested parties, a model for volume-based Negotiated Service Agreements that does not require a stop-loss cap.

[1003] The Commission expects that the Postal Service and mailers will examine this alternate approach carefully, and it hopes this approach will contribute to the development of new Negotiated Service Agreements that benefit all concerned.

[1004] The Commission finds that its recommendation to include a stop-loss cap is supported by the record and is consistent with statutory requirements. Because Bank One's volume estimates are unreliable, there is an unreasonable risk that without a stop-loss cap the Postal Service could sustain actual economic loss through a reduction in contribution as a result of entering into the agreement. The burden of recovering this contribution would fall largely on captive monopoly mailers not party to the agreement.

[1005] On reconsideration, Bank One and the Postal Service suggest that the Commission test the need for the stop-loss cap by balancing this risk of lost contribution

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[1] Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission Approving Negotiated Service Agreement with Bank One Corporation, Docket No. MC2004-3, February 16, 2005, at 2 (Governors' Decision).

against the potential for additional contribution. The Commission can not apply this test without reliable volume estimates, and neither Bank One nor the Postal Service provided such forecasts. The analysis supporting these conclusions is provided in Chapter III.

[1006] The Governors ask the Commission to provide additional discussion on three issues that arose during this proceeding that may bear on proposals for Negotiated Service Agreements in the future. Those issues are: the weight unopposed settlement agreements are accorded in Commission decisions; the acceptable level of risk that the system can tolerate; and the role of the functionally equivalent procedural mechanism. The Commission addresses these issues in Chapter IV.

[1007] The Governors request "that the Commission elaborate on the type and level of proof that it might find persuasive in avoiding caps in future cases." *Id.* at 2-3. The Commission responds to this request by describing a method for developing a Negotiated Service Agreement that would provide adequate safeguards without a stop-loss cap.

[1008] This alternative is offered in the spirit of cooperation. It has been developed in the abstract and it should be viewed only as advisory in nature. Requests for Negotiated Service Agreements incorporating declining block rate discounts require an adequate demonstration that the Postal Service and mailers not party to the agreement are protected from lost contribution resulting from giving discounts to mail that otherwise would have been sent at the full postage rate. This has been difficult to achieve because of the perceived unreliability of mailer provided volume estimates.

[1009] The Commission offers an approach for justifying declining block rate discounts that does not rely on mailer provided volume estimates. The approach would result in agreements that comply with all statutory requirements, and provide assurance of a "win-win-win" outcome. The Commission utilizes the principles found in the testimony in Docket No. MC2002-2, which was made part of the record in this case, to develop this approach.

[1010] The alternative approach relies on the demand characteristics of the mail eligible for the discount, and not on a mailer's specific before- and after-rates volume estimates. Just as system-wide costs can be utilized as proxies for mailer specific costs, demand characteristics established in the most recent omnibus rate case for a particular subclass of mail can be used to develop a declining block rate discount structure that is beneficial to the mailer and the Postal Service over a wide range of after-rates volumes.

[1011]   The alternative approach allows for trade offs in establishing discount amounts, discount block sizes, and threshold volumes. The mailer identifies a range of possible after-rates volumes, and receives discounts so long as volume falls within this range. This range can be quite large, for example, plus or minus 50 percent of forecast volume. As the ability of mailers to forecast after-rates volume improves, the potential for obtaining greater price incentives increases. The mailer, and not the Postal Service, decides on the level of risk in forecasting volumes that it will tolerate to qualify for discounts. This approach is explained in Chapter V.

II. PROCEDURAL HISTORY

[2001] On June 21, 2004, the United States Postal Service filed a formal request with the Postal Rate Commission pursuant to Chapter 36 of the Postal Reorganization Act, 39 U.S.C. § 3601 *et seq*., seeking a recommended decision approving a mail classification and related rates and fees predicated on a Negotiated Service Agreement with Bank One Corporation.[2] The Postal Service contended that the proffered Negotiated Service Agreement was functionally equivalent to the Capital One Financial Services, Inc. Negotiated Service Agreement recommended by the Commission[3] and approved for implementation by the Governors.[4]

[2002] During the initial consideration of the Request, the Postal Service, Bank One, and the Office of the Consumer Advocate (OCA) asked the Commission to consider a Stipulation and Agreement as the basis of its recommended decision.[5] Shortly thereafter, the Postal Service, Bank One, Valpak, and OCA notified the Commission that agreement in principle had been reached on the terms of a modification to the original September 15, 2004 Stipulation and Agreement, and asked that the

[2] Request of the United States Postal Service for a Recommended Decision on Classifications, Rates and Fees to Implement Functionally Equivalent Negotiated Service Agreement with Bank One Corporation, June 21, 2004 (Request). Ten days after filing the Request, Bank One Corporation merged with J.P. Morgan Chase & Co. The Federal Reserve Board approved the merger on June 14, 2004, and the merger was consummated on July 1, 2004. The merged Bank One Corporation and J.P. Morgan Chase & Co. corporate entities have adopted the J.P. Morgan Chase & Co. (Chase) name.

[3] Opinion and Recommended Decision, Docket No. MC2002-2, May 15, 2003 (Capital One Opinion).

[4] The Governors' decision announces that the Negotiated Service Agreement classification and related rates and fees shall be in effect from September 1, 2003 through September 1, 2006. Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission Recommending Experimental Rate and Service Changes to Implement Negotiated Service Agreement with Capital One, Docket No. MC2002-2, June 2, 2003.

[5] Joint Motion of the United States Postal Service, Bank One Corporation, and the Office of Consumer Advocate for Consideration of Stipulation and Agreement as the Basis for Recommended Decision, September, 15, 2004; Stipulation and Agreement, September 15, 2004. The Stipulation and Agreement was initially signed by the Postal Service, Bank One, and OCA, and subsequently signed by Alliance of Nonprofit Mailers, American Bankers Association, American Postal Workers Union, AFL-CIO, Association for Postal Commerce, Discover Financial Services Inc., Magazine Publishers of America, Inc., National Association of Postmasters of the United States, National Postal Policy Council, and Parcel Shippers Association. National Newspaper Association, Newspaper Association of America, and David B. Popkin did not sign or oppose the Stipulation and Agreement.

Commission consider the Modified Stipulation and Agreement as the basis of its recommended decision.[6]

[2003] On December 17, 2004, the Commission recommended that the Postal Service proceed with a Negotiated Service Agreement with Bank One Corporation.[7] The Commission found that the agreement suggested by the parties was in most respects consistent with postal policy; however, it determined that it was necessary to add a stop-loss cap to the agreement to provide a reasonable measure of protection for mailers not party to the agreement.

[2004] The Governors accepted the Commission's recommendation and the agreement became effective April 1, 2005. At the same time, the Governors' Decision announced the Postal Service would seek reconsideration of the Commission's finding that a stop-loss cap was necessary, and requested clarification and further explanation of the Commission's Decision.

[2005] On March 7, 2005, the Postal Service filed a motion resubmitting the case to the Commission for reconsideration, suggesting procedures to guide the reconsideration, and requesting that it be allowed to file a memorandum in support of reconsideration further elaborating on areas of concern to the Governors.[8] The Commission granted the time requested by the Postal Service to formulate its pleadings, and on May 16, 2005, the Postal Service filed a memorandum accompanied by a

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[6] Joint Statement of the United States Postal Service, Bank One Corporation, Valpak Direct Marketing Systems, Inc., Valpak Dealers' Association, Inc., and the Officer of Consumer Advocate Concerning Settlement, October 4, 2004; Modified Stipulation and Agreement, October 5, 2004. The Modified Stipulation and Agreement was initially signed by the Postal Service, Bank One, Valpak, and OCA, and subsequently signed by Alliance of Nonprofit Mailers, American Bankers Association, American Postal Workers Union, AFL-CIO, Association for Postal Commerce, Discover Financial Services Inc., Magazine Publishers of America, Inc., National Postal Policy Council, and Parcel Shippers Association. Four participants, National Association of Postmasters of the United States, National Newspaper Association, Newspaper Association of America, and David B. Popkin did not sign nor did they oppose the Modified Stipulation and Agreement.

[7] Opinion and Recommended Decision Approving Negotiated Service Agreement, Docket No. MC2004 3, December 17, 2004 (Decision).

[8] United States Postal Service Motion for Leave to File Memorandum on Reconsideration and for Proposed Procedures, March 7, 2005.

technical appendix and the sworn supporting statements of Michael K. Plunkett, John P. Matthews, and Samuel C. Hadaway, Ph.D.[9]

[2006] After review of the Memorandum and supporting materials, the Commission issued PRC Order No. 1443. The Commission found the Revised Memorandum and supporting materials to be general in nature and more directed at the broader advisory issues posed by the Governors related to uncapped volume-based discounts than at the issues arising from the limited factual record of the Bank One case. The Commission decided that the reconsideration of the Bank One opinion would be based on the existing record, and established September 16, 2005 and September 30, 2005 as the deadlines for participants to file comments and reply comments in regard to the reconsideration.

[2007] On September 14, 2005, Chase filed Petition of J.P. Morgan Chase & Co. to Reopen Record (Petition) to reconsider Order No. 1443 to the extent that it disallowed the filing of any supplemental testimony by the Negotiated Service Agreement proponents. Presiding Officer's Ruling No. MC2004-3/9 suspended the filing of comments and reply comments to allow participants the opportunity to reply to, and for the Commission to consider, the Petition. The Commission determined not to reopen the record, and re-established dates for filing comments and reply comments.[10]

[2008] Comments were filed by Chase and the Postal Service.[11] Reply comments were filed by the Postal Service.[12]

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[9] United States Postal Service Memorandum on Reconsideration, May 16, 2005; and United States Postal Service Revised Memorandum on Reconsideration, May 18, 2005 (Revised Memorandum).

[10] Order Denying Petition of J.P. Morgan Chase & Co. to Reopen the Record, January 6, 2006 (PRC Order No. 1450).

[11] Comments of J.P. Morgan Chase & Co. in Response to Order No. 1450, January 25, 2006 (Chase Comments); and United States Postal Service Comments on Reconsideration in Response to Order No. 1450, January 25, 2006 (USPS Comments).

[12] United States Postal Service Reply Comments in Response to Order No. 1450, February 1, 2006 (USPS Reply Comments).

III. RECONSIDERATION OF THE BANK ONE OPINION AND RECOMMENDED DECISION

[3001] The Governors request that the Commission reconsider the recommendation of a stop-loss cap in the Bank One case based on the existing record, and in light of the Governors' views expressed in their Decision. Governors' Decision at 2.

[3002] The Bank One Negotiated Service Agreement, as originally proposed, did not include a stop-loss cap. After careful consideration, the Commission concluded that there was an unacceptable risk that the Postal Service, and mailers not party to the agreement, could be financially harmed by the agreement if some level of protection was not provided against excessive discounts being given to mail that otherwise would have paid the prevailing postal rate. To protect against this risk yet proceed with a favorable recommendation, the Commission recommended the addition of a stop-loss cap.

[3003] Understanding the characteristics of the declining block rate element of the agreement, and the approach used to negotiate its parameters, is necessary to fully appreciate the risks involved. In its simplest form, the declining block rate discount element specifies that a mailer will receive a postage discount on mail that is sent in excess of a predetermined number of pieces (the threshold level). The negotiation process for a declining block rate discount agreement includes establishing the threshold level in relation to the mailer's before-rates volume, and establishing the discount. The Bank One agreement provides for multiple threshold levels and discounts.

[3004] Absent an accurate estimate of the mailer's before-rates volume, the Postal Service will not be able to accurately analyze the potential financial impact of the agreement and will not be able to determine, even after the fact, whether or not it would have been better off had it not made the agreement. The Commission could not conclude, in the case of Bank One, that the volume estimate presented on the record was reliable.

[3005] The discount should provide an incentive for the mailer to mail additional volume as a function of the mailer's demand characteristics. If the mailer's before-rates volume is overestimated, the threshold level may be set too high, dampening the mailer's incentive to increase mail volume and reducing (or even eliminating) any benefits from the agreement. If the mailer's before-rates volume is underestimated, the threshold level may be set too low, rewarding the mailer for mail that it would have mailed anyhow (anyhow volume).[13] The discount may provide an incentive to mail additional pieces, but the Postal Service may be worse off if substantial discounts are paid on mail that would have been sent anyway. In such cases, mailers not party to the agreement will have to make up the lost contribution.

[3006] Accurately estimating a mailer's before-rates volume, however, is a complex task that must look beyond a simple historical analysis. The mailer's before-rates volume estimate must reflect a dynamic environment with many "exogenous factors" influencing the result. A few examples of exogenous factors include: national economic trends, the business environment of the industry that the mailer is in, a change in business plans of the particular mailer, or a business's purchase by, or merger with, another entity. Because the purpose of the agreement is to increase system-wide institutional contribution above what would be realized absent the agreement, the threshold level must be established to assure that the additional mail volume is caused by the incentive to mail additional volume (because of the mailer's demand characteristics), and not because of exogenous factors. This requires the Postal Service to have a reasonable understanding of both predictable exogenous factors known to affect volume, and the impact of price changes (*i.e.*, the discount) on the Negotiated Service Agreement partner's mailings.[14]

[3007] At the time the Commission reviews the Postal Service's request, the threshold level and the discount incentive are known and fixed by the terms of the

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[13] The threshold level may be set at a level lower than the before-rates volume level if the intent is to make a payment to the mailer, for example, as a method of providing a return for participation in the address correction features of the agreement. Note that the same effect can be realized absent a declining block rate discount by making a transparent cash payment directly to the mailer for participation in the address correction features of the agreement.

[14] Negotiated Service Agreements never will be risk free because there likely will be unanticipated exogenous factors that are not accounted for. The goal should be to execute a thorough analysis that uncovers and accounts for as many exogenous factors as reasonably possible.

agreement. However, the mailer's before-rates volume is only an estimate, which remains subjective. This requires the Commission to look to record evidence in support of the estimate. The Commission starts with the testimony provided by the mailer. It also evaluates any steps that the Postal Service has taken to verify the information provided by the mailer. Finally, the Commission weighs any testimony in rebuttal to the mailer and the Postal Service.

[3008] The information provided by the Postal Service's Negotiated Service Agreement partner (the mailer) in Commission proceedings provides a starting point for estimating the financial effects of the agreement. The mailer is in the best position to explain its current and planned mailing practices. It also is in the best position to understand the other exogenous factors that may be influencing its business. The Commission is appreciative of the forthright statements provided by the Postal Service's Negotiated Service Agreement partners.[15]

[3009] When weighing the record evidence, the Commission makes a reasonable assumption that the Postal Service and its Negotiated Service Agreement partner each will negotiate consistent with their own best interests, as with any arms-length negotiations. The best interests of the Postal Service's Negotiated Service Agreement partner and the Postal Service may not always coincide. The material provided to the Commission by the Postal Service's partner may reflect this natural, and not unanticipated, bias.

[3010] The Commission did not have confidence in the reliability of the mailer-provided Bank One volume estimates. See Opinion at 54-62. This lack of confidence could have been overcome if the Postal Service had demonstrated due diligence by independently evaluating the reasonableness of the mailer-provided forecasts, and by presenting a conclusion which corroborated the forecasts. The Postal Service does not point to any record evidence upon reconsideration that would indicate

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[15] Nonetheless, as the trier of fact, the Commission must evaluate the reasonableness of evidentiary presentations, and the reliability of good faith estimates offered on the record.

that it had in fact done more to verify Bank One's volume estimates than originally recognized by the Commission.

[3011] Upon reconsideration, Chase asserts that witness Rappaport's volume projections were deliberately "conservative," and that the actual volume response to the block rate discounts was likely to be higher as supported by witness Buc's testimony.[16] Consistent with Chase's position, the Postal Service asserts that the Commission has made a faulty assumption that based on current volumes (or what appear to be actual volumes) witness Rappaport's estimates are inaccurate, unreliable, and might be the result of exogenous factors. USPS Comments at 6-7.

[3012] Chase witness Rappaport provided after-rates volume estimates that indicated that the stop-loss limit would not be reached over the life of the agreement. Chase now contends witness Buc's testimony demonstrates a probability that the price incentive will in fact encourage greater volume than estimated by witness Rappaport. While the Commission accepted witness Buc's general theory of how volume reacts to price incentives,[17] the Commission found witness Buc's numerical analysis inapplicable to Bank One. *See* Decision, ¶ 6089. Witness Buc does not use inputs specific to Bank One. Because of this, the Commission can not go beyond general theory and attempt to quantify how witness Buc's general predictions may be applicable to Bank One.[18]

[3013] The proponents of the agreement also argue that the Commission should have balanced the risk that a stop-loss cap could choke off additional new contribution against the risk that an uncapped agreement could result in reduced contribution by

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[16] Chase Comments at 18-19. Chase primarily is responding to Commission comments in Order No. 1450 that recent Chase volumes have been far above expectations. The Commission decided not to reopen the evidentiary record, and does not rely on such volumes.

[17] The Commission relied on witness Buc's general premise to establish a stop-loss cap at 100 percent of estimated cost savings.

[18] Chase sponsored witness Rappaport as providing the best possible Bank One volume estimates. In the future, it should be possible to advance witness Buc's analysis as useful data becomes available from Negotiated Service Agreements put into effect.

providing discounts to mail that otherwise would have paid the full postal rate.[19]

[3014] The Commission has not concluded and is not convinced that the balancing test described by Chase is an appropriate standard when reviewing a special rate provided by a government monopoly to an individual mailer. The policy considerations attendant to such a conclusion have never been fully explored before the Commission. See Order No. 1450 at 20-25.

[3015] However, even if the Commission wanted to apply such a test despite those important policy concerns, it would be unable to balance risks as proposed by Chase. On one side of the equation is the risk the discounts will be paid on mail that otherwise would have been mailed at the full postage rate. If this occurs, the Postal Service will realize a net loss in contribution on those pieces. Assessing this risk is a function of the confidence that the Commission has in the reliability of the mailer's volume estimates and the analysis undertaken to verify these estimates. The Commission did not find Bank One's volume estimates reliable. The record demonstrates that the Postal Service did little to independently verify the accuracy of the mailer provided estimates. Consequently, the Commission could neither quantify the potential loss of contribution nor estimate the probability that this loss may or may not occur.

[3016] The other side of the equation is the risk that a stop-loss cap will eventually stifle volume growth, and limit the potential for the Postal Service to realize additional new contribution. For this to happen, the discount incentive, and not exogenous factors, must be the cause of growth in actual volume in excess of estimated volume. Here, too, a reliable before-rates volume estimate as well as knowledge about the mailer's demand characteristics is needed before this risk can be quantified.

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[19] Chase Comments at 3-19; USPS Comments at 6. The Commission independently discusses each risk that Chase believes should be balanced in the Capital One decision. A comprehensive discussion of declining block tariffs, including the effects of stop-loss caps, appears on pages 57 through 111 of the Capital One Decision. The Commission's understanding of the issues is derived mainly from the written and oral testimonies of Presiding Officer witness John C. Panzar (JCP-T-1) and Postal Service witness B. Kelly Eakin (USPS-RT-2). The Postal Service has incorporated the testimonies of witnesses Panzar and Eakin into the Bank One record. Thus, the discussion appearing on pages 57 through 111 of the Capital One Decision also applies to Bank One.

[3017] The Commission is left with attempting to balance two well understood risks, without being able to quantify or place bounds on either risk. On reconsideration, the Commission finds that the Bank One record does not provide sufficient reliable evidence to perform such a balancing test.

[3018] The Commission determined that the Postal Service could realize up to $11.6 million in additional contribution, and Bank One could earn up to $11.5 million in postage discounts even with the addition of a stop-loss cap. Mailers not party to the agreement benefit by any increase in institutional contribution, but most importantly, their risk of having to make up possible lost contribution is substantially reduced. After a thorough review of the record and the comments provided by Chase and the Postal Service, the Commission has not been persuaded that there is justification for modifying its Decision.

IV. REVIEW OF PREVIOUSLY SETTLED ISSUES

[4001] The Governors' Decision discusses three issues that arose during this proceeding: what weight settlement agreements are accorded in certain Commission decisions; the acceptable level of risk that the system can tolerate; and the role of the functionally equivalent procedural mechanism. The Commission's views are summarized below.

[4002] *The role of settlement.* The Governors' request that the Commission discuss the role of settlement in uncontested cases. Specifically they request "the Commission to clarify whether, as a policy matter, it disfavors settlements in functionally equivalent NSAs." Governors' Decision at 9; *see also* 3, 16 and 18.

[4003] The Commission encourages participants to resolve issues through the settlement process. Order No. 1443 at 14-20. Settlement proposals are treated as proposals on the merits and receive full consideration by the Commission. The proposals must meet two absolute requirements before the Commission can accept a settlement agreement.

> Notwithstanding Commission policy to favor the participants' settlement of contested issues, two absolute requirements must be met before a settlement can be accepted. First, a settlement must be consistent with applicable statutory requirements, and second, a settlement must be consistent with the evidentiary record.

Id. at 17.

[4004] The Commission fostered the settlement negotiations and carefully reviewed the stipulation and agreement presented in the Bank One case. However, it found that the provisions of the settlement agreement fell short of bringing the Bank One Negotiated Service Agreement into compliance with statutory requirements. The Modified Stipulation and Agreement does not address the substantial risk associated with the loss of revenue from discounts applicable to mail that would have been sent at the full postage rate absent the agreement. This risk is well known, and similar to the conditions found in the baseline Capital One agreement where the application of a stop-loss cap also was necessary. Thus, the Commission could not accept the settlement agreement as proposed.

[4005] *The acceptable level of risk that the system can tolerate.* The Governors perceive the Commission's position on acceptable risk as an "apparent insistence that Negotiated Service Agreements, in effect, must guarantee that they will always result in a win-win situation, in which both the mailer that is party to an Negotiated Service Agreement, and all nonparticipating mailers, receive a positive benefit over the life of the agreement." Governors' Decision at 15. The Governors "understand this condition to be that under no conceivable circumstances will Negotiated Service Agreements result in a financial loss of any magnitude."[20]

[4006] The balanced approach taken by the Commission to consider the issue of risk is fair and equitable to the Postal Service, its Negotiated Service Agreement partners, and all other mailers. It does not require the elimination of all risk from Negotiated Service Agreements; however, it does require the incorporation of appropriate safeguards to mitigate the effects of unreasonable risk. The Commission discusses its general views in regard to risk in PRC Order No. 1443 at 13-14.

> The Commission cannot eliminate all risks from Negotiated Service Agreements, and the Commission does not expect that Negotiated Service Agreements will be risk-free. However, if an unreasonably significant risk is identified that could cause harm to the Postal Service and/or its customers, the Commission would be remiss if it did not condition its recommendation on the addition of an applicable risk control device.

Id. at 13.

[20] *Ibid*. The Governors also note that a policy which insists on eliminating all risk is contrary to the more lenient approach adopted in the Commission's recent Recommended Decision in the Experimental Priority Mail Flat-Rate Box case, Docket No. MC2004-2. *Id*. at 15, n.27. The Commission distinguishes the assessment of risk for experimental cases from the assessment of risk for Negotiated Service Agreement cases in PRC Op. MC2004-3, ¶ 6046, and further in PRC Order No. 1450 at 35.

[4007] Many risks are present within the Bank One Negotiated Service Agreement. The Commission mentions the risks associated with the implementation of PARS; misestimations of forwarding and return rates; changes in Bank One's business plans; mergers, acquisitions and portfolio changes; and myriad exogenous factors related to the nation's economy, among others. Any of these risks might influence whether, or how much, the Negotiated Service Agreement will benefit the Postal Service and the mailers not party to the agreement.

[4008] The Commission found that the risk associated with potentially inaccurate volume projections was unreasonable and as a result, imposed the stop-loss cap. By addressing this risk, the Commission was able to place bounds on the potential adverse financial effects of the agreement and to conclude that the Postal Service and mailers not party to the agreement probably would not be worse off because of the agreement. This conclusion was not possible without the application of a stop-loss cap. The Commission employed the same standard, analysis, and resolution when evaluating the Capital One Negotiated Service Agreement. This same standard and analysis of risk also was applied to evaluate Negotiated Service Agreements with Discover and HSBC. While the Commission has not made the Bank One Negotiated Service Agreement risk free, it has significantly mitigated the risks to the Postal Service and mailers not party to the agreement.

[4009] The Commission believes that the Postal Service has what is akin to a fiduciary responsibility to its captive mailers to conserve and properly apply its financial resources. Thus, the success or failure of a Negotiated Service Agreement should not be speculative. It is permissible to favor one mailer when other mailers will not be disadvantaged, but it is far more difficult to justify favoring one mailer at the expense of others. Most business agreements contain an element of risk. However, the Commission views quantifiable risk quite differently than risk that approaches speculation. It is unreasonable to subject monopoly mailers to speculative risk. The application of a stop-loss cap limits risk, resulting in an agreement likely to benefit the Postal Service, the participating mailer, and all other mailers.

[4010] *The role of the functionally equivalent procedural mechanism.* The Governors' understanding of the role of the functionally equivalent procedural mechanism appears consistent with the Commission's view.

> As we understand the Commission's rules, functional equivalency status is basically a procedural issue determining whether a case should proceed under Rule 193 for baseline NSAs, or under 196 for functionally equivalent NSAs. In this context, we do not understand functionally equivalent status to be determinative on the issue of whether a cap is warranted in the particular circumstances of this case.

Governors' Decision at 4, n.7. The Postal Service, however, asks the Commission to further address the role of functional equivalency in the determination to recommend a stop-loss cap. USPS Comments at 6.

[4011] The Commission addresses the implication of functional equivalency in PRC Order No. 1450 at 30-32. The rules for functionally equivalent Negotiated Service Agreements are a procedural mechanism designed to expedite review of certain Postal Service requests by simplifying the development of the record. The rules do not have a direct bearing on the finding of whether or not a proposed Negotiated Service Agreement comports with the statutory requirements of the Act. The rules influence the manner in which the record is developed, but not the level of support for the request that must be developed within the record.

> The proponents of a Negotiated Service Agreement must develop a record which demonstrates that their Request is in accord with the requirements of the Act. Whether or not the Negotiated Service Agreement is functionally equivalent to another agreement does not change this requirement.

Id. at 31.

[4012]   In regard to the Commission's recommendation of a stop-loss cap in the Bank One case, the functionally equivalent procedural mechanism established the framework for analyzing the risks to the Postal Service and to mailers not party to the agreement, and presented options based on the baseline agreement for resolving the Commission's concerns. However, compliance with the requirements of the Act, and not the functionally equivalent procedural mechanism, required the Commission to address the unreasonable risk to the Postal Service and other mailers created by the unreliable volume estimates. The selection of a stop-loss cap as the method to mitigate this risk was consistent with the baseline docket, but it was not required to be functionally equivalent to the baseline agreement. The Commission does not rule out approaches other than a stop-loss cap to address this issue.

V. AN ALTERNATIVE MODEL FOR NEGOTIATING VOLUME DISCOUNTS

[5001] *Background.* As part of the Reconsideration, the Governors seek guidance as to how future Negotiated Service Agreements might satisfy the Commission's concerns about the reliability of forecasted volumes without the imposition of a cost-savings based stop-loss cap. *See e.g.,* Governors' Decision at 10-13 and USPS Revised Memorandum at 5.

[5002] In Docket No. MC2002-2, the Capital One baseline Negotiated Service Agreement, the Commission solicited testimony from Professor John C. Panzar to explain the economic issues relevant to the review of customer-specific rate agreements, or optional tariffs. In his discussion of economic analysis of quantity discounts, he described the importance of establishing the accuracy of volume forecasts. "When, as in reality, demand schedules change over time, the focal point becomes the quantity that the large user *would have demanded* at the established rate. Thus, in any practical application, the evaluation of any optional tariff offering will always be an empirical question, but perhaps no more so than many other elements of the typical rate proceeding." Docket No. MC2002-2, Tr. 8/1588-89 (emphasis in original). He goes on to state that "assessing the desirability of optional tariff offerings requires the detailed analysis of (forecasted) demands and costs typical of rate proceedings." *Ibid.* at 1589. He concludes his testimony by restating that "NSAs and other optional tariff offerings must be determined on a case by case basis, using empirical procedures typical of the ratemaking process generally." *Ibid*. at 1596.

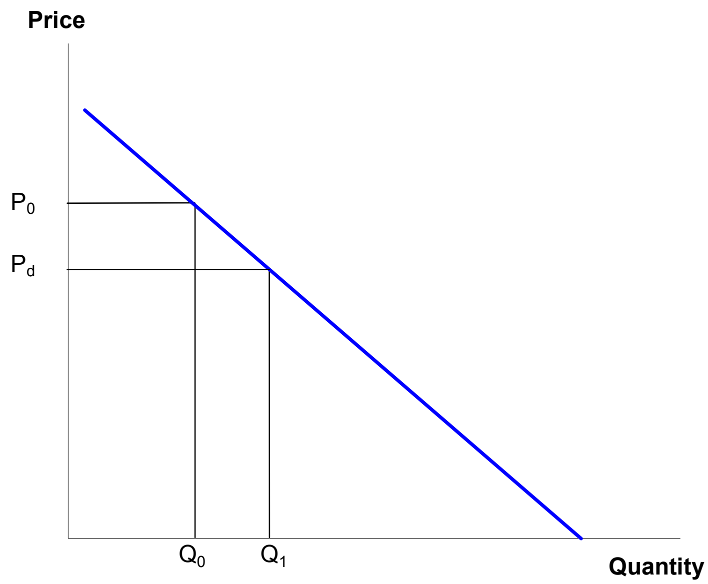
[5003] The Commission agrees that detailed analysis of forecasted demands and costs is necessary to assess the merits (indeed, the legality) of proposed Negotiated Service Agreements. Unfortunately, the record in this case is insufficient to allow a meaningful, independent analysis of forecasted demands. The addition of the savings-based stop-loss mechanism has enabled previous Negotiated Service Agreements to be evaluated independently from the forecasted demand.

[5004] In the Bank One case, as in all preceding Negotiated Service Agreements functionally equivalent to the Capital One Negotiated Service Agreement, the Postal Service utilizes volume estimates that were developed by the mailer and reviewed by the

Postal Service. In response to questions, the Postal Service fails to provide documentation of independent analysis of the forecast volumes. Unlike the estimates of unit costs and revenues incorporated into the Postal Service's evaluation of the financial impact of the Negotiated Service Agreement, there are no means to test the reasonableness of the assumptions underlying the volume forecasts. Nor can the sensitivity of the forecasts to changes in the underlying assumptions be judged so as to estimate the likelihood of significant variance from the forecast volumes. Decision at 67. These are significant flaws, since exogenous non-price factors can potentially have profound effects on the demand of an individual mailer.

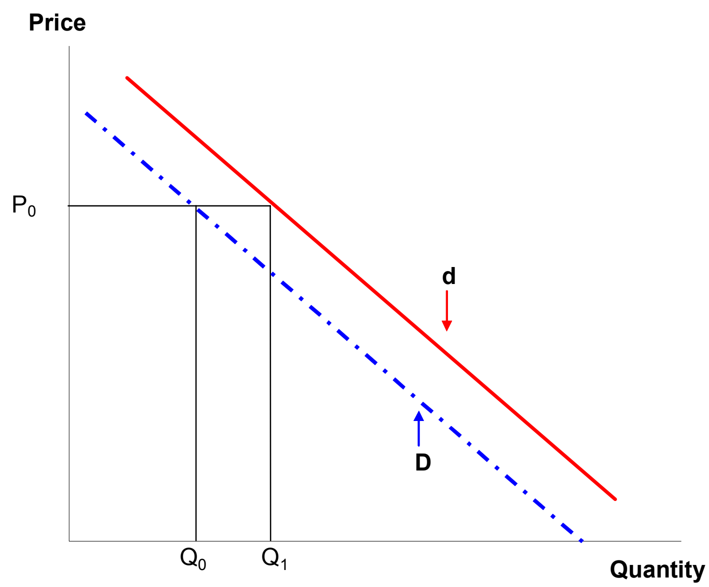
[5005] In the context of an offering of a volume discount, there are two potential reasons for changes in the mailer's volume. The first is the reaction of the mailer to the discounted price. The figure below presents the relationship between price and quantity purchased, or the demand curve, for a hypothetical mailer. In this example, the mailer would send Q_0 pieces at the undiscounted rate (p_0), and would increase its volume to Q_1 at the discounted rate (p_d). Without the discount, no additional volume would be sent. Therefore, as long as the discounted rate (p_d) yields a positive unit contribution (*i.e.*, it is above the unit attributable cost), and is applied only to those pieces above Q_0, the Postal Service will benefit by offering the discount.

Figure 1



[5006] The other potential reason for changes in volume is a reaction to factors other than price that cause a shift in the mailer's demand curve. Each mailer's demand curve can and does shift constantly in response to dynamic economic and market conditions. For example, the figure below might represent a mailer's demand curve before (D) and after (d) passage of legislation that had an impact on the conditions of the market it serves.

Figure 2



[5007] In response to the changing market conditions, the mailer sends more pieces at the undiscounted price. Thus, even without a volume discount, the mailer's volume increases from Q_0 to Q_1. In this case, discounts awarded to the mailer for the increase in volume from Q_0 to Q_1 would directly reduce the value of the agreement to the Postal Service. Volume increases caused by factors other than the discount incentive have the potential to make a volume discount agreement that would otherwise be profitable for the Postal Service into one that is unprofitable for the Postal Service.[21] Therefore, to properly analyze a volume discount proposal, it is critical to have a means

[21] Volume discount agreements (including declining block rate Negotiated Service Agreements) with a maximum rate equal to the undiscounted uniform rate will not be unprofitable for the mailer under any circumstances. In this regard, all risk related to volume forecasts used as the basis for unrestricted volume discounts is borne by the Postal Service and other mailers not party to the agreement.

of isolating the beneficial increases in volume directly attributable to the discount from changes in the mailer's demand that are unrelated to the discount.

[5008] The Commission appreciates the difficulties inherent in accurately forecasting volumes for an individual mailer. Many non-price factors can affect the actual volume sent by a mailer. But because so many factors can affect the outcome it is especially important to identify volume changes due to the discount as distinct from all other factors. In spite of the obstacles, the Commission does not believe that forecasting volumes for individual mailers in ways that allow for the necessary level of analysis is an impossible task. In particular, the Declaration of Michael Plunkett (revised May 18, 2005) describes a process that could yield progress toward that goal.

[5009] It bears emphasizing that forecasts need not be so robust and well supported as to be risk free. For example, the Commission has accepted the use of unit costs, unit revenues, forwarding rates, and other inputs that are not specific to the individual Negotiated Service Agreement partners. While the averages that have been used are imperfect proxies, the underlying data and calculations are presented transparently, enabling interested participants to identify potential sources of bias in the results. The transparency makes possible the development of an evidentiary basis for the Commission to evaluate the reasonableness of the proxies and to gauge the sensitivity of the results to potential biases underlying them.

[5010] *Suggested framework.* To satisfy the requirements of the statute, a quantity discount must demonstrate a reasonable likelihood of resulting in a net increase in contribution above what the contribution would have been absent the discount.[22] This condition is always met if (1) the threshold for discounts is above the volume that would have been sent absent the discounts, and (2) mail in every discount tier makes a positive contribution. If the threshold for discounts is below the volume that would have been

[22] *See e.g.,* PRC Op. MC2002-2, ¶ 8012. This is not the only issue to be considered in the evaluation of a Negotiated Service Agreement. Other relevant economic issues include resale, indirect arbitrage, and harm to competitors. The discussion in this section is limited to issues related to the forecasting of mail volumes for individual mailers. *See* PRC Op. MC2002-2, ¶¶ 5032-85 for a general discussion of economic issues related to the evaluation of declining block tariffs.

sent absent the discount, the increase in contribution from new volume must be greater than the contribution lost by awarding discounts to volume that would have been sent absent the discount. Panzar defined the requirement mathematically as $(p_d\text{-}c)(Q_1\text{-}Q_0) > (p_0\text{-}p_d)(Q_0\text{-}Q_T)$, where p_d is the discounted rate, c is the (constant) marginal cost, Q_1 is the new quantity (or after-rates volume), Q_0 is the initial quantity (or before-rates volume), p_0 is the initial (undiscounted) price, and Q_T is the threshold quantity.[23] Docket No. MC2002-2, Tr. 8/1632. The left-hand side of Panzar's inequality calculates the contribution for volumes above the initial quantity. The right-hand side of the inequality calculates the revenue lost to discounts on mail services that would have been purchased at the undiscounted rate.

[5011] In response to the Governors' Decision, and given the Postal Service's concerns about its ability to develop volume forecasts that would enable the parties and the Commission to perform detailed analysis typical of rate case proceedings, the Commission offers a possible framework based on the formula above for the design and negotiation of volume discounts. The intent is to demonstrate the feasibility of designing discounts utilizing inputs already used in rate cases, thus ameliorating the difficulties inherent in litigating the accuracy of mailer-specific volume forecasts before the Commission.

[5012] The essence of the framework would be for the mailer and the Postal Service to establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (after-rates volumes). The proponents would negotiate a set of discounts that would demonstrably satisfy the Panzar inequality above for every possible after-rates volume within the range.

[5013] At the outset of negotiations, the parties would select the range of potential after-rates volumes. They would also develop estimates of, or select proxies for, the mailer's undiscounted unit revenue, unit cost, and price elasticity (and cross-elasticities,

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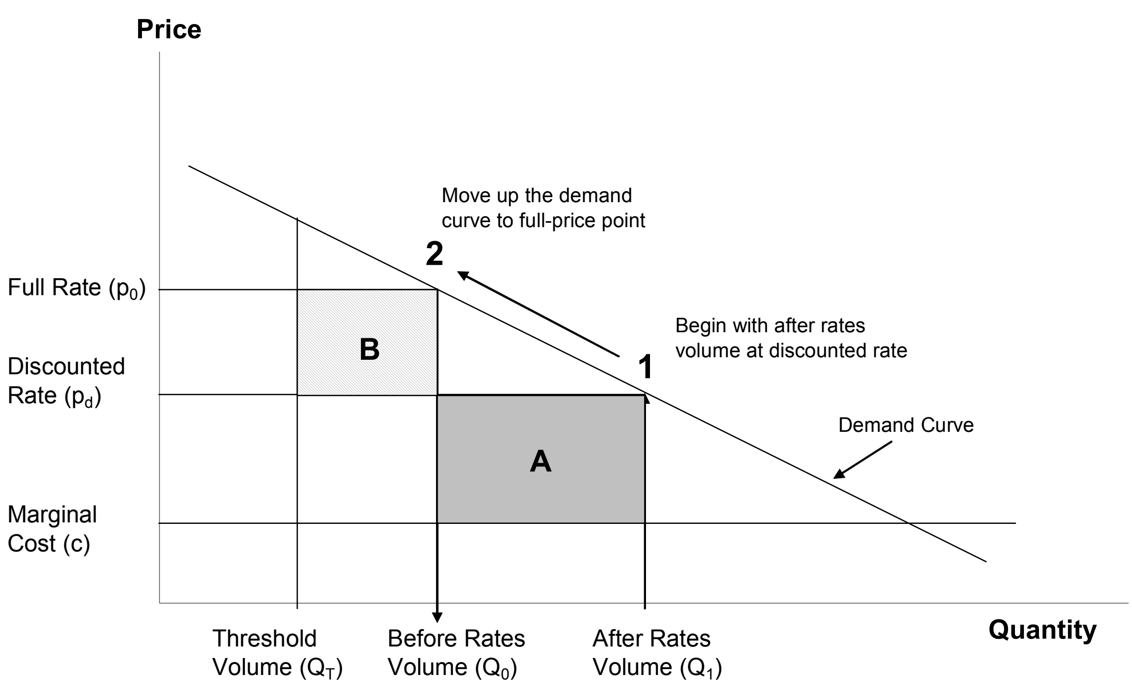
[23] Unit attributable cost is often used as a proxy for marginal cost.

if applicable). The elasticity, applied to a proposed discount, would allow for the estimation of before-rates volume for each after-rates volume in the potential range.

[5014] Figure 3 is a graphical representation of the construction of a before-rates volume estimate and the subsequent application of the Panzar inequality test for one potential after-rates volume. The price elasticity is used to draw a demand curve through the point defined by the after-rates volume and the discounted rate (Point 1). The before-rates volume is estimated by moving back up the demand curve to the full rate (Point 2). The net effect on contribution can then be estimated. The shaded area marked as A represents the contribution from mail above the initial quantity, and the area marked as B represents the revenue lost to discounts on mail that would have been purchased at the full rate. In this example, A is greater than B, indicating a net increase in Postal Service contribution.

Figure 3



[5015] These calculations are carried out in two steps for each potential after-rates volume in the realistic range. In the first step, the price elasticity is used to construct before-rates volume estimates. This approach isolates the discount-driven changes in volume from changes in volume due to all other exogenous factors. For each after-rates volume, the corresponding before-rates volume is estimated using the formula:

$Q_0 = Q_1\left(\frac{p_0}{p_d}\right)^e$ $_1$; where Q_0 is the initial quantity (or before-rates volume), Q_1 is the new quantity (or after-rates volume), p_0 is the initial (undiscounted) price, p_d is the discounted rate, and e is the own-price elasticity.[24]

[5016] Next, the net effect of the discount on Postal Service contribution is calculated using a slightly modified form of the Panzar formula: $(p_d-c)(Q_1-Q_0) - (p_0-p_d)(Q_0-Q_T)$. For each after-rates volume where the result is positive, the Postal Service will realize a net increase in contribution due to the discount.[25] A benefit of this model is that widely accepted measures of average cost, revenue, and price elasticity exist for classes and subclasses of mail. While it may be feasible to develop more reliable customer-specific estimates, when this is not possible the system-wide average for products will generally provide useable proxies.[26]

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[24] Since Docket No. R80-1, the Postal Service has been using log-log or constant-elasticity demand equations to estimate elasticities and forecast volumes. The constant-elasticity demand equation evaluated at the initial (undiscounted) price p_0, assuming all other variables, such as income and population, held constant, is: $Q_0 = \alpha p_0^e$; where Q_0 is the initial quantity (or before-rates volume), and e is the constant own-price elasticity of demand. Similarly, the constant-elasticity demand equation evaluated at the discounted rate p_d is $Q_1 = \alpha p_d^e$; where Q1 is the new quantity (or after-rates volume). The ratio of Q0 / Q1 can be expressed as: $\frac{Q_0}{Q_1} = \frac{\alpha p_0^e}{\alpha p_d^e} = \frac{p_0^e}{p_d^e} = \left(\frac{p_0}{p_d}\right)^e$; Therefore, $Q_0 = Q_1\left(\frac{p_0}{p_d}\right)^e$.

[25] The discussion here is simplified by using formulas for schedules with only one discounted rate. The calculations for multi-tiered discount schedules are more complicated. The spreadsheets in PRC ^LR-1^ include calculations for sample schedules with multiple discount tiers.

[26] A discussion of estimating and selecting proxies for elasticities appears later in this section.

[5017] The design and negotiation of a volume discount schedule would follow an iterative process along these lines:

1. Develop estimates and/or select proxies for unit cost, unit revenue, and price elasticity (and cross-elasticities, if applicable);
2. Select a realistic range of volumes that would be sent under the agreement;
3. Set up a tentative discount schedule for the Negotiated Service Agreement;
4. Construct the before-rates volume implied by the marginal discount and the elasticity for each potential after-rates volume;
5. Apply the Panzar formula to determine if the discount schedule generates a net increase in contribution to the Postal Service throughout the potential range of after-rates volumes;
6. Repeat steps 3-5, adjusting the size of the discounts and the volume thresholds at which they begin until both parties are otherwise satisfied with the terms of the Negotiated Service Agreement, and there is a net increase in contribution over the entire range of after-rates volumes.

[5018] This process provides a means for the proponents to negotiate a set of discounts that demonstrably satisfies the requirement to protect non-participating mailers by assuring a net increase in contribution to the Postal Service for every possible after-rates volume within the range deemed acceptable to both parties. Through the negotiation process, the terms of the agreement (*e.g.,* the size and threshold for discounts) can be adjusted so that the net effect on contribution to the Postal Service is positive over the agreed-upon range of after-rates volumes. The agreement would stipulate that if the mailer's actual volume under the agreement fell outside the agreed-upon range, this would represent an unexpected major shift in the mailer's demand due to changes in non-price factors, thereby voiding the agreement.

[5019] A few hypothetical examples demonstrate how this framework would allow the negotiating parties a great deal of flexibility to shape the terms of a volume discount proposal. The terms can be designed to accommodate the level of confidence in the ability of the mailer to accurately forecast its volumes. This flexibility should be sufficient to allow the development of terms that would be acceptable to mailers who are able to forecast their volumes with any reasonable degree of accuracy.

[5020] Each example below uses inputs intended to approximate recent averages for Standard Mail. The calculations assume undiscounted unit revenue of 18.8 cents, unit attributable cost of 11.3 cents, and an own-price elasticity of -0.55.[27] It is also assumed that the mailer expects to send about one million pieces under the agreement.[28] PRC-LR-2 contains the spreadsheets used to evaluate the sample discounts and generate the graphs below.

[5021] A hypothetical proposal for this mailer might include a discount schedule such as this:

Sample Discount Schedule 1

	Minimum Vol.	**Maximum Vol.**	**Discount**
No Discount	—	850,000	—
Tier 1	850,001	950,000	$ 0.010
Tier 2	950,001	1,050,000	0.020
Tier 3	1,050,001	1,150,000	0.030
Tier 4	1,150,001	1,250,000	0.040
Tier 5	1,250,001	1,370,000	0.050

[5022] Applying the Panzar formula, this schedule would result in net increases in contribution to the Postal Service for after-rates volumes between 850 thousand and 1.37 million pieces per year. This schedule reflects an expectation that outcomes more than 15 percent below or 37 percent above the forecast of one million pieces are unlikely to occur in the absence of significant changes in the non-price factors influencing the demand of the mailer.[29] These volumes set the upper and lower boundaries of the

[27] To simplify the calculations, the examples do not include any cross-price effects.

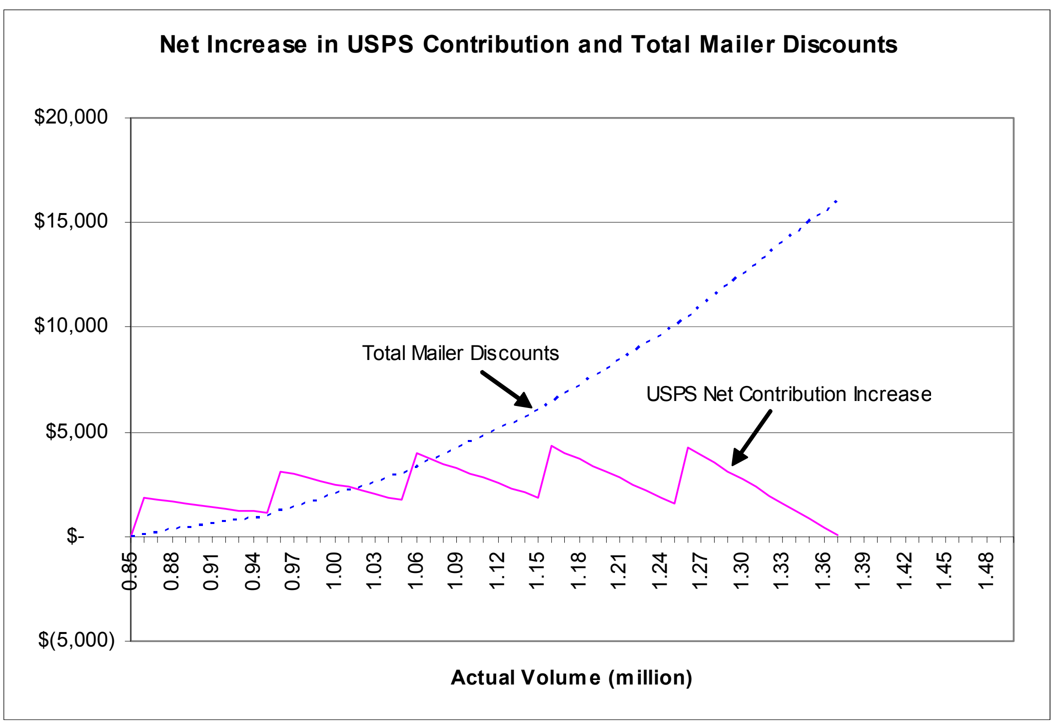
[28] The relatively small volume of a million pieces is selected to simplify calculations. The potential benefits increase proportionally with volume.

[29] 1,000,000 x (1-15%) = 850,000 and 1,000,000 x (1+37%) = 1,370,000.

parties' expectations. Volumes above the upper bound of the range would be considered by the parties to be primarily the result of non-price related shifts in the mailer's demand curve.   Enforcing the agreement under such a condition would result in an unjustified windfall payment to the mailer receiving discounts at the expense of all other mailers.

[5023]   Below is a graph of the benefit of the schedule to the Postal Service (solid line) and the mailer (dashed line). The dollar value is on the vertical axis and the actual volume sent by the mailer under the agreement is on the horizontal axis. The sawtooth pattern of the Postal Service's net benefit corresponds to the increasing discount tiers in the schedule. The beginning of a tier with a larger discount stimulates a larger volume response by the mailer. The larger volume response generates a larger increase in contribution to the Postal Service. For all points between 850 thousand and 1.37 million, the increase in contribution exceeds the discounts awarded to mail that would have been sent without the discount.

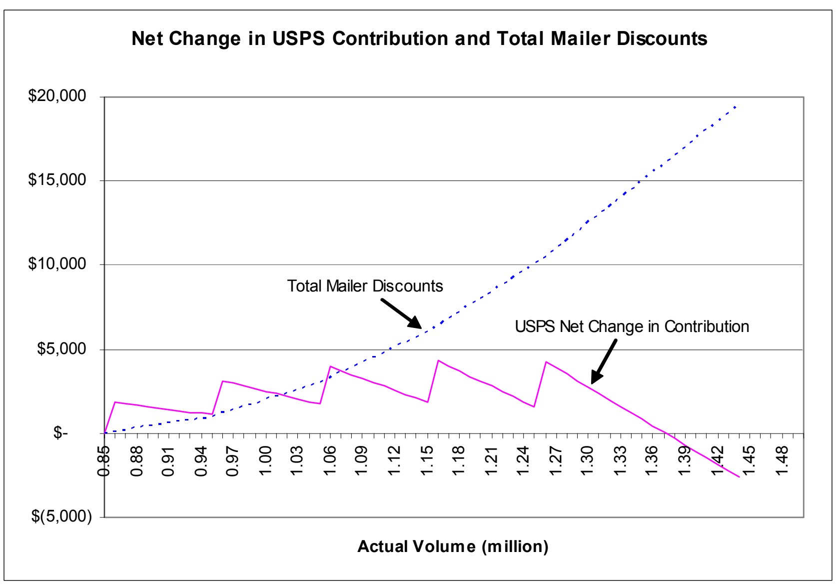
Figure 4



[5024] The framework provides the Postal Service and the mailer with a strong incentive to maximize the accuracy of the forecast. Both parties also have an incentive to understand the margin of error in the forecast and to build appropriate tolerances into the design of the discounts. Therefore, if either party to the negotiation process thought that there was a realistic chance the mailer might send more than 1.37 million pieces, it should seek to adjust the terms to prevent an undesirable outcome that would jeopardize their bargain.

[5025] Let us assume that the above schedule was considered for a mailer whose realistic range of after-rates volumes was between 850 thousand and 1.44 million. If left unchanged, the net effect on Postal Service contribution would be negative for some volumes within the potential range. This is shown below.

Figure 5



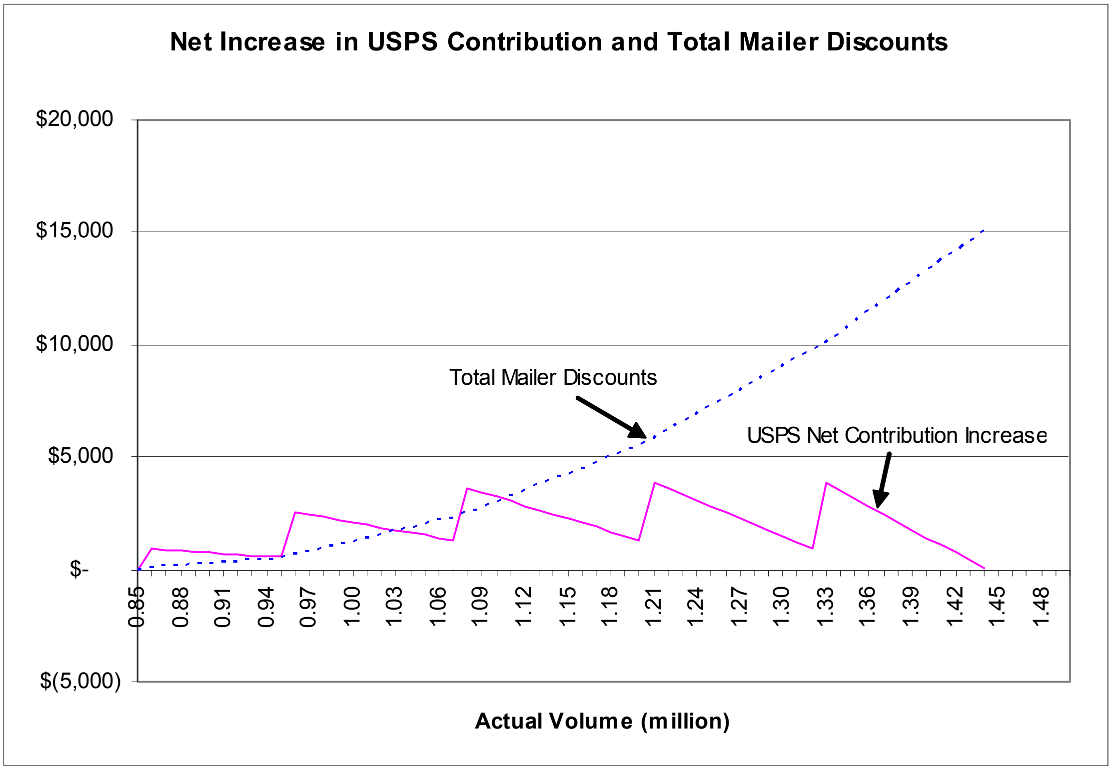
[5026] To protect the mailer's eligibility for discounts in case its actual volume is near the upper bound of the range, the parties would adjust and re-evaluate the discount schedule, which might look something like this:

Sample Discount Schedule 2

	Minimum Vol.	Maximum Vol.	Discount
No Discount	—	850,000	—
Tier 1	850,001	950,000	$ 0.005
Tier 2	950,001	1,075,000	0.015
Tier 3	1,075,001	1,200,000	0.025
Tier 4	1,200,001	1,325,000	0.035
Tier 5	1,325,001	1,440,000	0.045

[5027] This schedule has smaller discounts, some of which begin at higher thresholds. These changes convert what would be net decreases in contribution for volumes between 1.37 million and 1.44 million into net increases in contribution. The modified alternative schedule accommodates a wider range of outcomes or a larger margin for error in the volume forecast. In this example, the mailer might think that there was a possibility that circumstances would cause it to send volumes more than 37 percent above its forecast, but be confident that volumes more than 44 percent above expectations would be extremely unlikely. The trade off for reduced confidence in the forecast is slightly smaller increases in contribution to the Postal Service and reduced discounts for the mailer. These effects are presented in the graph below.

Figure 6



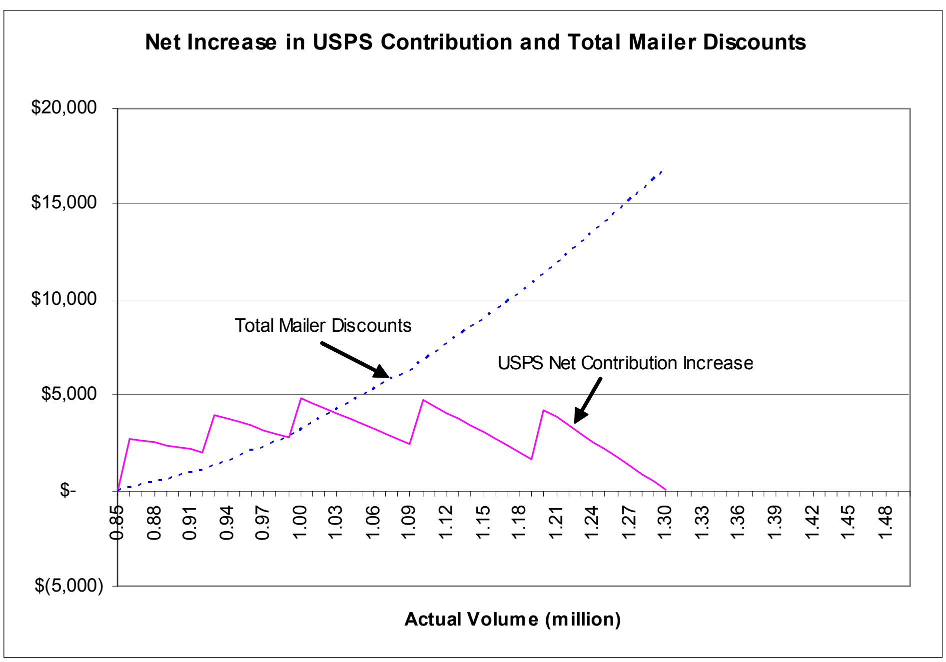
[5028] On the other end of the spectrum, the mailer and the Postal Service might have a high degree of confidence in their ability to accurately forecast the mailer's volume. Perhaps the mailer has a long, stable volume history or has been forecasting its volume with great precision for many years. In this case, the mailer and the Postal Service might agree to a set of discounts designed to increase the benefits to both parties in exchange for limiting the agreement to a relatively narrow range of actual volumes.

Sample Discount Schedule 3

	Minimum Vol.	Maximum Vol.	Discount
No Discount	—	850,000	—
Tier 1	850,001	920,000	$ 0.015
Tier 2	920,001	990,000	0.025
Tier 3	990,001	1,090,000	0.035
Tier 4	1,090,001	1,190,000	0.045
Tier 5	1,190,001	1,300,000	0.055

[5029] This schedule has larger discounts than Schedule 1 above, and most of the discounts begin at lower volumes. It produces larger benefits for the Postal Service and the mailer. The actual volume must be no more than 15 percent below or 30 percent above the forecast. The results of this schedule are presented in Figure 7.

Figure 7



[5030] The specifics of the examples above are not intended to be prescriptive. They are presented merely to illustrate how the framework could be used to design discount schedules based on the parties' confidence in forecasted demands. They also demonstrate the flexibility of the framework to allow for a significant margin of error in volume forecasts while assuring that discounts do not harm non-party mailers. These results can be accomplished even assuming that a mailer is fairly typical in terms of its unit revenues, unit costs, and elasticity.

[5031] While the framework eliminates the need for Commission review of mailer-specific volume forecasts, the selection of appropriate estimates or proxies for the mailer's elasticities (including cross-elasticities, if applicable) is of great importance. The ideal option would probably be customer-specific estimates derived empirically using techniques similar to those used to estimate subclass elasticities for rate case proceedings. However, as with customer-specific costs, customer-specific elasticities are not readily available and would likely be difficult to develop using the data currently possessed by the Postal Service.

[5032] For this reason, the Commission anticipates that volume discounts developed under the framework would, at least initially, likely utilize as proxies the most recently available elasticities for larger segments of mail. Just as with cost proxies, the use of elasticity proxies would not be optimal, but assuming a rational justification for the use of a proxy can be established, it could be deemed sufficiently representative.[30] As the Postal Service gains experience with volume discounts, it will gather data on volumes sent by specific mailers at various prices and under different economic conditions. This data may make it possible to develop empirically-derived elasticity estimates for those mailers, which could be subjected to the detailed analysis typical of rate cases.

[30] The best proxy for a mailer's elasticity might not be the average of the subclass in which the mail is sent. For example, it might be possible to rationally justify using the Standard Regular subclass elasticity as a proxy for a sender of First-Class advertising mail.

[5033] Because the elasticities of the individual mailers within a given subclass can be greater or less than the subclass average, it is important to consider the implications of using the average elasticity in either circumstance. If the mailer in question is more sensitive to price than the average (*i.e.,* its demand is relatively more elastic), the framework will underestimate the increase in volume and the resulting increase in contribution to the Postal Service. Conversely, if the specific mailer is less sensitive to price than the average, there will be a greater risk that the net change in contribution will not be positive. By avoiding the need to develop and litigate sophisticated demand forecasts for individual mailers, the framework should allow the Postal Service to offer volume discounts to a large group of mailers. As the pool of mailers receiving volume discounts expands, it should become less likely that the average elasticity of the subset of mailers receiving discounts will vary significantly from the subclass average.

[5034] There is also some risk that a situation could arise where the mailer, to avoid exceeding the upper bound of the agreed-upon volume range, would reduce its volume from what it would otherwise send. However, it is in the interests of both the Postal Service and the mailer to avoid this possibility by selecting an upper bound of after-rates volume that the mailer will not reach under any realistic scenario. It would be apparent in retrospect if such an outcome might have occurred, and with experience the parties should be able to further reduce this risk.

[5035] *Summary.* The framework can be used to resolve the two issues identified by the Postal Service as the main barriers to the continuation and expansion of Negotiated Service Agreements. Discounts developed using the framework do not require any cost reducing change in behavior on the part of the mailer, nor does the framework require the proponents to litigate the accuracy of mailer-specific volume forecasts. By removing these impediments, the Commission hopes that the framework will allow the Postal Service to offer optional tariffs to a much broader group of mailers and to fulfill the potential of the Negotiated Service Agreement program.

[5036] The Commission's suggested framework is not the only way for volume discounts or other optional tariffs to satisfy the requirements of the Act. It can not be used to design discount proposals that are free of all risks and allow for unlimited benefits regardless of the potential for changes in circumstances over time. What the framework provides is a potential means of developing volume discounts that are not tied to any form of cost savings. It also can be used to avoid the need for the Postal Service to justify and defend in litigation mailer-specific volume forecasts, while still allowing for the detailed analysis of critical assumptions and inputs necessary to develop an evidentiary basis for recommending volume discounts.[31]

[5037] The Postal Service will still need to determine to its satisfaction that it has a grasp of the volumes the mailer will send with and without discounts. However, by reaching terms whereby the mailer is willing to base the enforceability of the contract on a commitment to a defined margin of error around the forecast volumes, the proponents would not need to prove the reliability of the forecast volumes before the Commission.

[5038] It is reasonable to expect that a mailer seeking volume discounts would prefer not to commit to any level of certainty about its future volumes. However, in exchange for accepting some of the risk of forecasting errors, including unexpected shifts in its demand curve, a mailer could agree to a proposal that would require relatively little public disclosure of internal information. The negotiation and litigation process should also be simplified considerably, especially if the mailer did not seek to claim an elasticity different than existing measures for similar types of mailers.

[31] While all Negotiated Service Agreements filed by the Postal Service to date have utilized declining block rates, other forms of two-part tariffs could be developed using the framework. See PRC Op. MC2002-2, ¶¶ 5021-24 for an explanation of the equivalence of most non-linear tariffs and two-part tariffs.

VI. CONCLUSION UPON RECONSIDERATION

[6001] The Commission has reviewed the evidentiary record in light of the Governors' views presented in Decision of the Governors of the United States Postal Service on the Opinion and Recommended Decision of the Postal Rate Commission Approving Negotiated Service Agreement with Bank One Corporation, Docket No. MC2004-3, February 16, 2005. The helpful comments provided by Chase and the Postal Service also have been thoroughly considered in this review. The Commission finds that the record supports the recommendations in the Commission's Opinion and Recommended Decision Approving Negotiated Service Agreement, December 17, 2004.

[6002] The proposed classification changes and the related discounts set out in the June 21, 2004 Request, as modified by the Commission to incorporate select provisions of the Modified Stipulation and Agreement and the addition of a stop-loss cap, are consistent with the policies of the Postal Reorganization Act. Therefore, the Commission does not recommend any changes to existing rates or classifications.

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

Before Commissioners: George A. Omas, Chairman;
Dawn A. Tisdale, Vice Chairman;
Ruth Y. Goldway and Tony Hammond

Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Bank One Corporation

Docket No. MC2004-3

FURTHER RECOMMENDED DECISION

(Issued April 21, 2006)

The Commission, having further considered the Postal Service Request, has issued its Opinion thereon. Based on that Opinion, which is attached hereto and made a part hereof,

IT IS ORDERED:

1. That the Commission's Opinion and Further Recommended Decision shall be transmitted to the Governors of the Postal Service and the Governors shall thereby be advised the Commission recommends no changes to existing rates or classifications.

2. Except to the extent granted or otherwise disposed of herein, all motions, exceptions, and other outstanding requests filed in Docket No. MC2004-3 hereby are denied.

By the Commission.

(S E A L)

Steven W. Williams, Secretary

CONCURRING OPINION OF COMMISSIONER GOLDWAY

I fully agree with my colleagues that the Commission arrived at the appropriate recommendation in the Bank One case, including the recommendation of a stop-loss cap to provide a level of protection to the Postal Service and mailers not party to the agreement. While I do not find justification based on the existing record for providing the relief requested by the Governors, I continue to support Negotiated Service Agreements that are beneficial to the Postal Service and the mailing community, and am hopeful that the alternate model for negotiating volume-based discounts will foster the development of additional win-win-win agreements.

I, however, am concerned that the actual implementation of the Bank One Negotiated Service Agreement does not appear to be unfolding as predicted in the Request, but appears more in line with the predictions made in the subsequently filed omnibus rate case. I question whether the personnel involved with Negotiated Service Agreements had the benefit of the institutional knowledge incorporated into the rate case testimony. What may be the absence of the mailing of flats evident in the most recent data report further raises concerns that the Postal Service might not be fully realizing the cost savings anticipated from the agreement.

These concerns have come to light well after closing the Bank One record, and suffer from the limited available information. The Chase and Postal Service pleadings and the first data report actually raise more questions on the current status of the agreement than they answer. This adds to my concern that the Commission might not have a thorough understanding of the current status of the Bank One Negotiated Service Agreement, which might hinder the Commission’s ability to expeditiously consider future requests to modify or extend the Bank One agreement. The Postal Service should take these concerns into consideration in its future requests.

Although the Bank One / J.P. Morgan Chase merger added uncertainty to the analysis of the Bank One Negotiated Service Agreement, it also appears to have provided the Postal Service with an opportunity to study the effects of volume-based discounts. Heritage-Bank One and heritage-Chase may have been separately soliciting a similar, if not identical, product line through First-Class Mail for the first several months of the agreement. Heritage-Bank One had the benefit of the declining block rate discounts, and heritage-Chase did not. Because of this, it may be possible to isolate the effects of the declining block rate discounts from the other factors that influence volumes. A thorough understanding of this issue will aid the development of future agreements, and can be used by the Commission to make more informed recommendations. The Postal Service should not pass up the opportunity to study this important issue.

A. Docket No. R2005-1 Rate Case Testimony

The Postal Service sponsored testimony for the recent omnibus rate case, Docket No. R2005-1, which discusses mailing trends in the credit card industry. *See* Direct Testimony of Peter Bernstein on Behalf of the United States Postal Service (USPS-T-8); Docket No. R2005-1, Tr. 8A at 3168-71.[1] Witness Bernstein discusses recent "tremendous growth in the amount of direct mail solicitation undertaken by the credit card industry." At Tr. 8A/3170 he states: "Synovate reported that credit card solicitations for the first three quarters of 2004 were up more than 20 percent from the first three quarters of 2003. …More recently, Comperemedia reported that mailings in October 2004 were up 20 percent from October 2003[;]" and "Capital One reported that its marketing expenses increased more than 60 percent in the fourth quarter of 2004 compared with the third quarter of 2004." He reports on the positive effect of an October 2004 Supreme Court decision which opened the way for more banks and financial companies to begin issuing American Express cards. He discusses a probable lift to credit card solicitation as a result of the "Do Not Call" restrictions on telemarketing. Although he acknowledges that the saturation point may be approaching, he concludes: "Looking to the future, it is reasonable to expect the credit card industry to continue to expand its marketing activity as it has for at least the last decade." *Id.* at 3171.

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[1] The Postal Service presented a similar discussion in regard to credit card mailing trends in Docket No. R2001-1. *See* Direct Testimony of George S. Tolley on Behalf of the United States Postal Service (USPS-T-7).

Witness Bernstein's testimony leaves an impression of significant non-price exogenous factors influencing mailing trends in the credit card industry. Non-price exogenous factors as described also might be responsible for Bank One's increasing mail volumes. Conceivably, these non-price factors could quickly overwhelm the effect of any price incentive. If these factors are not accounted for in the Postal Service's analysis, the Postal Service could be paying incentives on mail that would have been mailed "anyhow" without a price incentive.

The Postal Service did not indicate on the Bank One record the extent to which it relied on this institutional analysis of the credit card industry. The analysis appears relevant to the Bank One request as Bank One contends it was the third largest credit card issuer in the United States. As such, its volume trends and those of the industry potentially could coincide.

An analysis of Bank One's assertion that without a discount it would experience flat to declining future mail volumes in light of the Postal Service's institutional analysis indicating that the credit card industry as a whole is experiencing increasing mail volumes might have further enlightened the Commission's recommendation. The implications of non-price exogenous factors also could have been contrasted with witness Buc's testimony describing the potential effects of price incentives. The Postal Service should consider undertaking such analysis in evaluating future requests, where applicable.

B. Mailing of Flats

The Commission estimated the Postal Service would realize a cost savings of $7.6 million attributed to the Address Correction Service (ACS) element of the agreement. The majority of this savings, $6.1 million, is related to the mailing of flats. Decision at 78.

The Postal Service filed its first data collection report in Docket No. MC2004-3 on February 7, 2006. The Postal Service reports the following First-Class Mail volumes in eligible Bank One permit accounts:

• Solicitations Non-automated Presort Letters:	17,736
• Solicitations Automation Presort Letters:	23,495,547
• Customer Mail Non-automated Presort Letters:	6,425,641
• Customer Mail Automation Presort Letters:	216,417,072
• Customer Mail Automation Carrier Route Presort Letters:	9,141,645

The data report does not mention the mailing of flats. If in fact flats are not being mailed, the Postal Service could be saving substantially less than estimated. It could also indicate that the stop-loss cap, which is calculated based upon the saving element, was set substantially higher than justified by actual cost savings.

I request that the Postal Service verify the accuracy of the first data collection report as to the mailing of flats. If accurate, the Postal Service should consider developing additional mechanisms to address the potential for unrealized savings if similar conditions are a part of future Negotiated Service Agreements.

C. Opportunity to Study Effects of Non-Price Exogenous Factors

Witness Rappaport presents record testimony projecting that in the first year of the Negotiated Service Agreement, Bank One's First-Class volume would increase as a result of the discount from 571 to 590 million pieces, an increase of 19 million pieces. Based on his estimates, the stop-loss cap limit established by the Commission should not be reached over the duration of the agreement.

Chase recently asserted that "[a]t current and projected volume trends, Chase could exhaust the aggregate volume cap imposed by the Commission as early as May 2006—

barely a year into the three-year scheduled life of the NSA."[2] To reach the stop-loss cap limit in the first year of the Negotiated Service Agreement (approximately May 2006), Bank One's First-Class volume would have to increase from 571 to 805 million pieces, an increase of 234 million pieces.[3]

In PRC Order No. 1450, the Commission stressed the importance of adhering to the contract provisions and of holding heritage-Bank One volumes separate from heritage-Chase volumes until formal integration occurs. The Postal Service has reassured the Commission that its concerns are being addressed.

> The Postal Service has carefully analyzed Chase's volume trends to date and has tracked Chase's compliance with the terms of the agreement. Chase is in full compliance with the terms of the NSA; and the merger has not prevented the Postal Service from verifying this fact.

USPS Reply Comments at 2.

Chase assures the Commission that heritage-Bank One volumes are being held separate from heritage-Chase volumes.

> The growth in heritage-Bank One Actual Rates volume was not accompanied by a collapse of First-Class Mail volume entered under heritage-Chase permits. In 2005, the last year before integration of Chase and Bank One permits, approximately 574 million pieces of First-Class Mail were

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[2] Petition at 22-23 (footnote omitted). Chase has since revised this assertion to indicate that the stop-loss cap limit appears more likely to be reached near the end of 2006. Chase Comments at 18, n.10. However, it remains that actual volumes are vastly exceeding estimated volumes. Whether the volume surge is the result of the discount incentive or the result of other factors is a question that has direct bearing on the need for a stop-loss cap.

[3] *See* PRC Order No 1450 at 12-13.

> entered under heritage-Chase permits, *more* than the 419 million pieces projected by Mr. Rappaport in his testimony.

Chase Comments at 19-20. (Emphasis in original.)[4]

Chase further contends that the testimony representing that post-merger-Chase marketing philosophy would be akin to the pre-merger-Bank One marketing philosophy was within Rappaport's competence as a fact witness. Chase Comments at 15-16. Chase had announced that the pre-merger-Bank One and pre-merger-Chase consumer and commercial banking businesses, which include their credit card businesses, would operate under the Chase brand after completion of the merger.[5] Every indication is that the heritage-Bank One credit card portfolio has converted to the Chase brand.[6]

It seems plausible from the limited information available to the Commission that heritage-Bank One and heritage-Chase are soliciting similar if not identical product lines. The solicitations are being mailed under separate identifiable and traceable mailing permits. Both mailings share the pre-merger-Bank One marketing philosophy. The heritage-Bank One mailings received the benefit of the Negotiated Service Agreement's declining block rate discounts. The heritage-Chase mailings are entered without the benefit of declining block rate discounts.

While data necessary to perform a detailed analysis have not been presented to the Commission, certain trends are indicated. Assuming the accuracy of Chase's first assertion that the stop-loss limit may be reached by May 2006, Bank One's First-Class

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[4] Witness Rappaport apparently underestimated heritage-Chase First-Class Mail volumes by 155 million pieces (574 million minus 419 million). The Commission did not rely on heritage-Chase First-Class Mail volumes in its Opinion. However, this again demonstrates the difficulty of obtaining accurate volume estimates, even for the near future.

[5] J.P. Morgan Chase Press Release dated June 8, 2004.

[6] Chase argues that the rebranding effort was a matter of public record, and that Chase did not conceal this fact. *Id*. at 16. While Chase may not have concealed this significant material fact, Chase did not disclose the nature of the rebranding effort on the record. The Commission became aware of this effort well after the record was closed.

volume would have had to increase from 571 to 805 million pieces, an increase of 41 percent.

Chase asserts that approximately 574 million pieces of First-Class Mail were entered under heritage-Chase permits compared with the 419 million pieces projected by Mr. Rappaport in his testimony, an increase of 37 percent. This surge in volume could only be due to other exogenous factors, because heritage-Chase mail was not subject to the benefit of the declining block rate discounts.

More meaningful comparisons can be made with the benefit of refined data. Negating the effect of growth in customer mail and isolating just solicitation mail could be an important comparison. Properly aligning time periods and using actual volumes to replace the Chase estimate of when the stop-loss cap will be reached is also necessary. Even though only limited information is available, it appears factors other than volume discounts may have had substantial impact on both the heritage-Bank One and heritage-Chase mailings.

The coincident mailing of heritage-Bank One and heritage-Chase mail has created an excellent opportunity for the Postal Service to study the impact of volume-based discounts. If the Postal Service can gather and preserve this information, and complete an appropriate analysis, the results could support future volume-based discounts. The assertions made by witness Buc concerning the effects of declining block rate discounts on volume also might be enhanced using witness Bernstein's rate case analysis of volume trends. It would be very helpful for the Postal Service to undertake such efforts and share the analysis and results with the Commission.

Ruth Y. Goldway, Commissioner