

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

RATE AND SERVICE CHANGES TO IMPLEMENT)
BASELINE NEGOTIATED SERVICE AGREEMENT) Docket No. MC2007-1
WITH BANK OF AMERICA CORPORATION)

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
RESPONSE TO NOTICE OF INQUIRY NO. 1
(April 17, 2007)

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc.

(hereinafter "Valpak") hereby respond to the Commission's Notice of Inquiry ("NOI") No. 1.

That NOI invited interested participants:

to comment on the methods of establishing baselines in longer term (three years in this instance) pay-for-performance agreements where actual mailer information is unavailable. Specific comments are encouraged which discuss the need to incorporate adjustment mechanisms, and the benefits or detriments of incorporating the approach outlined in the example above compared with an approach that solely utilizes system-wide averages. [NOI No. 1, pp. 2-3.]

To fully respond to the issues raised by this NOI, these comments are organized as follows.

First, we discuss criteria that might be used to evaluate the appropriateness of using any system-wide average — in this instance, the system-wide average accept rate — as a baseline in pay-for-performance agreements.

Second, we address the related issue of how baselines might be established when mailer-specific information is available.

Third, we discuss the questions of whether any baseline can be considered appropriate in the absence of mailer-specific information, and whether it is premature to consider an NSA that relies solely on the system-wide average for the baseline.

Fourth, we discuss possible adjustment mechanisms when an NSA is initiated in the absence of any mailer-specific information.

A. CRITERIA FOR EVALUATING THE APPROPRIATENESS OF USING SYSTEM-WIDE AVERAGES FOR BASELINES IN PAY-FOR-PERFORMANCE CONTRACTS

Before accepting any system-wide average for use as a baseline in a pay-for-performance contract, the Commission should address at least the following three critical questions and satisfy itself that the proposed baseline is appropriate.

1. How good are the data both (i) upon collection and (ii) after any cleaning or scrubbing?

The Commission's recent experience with MODS data indicate that Postal Service data bases may not be usable for certain types of analysis, to say nothing of their use as a baseline in a pay-for performance contract.¹ At a minimum, the data that underlie the system-wide average, which is proposed as a baseline in this docket, need to be inspected to ascertain whether they contain, and are contaminated by, any outliers. Simply because the data were submitted as part of a library reference in a prior case does not mean that they have received any kind of meaningful scrutiny and been found valid, inasmuch as those particular data did not play any critical role in setting rates as they would be used here as a baseline for proposed incentive payments. They come with no presumption of validity. Reliable measures of

¹ See Docket No. R2006-1, *Op. & Rec. Dec.*, App. J, ¶ 7, p.3.

statistical variation should be presented on the record of an NSA. This would establish a range within which Bank of America Corporation's ("BAC") accept rate could be expected to fall. Also, the current baseline then could be compared more meaningfully with subsequent updates; for further discussion about updates, *see* section 3, *infra*.

2. How current are the data underlying the system-wide average?

In the case at hand, the system-wide average is based on data collected in 1999. This means the proposed baseline is constructed from data that will be eight years old when the NSA begins, and 10 years old by the time the NSA terminates. Moreover, if the same system-wide average is used as a baseline for similarly situated mailers in any subsequent pay-for-performance NSAs, then the data will be progressively older in each subsequent NSA, an important factor which the Commission needs to consider at this juncture.

As the Postal Service explains in the response to VP/USPS-T1-9, the accept rate is subject to a number of influences, (a) some of which are under the mailer's control, and (b) some of which are solely under control of the Postal Service. Since 1999, the Postal Service has deployed MERLIN and some (unknown) number of later-model sorting machines, which may have fewer rejects and a higher accept rate than older equipment. These equipment deployments by the Postal Service hopefully have increased the accept rate over that recorded in 1999. If true, this could mean that well over half of all letter mailings now may exceed the 1999 system-wide average. Further, to the extent that the system-wide average accept rate is now higher than it was in 1999 because of the Postal Service's deployment of more recent equipment (which all mailers helped pay for), it is not clear why incentive payments should go

only to those mailers who (i) are selected to receive a pay-for-performance NSA, and (ii) have an accept rate that merely is higher than a system-wide average that is almost a decade old.

3. What plans exist for updating the data used to compute any system-wide average used as a baseline?

In this docket, the only estimate of the system-wide accept rate that has been presented is based on 1999 data. With a single point estimate for only one year, it is impossible to discern whether the trend underlying the accept rate has been stable or improving gradually. The total lack of any such information clearly puts the Commission at a disadvantage.

If any system-wide average is to be used as a baseline in a pay-for-performance contract, a plan needs to be in place for updating the data and the average at regular intervals. This is especially important when, as here, the NSA gives a major mailer an incentive to improve its own performance (*i.e.*, accept rate). Indeed, a regular update of information critical to rate-making has been standard practice in omnibus rate cases.

To the extent that the NSA is successful, and BAC materially improves the accept rate for its letter mail, that alone will increase the system-wide average by some small, but perceptible amount. BAC is, after all, a major originator of letter mail. A series of successful pay-for-performance NSAs with several of the largest letter mailers would, collectively, be expected to have a significant effect on the system-wide average. Unless the Commission is prepared to accept a baseline that it knows does not reflect then-current reality, it must insist on a plan to update the baseline at regular intervals.

Contemplating that pay-for-performance NSAs, such as the one proposed in this docket, will indeed be likely to increase the system-wide average, means the baseline will become a

“moving target” for subsequent NSAs. In other words, those mailers that are at the head of the line and are first in line to receive a pay-for-performance NSA will have a lower baseline than those who come later — unless, of course, the Postal Service makes no effort to collect new data and update the existing 1999 baseline.

B. ESTABLISHMENT OF BASELINES WHEN MAILER-SPECIFIC INFORMATION IS AVAILABLE

Widespread use of the 4-state barcode, sometimes referred to as the Intelligent Mail Barcode (“IMB”), along with deployment of IMB readers throughout the postal network, should make the development of mailer-specific information a distinct possibility in the near future. Once that time arrives, use of the IMB for at least one, and possibly two, years should be made a threshold requirement in order for any mailer to be considered a candidate for a pay-for-performance NSA, such as the one proposed in this docket — *i.e.*, a mailer that elects **not** to use the IMB on its letter mail for the required period of time should **not** be considered a candidate for a pay-for-performance NSA, such as the one proposed in this docket. The fact that the technology for determining mailer-specific accept rates was not in place when this contract was negotiated should not cause this NSA to become precedent for a series of NSAs based on “no mailer-specific information available.”

For those mailers that elect to use the IMB, and for which mailer-specific information then would be available, two possibilities present themselves: (1) the mailer’s initial accept rate is **less than or equal to** the system-wide average, or (2) the mailer’s initial accept rate is

greater than the system-wide average.² Under the condition where both the system-wide average and mailer-specific accept rates are known, the appropriate baseline should be either (a) the system-wide average, or (b) the mailer-specific accept rate, **whichever is greater**.

Adoption of the preceding baseline would mean that, for any mailer below the system-wide average, performance would need to reach the system-wide average before any sort of reward mechanism could take effect. In other words, no mailer would receive any kind of reward by virtue of starting below the system-wide average and merely coming up to the system-wide average. Incentives for any such mailers would become effective only after their performance began to exceed the system-wide average. Unless some procedure such as this is followed, the Postal Service could find itself in the position of giving the largest rewards, via similar NSAs, to those mailers whose performance historically has been among the worst; *i.e.*, the mailers who have had the lowest accept rate.

For a mailer whose performance already is known to be above the system-wide average, further improvement over the mailer's own average would be necessary before any incentives took effect. Under this arrangement, the mailer would indeed be paid for improved performance. It also might be useful to consider special bonuses for achieving specific thresholds, such as accept rates of 99.5, 99.7, and 99.9 percent, which are high by any standard. However, a word of caution is in order. Mailers might be tempted to "game" any such system by holding back on performance enhancing moves until they receive a pay-for-

² This discussion presumes that the data from which the system-wide average is computed are deemed sufficiently accurate and current for it to be considered an acceptable baseline; *see* Section A, *supra*, for more discussion of this issue.

performance NSA. This clearly would be an unintended consequence. To the extent that such unintended consequences were to occur, the existence of pay-for-performance NSAs could be counterproductive. The prospect of mailers gaming the system is another reason for requiring that mailers using the IMB have at least one, and possibly two, years of mailer-specific data before entering into negotiations for an NSA.

C. IN THE ABSENCE OF MAILER SPECIFIC INFORMATION, IT IS PREMATURE TO CONSIDER AN NSA THAT USES THE SYSTEM-WIDE AVERAGE AS A BASELINE

One of the oft-asserted advantages of NSAs is that they represent an opportunity to tailor terms of any agreement to fit an individual mailer's specific situation. The response to VP/USPS-T1-1 notes, for instance, that "In general, however, customers who have complex mail operations are all different to some degree...." With the understanding that such differences inevitably and invariably exist, use of any system-wide average as a proxy for mailer-specific information always should be considered suspect, and should be carefully, explicitly, and fully-justified before proceeding. NSAs admittedly put a heavy informational demand on an organization that is accustomed to running on system-wide averages. The fact that the system-wide averages constitute the only available data should not, in general, suffice for NSAs.

In the particular case at hand, it would appear that many mailers, including BAC, are on the threshold of being able to know their individual accept rates. Indeed, it would not be feasible for the Postal Service or the Commission even to consider implementation of this NSA without the ability to measure BAC's individual accept rate after the NSA becomes effective. In other words, accurate determination of the accept rate for BAC's own mail must represent a

technological achievement essentially at hand, or it would not be possible to evaluate whether (i) BAC's performance in the first instance (*e.g.*, the first year) has exceeded the system-wide average, or (ii) in subsequent years, BAC's performance has improved over the first year.

Once the technology is in place for determining mailer-specific data, the proposed NSA with BAC should not become a precedent for NSAs that fail to incorporate pertinent mailer-specific information which either will be, or could be, available.

D. POSSIBLE ADJUSTMENT MECHANISMS WHEN AN NSA IS BE INITIATED IN THE ABSENCE OF ANY MAILER-SPECIFIC INFORMATION

As noted previously, BAC and the Postal Service can expect to start accumulating data on the accept rate for BAC's letter mail immediately upon implementation. The immediate use of these mailer-specific accept rate data will be to determine whether BAC is owed any credits under the agreement. Going beyond that immediate use, NOI No. 1 asks whether the accumulated new information also should be used in years 2 and 3 to make any adjustments to the baseline.

The Commission has a long history of considering and incorporating the most recent data into its decisions. In this instance, where (i) the baseline is derived from system-wide data that possibly are out of date and possibly understate the system-wide accept rate, and (ii) the Postal Service apparently is not currently collecting any system-wide data that will be more recent than the 1999 data, it would seem especially appropriate to develop and incorporate some mechanism for adjusting the baseline in years 2 and 3, based on new mailer-specific (*i.e.*, BAC) information as it becomes available.

NOI No. 1 discusses possible adjustments which are symmetrical in the sense that they might adjust the baseline (i) downwards, to a lower accept rate if BAC's mail is below the system-wide average, or (ii) upwards, to a higher level, if BAC's mail is above the system-wide average. Inasmuch as BAC has agreed to pioneer this first pay-for-performance NSA, such symmetry in any adjustment of the baseline would seem to be fair to BAC. However, this symmetry in adjusting the reward structure for BAC does not alter the fact that the Postal Service faces an asymmetrical situation; *i.e.*, it does not at this time have any way to impose higher charges on mail that has a below-average accept rate. It only can reward those mailers who agree to improve their accept rates over some baseline.

The issue of second and third year adjustments to the baseline may operate differently, depending on whether average or mailer-specific information is used at the outset. If no mailer-specific information is available, as in this NSA, the result will be to reward those mailers who agree to improve their accept rate over the system-wide average, and the first year incentives may be disproportionate to any benefit the Postal Service receives, as NOI No. 1 recognizes. Certainly pay-for-performance NSAs should contain no motivation to continue disproportionate benefits in future years. If at the outset benefits are based solely on mailer-specific information, mailers who are most likely to want such an NSA are those with the worst accept rates. The effect would be to give the largest pay-for-performance rewards to those mailers who previously have not invested in achieving high accept rates, while giving small or no rewards for those mailers who previously have made such investment and achieved the highest accept rates. Such an outcome would not seem fair to those who have striven to get their accept rates up without any special incentive. And, it could serve as a disincentive for

mailers with below-average accept rates to invest without the inducement of a pay-for-performance NSA. The Commission needs to consider carefully the longer-term consequences of such NSAs, and not motivate mailers with the worst accept rates to delay improvements to their mail in the hope that they can be rewarded later for their failure to invest.

Respectfully submitted,

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