

BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

Rate and Service Changes to Implement )  
Baseline Negotiated Service Agreement ) Docket No. MC2007-1  
With Bank of America Corporation )

**COMMENTS OF BANK OF AMERICA CORPORATION  
IN RESPONSE TO NOTICE OF INQUIRY NO. 1  
(April 17, 2007)**

Bank of America Corporation (“BAC”) respectfully submits these comments in response to Notice of Inquiry No. 1, issued by the Postal Regulatory Commission (“the Commission”) on April 3, 2007 (“NOI 1” or “Notice”).

**INTRODUCTION AND SUMMARY**

Four months ago, Congress enacted the Postal Accountability and Enforcement Act (“PAEA”), in part to provide the Postal Service greater flexibility to reduce its prices “in the manner that they deem most appropriate to meet their needs and the needs of the mailing public.”<sup>1</sup> Somewhat surprisingly, the Commission now seeks comment on a method to *restrict* the Postal Service’s downward pricing flexibility in a Negotiated Service Agreement (“NSA”), a pricing arrangement specifically encouraged under the new law,<sup>2</sup> by limiting the discounts that the Postal Service may offer its NSA partner for making its barcodes more legible.

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<sup>1</sup> Docket No. RM2007-1, Letter from the Hon. Susan M. Collins and Thomas R. Carper to the Hon. Dan C. Blair (April 6, 2007) at 2.

<sup>2</sup> 39 U.S.C. § 3622(c)(10).

The Commission's concern involves the performance baselines for discounts proposed by BAC and the Postal Service for improvements in the rate/accept rates of the barcodes on BAC's letter-shaped First-Class and Standard Mail. Because neither BAC nor the Postal Service knows the actual level of BAC's current (i.e., Before Rates) read/accept rates, the NSA proponents have relied instead on system-average read/accept rates, weighted to reflect BAC's actual mail mix. This, the Commission suggests, may be problematic: if BAC's company-specific read/accept rates are already above the system-wide average, BAC could receive discounts without improving its actual read/accept rate. Conversely, if BAC's read/accept rates are *below* the system-wide average, a read/accept benchmark based on system-wide average data could raise the bar for improvement so high as to deter BAC from even attempting to improve its read accept/rates. NOI 1 at 1-2.

To mitigate these perceived risks, the Commission proposes to adjust the baseline after the first and second year of the NSA to give greater weight to "actual Bank of America-specific data." Specifically:

- At the end of the first year of the NSA, the read/accept benchmark would be adjusted by averaging the system-average benchmark with BAC's *actual* read/accept performance during the first year of the NSA. The resulting value would serve as the benchmark for discounts based on read/accept performance for the second year of the NSA.
- At the end of the second year, the read/accept benchmark would be adjusted by averaging the second-year benchmark with BAC's *actual* read/accept performance during the second year. The resulting value would serve as the

benchmark for discounts based on read/accept performance for the third year of the NSA.

*Id.* at 2. The effect of these adjustments would be to move the performance threshold for discounts up (or down) each year by giving less weight to the original Before Rates performance data, and more weight to After Rates data, in each successive year:

	Year 1	Year 2	Year 3
System-average Before Rates performance	100%	50%	25%
Year 1 BAC After Rates performance		50%	25%
Year 2 BAC After Rates performance			50%

BAC is pleased to provide this response to NOI 1. We believe that the issues it raises are fundamental to this case, and to NSAs and postal ratemaking generally. For this reason, we wish to reply to the notice fully and candidly. Unfortunately, for the reasons explained below, we believe that the proposed adjustment mechanism would be an unlawful and counterproductive solution to a nonexistent problem.

(1) First, the proposed adjustment is inconsistent with the PAEA, which mandates light-handed regulation of downward rate adjustments. When the ratemaking standards of PAEA take effect late this year or early 2008, any inconsistent pricing rules will become dead law. Developing new restrictions on NSA discounts at this point is not only inconsistent with the spirit of PAEA but a misallocation of resources that could be spent more usefully implementing the new law.

(2) Second, and in any event, the Commission's reluctance to rely on system average data as a proxy for BAC-specific read/accept rates is at odds with even traditional regulatory norms. The Commission, like other regulators, routinely relies on

system-average data when appropriate customer-specific data are unavailable. The testimony and discovery responses submitted by the NSA co-proponents make clear that the use of system-average data is entirely appropriate here. BAC-specific read/accept rate data do not exist. Remedying the omission with a special study based on Four-State Barcodes almost certainly would generate allegations that BAC had gamed the results by degrading its barcode quality during the study. Moreover, there is no reason to believe that BAC's current read/accept rates are higher than the industry average. BAC uses the same handful of third-party vendors to barcode its mail as do other large mailers. Moreover, the Commission has chosen to use the *same* underlying system-average data at issue here to estimate the mail processing cost savings from worksharing—cost avoidances that are used to establish worksharing discounts for all mailers, regardless of how much their customer-specific costs vary from system average costs.

(3) The below-100 percent passthroughs for the read/accept rate discounts, and the absence of any separate discounts for other cost-saving features of the NSA provide an additional margin of safety. BAC has committed to process changes that should reduce the volume of PKR (“personal knowledge required”) mail, as well as BAC Courtesy Reply Mail, Business Reply Mail and Qualified Business Reply Mail. The NSA offers BAC no discount for these improvements. The large positive net contribution from these ancillary performance obligations should make the NSA contribution-positive for BAC even if its read/rate improvement were barely half as large as the system-average baseline data suggest.

(4) By contract, the alternative methodology proposed in NOI 1 would not produce meaningful baseline estimates. Averaging system-average data with customer-specific After Rates data would produce meaningless results. Furthermore, by reducing the incremental incentives available to NSA partners, the adjustment proposed by the Postal Service would severely reduce (or even eliminate) the contribution that the Postal Service could otherwise expect to gain from cost-saving NSAs.

## **ARGUMENT**

### **I. THE PROPOSED BASELINE ADJUSTMENT WOULD CONTRAVENE THE POSTAL ACCOUNTABILITY AND ENFORCEMENT ACT OF 2006.**

The most obvious question about the proposed baseline adjustment is why the Commission is proposing it now, after the enactment of PAEA. The proposed adjustment mechanism would restrict the Postal Service's downward pricing flexibility by replacing the bargained-for allocation of NSA cost savings with a different allocation that the Commission thinks will make more money for the Postal Service. One of the central purposes of PAEA, however, is to *expand* the Postal Service's flexibility to reduce its rates when it determines that competition or other circumstances so warrant, and to limit the Commission's authority to override these decisions. As Senators Carper and Collins, the co-authors of PAEA, recently wrote to the Commission:

So long as a rate change put forward by the Postal Service is within the Consumer Price Index cap, it was our intention that the Postal Service should have significant flexibility to price their products in the manner that they deem most appropriate to meet their needs and the needs of the mailing public.

Docket No. RM2007-1, Letter from the Hon. Susan M. Collins and Thomas R. Carper to the Hon. Dan C. Blair (April 6, 2007) at 2.

PAEA gives effect to this policy in multiple ways. The centerpiece of ratemaking for market dominant products is the CPI-based rate cap established by 39 U.S.C. § 3622(d). The rate cap is a ceiling, not a floor: Section 3622(d) clearly contemplates that the Postal Service will selectively hold individual rates below the CPI-based cap. See *id.*, §§ 3622(d)(1)(D) (the Postal Service may adjust rates “not in excess of” the annual limitation); 3622(d)(2)(A) (providing that the rate cap applies at the class level, and that rate changes within a class may vary up or down from the class average).

Section 3622(c)(10) authorizes NSAs (“special classifications for both postal users and the Postal Section . . . including agreements between the Postal Service and postal users, when available on public and reasonable terms to similarly situated mailers”). An agreement that “enhance[s] the performance of mail preparation, processing, transportation, or other functions” is not required to increase the “overall contribution” of the mail “to the institutional costs of the Postal Service.” *Id.*, § 3622(c)(10)(A). Moreover, nothing in Sections 3622(c) or (d)—or any other provision of PAEA—conditions the right to make selective rate reductions, or to establish discounts through NSAs, on the use of mailer-specific data, or on a showing that the data used are perfectly certain or free from error.

Finally, Section 3622(d)(1)(C) expressly authorizes the Postal Service to implement rate changes, including rate changes resulting from NSAs under Section 3622(c)(10), on 45 days notice. Commission review of proposed rate changes during the 45-day period is limited: “The 45-day notice period that the Act gives the

Commission to review the rate filing is largely intended to be used to determine whether or not a rate filing is within the rate cap.”<sup>3</sup>

The result of these provisions is that, as soon as the new ratemaking standards of PAEA take effect, the elaborate and costly advance review process imposed on NSA proponents by the existing rules will be history. Although NSAs and other rate discounts in theory could be challenged after the fact by the Commission under the annual review mechanism of Section 3653 or by private parties under the complaint mechanism of Section 3662, PAEA clearly contemplates that the scope of such review will be limited.

The ratemaking standards established by PAEA will not take effect until PRC promulgates implementing rules later this year or early next year.<sup>4</sup> But it would be gratuitous and irrational to establish additional restrictions on NSA pricing during this transition that were clearly at odds with the substantive standards of PAEA, and which would soon terminate by operation of law in any event. See 39 U.S.C. § 3622(f) (establishing one-year transition period ending on December 20, 2008). Just as the Commission refrained from tinkering with rate design for competitive products in R2006-1 out of deference to the coming of the new regime,<sup>5</sup> so too should it not tinker with this NSA. Instead, the Commission should focus its resources on hastening the birth of the new regulatory order—not on prolonging the final throes of the old.

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<sup>3</sup> Letter from Senators Collins and Carper, *supra*, at 2.

<sup>4</sup> Section 3622(a) directs the Commission to establish rules implementing Section 3622 within 18 months after enactment of PAEA. PRC Chairman Blair has indicated a desire for the Commission to issue implementing rules sooner than that – and possibly by this October. See Statement of the Hon. Dan G. Blair at Postal Summit Meeting in Potomac, Maryland (March 13, 2007), Tr. 11.

<sup>5</sup> R2006-1 PRC Op. & Rec. Decis. at iv.

**II. THE PROPOSED BASELINE ADJUSTMENT WOULD BE AN ARBITRARY AND UNJUSTIFIED DEPARTURE FROM THE COMMISSION'S LONG POLICY OF RELYING ON SYSTEM-AVERAGE DATA WHEN MORE SPECIFIC DATA ARE UNAVAILABLE.**

The proposed baseline adjustment mechanism would be perplexing even if PAEA had never become law. Reliance on system-average data when more specific data are unavailable has been a policy of the Commission and other regulatory bodies since the dawn of common carrier rate regulation. Far from being suspect, such reliance is essential to the orderly operation of a regulatory system at a reasonable cost. Moreover, the testimony and discovery responses in this case make clear that the system-average data relied on by BAC and the Postal Service to establish baseline read/accept rates are the best available, and that the additional contribution generated by other provisions of the NSA provide a conservative margin of safety against the risk that BAC's actual Before Rates read/accept performance is better than the system average.

**A. Reliance On System-Average Data Is Entirely Appropriate When More Specific Data Are Unavailable.**

Perfectly accurate data are rare in postal ratemaking. The Commission, like other regulatory commissions, routinely uses estimates, proxies and surrogate data for key input values:

The Service makes projections about its costs and revenue that may or may not come to pass; projections are no more than educated guesses. The use of projections for future costs and revenues necessarily will involve some imprecision when actual data become available.

*United Parcel Service, Inc. v. USPS*, 184 F.3d 827, 834 (D.C. Cir. 1999). The use of such approximations and surrogate data is clearly appropriate despite their inherent

potential for error. *Capital One NSA*, MC2002-2 PRC Op. & Rec. Decis. ¶ 6019 (citing *National Association of Greeting Card Publishers v. USPS*, 569 F.2d 570, 591 (D.C. Cir. 1976)). In particular, regulatory commissions routinely rely on system-average or other aggregated data as surrogates for the cost, volume, demand elasticity or other relevant characteristic of an individual ratepayer, service, or segment of a regulated network. See, e.g., *GS Roofing Products Co. v. Surface Transportation Board*, 262 F.3d 767, 776 (8<sup>th</sup> Cir. 2001) (upholding use of system-wide costs as a proxy for the costs of the specific line at issue in a railroad abandonment case); *Burlington Northern R. Co. v. ICC*, 985 F.2d 589, 600-601 (D.C. Cir. 1993) (upholding the use of “generic system costs instead of movement-specific costs” in adjudicating the reasonableness of rates on particular shipments of wheat and barley).

Worksharing discounts are no exception to this practice. As the Commission recently found in Docket No. R2006-1, the costs avoided by mailer worksharing can vary widely from mailer to mailer because of “diverse mailer populations” and “heterogeneous mail characteristics.” R2006-1 PRC Op. & Rec. Decis. ¶ 5081. Accordingly, basing worksharing discounts on system-wide average cost avoidances for a particular class can lead to the same kinds of distortions noted by the Commission here. Cf. NOI 1 at 2. In Docket No. R2006-1, however, neither the Commission nor any economic witness appearing before the Commission suggested that the Commission abandon system average data in favor of mailer-specific cost avoidances. See R2006-1 PRC Op. & Rec. Decis. at ¶ 5079-5109.

The same is true in NSA cases. While the Commission understandably prefers to use mailer-specific cost and elasticity data, the Commission’s own NSA rules

specifically authorize the use of system-average values when relevant mailer-specific data are unavailable:

If mailer-specific costs or elasticity factors are not available, the bases of the costs or elasticity factors that are proposed shall be provided, including a discussion of the suitability of the proposed costs or elasticity factors as a proxy for mailer-specific costs or elasticity factors.

Rule 193(e), 39 C.F.R. § 3001.193(e).

The Commission has adhered to these principles in individual NSA cases. In *Capital One*, for example, the Commission held that, in the absence of customer-specific data, the NSA proponents could properly rely on system average cost data on the costs avoided by waiver of physical return of the mailers' undeliverable First-Class Mail. MC2002-2 PRC Op. & Rec. Decis. ¶¶ 6011-6019, 8031. Moreover, the Commission reached this result *even though the record indicated that system average data overstated the actual savings to the Postal Service* from waiver of physical return of *Capital One's* UAA mail. See also *id.* at ¶ 6053 (relying on system-average data on anticipated savings from ACS provisions of NSA).

Similarly, in the *Discover* NSA case, the Commission accepted the co-proponents' use of a generic ACS success rate value of 85 percent in lieu of a value based on *Discover*-specific data. The Commission found "unconvincing arguments that the ACS success rate will vary from the estimate used by the Postal Service enough to significantly affect the savings. The 85 percent rate used in the baseline docket [*Capital One*] has not been discredited to justify deviating from the precedent." MC2004-4 Op. & Rec. Decis. at 29.<sup>6</sup>

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<sup>6</sup> Similarly, the "Panzar formula" proposed by the Commission in Docket No. MC2004-3 as an alternative to a cost-savings in future cases was designed to use "inputs already

**B. The System-Average Data Used To Set The Baseline Read/Accept Rates For The Proposed NSA Are The Most Accurate Before Rates Data Available.**

The NSA proponents' use of system-average data as a proxy for BAC's actual Before Rates performance is fully consistent with the authorities cited above. In negotiating the baseline values for rate discounts, BAC and the Postal Service carefully considered what source of data to use for each relevant baseline. When BAC-specific data exist, the parties agreed to use them—even when BAC's actual specific performance is better than the system average and the use of BAC-specific baselines therefore reduces the expected financial value of the deal to BAC.<sup>7</sup>

BAC-specific data on the company's existing performance are unavailable, however, for the baseline read/accept rates specified in Section IV.C.2 and IV.F.2 of the NSA. BAC does not use Four-State Barcodes<sup>8</sup> on letter-rated First-Class Mail or Standard Mail.<sup>9</sup> The barcode now used on BAC mail, the Postnet barcode, does not have fields for information that would identify the mailer of the mailpiece. For this reason, it is not possible for the Postal Service to measure or calculate company-specific read/accept rates using the Postnet barcode. (BAC verified this fact with independent industry experts as well as the Postal Service.)

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used in rate cases, thus ameliorating the difficulties inherent in litigating the accuracy of mailer-specific volume forecasts before the Commission.” MC2004-3 PRC Op. & Further Rec. Decis. (April 21, 2006) at ¶ 5011.

<sup>7</sup> See, e.g., Jones Direct (BAC-T-1) at 17 (baseline forwarding rate for First-Class Mail); Jones answer to OCA/BAC-T1-1 (same); Ayub answer to OCA/USPS-T1-2(b) (same); Ayub answer to OCA/USPS-T1-34 (baseline return rates for First-Class Mail).

<sup>8</sup> The Postal Service also describes Four-State Barcodes as “Intelligent Mail Barcodes” or “IMB”. BAC, like the Postal Service, will use the terms interchangeably herein.

<sup>9</sup> Answer of USPS witness Jones to OCA/BAC-T1-4.

The parties considered the feasibility of deriving a BAC-specific baseline read/accept value by performing a special study of Postnet or Four-State Barcodes placed on a limited sample of BAC mail. This alternative was unacceptable, however, not only because of its expense, but also because such a special study would have involved moral hazard: BAC would have had an incentive to degrade the legibility of the addresses and barcodes in the study to produce an artificially (but profitably) low baseline value.

BAC and the Postal Service also considered whether any inferences could be drawn from any other source about whether BAC's current company-specific read/accept rates are better or worse than system-wide values. Both parties concluded that no such inference was warranted in either direction. The BAC mailpieces that would be the subject of the proposed NSA have their addresses and barcodes printed by major third-party vendors. The same vendors also print the addresses and barcodes for many other banks, financial institutions and other large originators of bulk prebarcoded letter-shaped mail. Accordingly, there is no reason to believe that the read/accept rates of BAC's addresses and barcodes differ substantially from the system average.<sup>10</sup>

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<sup>10</sup> *Accord*, Ayub Direct (USPS-T-1) at 16; Response of USPS witness Ayub to VP/USPS-T1-17(a). NOI 1 speculates that BAC's read/accept rates may already be higher than the system average because BAC "is already required to meet significant mail preparation requirements, and in addition has employed its Six Sigma system to address problems such as address hygiene." NOI 1 at 1. For address and barcode legibility, however, BAC's mail preparation requirements are no different than those imposed on other large originators of bulk letter-shaped mail. Moreover, BAC has not undertaken any Six Sigma analysis of potential methods for improving read/accept rates—and does not plan to do so before the NSA is approved.

Moreover, the systemwide data on read/accept rates used to set the baselines values in the present NSA are the *very same* data used by the Commission to estimate cost avoidances for First-Class and Standard Regular Mail letters in Docket Nos. R2006-1 and three previous omnibus rate cases: R2000-1, R2001-1 and R2005-1.<sup>11</sup> To accept these data as sufficiently reliable for determining worksharing-related cost avoidances, but insufficiently precise for an individual NSA, would be illogical and internally inconsistent.<sup>12</sup>

For all of these reasons, BAC and the Postal Service concluded that the best available evidence of BAC's current actual read/accept rates are the Postal Service's system-average data, weighted for BAC's company specific mail mix.<sup>13</sup>

The reasonableness of this approach has subsequently been confirmed by the results of a subsequent pilot test of Four-State Barcodes that the Postal Service is conducting with three other business mailers. The weighted average scan rate produced by the pilot test—97.14 percent—is only slightly higher than the 96.8 percent and 96.9 percent baseline values for read/accept rates used in the proposed NSA.<sup>14</sup>

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<sup>11</sup> See answers of USPS witness Ayub to APWU/USPS-T1-2, OCA/USPS-T1-6, and OCA/USPS-T1-7.

<sup>12</sup> The same facts also dispose of any claim that the data are stale. As noted above, the same data on baseline read/accept rates at issue here have been relied on to set worksharing cost avoidances in every omnibus rate case since R2000-1. Parties have been free to challenge the data in each such case. No participant has submitted evidence that current read/accept rates differ significantly from those estimates.

<sup>13</sup> See answers of USPS witness Ayub to OCA/USPS-T1-7 through T1-9, T1-24, and T1-25; and Valpak/USPS-T1-8(a).

<sup>14</sup> Response of USPS witness Ayub to OCA/USPS-T1-36(b). The Postal Service has obtained higher read/accept rates for move validation letter mailings to USPS employees. *Id.* The Postal Service's longer and more extensive experience with the Four-State Barcode and associated equipment, however, makes the Postal Service's

**C. The Likely Contribution From Other Components Of The NSA Provides An Additional Margin Of Safety.**

Any residual risk from this approach is mitigated by the requirement that BAC engage in several major cost-saving activities without separate compensation from the Postal Service.<sup>15</sup> In particular, (1) the address quality improvements needed to improve BAC's UAA rates are also likely to reduce the volume of PKR ("personal knowledge required") mail as well; and (2) the barcodes that BAC has agreed to place on the Business Reply Mail, Qualified Business Reply Mail and Courtesy Reply Mail envelopes sent to BAC customers is likely to result in improved read/accept rates of those envelopes when mailed back to the bank. The NSA offers BAC discounts for neither set of improvements. This conservatism provides an additional margin of safety for potential error in the baseline read/accept rates.

These additional cost savings are relevant because the Commission must consider the profitability of NSA as a whole, rather than focus on any one discount term in isolation. The only "association" required between the discounts received by the mailer and the benefits received by the Postal Service is that the *aggregate* benefits of all kind received by the Postal Service under the NSA must exceed the *aggregate* costs incurred by the Service in return. See MC2002-2 Op. & Rec. Decis. at ¶¶ 3058, 8006, 8010 (holding that the relevant dimension of profitability is the overall profitability of the NSA as a whole, not any individual component); Order No. 1391, *Negotiated Service*

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internal mailings a less apt measure for the baseline read/accept rates of actual mailers than does the three-mailer pilot study.

<sup>15</sup> See answer of USPS witness Ayub to OCA/USPS-T1-4(a) at 3 and OCA/USPS-T1-47.

*Agreements*, 69 Fed. Reg. 7574, 7577-78, 7580 (2004) (same); MC2004-4 Op. & Rec. Decis. at 52 (same).<sup>16</sup> We discuss each item in turn.

#### **1. Absence of discounts for reductions in PKR mail.**

The NSA will also provide value to the Postal Service by reducing the quantity of “Personal Knowledge Required” (or “PKR”) mail. PKR mail is mail with a defect in its address that requires manual intervention by a Postal Service employee with personal knowledge of the local delivery address (typically the delivery carrier or other Postal Service employee at the delivery unit) to complete delivery. PKR mail typically has an address element that is incomplete, incorrect, illegible, or inconsistent with the mailer-applied POSTNET delivery point barcode on the mailpiece. A common PKR error is the omission of an apartment number on a mailpiece when the apartment number (e.g., in a large high-rise building) is needed for delivery. See R2006-1 USPS-LR-L-61 at 4. Knowledgeable local postal employees manage to deliver PKR mail by redirecting it to another address on the same delivery route, or to an address on another delivery route within the same delivery station.<sup>17</sup>

The same address correction processes that BAC will use to reduce UAA rates will also reduce PKR rates. BAC and the Postal Service were unable to agree during negotiations on (1) a baseline PKR value or (2) a method for measuring improvements against the baseline. Nevertheless, the parties agree that PKR mail imposes

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<sup>16</sup> As noted above, 39 U.S.C. § 3622(c)(10)(A)(ii) provides that an NSA which “enhance[s] the performance of mail preparation, processing, transportation, or other functions” need not be contribution-positive.

<sup>17</sup> Mail that is redirected to another delivery station because of a defective address is classified as UAA mail, not PKR mail.

substantial costs on the Postal Service, and that a reduction in BAC PKR mail would provide the Postal Service with significant savings. If BAC PKR rates equal to system-average PKR rates by class, than BAC mail currently imposes over \$2 million annually on the Postal Service in PKR costs. See Exhibit 1, *infra*. Hence, improvements in address quality that reduced BAC PKR mail by ten percent would save the Postal Service an additional \$200,000 per year. Improvements that reduced BAC PKR mail by 50 percent would save the Postal Service an additional \$1,000,000 per year. All of these potential savings would be retained by the Postal Service, because the NSA provides BAC with no discount for reduced PKR rates.

**2. Absence of discounts for improved read/accept rates on Courtesy Reply Mail, Business Reply Mail and Qualified Business Reply Mail envelopes enclosed in BAC mail.**

Section III.G of the NSA will obligate BAC, with limited exceptions, to implement use of the Four-State Barcode on all Courtesy Reply Mail, Business Reply Mail and Qualified Business Reply Mail envelopes enclosed in its mail by the commencement date of the NSA. Including the Four-State Barcode on these envelopes, and the related process improvements that BAC intends to pursue if the NSA is improved, should generate the same kinds of improvements in read/accept rates, and the same kinds of cost savings for the Postal Service, that the parties expect result from the use of the Four-State Barcode on mailpieces entered by BAC itself. An improvement of only .3 percent will save the Postal Service over \$1.1 million a year; an improvement of 1 percent will save the Service over \$3.7 million a year; and an improvement of 1.5 percent will save the Service over \$5.6 million a year. See Exhibit 2, *infra*. The Postal Service will retain all of the additional savings for itself, however, because the NSA does

not offer BAC any additional discounts for use of the Four-State Barcode on CRM, BRM or QBRM.

The absence of any discounts for reducing PKR mail, and for placing Four-State Barcodes on CRM, BRM and QBRM mail, provide the Postal Service with a considerable margin of safety. As a result, BAC's company-specific Before Rates read/accept rates would have to be considerably higher than system average read/accept rates for the NSA to reduce the Postal Service's contribution from BAC mail. In fact, the NSA would be contribution positive for the Postal Service as long as BAC's actual improvement in read/accept performance (compared with BAC's actual company-specific baseline) was slightly more than *half* the improvement in performance indicated by use of the Postal Service's system-average read/accept baseline. See Exhibit 2, *infra*.

### **3. NSA benefits that are unquantified but likely to be significant.**

The proposed NSA is also likely to provide the Postal Service with unquantified, but almost certainly large, benefits from the Postal Service's ability to use it as a large scale beta test for the numerous additional functionalities that the Four-State Barcode and Intelligent Mail are likely to permit. Hence, even in the highly unlikely event that the NSA produced a negative contribution for the Postal Service, that outcome would be entirely justifiable as an R&D investment in a potentially industry-transforming technology.

Giving weight to these benefits is appropriate. As the Commission has recognized in an analogous context involving experimental classifications:

For a proposal that is experimental, initial data requirements are often relaxed because the required data do not exist. Additional focus is applied to reviewing the experimental aspects of testing or learning something, collecting data, and reaching a conclusion. Less weight may be given to any potential negative impact on the Postal Service, its customers, and competitors because the effects of an experiment typically are limited in scope and duration.

*Capital One NSA*, MC2002-2 PRC Op. & Rec. Decis. (May 15, 2003) at ¶ 4004.

Although the proponents of the present NSA have not sought its approval under the rules governing experimental classifications, the relatively small scope of the NSA as a fraction of total Postal Service mail volume and revenue makes the same logic relevant.

### **III. THE MOVING BASELINE ALTERNATIVE PROPOSED IN NOI 1 WOULD NOT PRODUCE MEANINGFUL BASELINE ESTIMATES, AND WOULD REDUCE OR ELIMINATE THE CONTRIBUTION TO THE POSTAL SERVICE FROM THE NSA.**

#### **A. After-Rates Performance Data, Even If BAC-Specific, Cannot Provide Meaningful Estimates Of BAC's Before-Rates Performance.**

The specific formula of the proposed baseline adjustment mechanism is equally problematic. As noted above, the mechanism would give progressively less weight to Before Rates performance data in years 2 and 3, and progressively more weight to BAC After Rates performance data. Injecting After Rates performance data into a purported measure of Before Rates performance, however, produces meaningless results. Only by coincidence will this arbitrary moving of the goalposts approximate BAC's actual Before Rates performance more closely.

Implementation of the NSA will change BAC's incentives and thus its behavior. BAC, among other things, will take steps to improve the readability of its barcodes. Once those steps begin to take effect, BAC will have left the Before Rates world of

baseline performance and entered the After Rates world. Data showing that the read/accept rate of Four-State Barcodes on BAC mail during the first year of the NSA is higher than the system-wide read/accept rate of Postnet barcodes reveals nothing about what BAC's actual company-specific baseline read/accept rate would have been *without the NSA discounts*, because there is no way to disentangle the (1) differential (if any) between system-average and BAC-specific baseline performance from (2) the *improvement* in BAC-specific performance resulting from the Year One discounts. Averaging Before Rates and After Rates performance data in an attempt to obtain better estimates of a mailer's Before Rates read/accept rates is as illogical as painting an "X" on the side of a motorboat after a day of fishing to mark for future reference the spot in the lake where fish were biting.

Consider first the scenario in which the unknown actual BAC Before Rates read/accept rate in fact is exactly equal to the system-average value. Suppose that the NSA induces BAC to improve its read/accept rates by one percent. At the end of the year, the PRC method would average the system wide Before Rates value with the new BAC-specific After Rates value to set a new baseline one-half percent higher than the old when, in fact, under these assumptions the precisely accurate BAC-specific Before Rates value will continue to equal the system-average Before Rates value.

Second, consider the scenario in which BAC's actual Before Rates performance is below the system average, but the company's actual After Rates performance is better than the systemwide average. The proposed adjustment mechanism would *worsen* the overstatement of the baseline caused by the use of system-average data,

and thus would *exacerbate* the distortion of incentives noted by the Commission. *Cf.* NOI I at 2.

Third, it is true that the proposed adjustment would move the discount baseline closer to BAC's actual Before Rates performance level if that value were closer to BAC's After Rates performance level than to the systemwide average performance level. This outcome would occur only by coincidence, however, and would be no more likely than Scenario Two, in which the proposed adjustment mechanism would make matters worse.

The nonsensical results of the proposed adjustment mechanism illustrate Professor Kahn's observation that "An approximation, even one subject to a wide margin of error, to the correct answer is better than the wrong answer worked out to seven decimal places." <sup>1</sup> Alfred E. Kahn, *The Economics of Regulation* (1970) at 199 n. 39. Relying on BAC After Rates data as a proxy for BAC Before Rates read/accept rates would produce the illusion of greater precision, and to more decimal places, but the question being answered would be economically meaningless.

**B. The Proposed Adjustment May Reduce The Postal Service's Gains From The NSA, Or Even Cause Its Termination.**

The proposed baseline adjustments may actually make the Postal Service financially worse off by reducing BAC's incentives to improve its performance—or to enter into the NSA at all. Improving the read/accept rate will require BAC to incur additional operating and capital costs. BAC will incur those costs only to the point that that expected incremental benefits (including postage discounts) from improved read/accept rates equal or exceed the expected incremental costs. Arbitrarily ratcheting

up the baseline values in years 2 and 3 would significantly reduce BAC's expected payoff from the NSA, and therefore would be likely to reduce the expenditures on barcode legibility that are cost-effective for BAC to make. Indeed, although BAC has not yet calculated the precise effect of the adjustments proposed in NOI 1, they may reduce the expected value of the NSA so greatly that BAC or the Postal Service would simply walk away from the deal under Section V.E.1.c of the NSA. Under either scenario, the losers would include BAC, the USPS, and the public interest in a financially healthy postal system.

As BAC and others have noted, improvements in read/accept rates and other dimensions of address quality are not free goods. Achieving these improvements will require BAC to make large sunk investments in hardware, technology and process improvements, and to make additional large ongoing (i.e., variable) investments in complementary resources such as labor and the services of outside vendors. With or without the NSA, BAC will invest in improving address quality only to the extent that the expected incremental benefit to BAC exceeds the expected incremental cost. The discounts offered to BAC under the NSA will increase the incremental benefit from spending more on barcode legibility and other dimensions of address quality, and thus justify a higher level of expenditure on these goals. Conversely, however, a Commission-imposed baseline adjustment that reallocated the benefits of improved read/accept rates from BAC to the Postal Service would significantly reduce the expected payoff to BAC from such expenditures during the second and third years of the NSA, and therefore reduce the amount that BAC would be willing to spend. See answer of BAC witness Jones to OCA/BAC-T1-3; answer of USPS witness Ayub to OCA/USPS-T1-26.

That the adjustment would take effect only during the second and third years of the NSA does not cure the problem. Businesses make decisions about expenditures and investments by considering the present value of the expected future payoff over the entire life of the project. The proposed adjustment, while leaving the payoff during year 1 unaffected, would be likely to reduce or eliminate the payoff during years 2 and 3. The latter outcome would reduce the aggregate discounts for improved read/accept rates by two-thirds, and the present value of those discounts by nearly as much.

Perhaps the Commission has assumed that such a downward adjustment would be tolerable because most of BAC's investment in improved read/accept rates would already be made and sunk by the end of Year 1. But *no* investment is sunk until it is actually made. BAC is not going to invest in the process improvements needed to take advantage of the NSA until the PRC and the Governors issue their decisions, and BAC knows what discounts will in fact be available. Moreover, many of the costs of the process changes needed for improved read/accept rates are variable and recurring. Take away the incentives in years 2 and 3, and the expenditures will stop, causing the read/accept performance to regress.

**C. Experience With Cost-Savings Caps On Volume Discount NSAs Provides No Support For the Baseline Adjustment Mechanism Proposed Here.**

Perhaps NOI 1 was prompted in part by a concern that uncertainties in baseline performance data warrant a regulatory safeguard analogous to the cost savings cap imposed by the Commission on all but one volume discount NSA. This precedent, however, should not be extended by analogy to the instant NSA proposal. Even if the

cost savings cap were appropriate for volume discount NSAs, the risk scenario that motivated the Commission to impose cost savings caps is absent here.

The fundamental impetus for the stop-loss cap appears to have been the Commission's belief that asymmetries in knowledge possessed by the Postal Service and its mailer co-proponent about the Before Rates volumes of the mailer could create a "moral hazard"—i.e., could enable the mailer to hoodwink the Postal Service by understating the mailer's anticipated Before Rates volumes. See, e.g., *Capital One NSA*, MC2002-2 PRC Op. & Rec. Decis. ¶ 5094. By contrast, the uncertainties over BAC's actual Before Rates read/accept rates are bilateral—i.e., shared by BAC as well as the Postal Service. See NOI 1 at 1 ("The current Bank of America-specific read/accept rates are unknown by the Postal Service *and Bank of America.*") (emphasis added). Accordingly, the putative risk of moral hazard that concerned the Commission with respect to Before Rates volume projections is absent.

## CONCLUSION

For the foregoing reasons, Bank of America Corporation respectfully requests that the Commission recommend the NSA as proposed by BAC and the Postal Service, including the proposed baseline read/accept rates.

Respectfully submitted,

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**EXHIBIT 1. POTENTIAL USPS COST SAVINGS FROM BAC IMPROVEMENT OF PKR MAIL**

Mail Class/Type	PKR Volume (000)	Total Volume (000)	PKR %	Unit Cost of PKR	Total BAC Mail Volume	Total Cost of BAC PKR	Total Savings on BAC PKR Mail (by Percentage Improvement)				
							10%	20%	30%	40%	50%
	[1]	[2]	[3]=[1]/[2]	[4]	[5]	[6]=[3]*[4]*[5]	[7]=[6]*10%	[8]=[6]*20%	[9]=[6]*30%	[10]=[6]*40%	[11]=[6]*50%
First-Class Mail Automation	558,209	45,174,506	1.24%	\$0.060	1,400,000,000	\$1,037,965	\$103,796	\$207,593	\$311,389	\$415,186	\$518,982
Standard Regular	419,584	57,208,276	0.73%	\$0.074	1,900,000,000	\$1,031,206	\$103,121	\$206,241	\$309,362	\$412,482	\$515,603
<b>Total</b>					<b>3,300,000,000</b>	<b>\$ 2,069,171</b>	<b>\$ 206,917</b>	<b>\$ 413,834</b>	<b>\$ 620,751</b>	<b>\$ 827,668</b>	<b>\$ 1,034,585</b>

[1],[4] PKR volumes and unit costs from USPS-LR-61, Tables 5.15 and 5.17

[2] FY 2004 Revenue, Pieces, and Weight (RPW) Report

[5] Direct Testimony of Richard D. Jones on behalf of Bank Of America Corporation, Page 8

Note: PKR and total volume are for FY 2004

**EXHIBIT 2. YEAR 1 DISCOUNTS AND USPS COST SAVINGS (BY MAIL PROCESSING IMPROVEMENT)**

Mail Processing Improvement	Year 1 Discounts for Mail Processing Improvements			Year 1 Cost Savings		
	First-Class Mail	Standard Mail	Total	CRM/BRM	FCM/Std Mail	Total
	[1]	[2]	[3]=[1]+[2]	[4]	[5]	[6]=[4]+[5]
0.1%	\$448,000	\$456,000	\$904,000	\$375,004	\$1,219,444	\$1,594,447
0.2%	\$910,000	\$931,000	\$1,841,000	\$750,967	\$2,441,213	\$3,192,180
0.3%	\$1,358,000	\$1,387,000	\$2,745,000	\$1,127,894	\$3,665,311	\$4,793,205
0.4%	\$1,806,000	\$1,843,000	\$3,649,000	\$1,505,785	\$4,891,743	\$6,397,528
0.5%	\$2,268,000	\$2,318,000	\$4,586,000	\$1,884,643	\$6,120,511	\$8,005,155
0.6%	\$2,716,000	\$2,774,000	\$5,490,000	\$2,264,471	\$7,351,620	\$9,616,092
0.7%	\$3,178,000	\$3,249,000	\$6,427,000	\$2,645,271	\$8,585,074	\$11,230,345
0.8%	\$3,640,000	\$3,705,000	\$7,345,000	\$3,027,045	\$9,820,876	\$12,847,921
0.9%	\$4,088,000	\$4,180,000	\$8,268,000	\$3,409,796	\$11,059,030	\$14,468,825
1.0%	\$4,550,000	\$4,636,000	\$9,186,000	\$3,793,526	\$12,299,539	\$16,093,065
1.1%	\$5,012,000	\$5,111,000	\$10,123,000	\$4,178,237	\$13,542,408	\$17,720,645
1.2%	\$5,474,000	\$5,586,000	\$11,060,000	\$4,563,932	\$14,787,641	\$19,351,573
1.3%	\$5,936,000	\$6,061,000	\$11,997,000	\$4,950,613	\$16,035,241	\$20,985,854
1.4%	\$6,398,000	\$6,517,000	\$12,915,000	\$5,338,283	\$17,285,211	\$22,623,494
1.5%	\$6,762,000	\$6,897,000	\$13,659,000	\$5,683,902	\$18,271,592	\$23,955,494
1.6%	\$7,084,000	\$7,201,000	\$14,285,000	\$6,006,755	\$19,114,497	\$25,121,252
1.7%	\$7,406,000	\$7,524,000	\$14,930,000	\$6,330,145	\$19,958,114	\$26,288,260
1.8%	\$7,728,000	\$7,961,000	\$15,689,000	\$6,654,073	\$20,802,445	\$27,456,518
1.9%	\$8,050,000	\$8,854,000	\$16,904,000	\$6,978,539	\$21,647,489	\$28,626,028

[1], [2], [3]: Total discounts derived by multiplying BAC mail volumes from Page 3 of MC2007-1\_Appendix\_A\_(R2006\_PRC)2 by the appropriate Mail Processing Incentives from Page 4, Columns G and H.

[4], [5], [6]: The Year 1 cost savings for First-Class Mail and Standard Mail were derived by setting input values for mail processing improvements on Page 2 of MC2007-1\_Appendix\_A\_(R2006\_PRC)2 to the appropriate value and then summing Mail Processing and Delivery Savings on Page 1 of MC2007-1\_Appendix\_A\_(R2006\_PRC)2, lines 5, 6, 7, and 8. The total cost savings for BRM/CRM pieces was derived using a similar process and based upon two assumptions -- (1) there will be 450 million CRM/BRM pieces per year per the testimony of Richard D. Jones, page 7; and (2) the unit mail processing and delivery savings from improving read/accept rates for CRM/BRM will be the same as for First-Class Mail Mixed AADC Automation Letters.