

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

RATE AND SERVICE CHANGES TO IMPLEMENT
BASELINE NEGOTIATED SERVICE AGREEMENT
WITH BANK OF AMERICA CORPORATION

Docket No. MC2007-1

**REPLY COMMENTS OF UNITED STATES POSTAL SERVICE
TO NOTICE OF INQUIRY NO. 1**

(April 24, 2007)

On April 3, 2007, the Postal Regulatory Commission (Commission) filed Notice of Inquiry No.1 (NOI). Interested participants were invited to comment on the methods of establishing baselines in longer term (e.g., three year) pay-for-performance agreements where actual mailer information is unavailable. The Commission indicated that the three-year duration of the BAC NSA provides an opportunity to gather data on read/accept rates for BAC mail during the first year of the NSA, and to incorporate this information into the system-wide averages so the baseline for the second and third years of the NSA would reflect BAC-specific data. The NOI encouraged interested parties to submit specific comments discussing the need to incorporate adjustment mechanisms, and the benefits or detriments of incorporating the approach described in the NOI compared with an approach that solely utilizes system-wide averages (e.g., the Bank of America NSA).

Initial comments to the NOI were submitted by the Postal Service, Bank of America Corporation ("BAC"), the Office of Consumer Advocate ("OCA"), and

Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (collectively "Valpak") on April 19, 2007. Generally, these comments discuss the merits of using the data underlying the systemwide average read/accept rates to determine the baselines from which mail processing improvements would be measured. These comments also discuss the feasibility and desirability of the Commission's proposal for readjusting the NSA baselines in the second and third years of the agreement. Additionally, the OCA and Valpak advance possible alternatives to the proposal outlined by the Commission in the NOI.

The Postal Service respectfully submits the following reply comments in response to the NOI. In summary, the Postal Service continues to believe that its approach for establishing the baseline values set forth in this NSA are appropriate and are supported by record evidence in this docket, and that the Commission's suggested approach, and the approaches proposed by the OCA and Valpak, should not be adopted.

To fully respond to the initial comments of BAC, the OCA, and Valpak, these reply comments are organized as follows. First, we discuss the inherent reliability of the data underlying the systemwide average read/accept rates for all mailers and why it is reasonable to use the systemwide average as a proxy for BAC's specific read/accept rates. Second, we discuss our concerns with the Commission's approach in light of the comments submitted by BAC, the OCA, and Valpak. Third, we analyze the alternative approaches advanced by the OCA and Valpak and discuss the likely advantages and disadvantages of both.

I. THE POSTAL SERVICE'S RELIANCE ON SYSTEMWIDE AVERAGE DATA IS REASONABLE BECAUSE IT IS SUPPORTED BY RECORD EVIDENCE AND IS THE BEST AVAILABLE PROXY FOR BAC'S SPECIFIC READ/ACCEPT RATE

A. The Commission May Reasonably Rely Upon Systemwide Average Data On The Read/Accept Rates For All Mailers To Establish Baselines From Which Improvements In Address Quality And Mail Processing Performance Will Be Measured

Both the Postal Service and BAC have highlighted the acceptance by the Commission of systemwide average data on read/accept rates in its recent Opinion and Recommended Decision in Docket No. R2006-1. See Response of United States Postal Service to Notice of Inquiry No. 1 at 4-5 ("USPS Comments"); Comments of Bank of America Corporation in Response to Notice of Inquiry No. 1 (April 17, 2007) ("BAC Comments") at 13. The NSA proponents have also emphasized that the current pricing structure for letter-rated First Class-Mail and Standard Mail worksharing discounts is based on the average read/accept rate for all mailers of given presort levels and usage of particular automated letter sorting equipment. USPS Comments at 4-5; see also BAC Comments at 9-10. Moreover, previous decisions by the Commission suggest that in the absence of customer-specific data, NSA proponents may rely on the systemwide average data as a proxy. See BAC Comments at 8-10. The systemwide average data, therefore, comes with more than a "presumption of validity"¹ and its use is reasonable in this docket.

The Commission need not insist that "reliable measures of statistical variation" be presented on record before approving baseline calculations

¹ Quote from Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Response to Notice of Inquiry No. 1 ("Valpak Comments") at 2.

underlying this NSA, as Valpak incorrectly suggests.² Valpak does not point to evidence indicating deficiencies in the calculation of baseline averages as used in the NSA. Rather, Valpak asserts that 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.”³ Valpak is referring to the Commission’s analysis of MODS data in the context of its use in modeling the variability of mail processing costs with volume:

For more than a decade, the Commission has expressed concern that the quality of the Management Operating Data System (MODS) data upon which mailprocessing variability models depend is too poor to support valid statistical models.

Opinion and Recommended Decision, Docket No. R2006-1, at ¶ 3068, page 42. The Commission indicated concern with errors in MODS data by certain separations for which the data are used in econometric modeling, not for the aggregate approach in which the data are used in the NSA. In fact, the Commission relies on MODS data for other purposes, such as development of cost pools in distributing costs to the categories of mail and service. Volume-variable costs by subclass were developed using the IOCS/MODS-based method employed by the Postal Service since BY 1996 of Docket No. R97-1, and also adopted by the Commission (with modifications) in that proceeding, and in subsequent proceedings, including Docket No. R2006-1. In the context of this NSA, in which the underlying data are being used to set the benchmarks for

² See Valpak Comments at 2.

³ Valpak Comments at 2.

determining pricing discounts, the Commission may confidently rely upon the systemwide average data regardless of potential variability within those data. Moreover, it would be inconsistent for the Commission to rely upon systemwide average data to estimate the *incremental* costs from greater use of a service or facility while rejecting the same data to estimate the *decremental* savings from less intensive use of a service or facility through worksharing encouraged by an NSA.

B. The NSA Proponents May Reasonably Rely On The Systemwide Average Read/Accept Rates As A Proxy For BAC's Specific Read Rates Because The Systemwide Average Data Are The Best Available Data

The NSA proponents continue to submit that there is no reason to believe that BAC's read/accept rates deviate significantly from the systemwide average read rate, either above or below, and therefore, it is reasonable to rely upon the systemwide average as a proxy for BAC's specific read rate. See USPS Comments at 4; BAC Comments at 4 and 12. We also note that there is no record evidence to support an inference that BAC agreed to a baseline read/accept rate based on the systemwide average because it expected to exceed the systemwide average without undertaking the activities and process changes mandated by this NSA.⁴ Such an inference is especially suspect in light of BAC's agreement to use BAC-specific baselines as a benchmark for improvements in UAA mail even though BAC's specific performance is better

⁴ See Office of the Consumer Advocate Comments in Response to Notice of Inquiry No. 1 ("OCA Comments") at 1-2 ("In addition, the fact that BAC has agreed to the use of a 1999 baseline sends a strong signal that BAC expects to exceed that baseline. The possibility that BAC's read rates will be below the baseline can be safely ignored.")

than the systemwide average, and the use of that average would increase the expected financial value of the Agreement to BAC. See BAC Comments at 11.

Moreover, the reliability of the systemwide average data should outweigh any concerns that the data supporting the systemwide average read/accept rate is not current or that BAC will receive discounts for read/accept rate increases attributable to technological improvements to postal mail processing equipment, or other activities unrelated to BAC's performance under the Agreement.⁵ As noted above, the data currently used to support the systemwide average, which as OCA and Valpak have pointed out were collected in 1999, were recently used by the Commission in Docket No. R2006-1 to set worksharing discounts. The Commission did not, however, require the Postal Service to update these data. In our judgment, the use of the data was reasonable because 1) the costs associated with such data collection and analysis are high and it is reasonable to expect that some data will not be updated every omnibus rate cycle, and 2) there was no reason to believe that the mail processing environment had undergone such significant changes that would necessitate such a substantial undertaking. Whether the technological enhancements to postal mail processing equipment cited by Valpak and the OCA (e.g., the deployment of MERLIN, improvements in barcode reading and printing technology, etc.) have lead to increases in the systemwide average read/accept rates, is speculative.

⁵ See NOI No. 1 at 2 ("If Bank of America's current read/accept rates are higher than the system-wide baselines, Bank of America will obtain discounts without further effort (beyond the operational commitments of the agreement).")

Additionally, and contrary to Valpak's assertion, customers such as BAC are not "on the threshold of being able to know their individual accept rates."⁶ Not all mailers are willing and/or able to make the substantial investments that would be required for the Postal Service to begin gathering meaningful data on a mailer's specific read/accept rate, especially under conditions that are controlled by the Postal Service and mandated by this NSA.

Given that the Commission found that the systemwide average data used in this docket were sufficiently reliable to serve as basis for recommending a rate structure involving billions of dollars, it would be inconsistent for the Commission to reject the use of these data in this NSA on the grounds that the data are not current, and therefore, are unreliable. As the Postal Service has noted, the use of systemwide average data to set baselines in a customer-specific worksharing agreement is no less reasonable than the current pricing structure, under which each individual mailer will receive the same price discount for regular worksharing discounts even though its customer-specific read/accept rate is likely to be above or below the average. See USPS Comments at 5. Because the risk to the other mailers that BAC's mail characteristics exhibit lower costs than other mailers will have almost no impact on the rates paid by other mailers, the concern that the systemwide average data used in this NSA may not precisely reflect the current systemwide average should not deter the Commission from approving an NSA that conditions financial rewards on more

⁶ Valpak Comments at 7.

than mere improvements in a mailer's read/accept rates. See USPS Comments at 6.

II. THE APPROACH TAKEN BY THE NSA PROPONENTS TO ESTABLISH THE BASELINES IN THE AGREEMENT IS SUPERIOR TO THE COMMISSION'S PROPOSAL FOR READJUSTING BASELINES IN THE SECOND AND THIRD YEARS OF THE AGREEMENT

Both the OCA and Valpak have endorsed the Commission's suggestion of readjusting the NSA baselines in the second and third years of the agreement. See OCA Comments at 2; Valpak Comments at 8. However, the comments of the OCA and Valpak have not taken into account the NSA proponents' concerns that the Commission's proposal would introduce greater uncertainty and risk with regard to BAC's expected return on its investments and would likely make the Agreement unpalatable to BAC and functionally equivalent customers who must consider "the present value of the expected future payoff over the entire life of the project." See BAC Comments at 22. Baseline readjustments such as those proposed by the Commission could significantly diminish the projected benefits that BAC has forecasted in the second and third years of the NSA, thereby reducing BAC's incentives to improve its performance or to enter into the NSA. See BAC Comments at 20-22. Additionally, we noted that the Commission's proposal would undermine the discount structure negotiated by the parties which is intended to compensate BAC for the additional investments it would have made to fulfill the operational commitments of this NSA. USPS Comments at 3.

The Commission's proposal also introduces a risk that an NSA candidate may refuse to upgrade, or perhaps even downgrade, the quality of its mail for the purpose of establishing a lower benchmark early on in the contract period. See

USPS Comments at 6; BAC Comments at 12. Finally, BAC has illustrated on pages 18 through 20 of its comments that the Commission's proposal, which would involve averaging BAC's after-rates performance data with the systemwide average in the second and third years of the Agreement, would not yield any meaningful data on BAC's before-rates performance and could yield an even less reliable proxy for BAC's specific before-rates performance than the system-wide average.⁷ For these reasons, the Postal Service submits that its reliance on the systemwide average, throughout each year of the Agreement, is preferable to the Commission's adjustment mechanism as presented in the NOI.

III. THE APPROACH TO ESTABLISHING WORKSHARING DISCOUNTS ENDORSED BY THE NSA PROPONENTS IS SUPERIOR TO THE ALTERNATIVES PROPOSED BY VALPAK AND THE OCA

A. Valpak's Approach To Establishing Worksharing Discounts Based On Mailer Specific Data Gathered From Intelligent Mail Barcodes Presents No Unique Advantages In Comparison To This NSA And Creates Additional Problems

There are two main components to Valpak's approach to establishing baselines when mailer specific information on read/accept rates is available. First, Valpak's approach would require any mailer seeking to enter into a performance-based NSA with the Postal Service to implement the Intelligent Mail Barcode for "at least one, and possibly two, years" before that mailer could be eligible for an NSA. Valpak Comments at 5. According to Valpak, such a

⁷ See BAC Comments at 20 ("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 [the scenario] in which the proposed adjustment mechanism would make matters worse.")

requirement would allow the Postal Service to gather specific data on that mailer's read/accept rates which could then be used as the basis for determining the "appropriate" baselines for an NSA.

Second, the baselines from which discounts would be calculated would be established as follows:

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. 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**.

Valpak Comments at 6 (emphasis in the original). Valpak submits that this approach would prevent mailers with below average read/accept rates from receiving discounts for "merely coming up to the system-wide average." Valpak Comments at 6. Moreover, Valpak states that mailers with above average read/accept rates would only be rewarded for improvements in performance over their mailer-specific baselines. It is unclear whether Valpak's approach would contain a mechanism for adjusting the baselines during the course of an NSA.

It is unclear whether Valpak's approach to establishing baseline values based on mailer-specific information is intended to provide the Commission with an alternative to this NSA. To the extent that it is, we believe that the approach is flawed for two reasons. First, Valpak incorrectly assumes that a mailer would be receptive to migrate voluntarily to beta test an Intelligent Mail Barcode.⁸ As

⁸ See Valpak Comments at 5.

noted in the Postal Service's response to interrogatory VP/USPS-T1-27⁹ and in BAC Comments at 21, BAC, and presumably other NSA customers, will have to make substantial investments to implement the Intelligent Mail Barcode and the other requirements specified in the NSA to enable the Postal Service to gather meaningful data on a mailer's specific read/accept rate. It is reasonable to assume that a mailer would be unlikely to make such investments in the absence of an NSA that would guarantee the mailer with a return on its investment in this context, where the Intelligent Mail Barcode is in its infancy and not required for eligibility for worksharing discounts.

Second, to the extent that Valpak's approach is intended as an alternative to this NSA, mailers "might be tempted to 'game' [the] system...by holding back on performance enhancing moves until they receive a pay-for-performance NSA," thereby exposing Valpak's proposal to the same risk that the Commission's proposal invites. See Valpak comments at 6-7. However, it does not follow that because of this vulnerability, the Commission must require mailers "using the IMB [to] have at least one, and possibly two, years of mailer-specific data before entering into negotiations for an NSA,"¹⁰ especially when the systemwide average is available as a reliable proxy. The associated time or cost of compliance with such a requirement would not only serve as a strong disincentive for customers contemplating an NSA with the Postal Service, but

⁹ Response of United States Postal Service Witness Ayub to Interrogatory of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. (VPUSPS-T1-27).

¹⁰ Valpak Comments at 7.

would force the Postal Service to forgo revenue that could be generated from an NSA during the data collection time period. See BAC Comments at 12.

For these reasons, Valpak's approach does not offer any unique advantages over the Bank of America NSA and comes with certain drawbacks that are avoided by the NSA proposed in this docket.

B. The OCA's Proposal For Establishing Worksharing Discounts Based On Actual Data From A Test Of The Intelligent Mail Barcode Presents No Unique Advantages In Comparison To This NSA And Creates Additional Problems

The OCA proposes to adjust the Commission's approach to establishing baselines for this NSA in two ways. First, the OCA proposes that the Commission use an average of the actual test results of the Intelligent Mail Barcode (set forth in the USPS response to OCA/USPS-T1-36(a)) to establish the baseline for the first year of the NSA.¹¹ OCA Comments at 2. Second, and alternatively, the Commission would use "actual read rates" on non-BAC Intelligent Mail Barcodes "in Year 1 as the baseline for Year 2, and similarly use actual Year-2 data as the baseline for Year 3." OCA Comments at 2.

Although the OCA's proposal has the advantage of avoiding the risk discussed in Sections II and III.A. above because it would not provide mailers with an opportunity to affect the initial read/accept rates from which the baselines would be derived, it does contain an adjustment mechanism that would be undesirable for the reasons set forth in Section II above, namely that adjustments to the baselines in the second and third years of the Agreement would introduce

¹¹ In its comments, the OCA refers to the Intelligent Mail Barcode as the "Four-State" Barcode. Both terms refer to the same type of barcode.

greater uncertainty and risk with regard to BAC's expected return on its investments and would undermine the discount structure negotiated by the NSA proponents to compensate BAC for those investments. Furthermore, the data underlying the systemwide average read/accept rate are arguably more appropriate as a benchmark for the average read/accept rate for all mailers than the actual test results of the Intelligent Mail Barcode because the test results do not do not necessarily reflect the average read/accept rate for a representative mix of mailers.¹²

The OCA suggests that this alternative proposal would "protect" the Postal Service from the likelihood that BAC will receive discounts for no actual improvement in its read/accept rates. However, its difficult to understand why such protection is warranted given that "the below-100 percent passthroughs and the absence of any separate discounts for other cost-saving features of the NSA" guard against the loss in contribution that OCA and Valpak theorize could occur if BAC's mailer specific read/accept rate is higher than the systemwide average. See BAC Comments at 4. The unique disadvantages of the OCA's proposal and the reliability of the data underpinning this NSA should persuade the Commission that baseline read/accept rates and incentive structure set forth in this NSA are superior to the alternatives proposed in this docket.

¹² Stated otherwise, the baseline values that the OCA proposes to use are also system average values, but are based on a much narrower and potentially unrepresentative population of users.

IV. CONCLUSION

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

UNITED STATES POSTAL SERVICE

By its attorneys:

Anthony F. Alverno
Chief Counsel, Customer Programs

Frank R. Heselton
Matthew J. Connolly

475 L'Enfant Plaza, S.W.
Washington, D.C. 20260-1135
(202) 268-8582; Fax -5418

CERTIFICATE OF SERVICE

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

Matthew J. Connolly

475 L'Enfant Plaza, S.W.
Washington, D.C. 20260-1135
(202) 268-8582; Fax -5418
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