Evaluating Negotiated Service Agreements
For Market Dominant Products Under PAEA

By

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I. Introduction

A negotiated service agreement ("NSA") is a customized contract between the Postal Service and an individual mailer. Such contracts provide the Postal Service with a way to recognize explicitly those characteristics of a mailer that, individually or in combination, are either unique or sufficiently different from average to warrant special rate recognition. Under an NSA, postal services, and prices of those services, can be tailored to a mailer's individual circumstances.

Offsetting the potential advantages of individualization is the fact that for most mail which the Postal Service handles, it is the dominant provider. For market dominant products, which are the sole concern of this paper, the Postal Service has a threshold obligation to charge fair and reasonable rates and to avoid unreasonable preferences, such as by seeking non-discriminatory solutions in the form of either changes to the general tariff schedule or niche classifications.[2] Such changes are more fair to all

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[2] See e.g., 39 U.S.C. §§ 403(a), 403(c), and 3622(c)(10). Proponents of NSAs do not acknowledge the primacy or relevance of any threshold conditions. Levy *et al.* (2006), for example, would drop the bar to where a proposed NSA should be approved by the PRC if it satisfies only the following two tests: (1) the USPS has

(continued...)

mailers, both large and small, whereas NSAs have been, and almost certainly are going to be, restricted to certain large mailers. As Adra, *et al* (2003) explain, "the identified opportunity [for an NSA] needs to be financially viable **and significant in terms of sales**." (p. 372, emphasis added.) The primacy of enforcing these threshold conditions under PAEA, and maintaining a level and impartial playing field, is central to this paper. Importantly, broadening benefits to encompass the greatest number of eligible mailers whenever feasible also offers greater benefits to both the Postal Service and the mailing public.

NSAs are in their infancy. The first NSA, with Capital One Services, Inc. ("Cap One"), was submitted by the Postal Service on September 12, 2002, and recommended for approval by the Postal Rate Commission (now the Postal Regulatory Commission, "PRC") on May 15, 2003.[3] Including Cap One, which expired and was renewed, only nine separate NSAs have been submitted to the PRC over a 5½-year period, of which six have been recommended, one was withdrawn and, as of mid-April 2008, two were pending (see Appendix). Although experience with NSAs has been limited, they have exhibited a variety of characteristics which provide a reasonable base for analysis.[4]

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[2](...continued)
performed appropriate due diligence in scrutinizing the claims of the mailer about its anticipated Before-Rates volume; and (2) the potential financial benefits of the NSA appear likely to outweigh its expected costs, including the potential costs of needless discounting. (p. 355.)

[3] Adra *et al.* (2003) describe the Capital One NSA in some detail, as well as events leading up to it.

[4] The two pending NSAs are not discussed in this paper.

Each NSA thus far presented to the PRC for review has been asserted to generate benefits for the Postal Service that significantly exceed discounts given to the mailer. According to Robinson (2007), however, net benefits actually generated for the Postal Service have been disappointing for NSAs implemented to date. Two NSAs have resulted in no benefits to mailers in FY2007; see Appendix.

Interestingly, all nine NSAs to date have been negotiated and submitted to the PRC for review under the Postal Reorganization Act ("PRA"). Each NSA was subjected to the then-existing review process, which entailed an adversarial-type hearing. On December 20, 2006, the President signed the Postal Accountability and Enhancement Act ("PAEA"), which generally has reduced the role of adversarial-type hearings in favor of notice and comment proceedings. Effective December 12, 2007, the PRC modified the rules applicable to NSAs, but as of April, 2008, no NSA has been submitted to the Commission for its review under PAEA.

Contract pricing has existed for many years in industries where sellers can be said to have a substantial degree of market dominance (*e.g.*, electric utilities, pipelines and railroads), as well as in industries where sellers are highly competitive (*e.g.*, hotels or car rentals).[5] Within the delivery industry, FedEx and UPS are said to use contract pricing extensively. The existence of contract pricing elsewhere gave rise to extensive discussion within the Postal Service and the postal community at large about contract pricing, starting many years before the first NSA with Cap One was submitted to the PRC. According to Adra *et al.* (2003), the Postal Service had internal discussions about

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[5] Levy (2005) and Levy, *et al.* (2006) elaborate on contract pricing in other industries.

contract pricing as far back as the 1970s. Much of the discussion that preceded the Cap One NSA was generated by proponents, who tended to be long on generalities but short on specifics, while critics were noticeable by their absence (or silence). Consequently, discussion concerning the specific nature and extent of benefits that the Postal Service might expect to gain from NSAs has occurred only since 2002.

II. Requirements for Special and Experimental Classifications Under PAEA

A. Special Classifications and NSAs

The provision of PAEA which provides the sole statutory authorization for NSAs for market-dominant products is 39 U.S.C. § 3622(c)(10). That provision authorizes the Commission to consider as a factor in designing a modern rate system the desirability of:

> **special classifications** for both postal users and the Postal Service in accordance with **the policies of this title**, including **agreements** between the Postal Service and postal users, when available on public and reasonable terms to **similarly situated mailers,** that —
> (A) either —
> (i) improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service; or
> (ii) enhance the performance of mail preparation, processing, transportation, or other functions; and
> (B) **do not cause unreasonable harm** to the marketplace. (Emphasis added.)

In addition to all other criteria applicable to rate changes, the statute thus establishes further requirements for NSAs (and other special classifications). All special classifications and agreements must be available to similarly situated mailers. Further, without harming the marketplace, NSAs must either improve the finances of the Postal Service or enhance Postal Service performance. The apparent purpose of these requirements is to ensure that other mailers and the marketplace in general are not harmed by special deals for particular mailers. No waiver of these requirements is authorized by the PAEA. Importantly, the statue expressly requires that NSAs adhere to “the policies of this title,” which of course includes all applicable provisions in 39

U.S.C. § 3622, as well as the requirement that "the Postal Service shall not ... make any undue or unreasonable discrimination among users of the mail, nor shall it grant any undue or unreasonable preferences to any such user." 39 U.S.C. § 403(c).

In Docket No. RM2007-1, the Commission promulgated rules applicable to its consideration of NSAs under PAEA.[6] Those rules, which refer to NSAs as "Type 2 Rate Adjustments," repeat the requirements of 39 U.S.C. § 3622(c)(10), and reinforce that NSAs "be available on public and reasonable terms to similarly situated mailers."[7] 39 C.F.R. § 3010.40-44. Interestingly, NSAs under PAEA will have no three-year limit on their duration, as existed under the PRA regulations.

PAEA and the new Commission rules do not provide for lengthy pre-implementation review of NSAs. After a Notice of Agreement is filed (no later than 45 days before the implementation date) with the Commission, a 10-day period is established for public comment, after which the Commission will issue an order announcing its findings. *See* 39 C.F.R. § 3010.44. The Commission has provided, however, that any pre-implementation determination is "provisional and subject to subsequent review." 39 C.F.R. § 3010.44(c).

In addition to the Notice of Agreement provisions mentioned above, the Commission's new rules set forth procedures which require all new NSAs to be

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[6] However, in its *Strategic and Operational Plan 2008-2012,* the Commission states that as part of its short-term operational strategies, it intends to "[d]evelop a method to examine Negotiated Service Agreements by June 2008." (p. 12.)

[7] The new system disposes of the previous distinction between baseline and functionally equivalent NSAs, both being implemented under the same procedures.

submitted as a request to add a product to the Mail Classification Schedule (MCS). 39 C.F.R. § 3020.30-35. The purpose of these procedures is to determine whether the agreement should be added to the market dominant product list or the competitive product list. Under these procedures, the Postal Service must submit "supporting justification" (39 C.F.R. § 3020.32), and there is a public comment period (39 C.F.R. § 3020.33(e)). [8]

B. Experimental Classifications

PAEA also provides for experimental products, with 39 U.S.C. section 3641 exempting experimental products from the systems for market dominant products (section 3622), competitive products (section 3633), and changes to the MCS (section 3642). 39 U.S.C. § 3641(a)(2).[9]

Three conditions precedent to the Postal Service testing an experimental product are: (1) the experimental product must be different (from the viewpoint of mail users) from all products offered by the Postal Service in the two years preceding start of the test; (2) the experimental product would not create an unfair or otherwise inappropriate

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[8] The Commission had no liberty to dispense with the "new product" requirements, as PAEA defines a "product" as "a postal service with a distinct cost or market characteristic for which a rate or rates are, or may reasonably be, applied," a test clearly met by all previous NSAs, and likely all future ones as well. *See* 39 U.S.C. ¶102(6).

[9] In one NSA, it was argued that the NSA was in the nature of an experiment, "as a large scale beta test for the numerous additional functionalities that the Four-State Barcode and Intelligent Mail are likely to permit." Bank of America (2007a), pp. 17-18. See also PRC Docket No. MC2007-1, Tr. 2/368, ll. 14-15 ("...this is a test environment for us.)

advantage for the Postal Service or any mailer, particularly in regard to "small business concerns" (as specified in section 3641(h)); and (3) the Postal Service identifies the product as either market dominant or competitive. 39 U.S.C. § 3641(b).

The Postal Service can undertake a market test of an experimental product by giving notice to the Commission at least 30 days before it begins, and the market test may not exceed two years (although it may be extended for one year by the Commission). 39 U.S.C. § 3641(c) and (d). Revenues from a market test (anticipated or actually received) are limited to $10 million, but the Commission may exempt it from that limitation if certain criteria are met, although the revenues from the market test still may not exceed $50 million.[10] 39 U.S.C. § 3641(e).

Although these market tests are not subject to pre-implementation review by the Commission, the Commission may order cancellation of the market test or other appropriate action if it determines that the market test fails to meet any of the requirements. 39 U.S.C. § 3641(f).

As of mid-April 2008, the Postal Service has not proposed any experimental products under PAEA and, with no statutory deadline to do so, the Commission has not promulgated any regulations implementing section 3641.[11]

The Postal Service is not expressly required to use provisions of section 3641 to introduce, or even test, a new product. Consequently, rather than be subject to the

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[10] These limitations are to be adjusted annually according to the CPI. 39 U.S.C. § 3641(g).

[11] In its *Strategic and Operational Plan 2008-2012*, the Commission states that as part of its short-term operational strategies, it intends to establish regulations and procedures for experimental product market tests by June 2008. (p. 11.)

time and revenue limitations of section 3641, it might be possible for the Postal Service to offer a niche classification as a permanent product and remove it later if it decides to discontinue that product.

III. Evaluation of NSAs That Incorporate Volume Discounts

Two principal rationales generally are proffered in support of using NSAs to give volume discounts to selected mailers or a selected portion of the mail stream. First, it is asserted that large volume mailings enable lower costs to be realized by the Postal Service. Second, it is asserted that volume discounts will increase mail volume measurably over what it otherwise would be, thereby increasing total contribution.[12] As discussed herein, each rationale is problematic.

A. Opportunities for Lower Costs via NSAs Appear to be Scarce

With respect to presortation, destination entry and pre-barcoding by mailers, it is well established that worksharing by mailers can reduce Postal Service costs. Such practices already are recognized in workshare discounts that for many years have been embodied in the general tariff schedule. The corresponding rate reductions (*i.e.*, discounts) generally reflect 100 percent of costs avoided, and are an excellent example of innovative pricing that has produced win-win results for the Postal Service and mailers.

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[12] Levy (2005) urges selective discounts, including volume discounts, to stem the diversion of bill presentment and payment communications from First-Class Mail to the Internet. His argument focuses largely on the legality of such discounts. One problem with his proposal is that the decision to switch from mail to the Internet is made not by those who mail the bills, but by those who receive them. Thus, in order to affect that critical decision regarding Internet usage, any such price signal (*i.e.*, discount) somehow would need to be given to all the individuals who still rely on the mail to remit payments. At a minimum, any such discount given to large mailers would need to require in return that the mailer cease promoting electronic presentment and payment. Otherwise, hopes that such discounts might discourage the diversion of bill presentment and payment communications to the Internet would appear to be misdirected and doomed from the outset.

In the context of an NSA, cost savings that would support a volume discount, therefore, must refer to **additional** cost savings — over and above those that already are incorporated in discounts available to all mailers in the general tariff schedule — which very large-volume mail can (or does) provide, but which other mailings of lesser volume are not capable of attaining. Otherwise, whatever cost-savings the NSA might reward would be handled more appropriately via recognition in the general tariff schedule.

The chief example of cost savings enabled by an NSA involves the agreement to waive free physical return of non-forwardable undeliverable-as-addressed ("UAA") First-Class Mail (a high-cost service) and in lieu thereof accept electronic address correction return service ("eACS," a lower-cost service). The cost savings resulting from this substitution was an important part of the justification for the first four NSAs. Had adoption of eACS been encouraged via appropriate changes in the general tariff schedule, however, it likely would have been accepted by many other mailers, including many with volumes less than those entered by parties to the NSAs, to the benefit of the Postal Service. Moreover, the ability to adopt eACS in lieu of physical return does not depend on the volume of mail generated by a mailer. Indeed, no examples of volume-related costs savings have been identified in prior NSAs or the published literature.[13]

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[13] The unit cost of presort First-Class Mail is considerably lower than the unit cost of single-piece First-Class Mail. To the authors' knowledge, however, it has not been asserted that the unit cost of **large-volume** presort mailings is lower than the unit cost of **small-volume** presort mailings. The effort to "de-link" presort rates from single-piece rates has not been presented as a volume-related issue.

After discussions and in-depth explorations of NSAs with a number of mailers, the Postal Service itself has recognized that instances of cost savings unique to any mailer are rare:

> **NSAs** that grow contribution through inducing cost-savings behavior will be the exception, not the rule. Rather, the Postal Service and the Governors believe that opportunities for **increasing contribution** through **volume incentives** are far better than through cost-based discounts.[14]

B. Using an Individual Mailer's Perceived Elasticity of Demand to Justify a Volume Discount Can Have Troublesome Consequences.

With respect to the second rationale, demand for every mail product has some price elasticity, hence a lower rate always can be expected to have a positive volume response. In the context of an NSA with an individual mailer, any allusion to greater volume in return for a deeper discount (or lower rate) must mean that the response of the mailer in question will exceed by a substantial amount the average response of the product(s) involved. Otherwise, it would be both fairer and more sensible to have an across-the-board reduction in rates for all mailers that use the product(s), especially under the new pricing flexibility which PAEA gives the Postal Service.

Within a broad class of mail, each mailer may have a different elasticity of demand. It also is the case, however, that when mailers compete head-to-head, the elasticity facing one mailer can be highly dependent on prices charged by close competitors. When this occurs, using the elasticity that one mailer "perceives" (on the assumption that he receives a discount not offered to others) to justify a volume

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[14] Docket No. MC2004-3, United States Postal Service Revised Memorandum on Reconsideration (May 18, 2005), p. 8.

discount in an NSA is troublesome, and has the potential to create considerable mischief. Succinctly, using an NSA to give a volume discount to one mailer, while not extending it **simultaneously** to other similarly-situated mailers that compete head-to-head with the first mailer, would give that mailer a competitive advantage, along with an incentive to raid customers of its competitors. Such a situation is difficult to perceive as being fair. In those markets where postal rates are a major factor, this is especially the case; the competitive advantage conferred by an NSA with a volume discount could be decisive. Moreover, this observation applies not only to straight volume discounts, but also to declining block discounts.[15]

Panzar (2003a) has argued that volume discounts, in the form of declining block discounts, even though designed for large users, are “inherently nondiscriminatory” because “the same outlay schedule is available to all consumers,” but notes this applies only when ratepayers do not compete against one another in downstream markets. Panzar says that when they do so compete, volume discounts may disadvantage smaller mailers vis-a-vis larger mailers. In fact, volume discounts will serve to disadvantage any competing mailer, large or small, that does not have access to such discount(s) while a competitor does.

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[15] Although in the past it has been viewed as appropriate for an NSA to be extended to one "baseline" mailer now, and a "functionally equivalent" to other "similarly situated" mailers months or years later, this approach may be at odds with PAEA, which permits "special classifications" and "agreements" only "when available on public and reasonable terms to similarly situated mailers...." This language indicates that an NSA is permissible only when it is simultaneously made available to similarly situated mailers, at least if the Postal Service and Commission is aware that any such mailers exist.

NSAs receive credit for pioneering the use of declining block discounts by the Postal Service. Importantly, however, the Postal Service can take advantage of the benefits of declining block discounts identified by Panzar without resorting to NSAs. In the first rate adjustment for competitive products filed under PAEA, Docket No. CP2008-3, for Parcel Select services, the Postal Service established incentives, "in the form of declining block prices, for shippers with greater than $5 million annual Parcel Select revenue who increase their volume from the previous twelve month period."[16] Making declining block discounts available simultaneously to any qualified mailer, rather than restricting such discounts to a few selected NSAs, not only is fairer, but also will generate more benefits for the Postal Service.

If either a class of mail or, more likely, an individual product within a class of mail has an identifiable subgroup of mailers who (1) compete quite strongly with each other (*i.e.*, a high cross-elasticity of demand within members of the group), but (2) not so much with others (*i.e.*, a low cross-elasticity of demand between members of the group and others not in the group), then instead of an NSA, it would be more fair to create a niche classification for all those in the subgroup with demand elasticity that greatly exceeds the average elasticity of other mailers using the product. In this way, all eligible mailers could take advantage of the new niche classification simultaneously.

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[16] United States Postal Service (2008), p. 2. The implementing regulations refer to these as "loyalty incentives" and "growth incentives." Loyalty incentives are available "on qualified DDU volume to shippers who pay certain minimum levels of total Parcel Selects postage, **and who exceed their previous year's total Parcel Select volume,** as specified in the Domestic Mail Manual." Errata to Notice of the United States Postal Service of Governors' Decision No. 08-3, Attachment A, p. 23 (filed March 12, 2008, emphasis added).

C. Volume Discounts: NSAs in Competitive Industries

In certain competitive retail industries, contract rates are common. For example, large hotel chains enter into contracts that offer discounts to corporations with many employees or organizations with many members (such as AAA or AARP) who need hotel rooms.

In those hotel chains that are party to such discounts, each hotel room is likely to have a number of different rates. The highest rate, which is the published tariff rate, is for those small businessmen or unaffiliated individuals who cannot qualify for any of the various discounted rates. The lowest rate (*i.e.*, the highest discount) frequently is extended to employees of the federal government, which attempts to take maximum advantage of volume-based discounts wherever they are available.

These discounts to large corporations and other organizations with numerous users are not supported by any significant cost reductions of the type normally associated with economies of scale or scope. Those travelers eligible for discounts make (and change) their reservations just like those who do not qualify for any discount. And when they arrive at a hotel, they check in and out just like those who pay the full undiscounted tariff. For any given room, variable costs are approximately the same for all guests, regardless of whether they pay the full price or receive a discounted rate.

Like most businesses, hotel operators have substantial fixed costs that are similar to the Postal Service's institutional costs. One effect of these discounted rates is that a disproportionate share of the operator's fixed costs are covered by those hotel guests who pay the full, published tariff rate, while those guests who receive the maximum discount make the lowest percentage contribution to the operator's fixed costs. In common parlance, these discount structures might be described as a way to "sock it to the little guy," by charging them the highest rate that the traffic will bear.

Within the competitive delivery industry, it is no secret that FedEx and UPS have negotiated agreements with all major customers. And, as with hotels and car rentals, the federal government is said to enjoy a discount on its expedited packages that is equal to or greater than the deepest discount given to any other customer. Rates and terms of the negotiated agreements not only are considered confidential by FedEx and UPS, but also their recipients typically are bound contractually not to disclose either the rates or any other terms. In consequence of the non-disclosure provisions, knowledge about actual pricing of competitive delivery products is generally limited to anecdotal-type information.

D. Volume Discounts in Market Dominant Industries

If volume discounts were to be incorporated into NSAs for market dominant products, under PAEA — whether given openly or in some indirect form[17] — they would have the potential to be transformative, but not in any manner trumpeted by proponents. As explained below, such volume discounts could convert what has been a level playing field for all mailers into one that is distinctly non-level. The following illustrates one way such conversion might take place.

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[17] Of the NSAs that have been submitted to date, several have compensated the mailer on the basis of one activity in return for various benefits derived from other activities. See Section VI, *infra*, for further discussion concerning this practice.

Some believe that PAEA calls for “light-handed” regulation. Some proponents of NSAs even aver that no one, other than the parties to an NSA, should have standing to question or criticize such NSAs. From their viewpoint, any objection by third parties to volume discounts should be considered out of order and not given any weight by the PRC. However, PAEA requires that an NSA embodying volume discounts, however framed, must be “available ... to similarly situated mailers,” and volume discounts for (very) large mailers could proliferate.

How could the cost of volume discounts to large mailers be funded within the CPI rate cap? Very easily. The PAEA puts an upper limit on workshare discounts, but does not establish any floor.[18] Also, the Postal Service now has flexibility with respect to rates, so long as revenues from rate changes do not exceed the rate cap. Thus, within any class of mail the Postal Service could increase effective rates (and revenue) by reducing the workshare discounts given to all qualifying mailers, while more than compensating large mailers for their “loss” of workshare discounts with generous

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[18] In the first market dominant rate adjustment filed under PAEA, Docket No. R2008-1, in respect to workshare discounts with passthroughs below 100 percent, the United States Postal Regulatory Commission (2008a) held as follows (pp. 18-19):

> The Postal Service’s plan to **set discounts below 100 percent** or to reduce existing discounts, by itself, **does not make the planned discounts unlawful.** In support of its position, MMA calculates the passthroughs that would be implied by the planned discounts . . . are between 86 and 95 percent, depending on the discounts. Acceptance of MMA’s cost avoidance methodology **would not change the finding that the planned discounts are consistent with the worksharing limitations of the PAEA.** [Emphasis added, ref. omitted.]

volume discounts that are not justified by any reduction in costs.[19] The net effect would be to leave small and mid-size mailers paying a disproportionate share of the Postal Service's institutional costs, while those large mailers with volume discounts gain a competitive advantage over smaller rivals. Thus, the effect of volume discounts doled out selectively to large volume mailers and not supported by lower costs can be especially pernicious. Even strong proponents of NSAs acknowledge that "[f]airness dictates that a monopolist like USPS treat all similarly situated customers in a like manner. Generally, a customer's level of postage spending has not been a basis for discrimination by USPS." Levy *et al.* (2006), p. 352.

Large volume mailers, especially large users of First-Class Mail, obviously make a total contribution to the Postal Service's institutional costs that, in absolute amount, is significant. For an NSA under PAEA, however, the absolute size of a mailer's total contribution should be totally irrelevant. The critical issue is whether changes incorporated in and induced by the special classification (NSA) improve the net financial position of the Postal Service through increasing the net contribution to the institutional costs of the Postal Service.[20]

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[19] Allowing the Postal Service to grant undue preferences to large mailers opens the Postal Service up to the risk of inappropriate pressures from those seeking special rates.

[20] In the NSA with Bank of America Corp. ("BAC"), the absolute size of BAC's volume and contribution to institutional costs was advanced (by BAC) as reason for approval. "With or without the NSA, the Postal Service will earn about $500 million in contribution from BAC's mail each year during the next three years." Bank of America, (2007), p. 1.

IV. Evaluation of NSAs With Negative Contribution, or Losses

PAEA requires that all future NSAs (i) comply with the policies of 39 U.S.C. (Including the prohibition on unreasonable preferences), (ii) be available to similarly situated mailers, and (iii) not cause unreasonable harm to the market place and, in addition, either (a) increase financial contribution to the Postal Service, or (b) enhance the performance of mail preparation, processing, transportation, or other functions. Therefore, in addition to meeting the threshold conditions discussed above, it also would appear necessary for the Commission to determine that a proposed NSA has a high likelihood of providing increased contribution to the Postal Service, unless neutral or negative contribution is outweighed by enhanced performance.

If any increase in contribution for the Postal Service is found to be highly doubtful, or even a virtual impossibility, the Commission generally could be expected to disapprove the filing, on grounds that the NSA would cause the Postal Service to incur a reduction in contribution which it otherwise could avoid, and therefore fails to comply with the statutory standard.

It is conceivable, however, that non-pecuniary benefits from as proposed NSA, in the form of enhanced performance, could be perceived by the Postal Service as worth incurring a reduction (or no increase) in contribution. When any lack of increase in contribution to overhead is problematic, those non-pecuniary benefits associated with enhanced performance need to be weighed particularly carefully, especially by the Commission, but also by the Postal Service, because any diminution in contribution to overhead from an NSA will adversely impact other mailers. Under such a circumstance, the reduction in the rights afforded mailers to challenge an NSA in an adversarial process imposes a duty on the regulator to be proactive in "establishing or revising" "a modern system for regulatory rates and classes" which protects the interest of other mailers not party to the NSA.[21] 39 U.S.C. ¶3622(a). This point needs to be given full recognition because some proponents of NSAs actually have asserted that (1) any losses from NSAs no longer matter because the rate cap provision in PAEA protects other mailers in the class,[22] and (2) all NSAs should be subjected to a review that is so "light-handed" as to constitute almost rubber-stamp approval.[23] Significant, hidden unproven and dangerous assumptions underlie any such claim.

Namely, it is assumed implicitly that (1) each year the Postal Service inevitably will increase rates within each class to the maximum allowed by the cap, regardless of whether it loses money on one or more NSAs, and (2) by so doing, the Postal Service will never need to file an exigent rate case for increases above the cap. However, if the Postal Service ever finds itself in a situation where it would have increased any rate

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[21] For a general discussion concerning the need for the Commission to be proactive, see Wolak (2008). Adra, *et al.* (2003) state that "USPS has learned that regulation, while perceived as a hindrance by some, can also improve the organization's bargaining position. Customer discounting can become a costly race to the bottom in industries with limited regulation. Regulation acts to ensure that USPS will not put money-losing agreements into action. . . . Where organizational goals and individual incentives are not clearly aligned with profit maximization, some form of regulatory oversight ensures a focus on only contribution-positive agreements." (p. 388)

[22] Such thinking is dangerous. If NSA losses do not matter, neither should any other type of losses. This is the direct opposite of the message that the Postal Service should have received from Congress in PAEA.

[23] In the NSA with Bank of America ("BAC"), the PRC estimated that it would result in losses of between $25 and $45 million over the three-year life of the NSA. United States Postal Regulatory Commission (2007), p. 2. The NSA with BAC was asserted to be "experimental," but it is unlikely that it would have met the terms of an experimental product as defined by PAEA.

within the class by a lesser amount **but for losses on one or more NSAs**, then in fact other mailers in the class will have been adversely impacted by those losses, notwithstanding claims to the contrary. And the same is true if the Postal Service has to file for an exigent rate increase partly or wholly due to losses on one or more NSAs.

In conclusion, losses on NSAs for market dominant products do matter, to other mailers as well as the Postal Service. Further, if mailers not party to the NSA are to be procedurally impaired from actively protecting their interests, then the PRC needs to assume responsibility for developing a system for rejecting NSAs which do not meet statutory requirements.

V. Evaluation of Partial Solutions to Systemic Problems

An excellent illustration of a systemic problem is the Postal Service's cost of handling UAA First-Class Mail.[24] For UAA First-Class Mail that cannot be forwarded, the Postal Service provides physical return at no charge to sender, but at a significant cost to the Postal Service for each piece returned. For bulk (presorted) First-Class Mail, it has developed a lower-cost option, eACS, described previously.

Large volumes of UAA mail, originated by many mailers, are involved. A recent statement by the Public Representative (2008) noted that:

> the forwarding (and return or wasting) of undeliverable-as-addressed First-Class Mail remains a large and costly problem for the Postal Service. In FY 2004, the most recent year available, 3.33 billion pieces of First-Class Mail were UAA, representing 3.4 percent of total First-Class Mail, **with nearly 64 percent of the UAA mail originating as presorted or automation pieces.** The **total cost** to process undeliverable-as-addressed First-Class Mail, including the processing of address correction notices, was **$1.03 billion**. [Emphasis added, footnotes omitted.]

Obviously, if most bulk First-Class mailers were to adopt the electronic information return option, in lieu of physical return, the Postal Service could save a considerable sum of money. However, at the time early NSAs were filed, adoption of eACS was *de minimis* because the Postal Service paradoxically charged a fee for its

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[24] To its credit, the Postal Service has worked diligently to develop and implement electronic address correction systems designed to help all bulk mailers avoid creation of UAA mail. Without the existence of these address correction systems, one only can speculate on how much greater would be the volume of UAA mail that is created today. Furthermore, knowing that, despite it best efforts at prevention, large volumes of UAA mail nevertheless will continue to be entered, the Postal Service has developed and implemented the Postal Automated Redirection System ("PARS") designed to recognize and redirect forwardable UAA mail before it travels through the entire network and is given to the wrong carriers for delivery.

low-cost eACS, while continuing to provide high-cost physical return service without any charge; *i.e.*, free to the sender. As a result of this mis-pricing of return services, only a very small volume of bulk First-Class Mail was using eACS.

Several of the early NSAs included a requirement that the mailer adopt the option for electronic return of information. The full difference between the cost of physical and electronic returns, or the costs saved from adoption of eACS, was counted as a benefit in those NSAs. At the same time, the benefits of electronic return services were "incidental" to the incentive structure incorporated into those NSAs. Although cost savings from use of eACS were quantified, the mailer was not given any explicit benefit tied to the number of electronic returns generated by mail submitted under the NSA. Instead, cost savings from eACS were bundled together with other benefits to help justify discounts for other, unrelated activities (see Section VI, *infra*, for more discussion on this subject).

For instance, in the case of the Cap One NSA, remuneration to the mailer centered on declining block discounts that were given for additional First-Class Mail volume. In the NSAs with Bank One Corporation, Discover Financial Services, Inc., and HSBC North American Holdings, Inc., remuneration to the mailer also was based on declining block discounts.[25] The purpose of declining block discounts is to induce the submission of additional mail volume that is profitable at the margin.[26]

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[25] In those NSAs, enhanced profitability resulted from conversion of Standard Mail to First-Class Mail, with no expectation of a net increase in mail volume.

[26] Panzar (2003a) discusses the economic theory that underlies declining block discounts.

In order to improve its efficiency, the Postal Service needs to employ the pricing mechanism aggressively, in creative and innovative ways. Doing exactly that has enabled it to achieve remarkable progress.[27] However, declining block discounts restricted to a few selected mailers, regardless of how large their volume may be, are not an appropriate means for materially reducing the large volume of UAA mail with which the Postal Service must cope each year. When a proposed NSA quantifies projected cost savings — as has occurred for replacement of expensive physical return of undeliverable First-Class Mail with less costly electronic return of the information — yet those savings do not receive any explicit recognition in the "pricing mechanism" created by the NSA, and are incidental to a systemic problem that otherwise is not addressed, a pertinent question is whether the asserted benefits deserve to be recognized at their full estimated value, or should be discounted to allow for their ephemeralness to both the systemic problem and the NSA's incentive structure.

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[27] See, for example, Elcano, *et al.* (2000).

VI. Evaluating Unpriced Benefits

Of the six NSAs that have been approved to date, most have had more than one component that was asserted to provide the Postal Service with quantifiable benefits, yet typically no causal relationship or other interaction of any kind was asserted to exist between the different beneficial components. For reasons almost never explained, the incentive to the mailer was based solely (or almost solely) on its performance with respect to only one component. In other words, the mailer received an incentive, or price signal, usually in the form of a discount, with respect to one component, but no incentive or price signal with respect to the other component(s). In short, rather than being priced separately, for compensation purposes, unrelated components were bundled together.[28]

For example, in the very first NSA with Cap One, in order to reduce the Postal Service's costs associated with return of Cap One's undeliverable UAA mail, the mailer was required to forego physical return of undeliverable First-Class Mail and accept eACS in lieu thereof. Cap One was not required to pay the counterproductive fee for eACS since it had been accustomed to receiving free physical return of its UAA mail. The benefits estimated to accrue from substituting eACS for physical return were substantial, approximately 87.6 percent of the gross value to the Postal Service from the NSA. However, instead of giving Cap One some kind of discount or other reward based on usage of eACS, its only compensation was the declining block discounts that it received for increasing its volume of First-Class Mail above specified thresholds.

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[28] Bundled pricing by market dominant firms is generally viewed as problematic under existing anti-trust law, as unlawful discrimination.

Why didn't the NSA incorporate a separate incentive to encourage and reward use of eACS? As stated above, reasons for the bundled pricing are almost never provided. One possible explanation is that any separate pricing would have highlighted what Panzar (2003b) described as "the distorted pricing structure that's built into return policies." That, in turn, would have revealed a weakness of that particular NSA. Namely, if the overall pricing structure for return services were rationalized, those particular benefits asserted to be uniquely tied to the NSA instead would be extended to all other mailers and realized outside the context of an NSA (as they subsequently were), **and hence would add no value within the context of the NSA**.[29]

The Postal Service's savings from eACS also were bundled in similar fashion into subsequent NSAs considered to be functionally equivalent with Bank One, Discover, and HSBC. In those three follow-on NSAs, the savings associated with adoption of eACS represented, respectively, 34, 69 and 63 percent of the gross value which the Postal Service expected to receive. In the latter two NSAs, the unrelated component (which had no direct incentive) is seen to have constituted approximately two-thirds of the total gross value to the Postal Service. These savings have turned out to be quite real, and the Postal Service presumably could have been realized even greater benefits by having the general tariff structure provide incentives that explicitly

[29] The Postal Service estimated the benefits of Cap One's additional volume at $1.846 million, and discount leakage at $6.735 million. Clearly, the declining block discount was a money loser but for inclusion of the benefits from accepting electronic address correction in lieu of physical return (which could have been obtained via a change in the general tariff).

focused on and encouraged substitution of electronic return notices for physical return of undeliverable solicitations.[30]

Whenever parties to an NSA agree to bundle components needlessly into one incentive structure, they create unnecessary complexity. And complexity, as Levy *et al.* (2006) point out, can drive up transaction costs. The published tariff schedules for some mail classes, especially Periodicals, can be somewhat complex. However, the kind of complexity that has been designed into the bundled pricing of some NSAs is of a different order of magnitude. In general, it would seem more appropriate for activities with quantifiable benefits that could be rewarded separately to have separate incentives, rather than being bundled. Unbundling, where feasible, also would help reveal the opportunity to improve the general tariff structure or establish niche classifications in lieu of NSAs.

[30] Moreover, an after-the-fact analysis of data submitted by the Postal Service to the PRC indicates that they are essentially the only meaningful benefit of those early NSAs. U. S. Postal Rate Commission (2008b), Negotiated Service Agreements, pp. 125-130..

VII. Extension of NSAs to Similarly Situated Mailers

A mailer's individual circumstances and terms of an NSA with that mailer could be so different from others as to classify the NSA as "unique."[31] Under such circumstances the Postal Service could have no intention of extending the NSA to any other mailer, and it should be required to so state at the time when the NSA is submitted to the PRC. If the Postal Service is wrong, and similarly-situated mailers do exist, they can self-identify after published notice by the PRC. Conversely, if the Postal Service does not consider the NSA to be unique, it should amend the general tariff or seek a niche classification. Without such a requirement, an NSA could be offered that then would not be available to similarly situated mailers, violating PAEA and principles of fairness, discussed in Section III-B, *supra*.

Rules governing NSAs adopted by the PRC prior to enactment of PAEA implied that the Postal Service would make functionally equivalent NSAs available to similarly situated mailers, PRC Rules 190-198, but PAEA made this a statutory requirement.[32] 39 U.S.C. §3622(c)(10). The new PRC rules are in accord. PRC Rule 3010.40(c). However, no definition of what makes one mailer "similarly situated" to another mailer

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[31] Within the previous dichotomy of classifying each NSA as either (1) baseline, or (2) functionally equivalent, the unique NSA in question clearly would have fallen in the baseline category. At the same time, a truly unique NSA could not have served as the basis for functionally equivalent NSAs, mooting the question of whether other mailers are similarly situated.

[32] A case might be made for "experimental" NSAs that explicitly are intended to be one of a kind, with no intention to extend functionally equivalent NSAs to any other mailers, no matter how similarly situated they may be. However, PAEA makes no provision for this type of NSA, although it does have separate sections relating to experimental and new products, beginning with section 3641.

exists, in either PAEA or any regulation of the PRC (or the Postal Service); hence, it may be appropriate to propose a few common-sense observations to guide such criteria.

First, for any particular baseline NSA, a working definition establishing the elements necessary to be "similarly situated" should be developed at the outset. If "similarly situated" is defined very loosely — *e.g.*, as any First-Class mailer qualifying for presort discounts — that would raise to the forefront immediately a question of whether the substance of the NSA should be a candidate for inclusion in the general tariff structure, and possibly rejected as inappropriate for an NSA because it fails to meet the threshold condition for fairness to other mailers.

Second, suppose that under the circumstance of a particular baseline NSA "similarly situated" is defined loosely, in a way that potentially could include, say, a large minority or even a majority of all mailers using a class or product.[33] That likewise would raise a question of whether the NSA should be considered a strong candidate for a niche classification made available simultaneously to all qualified, similarly-situated

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[33] When many mailers within a class are not considered to be similarly situated, it would be helpful to indicate at the outset the principal characteristics that would cause mailers within the class to be included or excluded from being considered as similarly situated. The basis for the NSA with BAC was a requirement that BAC adopt a number of desirable activities (*e.g.*, use FAST, seamless acceptance and IMBs on all letter mail), all of which BAC was not doing. In other words, as regards these stipulated activities, BAC might be described as a "total laggard," because some of these other activities were already in use by other mailers, with one (the IMB) already announced to be a universal requirement starting some time in 2009. To be similarly situated, must a mailer NOT be doing ANY of the activities, like BAC? That is, does early adoption of such desired activities disqualify a mailer from being similarly situated and entitled to the rewards offered by the BAC NSA? If not, should every bulk mailer — total laggards, those in the vanguard, and others in between — be offered rewards similar to those given to BAC?

mailers. This is required under current Commission rules. *See* Rule 195(a)(1). Even putting aside PAEA's apparent requirement of simultaneous offering, the time and transaction costs required to implement a large number of individual NSAs with similarly-situated mailers seemingly would be prohibitive. Furthermore, failing to extend terms of the NSA to many otherwise qualified mailers seemingly would result in unfair discrimination, and also would deny benefits to both the Postal Service and mailers who, despite being similarly situated, are excluded because of logistical or "practical" considerations. Under these conditions, such NSAs would seem to be far less desirable than a niche classification, and as a matter of sound public policy should not be encouraged.

Third, suppose that, under the circumstances of a particular NSA, the number of mailers defined as similarly situated is comparatively small — *e.g.*, not more than 10 — but from the perspective of their mailing characteristics they are essentially a homogeneous group. Here again the desirability of restraining transaction costs, as well as treating all similarly situated mailers both expeditiously (*i.e.*, simultaneously) and fairly, argues that public policy should favor a niche classification over a series of individual NSAs which likely would be spread over many months or years.

What remains? For a new NSA, the number of similarly-situated mailers should constitute a group that is comparatively small, but with mailing characteristics distinctive enough to warrant individual recognition via NSAs. However, when many mailers within a class or product are not considered to be similarly situated, it would be helpful to indicate at the outset principal characteristics that would cause mailers within the class to be excluded from being considered as similarly situated.

The NSA with Bookspan illustrates the importance of early definition of the scope of similarly situated mailers. Bookspan was offered a discount to promote conversion of Standard Mail flats to Standard Mail letters, because letters were considerably more profitable to the Postal Service; *i.e.*, in the then-existing general tariff structure, flats made a low contribution relative to letters. In support of the NSA, the Postal Service explained that Bookspan falls into a small category of mailers known as continuity shippers, which have "members" who agree to some minimum number of purchases after they "join the club." It was asserted that Bookspan solicitations result in new members, and each new member in turn results in additional mail volume, which is described as a "multiplier effect" from the solicitation mail. The multiplier effect has the potential to be a significant distinguishing characteristic. The Postal Service, however, declined to quantify the multiplier effect, or state how it might be used in some objective way to distinguish similarly situated mailers who might qualify for a functionally equivalent NSA. Without any such qualification, almost every mailer of Standard flats potentially might have qualified as a similarly situated mailer (at least until the PRC re-balanced letter-flat contributions in Docket No. R2006-1), provided only that they would convert some of their flats to a letter format.

VIII. Summary and Conclusions

Proponents of NSAs have asserted that they have a great unfulfilled potential. Such claims, however, have been long on rhetoric and short on specifics. Benefits from those NSAs implemented under the PRA have exhibited rather limited potential. It is interesting to note, as Robinson (2007) points out, that the greatest contribution from NSAs to date has been to reveal and highlight weaknesses in generally available tariffs. If that is the case, then NSAs unintentionally have contributed to improved postal pricing, but whether this is the potential that NSA proponents had in mind seems doubtful.

The review of NSAs by the PRC (2008b) finds that volume increases have been minimal, and cost savings have been limited to acceptance of electronic return information in lieu of physical return of UAA solicitation mail. As indicated above, that source probably could have yielded far greater savings if the Postal Service had made appropriate changes in the general tariffs rather than resort to a few selected NSAs.

The most important caveat pertaining to NSAs for market dominant products under PAEA is, by far, the issue of fairness. As a threshold condition, fairness dictates that the Postal Service should implement changes in rates and classifications **simultaneously** for all eligible mailers, as it historically has done prior to the advent of NSAs. This means that changes in general tariffs and niche classifications take precedence over NSAs wherever there are similarly situated mailers. The burden of proof should be on the Postal Service to show that changes sought in an NSA cannot be offered on the same terms **simultaneousl**y to all similarly-situated mailers, which is only fair.

Nor should the Postal Service bundle and price benefits in arcane ways that appear to deny the appropriateness of niche classifications or changes in tariffs. Using NSAs to deviate from this standard and give preferential treatment to selected mailers has the potential to create considerable mischief, most especially in any sector where mailers compete head-to-head.

To sum up, giving one or more mailers an NSA with favorable provisions, while failing to extend those terms **simultaneously** to competitors, can give the mailer(s) with the NSA an unfair competitive advantage. Almost by definition, that creates a non-level playing field for an unspecified period of time, which is likely to cause harm to the marketplace.

APPENDIX: OVERVIEW OF PROPOSED NSA's
(Baseline NSAs bolded)

Party (Docket #)	Date Initiated	Decision	Expire Date	New Volume	Cost Savings	Increased Contrib. from Conversion
Capital One* (MC2002-2)	9/19/02	5/15/03	9/1/06 (expired)	Yes	UAA/shift from physical return to ACS	No; new First-Class volume only
Bank One (MC2004-3)	6/21/04	12/17/04	4/1/08	No	UAA/shift from physical return to ACS	Yes; Standard to First-Class
Discover (MC2004-4)	6/21/04	9/30/04	1/1/08 (expired)	No	UAA/shift from physical return to ACS	Yes; Standard to First-Class
HSBC* (MC2005-2)	2/23/05	5/20/05	1/1/09	No	UAA/shift from physical return to ACS	Yes; Standard to First-Class
Bookspan (MC2005-3)	7/14/05	5/10/06	6/1/09	No	Flats to Letters	Yes; Std flats to Std letters; multiplier
WMB (MC2006-3)	3/29/06	With-drawn	---	No (less volume)	UAA/ACS – not relied on	Yes; Standard to First-Class
Capital One Extension (MC2006-6)	7/26/06	8/25/06	9/1/07 (expired)	See above	See above	See above
BAC (MC2007-1)	2/7/07	10/19/07	4/1/11	No		
Bradford (MC2007-4)	8/3/07	Pending	3-year term	Yes	None	
Lifeline (MC2007-5)	8/8/07	Pending	3-year term	Yes	None	

* No discount received in FY 2007. See U.S. PRC (2008b), p. 126.

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