

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)

**INITIAL POST-HEARING BRIEF OF
BANK OF AMERICA CORPORATION**

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The Bank of America Corporation (“BAC”) respectfully submits its initial post-hearing brief in this case.

INTRODUCTION AND SUMMARY

The Negotiated Service Agreement (“NSA”) proposed in this case involves several important firsts. It would be the first pure cost savings NSA, with no volume incentives at all. It would be the first NSA to take effect after the enactment of the Postal Accountability and Enhancement Act (“PAEA”). It probably would be the first NSA to take effect after the effective date of the Commission’s rules *implementing* PAEA. And it would be the first NSA whose contribution to the Postal Service would remain unknown until after December 20, 2007, when the Postal Service’s authority to seek rate increases based on an overall break-even requirement expires pursuant to 39 U.S.C. § 3622(f). These milestones warrant a fresh look at the Commission’s standards for review of proposed NSAs. We respectfully submit that this NSA warrants approval—without conditions or modifications—under both the traditional and new regulatory norms.

First, the innovative process changes that the NSA would require BAC to make would generate major benefits for the Postal Service. In effect, BAC—and its annual letter mail volume of more than three billion pieces—would become a large-scale pilot and test bed for the Postal Service’s new Intelligent Mail technologies. These process changes would include the use of Intelligent Mail Barcodes, Confirm® service, OneCode ACS, FAST, eDropship, Seamless Acceptance, and postage payment through the Centralized Automated Payment System (“CAPS”). Intelligent Mail barcoding on Courtesy Reply Mail and Business Reply Mail alone would save the Postal Service several million dollars annually. The longer term benefits of testing Intelligent Mail technology, while less easy to quantify, may be even greater. Enabling the Postal Service to move more quickly up the learning curve toward full-scale deployment of Intelligent Mail technology would benefit much of the Postal Service’s customer base.

Second, the NSA would offer BAC discounts for optional process changes that produce quantifiable improvements in the read/accept rates of BAC letter mail, the return and forwarding rates of Undeliverable As Addressed (“UAA”) First-Class Mail, and the disposal rates of UAA Standard Mail. Because the discounts offered by the Postal Service would pass through less than 100 percent of the unit cost savings, the Postal Service would benefit from this pay-for-performance regardless of the magnitude of the improvement in performance.

Virtually none of these benefits have been challenged. Instead, three participants, two of whom have no economic stake in the outcome of this NSA, have seized upon a single element—discounts for improved mail processing

performance—as a basis for unilaterally altering the arms-length bargain that the Postal Service and BAC have struck.

The Commission should decline to alter the bargained-for terms. The Commission has held repeatedly that the financial impact of a proposed NSA must be assessed by reference to the NSA as a whole, not any individual element in isolation. No party has shown that NSA as a whole would be unprofitable for the Postal Service.

Moreover, the parties challenging the discounts for improved read/accept rates have failed to show that this element of the NSA would be unprofitable for the USPS, even in isolation. The NSA proponents' reliance on system average data for baseline read/accept rates is consistent with long-established Commission precedent. There is no credible evidence that current read/accept rates for BAC mail are substantially higher than the 1999 system average values underlying the proposed baselines. The pilot test data and end-of-run reports belatedly offered by APWU reflect neither the particular circumstances in which BAC actually enters its mail, nor the shop floor environment where it is actually processed.

The enactment of PAEA provides further support for approval of the NSA without conditions. The central thrust of PAEA is to expand the Postal Service's pricing flexibility, including the flexibility to reduce prices. Within a few months, the Postal Service will be entitled to file NSAs like the current proposal, on 45 days notice, with virtually none of the time-consuming and costly advance review that the current NSA has endured. Moreover, an NSA that enhances the

“performance of mail . . . processing . . . or other functions” need not be priced at a level that makes the arrangement contribution positive. See 39 U.S.C. § 3622(c)(10)(A).

Furthermore, the expiration on December 20, 2007, of the Postal Service’s authority to seek rates increases based on an enterprise-wide break-even requirement provides a critical safeguard for other mailers. By the time that the actual financial impact of the NSA is known, the Postal Service’s right to overall rate increases will be determined not by the Postal Service’s own costs and revenue, but by the CPI-based cap established by 39 U.S.C. § 3622(d). See *id.*, § 3622(f). The abrogation of cost-of-service (“revenue requirement”) ratemaking in favor of CPI-based cap means that size of contribution from any one NSA (or all NSAs combined) cannot, as a matter of law, affect the rates charged other mailers. If the Postal Service enters into an NSA that proves to be contribution-negative, the Postal Service, not its other mailers, must absorb the shortfall. This fact undermines the entire premise of regulatory oversight of the profitability of a proposed NSA.

Moreover, intrusive review of the contribution from this NSA would be particularly ironic in light of the deference that all participants agree should be given to the business judgment of the USPS in setting contribution-maximizing rates for market dominant and competitive products generally. No one—including APWU, OCA, and Valpak—has argued in RM2007-1 that the Commission should engage in advance review of future rate changes of general applicability for market dominant or competitive products to make sure that each

of those rate changes will increase the Postal Service's net contribution to institutional costs. The Postal Service's revenue from market-dominant mail amounts to approximately \$64.0 billion per year, or roughly \$190 billion over the three-year term of the NSA. See Revenue-Piece-Weight ("RPW") Report for Fiscal Year 2006. Competitive mail accounts for another \$7.6 billion or so in annual revenue, or about \$23 billion over three years. *Id.* If the Postal Service is to be trusted to figure out the contribution-positive prices for its rates of general applicability, the notion that the Postal Service should be second-guessed for offering rate incentives equivalent to perhaps *1/100 of one percent* of the Postal Service's total revenue from market-dominant products during the same three-year period is irrational indeed.

Finally, "protecting" the Postal Service and its other customers against the purported risk that the negotiated baseline values are too low by substituting higher values is likely to make the Postal Service, BAC, and other mailers worse off. Improvements in read/accept rates and other dimensions of address quality would require costly investments and process changes by BAC. BAC is willing to incur those costs only to the extent that they are exceeded by the expected financial benefits of the NSA over its three-year term. By reducing the potential gains to BAC, an adjustment in the discount baselines would reduce BAC's incentive to invest in improved mail processing performance, and could jeopardize the willingness of BAC and the Postal Service to implement the NSA at all.

STATEMENT OF FACTS

A. Description Of BAC

1. BAC's business

Bank of America Corporation ("BAC") is a Delaware corporation headquartered in Charlotte, North Carolina, that provides a full range of banking, investing, asset management and other financial and risk-management products and services to individual consumers, small and middle market businesses, and large corporations. BAC serves more than 55 million consumer and small business relationships in the United States through over 5,700 retail banking offices, nearly 17,000 ATMs, and an online banking network used by more than 20 million active users. The company serves clients in 175 countries and has relationships with 98 percent of the U.S. Fortune 500 companies and 80 percent of the Global Fortune 500. BAC stock is listed on the New York Stock Exchange.

BAC is one of the largest financial institutions in the United States and the world. With FY 2005 revenue of almost \$57 billion and over 176,000 Full Time Equivalent employees, BAC is the second largest bank in the United States by revenue and the 12th largest firm on the Fortune 500 list for 2006. Measured by market capitalization, BAC is one of the two largest banks in the United States, and, by several measures, is the largest issuer of credit cards in the United States. It is the No. 1 overall Small Business Administration (SBA) lender in the United States and the No. 1 SBA lender to minority-owned small businesses. (Jones Direct (BAC-T-1) at 3)

BAC is active in community development and philanthropy. Several years ago, the Bank set a ten-year goal to lend and invest \$750 billion in community development. In furtherance of this goal, it committed up to \$100 million to rebuild Gulf Coast communities following Hurricanes Katrina and Rita. The Bank also is involved in numerous philanthropic activities, contributing over \$130 million to charitable activities in 2005 and planned to donate an additional \$200 million in 2006.

Not only does BAC provide financial support and donate funds, but it also encourages its associates to perform volunteer activities on company time. All associates are encouraged to volunteer up to two hours a week on company time and many have accepted the offer. Jones Direct (BAC-T-1) at 4 to 5.

2. BAC's mail

Bank of America uses large amounts of First-Class and Standard Mail for operational purposes and also for solicitations both to existing customers and to prospective customers. The Bank uses First-Class Mail for statements and plastics, for privacy notifications, for some solicitations, and for small amounts of miscellaneous correspondence. It uses Standard Mail for solicitations as well as other non-personalized communications.

Table 1, below, provides BAC's historic mail volumes by class, year and (for First-Class Mail) purpose, for each year from 2003 through 2006:

Table 1
BAC Letter Mail Volume by Class, 2003-2006
(pieces)¹

	2003	2004	2005	2006
First-Class				
Solicitation	640,000,000	560,764,566	211,292,151	82,394,252
Operational	1,100,000,000	1,169,185,777	1,256,717,532	1,224,569,376
Total 1C	1,740,000,000	1,729,950,343	1,468,009,683	1,306,990,628
Standard Mail	1,400,000,000	1,546,837,606	1,676,770,788	1,852,019,707
Grand Total	3,140,000,000	3,276,787,949	3,144,780,471	3,159,010,335

Table 2 shows the mail volume that BAC projects to enter over the next three years, both with and without an NSA:

Table 2
BAC Projected Letter Mail Volume by Class, 2007-2009
(Before and After Rates, pieces)

	2007	2008	2009
First-Class Mail:			
Solicitation	100,000,000	100,000,000	100,000,000
Operational	1,300,000,000	1,300,000,000	1,300,000,000
Total First-Class	1,400,000,000	1,400,000,000	1,400,000,000
Standard Mail	1,900,000,000	1,900,000,000	1,900,000,000
Grand Total	3,300,000,000	3,300,000,000	3,300,000,000

Jones Direct (BAC-T-1) at 8.

BAC also receives approximately 450 million pieces annually of Courtesy Reply Mail, Business Reply Mail, and Qualified Business Reply Mail and provides its customers with envelopes for much of this mail. Tr. 468 (Jones answer to

¹ Values for 2003 through 2005 from Jones Direct (BAC-T-1) at 7. Values for 2006 from Tr. 482 (BAC answer to OCA/BAC-T1-5).

GHS/BAC-T1-1). BAC expects to continue this practice during the three-year term of the NSA. While some additional number of customers will choose to pay their statements electronically, BAC expects some, but not a substantial, diversion of credit card payments from mail to electronic payment. Jones Direct (BAC-T-1) at 8.

3. Role of Six Sigma in BAC operations

Six Sigma, a process management tool used at the Bank since 2001, is central to BAC's operations and will play a critical role in maximizing the value of the proposed NSA. Six Sigma is a data-driven method of process control that can be used to reduce defects in any process—whether manufacturing or transactional. Although the engineering and statistical principles underlying Six Sigma date to the early 20th century, they were first combined in a systematic fashion in the 1980's, when Motorola pioneered the use of Six Sigma to measure defects and improve process quality for its own operations. A process that experiences fewer than 3.4 defects per million opportunities is considered to be performing at a "Six Sigma" level.

Six Sigma complements the bank's "Higher Standards" culture by focusing on the customer, minimizing process variation, promoting accountability by establishing meaningful benchmarks for performance, and targeting sustainable gains and improvements. It has enabled BAC to increase revenue and productivity throughout the enterprise. Jones Direct (BAC-T-1) at 8-10.

B. Description Of Proposed NSA

The proposed NSA, unlike the NSAs previously approved by the Commission, includes no volume discounts. Jones Direct (BAC-T-1) at 10-11; Ayub Direct (USPS-T-1) at 4. Instead, the NSA would offer BAC incentives to make operational changes that would reduce the Postal Service's costs and improve its operations, in both the short run and the long run.

1. Operational changes that BAC would commit to making without additional compensation

Some of the operational changes would be mandatory, and BAC must commit to make them without any separate compensation. In particular, BAC must:

- (1) Place **Four-State Barcodes** on all First-Class Mail and Standard Mail that qualifies for the proposed rate discounts. NSA § III.A; Proposed DMCS ¶ 630.31; Jones Direct (BAC-T-1) at 11; Ayub Direct (USPS-T-1) at 7-8; Tr. 479 (BAC answer to OCA/BAC-T1-4).
- (2) Subject to narrow exceptions, use **Confirm®** Service on all First-Class Mail and Standard Mail that qualifies for the proposed rate discounts. NSA § III.C; Proposed DMCS ¶ 630.34; Jones Direct (BAC-T-1) at 12; Ayub Direct (USPS-T-1) at 9.
- (3) Subject to narrow exceptions, place **OneCode ACS** markings on all First-Class Mail and Standard Mail that qualifies for the proposed rate discounts. NSA § III.B; Proposed DMCS ¶ 630.32; Jones Direct (BAC-T-1) at 12; Ayub Direct (USPS-T-1) at 8-9; Tr. 479

(BAC answer to OCA/BAC-T1-4).

- (4) Use the automated scheduling services provided to the **FAST** system through the PostalOne! electronic data exchanges for entry of all letter-rated Standard Mail with destination entry discounts. NSA § III.F; Proposed DMCS ¶ 630.36; Jones Direct (BAC-T-1) at 11; Ayub Direct (USPS-T-1) at 12. See also Tr. 143-44 (answer to VP interrogatory 31) (explaining why mailers will not commit to this condition without discounts); *id.* at 291 (answer to VP interrogatory 25) (same); *id.* at 479 (BAC answer to OCA/BAC-T1-4) (same).²
- (5) After **eDropship** features become available for First-Class Mail, implement use of the service for entry of all letter-rated First-Class Mail.
- (6) Subject to narrow exceptions, use **Seamless Acceptance** for all First-Class Mail and Standard Mail that will qualify for the proposed rate discounts. NSA § III.E; Proposed DMCS ¶ 630.35; Jones Direct (BAC-T-1) at 12; Ayub Direct (USPS-T-1) at 9-12. See also Tr. 208, 246 and 286-87 (answers to OCA interrogatory 39 and Valpak interrogatories 3 & 22) (explaining why Seamless Acceptance won't be adopted without the NSA); Tr. 480 (BAC answer to OCA/BAC-T1-4) (same).

² The NSA also would require BAC to use PostalOne! for assignment of transportation for First-Class Mail, even before the deployment of the eDropship functionality. See NSA §§ III.E.2.b. and III.F.2.

- (7) Pay postage through the Centralized Automated Payment System (“CAPS”). Ayub Direct (USPS-T-1) at 11; Tr. 249-52 (Ayub responses to VP/USPS-T1-5 and 6).
- (8) With certain exceptions, place Intelligent Mail barcodes on all Courtesy Reply Mail and Business Reply Mail envelopes enclosed in BAC mailings to its customers. NSA § III.G; Proposed DMCS ¶ 630.37; Jones Direct (BAC-T-1) at 11; BAC comments on NOI #1 (4/17/2007) at 16-17; Tr. 237 (answer to OCA interrogatory 47). The customers’ use of these more-readable barcoded envelopes would save the Postal Service substantial amounts of money. An improved read/accept rate of only one-half percent would save the Postal Service over \$1.8 million in the first year of the contract alone; a one percent improvement would save it almost \$3.8 million in the first year, and a 1.5 percent improvement would save it almost \$5.7 million. See Tr. 468, 479 (BAC discovery responses).

These commitments, taken collectively, would commit a very major mailer, for the very first time, to using all the productivity enhancing tools that the Postal Service currently plans for the network of the future. In effect, this NSA would provide as a large-scale test bed for intelligent mail and for streamlining mail acceptance, tracking, and processing. Ayub Direct (USPS-T-1) at 6. This arrangement would provide major benefits to the Postal Service, while requiring BAC to make a variety of far-reach operational changes, for which it must incur

substantial costs. See Tr. 494-499 (BAC response to Valpak interrogatory VP/USPS-T1-32(b)) (redacted version).

2. Pay-for-performance elements

For other operational changes by BAC, the Postal Service is offering to share the resulting savings with BAC through discounts on the bank's First-Class Mail and Standard Mail rates of postage. BAC would qualify for discounts for reducing the percentage of First-Class Letter Mail that is forwarded or returned, reducing the percentage of Undeliverable-as-Addressed Standard Letter Mail, or increasing the read/accept rate for Letter Mail of either class. To track its performance against these benchmarks, the Bank would put Intelligent Mail Barcodes on over 3 billion pieces of mail annually (discussed in subsection 1, *supra*). Under these pay-for-performance elements, these discounts would be a share of the cost savings to the Postal Service. The agreement, rather than specifying any particular operational changes, would allow the Bank to decide how best to change its practices to obtain these discounts. NSA §§ IV.A and B; Ayub Direct (USPS-T-1) at 4-6, 13; Jones Direct (BAC-T-1) at 10-13.

These pay-for-performance elements are extremely attractive to BAC. BAC is experienced with Six Sigma and believes that it is well tailored to helping the Bank reduce its UAA rate and increase the read/accept rate on its mail. If the NSA is approved, BAC will use Six Sigma to explore multiple tools and methods for improving addresses to reduce UAA mail and to increase read rates. Jones Direct (BAC-T-1) at 13-16.

a. Improved mail processing performance for First-Class and Standard Mail

The NSA would offer BAC rate incentives for improved mail processing performance for First-Class and Standard Mail. See *generally* Ayub Direct (USPS-T-1) at 13.³ The incentive provisions for First-Class Mail appear in NSA § IV.C, proposed DMCS ¶¶ 630.421 and .422, and proposed Rate Schedule 630A. The incentive provisions for Standard Mail appear in NSA § IV.F, proposed DMCS ¶¶ 630.431 and .432, and proposed Rate Schedule 630D.

The baseline read/accept rates from which improvements in performance are calculated would be 96.8 percent and 96.9 percent, respectively, for First-Class and Standard Mail. Ayub Direct (USPS-T-1) (revised) at 18 and 20.

The Postal Service has assumed in its financial calculations for the NSA that read/accept rates in the first year of the agreement would improve for both classes of mail by 0.1 percent, in the second year by 0.7 percent for both classes, and in the third year by 1.3 percent for First-Class Mail and 1.6 percent for Standard Mail. Ayub Appendix A, Bank of America NSA Filing Model (Revised), at 2. BAC has estimated that the mail processing improvement will be one percentage point. Jones Direct (BAC-T-1) at 17. The profitability of the NSA, however, does not depend on the precise amount of the actual improvement. Because the discounts for improved mail processing performance are set at less

³ For a definition of the term read/accept rate, see Tr. 74-80, 134 and 263 (Ayub responses to OCA/USPS-T1- 5 and 32 and VP/USPS-T1-10).

than 100 percent of unit cost savings, the agreement would be profitable at all levels of improvement. Tr. 71-73 (Ayub response to OCA/USPS-T1-4).⁴

b. Reduced return rates for First-Class Mail

The NSA also would offer BAC financial incentives for reducing the return rates of its qualifying First-Class Mail. NSA § IV.D; proposed DMCS ¶ 630.423 and .424; proposed Rate Schedule 630B; Ayub Direct (USPS-T-1) at 13.

The baseline performance values for calculating improvements in return rates would be 0.7 percent for operational mail and 2.7 percent for marketing mail. These rates, weighted by BAC's mail mix, produce an overall BAC return rates for First-Class Mail below the system-wide average of 1.7 percent. Jones Direct (BAC-T-1) at 16. 1; Ayub Direct (USPS-T-1) at 18; Tr. 67 (Ayub response to OCA interrogatory 1); *id.* at 137 (Ayub response to OCA interrogatory 34).

The Bank estimates that, under the NSA, it could improve its current performance by 10 percent. Jones Direct (BAC-T-1) at 18.

The derivation of the resulting unit cost savings appears in Ayub Direct (USPS-T-1) at 18-19 and Appendix A. The rate incentives offered by the Postal

⁴ For an explanation of how baseline performance values were determined, see Ayub Direct (USPS-T-1) at 16, 20-21; Tr. 82 (Ayub response to OCA/USPS-T1-7); Tr. 83-84 (Ayub responses to OCA/USPS-T1-8 and 9); Tr. 114-115 (Ayub responses to OCA/USPS-T1-24 and 25). For an explanation of how the unit cost savings were estimated, see Ayub Direct (USPS-T-1) at 17, 21-22; Tr. 101-102 (Ayub responses to OCA/USPS-15 and 16). The challenges by APWU, OCA and Valpak to the reasonableness of the baseline values are discussed in section II.B.2, *infra*.

Service would pass through less than 100 percent of those unit cost savings to BAC as discounts. Tr. 71-73 (Ayub response to OCA/USPS-T1-4).

c. Reduced forwarding rates for Undeliverable-As-Addressed First-Class Mail

The NSA would also offer BAC financial incentives for reducing the forwarding rate of its UAA First-Class Mail. NSA § IV.E; Proposed DMCS ¶¶ 630.425 and .426; Rate Schedule 630C.

The baseline forwarding rate assumed in calculating discounts would be 1.7 percent. This value was derived from an analysis of actual NCOA data on BAC's current forwarding rate for First-Class Mail. Jones Direct (BAC-T-1) at 17; Ayub Direct (USPS-T-1) at 19-20; Tr. 68 (Ayub response to OCA/USPS-T1-2); Tr. 469-473 (BAC answer to OCA/BAC-T1-1) (explaining derivation of value); *id.* at 491-93 (BAC answer to POIR 1, Question 3) (same).

BAC estimates that, with the NSA in place, it could reduce the forwarding rate of its First-Class Mail by 10 percent. Jones Direct (BAC-T-1) at 18.

The derivation of the resulting unit cost savings appears in Ayub Direct (USPS-T-1) at 18-19 and Appendix A. The rate incentives offered by the Postal Service would pass through less than 100 percent of those unit cost savings to BAC as discounts. Tr. 71-73 (Ayub response to OCA/USPS-T1-4).

d. Reduced UAA rates for Standard Mail

The NSA also would offer BAC financial incentives for reducing the UAA rate of its qualifying Standard Mail. NSA § IV.G; Proposed DMCS ¶¶ 630.433 and .434; Rate Schedule 630E. A reduction in the UAA rate would enable the Postal Service to avoid the cost of disposing of UAA Standard Mail. Ayub Direct (USPS-T-1) at 21-22.

Because the Bank lacks company-specific data on the UAA rate of its Standard Mail, the Bank and the Postal Service have agreed to use the UAA rate for all subclasses and shapes of Standard Mail, 6.4 percent, as a proxy baseline rate. Jones Direct (BAC-T-1) at 17; Ayub Direct (USPS-T-1) at 16. This baseline value is conservatively low. Tr. 85-87 (Ayub answer to OCA interrogatories OCA/USPS-T1-10 and 11).

The Bank estimates that, with the NSA in place, the Bank would reduce the UAA rate for its Standard Mail by 10 percent. Jones Direct (BAC-T-1) at 18.

The derivation of the resulting unit cost savings appears in Ayub Direct (USPS-T-1) at 17-19 and Appendix A. The rate incentives offered by the Postal Service would pass through less than 100 percent of those unit cost savings to BAC as discounts. Ayub Direct (USPS-T-1) at 17; Tr. 71-73 (Ayub response to OCA/USPS-T1-4).

e. Reduction in PKR mail

The actions taken by BAC to improve the accuracy of its addresses (to reduce its rate of UAA mail) would also have the further effect of reducing the

amount of “Personal Knowledge Required” (“PKR”) mail. PKR mail is mail with an addressing defect that requires personal intervention by a Postal Service employee—typically a carrier—to complete delivery. The local employee manages to achieve deliver of PKR mail by redirecting it to another address on the same delivery route or to an address on another delivery route with the same station. BAC comments on NOI #1 (April 17, 2007) at 15-16.

During the negotiations for this NSA, the Bank and the Postal Service were unable to agree on a baseline for BAC PKR mail and on a method for measuring improvements from a baseline. But the parties did agree that PKR imposes substantial costs on the Postal Service. IF BAC mail has PKR rates by class equal to system-wide PKR rates by class, then BAC PKR mail imposes costs of over \$2 million annually. If BAC address improvements reduce the PKR rate by 10 percent, the Service will save over \$200,000 annually; if the rates are reduced by 50 percent, the savings will be over \$1 million per year. *Id.*

ARGUMENT

I. THE GOVERNING LEGAL STANDARDS

This proceeding is governed by the standards set forth in former Sections 3622 and 3623 of Title 39, United States Code (which remain in effect for a transition period pursuant to 39 U.S.C. §§ 3622(f)), and under the applicable Commission rules of practice and procedure. The Commission, however, should also take into account the provisions of the Postal Accountability and Enhancement Act (“PAEA”), P.L. 109-435, 120 Stat. 3198, *et seq.*, which gives the Postal Service greater flexibility in ratemaking generally, and more

specifically in establishing NSA rate discounts like those proposed here, and which terminates on December 20, 2007, the Postal Service's right to seek rate increases when revenues fail to cover costs.

A. Standards For Review Of NSAs Under Pre-PAEA Law

Prior to the enactment of the PAEA, the rates and other terms of proposed NSAs were subject to review under the standards of former 39 U.S.C. § 3622(b) and 3623(c) governing review of rate and classification changes, respectively. The transition provisions of PAEA give continued effect to these standards until the Commission establishes rules implementing the new ratemaking standards of PAEA. See 39 U.S.C. § 3622(f) (establishing one-year transition period, ending on December 20, 2007, after which preexisting provisions of Title 39, to the extent repealed by PAEA, will have no further effect); *Ayub Direct (USPS-T-1)* at 29:2-4.

The Commission' rules governing the review of NSAs under pre-PAEA law are codified in Rules 190 *et seq.* of the Commission's Rules of Practice and Procedure. Rule 190(b) states that "it shall be the policy of the Commission to recommend Negotiated Service Agreements that are consistent with statutory criteria, and benefit the Postal Service without causing unreasonable harm to the marketplace." 39 C.F.R. § 3001.190(b). These rules, particularly Rule 193, provide a detailed checklist of information that NSA proponents must file with the Commission in support of a request for a decision recommending implementation of the NSA. See *also* Postal Service Request, Attachment E (listing relevant

requirements of Rules 193 and 195 and stating that the Postal Service has complied with them, to the extent that they are applicable here).

In practice, the Commission has focused on three factors: (1) what financial impact, if any, the NSA will have on the Postal Service, including whether the rates in the NSA would make a fair contribution to the Postal Service's institutional costs; (2) whether the NSA would discriminate unduly against competitors to the parties to the NSA, or against any other parties; and (3) whether the NSA would have an adverse effect on downstream competition. See, e.g., *Bookspan NSA*, MC2005-3 PRC Op. & Rec. Decis. ¶¶ 4001-4004 (May 10, 2006); *Capital One NSA*, MC2002-2 PRC Op. & Rec. Decis. ¶¶ 1008, 8033 (May 15, 2003).

B. The Effect of the Postal Accountability and Enhancement Act on Standards For Review Of NSAs

The provisions of PAEA are also relevant to the Commission's consideration of the NSA at issue here. One of the central purposes of PAEA 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 regulatory oversight of 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 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). With certain exceptions not relevant here, Section 3622(d) limits the average percentage rate increase for each class of mail to an amount not exceeding the annual increase in the CPI. See *id.*, §§ 3622(d)(2)(A) , 3622(d)(1)(D).

Section 3622(c)(10) both recognizes and authorizes NSAs. It requires the Commission, in establishing a system for regulating rates for market-dominant products, to take into account “the desirability of special classifications for both postal users and the Postal Service . . . , including agreements between the Postal Service and postal users, when available on public and reasonable terms to similarly situated mailers.” *Id.* § 3622(c)(10). Once the rules are in place, the Postal Service will be entitled to implement rate changes on 45 days’ notice, including rate changes resulting from NSAs under Section 3622(c)(10). *Id.*, § 3622(d)(1)(C). The scope of Commission review of proposed rate changes during this 45-day period will be limited. As the Senate sponsors of the legislation recently stated, “The 45-day 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.”⁵

⁵ Letter from Senators Collins and Carper, *supra*, at 2.

Significantly, 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 a high level of certainty that the NSA will increase the contribution made by the affected mail to the Postal Service’s institutional costs. To the contrary, an NSA that enhances the performance of mail processing and other Postal Service functions, as this would do, need not be contribution positive at all. 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).

Although the ratemaking standards established by PAEA will not take effect until PRC promulgates implementing rules later this year or early next year,⁶ deciding the instant proceeding solely by reference to pre-PAEA law would be irrational. Regardless of the outcome of the instant proceeding, the Postal Service will be entitled in a few months to file NSAs substantially identical to this one on only 45 days advance notice, a period obviously too short for the elaborate advance review that has occurred here.⁷ Moreover, even if the NSA at

⁶ 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. at 9-11.

⁷ The pendency of the notice-and-comment rulemaking in RM2007-1 regarding the provisions of the PAEA does not preclude the Commission, in the course of adjudicating this case, from interpreting PAEA to the extent that it bears on the outcome of the case. An agency “is not precluded from announcing new principles in an adjudicative proceeding.” *E.g., NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 294 (1974) (holding that NLRB was not required to use notice-and-

issue here were implemented tomorrow, its contribution to the Postal Service would remain unknown until long after December 20, 2007, when the level of the Postal Service's authority to justify rate increases by reference to the Service's overall earnings will lapse pursuant to new 39 U.S.C. § 3622(f)).

II. THE NSA OFFERS MAJOR BENEFITS TO THE POSTAL SERVICE

For the reasons explained at pages 10-18, *supra*, the proposed NSA would offer major benefits, both short-term and long-term, to the Postal Service. First, BAC's commitment to serve as a very large-scale beta test for Intelligent Mail technologies, without any additional compensation by the Postal Service, would confer very large benefits on the Postal Service. See pp. 10-13, *supra*. The placement of Intelligent Mail Barcodes on Business Reply Mail and Courtesy Reply Mail alone could save the Postal Service several million dollars in each year of the NSA. See p. 12, *supra*.

Second, the pay-for-performance discounts offered by the Postal Service for measurable improvements in the read/accept rates of letter mail, the return and forwarding rates of Undeliverable-As-Addressed ("UAA") First-Class Mail, and the disposal rates of UAA Standard Mail all would pass through less than 100 percent of the estimated cost savings to the Postal Service from such

comment rulemaking procedures, rather than adjudicatory procedures, to interpret the phrase "managerial employees" in the National Labor Relations Act). See also, e.g., *SEC v. Chenery Corp.*, 332 U.S. 194, 203 (1947) ("the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency"); *West Virginia v. Thompson*, 475 F.3d 204, 210 (4th Cir. 2007); *Davis v. United States Environmental Protection Agency*, 348 F.3d 772, 785 (9th Cir. 2003); *Cassell v. FCC*, 154 F.3d 478, 485-486 (D.C. Cir. 1998).

process improvements. See pp. 13-17, *supra*; Ayub Direct (USPS-T-1) at 15-16 & Appendix A (general methodology for estimating cost savings). And the savings from the reduction of PKR mail would be a side benefit for which BAC would receive no postage discounts at all. See pp. 17-18, *supra*.

With one exception, these benefits have been essentially unchallenged by the participants in this case. The exception involves the proposed discounts for improvements in mail processing. APWU, OCA and Valpak have criticized the baseline read/accept rates from which improvements in mail processing performance will be calculated, and have asserted that the Postal Service could therefore be paying BAC discounts for purported improvements in mail processing performance that are merely the result of unrealistically low baseline values. These concerns do not warrant rejection of the NSA or, in what could amount to the same thing, modification of the proposed baseline values. First, the contribution from the NSA must be evaluated for the NSA as a whole, not for any discount element alone. Moreover, the best evidence of record indicates that the discounts for improvements in mail processing performance, even if assessed in isolation, would be contribution positive. Also, the expiration of the Postal Service's authority to file a rate case under pre-PAEA law expires on December 20, 2007. 39 U.S.C. § 3622(f). This ensures, as a matter of law, that the Postal Service could not recover from other mailers a shortfall in contribution caused by this NSA, even in the unlikely event that such a shortfall occurred. We discuss each point in turn.

A. The Contribution From The Proposed NSA Must Be Evaluated For The NSA As A Whole.

In resolving claims that this NSA may not be contribution-positive for the Postal Service, the Commission must consider the profitability of the 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 PRC 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 Agreements*, 69 Fed. Reg. 7574, 7577-78, 7580 (2004) (same); MC2004-4 PRC Op. & Rec. Decis. at 52 (same).⁸

Moreover, even before the enactment of 39 U.S.C. § 3622(c)(10)(A) by PAEA, the Commission recognized that the likelihood of a positive contribution from proposed rate and classifications changes was less important when the proposal was novel, experimental, and/or of relatively limited scale:

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.

⁸ 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.

Capital One NSA, MC2002-2 PRC Op. & Rec. Decis. (May 15, 2003) at ¶ 4003.

None of the participants challenging the proposed discounts for improvements in mail processing performance has offered any evidence that the proposed NSA would fail to offer positive net benefits to the Postal Service *even if the existing read/accept rates were higher than the negotiated baseline*.

B. The Best Evidence Of Record Indicates That The Proposed Discounts For Improvements In Mail Processing Performance Would Be Contribution-Positive Even If Assessed In Isolation From The Other Elements Of The NSA.

Even if the contribution from the proposed discounts for improvements in mail processing performance were assessed in isolation, the record provides ample support for the specific discounts and baselines negotiated by the Postal Service and BAC.

1. In the absence of reliable BAC-specific Before Rates data, reliance on system-average data to set the mail processing baseline is entirely appropriate.

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 existed, 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.⁹

⁹ 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); Tr. 68 (Ayub answer to

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 Barcodes¹⁰ on letter-rated First-Class Mail or Standard Mail.¹¹ Only about half of BAC statement mail currently has a POSTNET barcode, and less than one percent of BAC mail has a PLANET barcode. In any event, neither of these existing symbologies has sufficient fields to carry the information needed to determine mailer-specific read/accept rates.¹² Further, BAC does not currently enter its mailings with mail.dat files or other information needed to enable the Postal Service to determine the denominator of the read/accept ratio.¹³ For these reasons, it is not possible for the Postal Service to measure or calculate read/accept rates specific to BAC.¹⁴

OCA/USPS-T1-2(b)) (same); Tr. 137 (Ayub response to OCA/USPS-T1-34) (baseline return rates for First-Class Mail).

¹⁰ 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.

¹¹ Tr. 71-73 (Ayub response to OCA/BAC-T1-4).

¹² See Ayub Direct (USPS-T-1) at 5, 8, 16; Tr. 98-100 (Ayub response to OCA/USPS-T1-14); Tr. 273 (Ayub response to VP/USPS-T1-3(d)).

¹³ See Ayub Direct (USPS-T-1) at 11:7-8; Tr. 253 (Ayub response to VP/USPS-T1-6). The costs of generating and submitting mail.dat or similar files would be "significant" for BAC. *Id.*

¹⁴ Ayub Direct (USPS-T-1) at 16. See also Tr. 65 (Ayub answer to APWU/USPS-T1- 9) (explaining why MERLIN data cannot be used to generate reliable BAC-specific read/accept rates); Tr. 97 (Ayub answer to OCA/USPS-T1-13) (explaining why CONFIRM data cannot be used to generate reliable BAC-specific read/accept rates).

Under these circumstances, the parties' reliance on system-average data for read/accept rates was entirely appropriate. Perfectly accurate and specific 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 becomes 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.¹⁵ 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.¹⁶

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

¹⁵ *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)).

¹⁶ See, e.g., *GS Roofing Products Co. v. Surface Transportation Board*, 262 F.3d 767, 776 (8th 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 for wheat and barley shipments instead of movement-specific costs" in adjudicating the reasonableness of rates on particular shipments of wheat and barley).

populations” and “heterogeneous mail characteristics.” R2006-1 PRC Op. & Rec. Decis. ¶ 5081. Nonetheless, neither the Commission nor any economic witness appearing before the Commission in Docket No. R2006-1 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)(1)(v).

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 29.¹⁷

2. The record provides no credible evidence that the current read/accept rates for BAC mail are substantially higher than the 1999 system average values relied on by the Commission in R2006-1.

In response to the foregoing precedent, APWU, OCA and Valpak have shifted the main focus of their criticisms from the system-average nature of the data on read/accept rates relied on by the NSA proponents to the *vintage* of the data, suggesting that read/accept rates have increased significantly since 1999, when the data were collected. The 1999 data, however, have been relied on by the Postal Service, and accepted by the Commission without challenge by any participant, to estimate worksharing cost avoidances in every omnibus rate case since Docket No. R2000-1, including Docket No. R2006-1.¹⁸ Under these

¹⁷ 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 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.

¹⁸ See Tr. 40, 81-82 (answers of USPS witness Ayub to APWU/USPS-T1-2, OCA/USPS-T1-6, and OCA/USPS-T1-7).

circumstances, participants challenging the reasonableness of these values in an individual NSA case should bear the burden of demonstrating that the values are no longer correct. None of the more recent data offered into the record satisfy this burden. We discuss in turn (1) the results of comparative tests of competing models of Wide Field-of-View barcode readers under consideration for purchase by the Postal Service about six years ago; (2) data generated by three recent pilot tests of the use of Intelligent Mail Barcodes by other mailers; (3) and end-of-run report data. None warrant the adoption of higher baseline values.

Tests of the Wide Field-Of-View Barcode Reader in 2001-2003. During this proceeding, in response to APWU discovery requests, the Postal Service produced several documents from the 2001-2003 time period assessing the potential performance of Wide Field-of-View barcode reader equipment then under consideration and ultimately purchased by the Postal Service. While some of the test results indicated read/accept rates higher than 96.8 or 96.9 percent, the results are clearly inapposite here.

First, the accept rates collected by the tests were not intended to be used as a basis for setting rates, a use that would require data on *absolute* accept rates, but rather were intended for the comparative exercise of determining which vendor's model performed best *in comparison to the competing vendors'* models. Tr. 411 (Raney answer to APWU/USPS-T1-1 at 5).

Second, the competitive test was conducted "under controlled conditions that do not necessarily reflect the real world conditions under which BAC's mail processing performance will be measured and evaluated." *Id.* Technicians for

the vendors were permitted to “conduct routine preventative maintenance and corrective maintenance on the equipment during the test”; were “encouraged to have ample spare parts to support their [WFOV] systems during the entire [test period]”; and were given a procedure for “mak[ing] hardware, software, and cabling improvements to the WFOV camera systems during the test.” *Id.* at 411-412.

Third, data were reported for only a selected subset of about 10 percent of the pieces for which data were collected during each week. Moreover, vendors were given “pretests” and a week of “fine-tuning” before the “formal test period commenced.” *Id.* at 412.

Needless to say, the kid glove treatment given to the vendors and their equipment in the test—and the obvious competitive incentives of the vendors to tweak their equipment to obtain the best possible results—do not reflect the actual shop floor conditions in which mail is processed in the ordinary course of business by the Postal Service.¹⁹

Pilot test of Intelligent Mail Barcodes with three other business mailers. It has also been suggested that the results of pilot tests with the use of Intelligent Mail Barcodes by three other mailers may also warrant the adoption here of baselines higher than 96.8/96.9 percent. Like the Wide Field-of-View tests, however, the pilot tests do not provide a reliable estimate of the

¹⁹ We emphasize that there was nothing improper about the test protocol. But its purpose was to obtain a *relative* ranking of the rival equipment that the Postal Service was considering for purchase, not determine the *absolute* performance of mail processing equipment in a shop floor environment six years later.

read/accept rates that barcodes from mailers like BAC are likely to achieve in the ordinary course of business. Tr. 141-42 (Ayub answer to OCA/USPS-T1-35); Tr. 205 (Ayub answer to OCA/USPS-T1-36(b)).

First, the scan rates in the pilot tests were not based on the same definition of “read/accept” as the NSA. “Pieces could be scanned” within the meaning of the pilot test reports “without being read and accepted within the meaning of the NSA, and *vice versa*.” Tr. 42 (Ayub response to APWU/USPS-T1-4).

Second, high profile pilot studies of this kind are often viewed by the participants as an opportunity to showcase both the new technology and the skill of the study participants at mastering it. For this reason, participants in studies of this kind often devote more resources to maintenance, alignment, cleaning and calibration than might be expected with a mature technology used in the ordinary course of business. Tr. 141-42 (Ayub answer to OCA/USPS-T1-35).

Third, the pilot test results were based on a unrepresentative *subsample* of the mailpieces that was produced by *excluding* mailings with a MERLIN success rate below 95 percent. This selection process obviously skewed the results upward, because barcode readability is one of the grounds for rejection of mailpieces by MERLIN, and MERLIN pass rates correlate strongly with successful scan rates. *Id.* at 142 (citing <http://ribbs.usps.gov/files/mtac/merlinbc.doc>); Tr. 155 (USPS *Seamless Acceptance Pilot* (Feb. 20, 2007), p. 8).

Fourth, even with all the special attention, the scan rates from the pilot tests are only marginally improved over the older values. The weighted average scan rate of the three study participants—97.14 percent—is barely higher than the baseline scan rates of 96.8 and 96.9 percent. *Id.*

Fifth, equally significant is the *variation* in performance among the three participants, ranging from 96.88 percent for mailer C to 97.28 percent for Mailers A and B. *Id.*; see also Tr. 145-47 (Attachment A to Ayub response to OCA/USPS-T1-35). This variation refutes the notion that the mere use of Intelligent Mail Barcodes is a magic bullet that produces higher read/accept rates without additional care and effort by the mailer. To the contrary, a variety of factors can cause the barcodes on automation letters to fail to be read and accepted. Tr. 117-19 (Ayub response to OCA/USPS-T1-27) (enumerating causes). Overall, there is no reason to believe that the deployment of Intelligent Mail Barcodes has had a “measurable increase in the read/accept rates of First-Class Mail or Standard Mail letters.” Tr. 206 (Ayub answer to OCA/USPS-T1-37).

End-of-Run Reports. In the late stages of this proceeding, APWU focused its discovery efforts on certain end-of-run report data generated by the Postal Service. For the reasons explained by USPS witness Brent Raney, however, the baseline read/accept rates of BAC mail are almost certainly lower than the scan rates reported by the end-of-run reports for the average mail at a comparable stage in the network.

The reason is that average accept rates in operations where mail is predominantly processed for the first time tend to be lower than in operations where mail has already been run multiple times upstream on the Postal Service's automated equipment. Because BAC's mail mix is predominantly 3-digit and 5-digit, BAC's automation mail is likely to bypass upstream operations and receive its first scan in a downstream mail processing operation. As a result, BAC's mail is more likely to experience lower-than-average accept rates than mail processed in the same operation that has been previously processed and accepted in an upstream operation, since the mail mix in downstream operations would presumably exclude pieces that were already processed and rejected upstream. Tr. 403 (Raney answer to APWU-ST3-5).

C. Implementation Of PAEA Within The Next Few Months Will Insulate Other Mailers From Any Revenue Shortfalls Potentially Caused By The Failure Of Any NSA To Make A Positive Contribution To The Postal Service's Institutional Costs.

As noted above, one of the central purposes of PAEA 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. See pp. 20-23, *supra*. The enactment of PAEA has eliminated the putative threat of harm to other mailers that Commission relied on to justify oversight of NSA discount terms in the first place: the risk that the "burden of recovering" any loss in "contribution" resulting from unnecessary or needlessly large NSA discounts "would fall largely on captive monopoly mailers

not party to the agreement.”²⁰ PAEA has eliminated this risk by breaking the link between the contribution from NSAs and the regulatory ceiling on other postal rates. Regardless of the profitability of any individual NSA, or even all NSAs in the aggregate, 39 U.S.C. § 3622(d) caps overall increases to the levels justified by the CPI. If the Postal Service offers excessive or needless discounts to an NSA partner, the Postal Service alone will bear the financial consequences.

To be sure, the ratemaking standards established by PAEA will not take effect until PRC promulgates implementing rules later this year or early next year.²¹ But even if the NSA at issue here were implemented tomorrow, its financial impact on the Postal Service will not be known until long after December 20, 2007, when the Postal Service’s ability to seek rate increases under the pre-PAEA ratemaking standards lapses under 39 U.S.C. § 3622(f)). Thus, there is no possibility that the amount of financial contribution generated by the BAC NSA could influence the regulatory constraints on any future rate changes of general applicability.

Concerns have been expressed that NSA discounts could lead to higher rates for services of general applicability within the same class(es) of mail covered by an NSA because the CPI-based cap established by 39 U.S.C.

²⁰ *Bank One NSA*, MC2004-3 PRC Op. and Further Rec. Decis. ¶ 1004 (April 21, 2006); *accord, id.*, PRC Op. & Rec. Decis. ¶ 1010 (Dec. 17, 2004); *Capital One NSA*, MC2002-2 PRC Op. & Rec. Decis. ¶¶ 1008 (if an NSA reduced the net contribution to the Postal Service from the mailer, “other mailers’ rates would have to increase to make up the difference”), 3062-63, 5061, 5084-85, 8036-37, 8043.

²¹ The Commission has indicated a desire to issue implementing rules as early as this October. See p. 22 n. 6, *supra*.

§ 3622(d) applies to each class as a whole, not to individual services. Hence, the reasoning goes, an NSA that is contribution-negative could entitle the Postal Service to higher rates for other services within the same class or classes. This concern is misplaced on several grounds.

First, it overlooks the distinction between *contribution* and *revenue per piece*. Any rate reduction for any service within a class will, by definition, allow the Postal Service to charge higher rates for the remaining services within the same class. That is the nature of an average. If that push-up effect were considered undesirable by the drafters of PAEA, however, the legislation would not have authorized the Postal Service to implement non-uniform rate increases under Section 3622(d), let alone give the Postal Service so much downward pricing flexibility.

In contrast, reductions in the Postal Service's *total contribution* resulting from an NSA discount (or any other rate change, whether up or down) cannot affect the regulatory ceiling established by Section 3622(d) because total contribution, unlike average revenue per piece, is not an input to the Section 3622(d) rate escalation mechanism. The elimination of the revenue and break-even requirements from postal ratemaking completely severs any link between (1) the effect of an NSA on the Postal Service's total contribution, and (2) the rates that the Postal Service may charge for any other services. See Section I.B, *supra*.

Finally, even if changes in average revenue per piece (as opposed to total contribution) resulting from NSA discounts were an appropriate focus of

regulatory concern, the Commission could insulate other mailers from any push-up effect caused by the NSA discounts by either (1) excluding the NSA mail volumes from the mix of outputs to which the CPI index is applied, or (2) imputing undiscounted rates to those volumes.

In an analogous context—the pricing of competitive services—the Commission appropriately has taken a hands-off approach to rate setting in the wake of PAEA. As the Commission explained in its recent recommended decision in Docket No. R2006-1:

The Postal Accountability and Enforcement Act of 2006 has altered the way postal rates will be set in the future. In particular, the Postal Service will have wide flexibility to set the rates for competitive products, so long as those products generate revenues sufficiently above costs. In recognition of that fact, the Commission has not recommended new rate designs for the Postal Service’s competitive products. Rates for Express, Priority and Parcel Post include adjustments to better reflect costs, but otherwise are largely as suggested by the Postal Service.

R2006-1 PRC Op. & Rec. Decis. at iv. The amount of revenue at stake in these competitive mail classes—approximately \$6 billion annually for Priority Mail and Express Mail alone—exceeds by a ratio of approximately 250-to-1 the \$24 million in total rate incentives that the Postal Service estimates it could pay BAC over the entire three-year life of the NSA.²² Moreover, \$24 million would represent only *one percent* of the postal revenue that the Postal Service would receive over the three-year term of the NSA. Ayub Direct (USPS-T-1) at 26.

²² Compare NSA Request, Ayub Direct (USPS-T-1), App. A, worksheet “USPS Value,” cell I-36 and R2006-1 PRC Op. & Rec. Decis., App. G, Schedule 1.

The participants in the instant proceeding do not challenge the Commission's deference to the Postal Service's business judgments concerning the contribution-maximizing rates to charge in non-NSA contexts. No participant here—including the APWU, OCA, and Valpak—has proposed in Docket No. RM2007-1 that the Commission engage in an advance general review of future rate changes for market-dominant products to verify that the Postal Service has maximized its net contribution to institutional costs from those products. Nor has any participant here proposed in Docket No. RM2007-1 that the Commission engage in any such scrutiny of rates for *competitive* products.

To the contrary, APWU has acknowledged in its comments in Docket No. RM2007-1 that:

Section 3632 of the PAEA vests the Postal Service Governors with the primary responsibility for establishing rates and classes for competitive products. The Commission is tasked with enacting regulations to address only three things: 1) prohibit subsidization of competitive products by market dominant products; 2) ensure these products cover their attributable costs; and 3) ensure these products cover their appropriate share of the institutional costs. *In so doing the Commission should use a light hand and give the Postal Service a maximum amount of flexibility.*²³

²³ Initial Comments of APWU In Response To Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, filed April 6, 2007, in Docket No. 2007-1, at 12 (emphasis added; footnote omitted). See also Initial Comments of APWU In Response to Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, filed June 18, 2007, in Docket No. RM2007-1, at 5-6 (“As long as products within the competitive products category cover their attributable costs, there is no problem with cross-subsidization. . . . The annual compliance report should contain all the data necessary to enable the Commission to determine compliance. More frequent reporting is not and should not be required”).

OCA proposed a similarly light-handed approach to the pricing of competitive products:

OCA is not proposing that each competitive product, i.e., Priority Mail, etc. be required to make the same percentage of contribution to institutional costs as it did in Docket No. R2006-1. Rather, the percentage contribution each competitive product summed together made, in Docket No. R2006-1, is the *starting point* for the level of contribution that total competitive products must make to institutional costs. From that point, the Commission may apply adjustments, as it deems necessary, to reach the appropriate collective share of institutional costs.²⁴

Valpak has taken a similar position. In describing the Commission's review of the ratesetting decisions of the Postal Service, Valpak stated that under PAEA the authority over ratesetting for competitive products "is vested in the Board of Governors," and that such authority is "broad."²⁵ In short, these three

²⁴ OCA Comments In Response To Second Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, filed June 18, 2007, in Docket No. RM2007-1, at 35 (emphasis in original). See *also id.* at 33 ("the appropriate standard for determining whether competitive products are being subsidized by market-dominant products should be based on the ability of *all competitive products, collectively*, to cover both their attributable and an appropriate share of institutional costs as determined by the Commission") (emphasis added). See *also, e.g.*, OCA Comments In Response To Advance Notice of Proposed Rulemaking on Regulations Establishing a System of Ratemaking, filed April 6, 2007, in Docket No. RM2007-1, at 15 (due to PAEA, "the Postal Service is no longer required to set rates by marking up attributable costs. Rather, the Postal Service, as a profit-seeking enterprise, can be expected to set rates for individual classes, categories or mailers (or individual pieces) based on *its* estimate of marginal cost and elasticity of demand. The Commission's task will be to verify that revenues of subclasses covered attributable and reasonably assignable costs, as defined by the Commission") (emphasis in original).

²⁵ Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Regulations Establishing a System of Ratemaking In Response To Commission Order No. 2, filed April 6, 2007, in Docket No. RM2007-1, at 29. See *also, e.g.*, Valpak Reply Comments on Regulations Establishing a System of Ratemaking In Response To Commission Order No. 2, filed May 7, 2007, in

participants concur that the Commission should defer to the Postal Service's business judgment concerning the approximately \$72 billion in postal revenues from rates of general applicability, including approximately \$6 billion from rates for competitive products.

If the Commission and the participants here concur (as does BAC) that the public interest is best served by this deference, it is utterly illogical to obsess over an NSA such as the one at issue here, which involves only an estimated \$24 million in rate incentive payments—several orders of magnitude less than the Postal Service's revenue from competitive products alone. Even the total combined revenue impact of *all* of the existing NSAs approved by the Commission (or submitted for approval) pales in magnitude to the revenues from the services that all of the participants agree should be left to the general discretion of the Postal Service. The participants, having (properly) urged the Commission to swallow these camels, cannot logically ask the Commission to strain the NSA gnat.

D. Adjustments To The Baseline Read/Accept Rates Negotiated By BAC And The Postal Service Would Reduce The Economic Incentive For BAC To Invest In Improved Performance, And Could Jeopardize The Entire NSA.

Adjusting the baseline read/accept rates negotiated by BAC and the Postal Service would be counterproductive as well as unnecessary. "Protecting" the Postal Service and its other customers against the purported risk that the

Docket No. RM2007-1, at 10 ("If there is any observation about PAEA which is incontestable, it is that the Postal Service is given greater authority to set rates for competitive products than for market dominant products").

negotiated baseline values are too low by substituting higher values would in fact reduce the potential benefits of the NSA—for BAC, the Postal Service, and mailers generally. By reducing the potential gains to BAC, such an adjustment would reduce BAC's incentive to invest in improved mail processing performance, and could jeopardize the willingness of BAC and the Postal Service to implement the NSA at all.

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. Tr. 494-499 (BAC response to VP/USPS-T1-32(b)). With or without the NSA, BAC will invest in improving address quality only to the extent that the incremental benefits that BAC expects to receive over the three-year term of the NSA exceed 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—whether through a flat increase in the baselines, or a sliding scale adjustment in the second and third years of the NSA—would reduce the expected payoff to BAC from such expenditures over the life of the NSA, and

therefore reduce the amount that BAC would be willing to spend. See Tr. 477-78 (Jones answer to OCA/BAC-T1-3; Tr. 116 (Ayub answer to OCA/USPS-T1-26). Beyond a certain point, a large enough diminution in the expected value of the NSA could induce BAC or the Postal Service to abandon the NSA entirely under Section V.E.1.c of the NSA. Under either scenario, the losers would include BAC, the Postal Service, and the public interest in an efficient and financially healthy postal system.

III. THE NSA WILL NOT HARM OR UNDULY DISCRIMINATE AGAINST COMPETITORS OF BAC.

The record in this proceeding contains no evidence that the proposed NSA is anticompetitive or discriminatory. Both the history of previous NSAs, and the evidence in this case, establish to the contrary. Moreover, the suggestion of APWU that the NSA somehow contravenes anti-discrimination statutes as a matter of law is baseless.

A. The NSA Will Not Discriminate Unduly Against Competitors Of BAC Or Otherwise Impair Downstream Competition.

Rule 195 of the Commission's Rules of Practice and Procedure requires that the Postal Service's request for approval of an NSA include a written justification for filing its proposal as an NSA, as opposed to a more generally applicable form of classification. 39 C.F.R. § 3001.195(a)(1). The Postal Service has fully satisfied that requirement. See Request, Attachment E-11. As the Postal Service explained, the terms and conditions of the NSA are tailored to the mail entered by BAC, and the particular effect of the mail on Postal Service

operations and costs. Because the baseline mailing profiles of other mailers (including other banks) are likely to differ, a generally available classification would not be a reasonable substitute for the NSA at issue here. Request at 3.

Approval of the proposed NSA by the Commission will not result in undue or unreasonable discrimination prohibited by 39 U.S.C. § 403(c). Mailers who can demonstrate that they are similarly situated to BAC may negotiate a functionally equivalent NSA tailored to the customer's specific mailing profiles. See *Ayub Direct* (USPS-T-1) at 26:21-23. In fact, the Postal Service, noting the possibility that Valpak may qualify as a functionally equivalent mailer, has specifically invited Valpak to enter into discussions over a functionally equivalent NSA. Tr. 270 (Response of USPS Witness Ayub to VP/USPS-T1-16).

The terms of the NSA underscore the Postal Service's willingness to offer functionally equivalent arrangements to other mailers. Proposed paragraph 630.22 of the DMCS provides:

Functionally equivalent NSAs, involving worksharing discounts for performance-based improvements resulting from (i) the implementation of Four-State Barcode, OneCode ACS, CONFIRM Service, Seamless Acceptance, FAST, and eDropShip, (ii) the barcoding of Courtesy Reply Mail, Business Reply Mail, and Qualified Business Reply Mail, and (iii) the adoption of electronic Address Correction Service in lieu of physical returns for letter-rated First-Class Mail that would otherwise be eligible for Standard Mail Rates, may be entered into with other customers, as specified by the Postal Service, and implemented pursuant to proceedings under Chapter 36 of Title 39, United States Code.

Request, Attachments A-1 – A-2 (emphasis added).

The willingness of the Postal Service to offer functionally equivalent NSAs to similarly situated customers precludes any finding that the NSA at issue here is unduly or unreasonably discriminatory. As the Commission has repeatedly stated, and reiterated most recently in the Bookspan NSA case, if “the essential features of the NSA are available to other similarly situated mailers, the Agreement does not run afoul of § 403(c)”—even if, as here, the NSA “is tailored to a specific mailer.” MC2005-3 Op. & Rec. Decis. at ¶ 4016.

Concerns about competitive injury to BAC’s rivals are equally unfounded. The proposed NSA will have no material adverse effect on competitors. The incentives that the Postal Service offers in this NSA are not intended to increase the volume of BAC’s mail, and are not expected to produce a measurable effect on the number or types of accounts that BAC may acquire through the mail during the three-year duration of the NSA. See *Ayub Direct (USPS-T-1)* at 26:11-14. Moreover, the savings that will accrue to BAC under the NSA are estimated by the Postal Service to be only \$24 million—only one percent of BAC’s total spending on postage over the life of the NSA (and an even smaller percentage of total BAC costs and revenue). *Id.* at 26:14-20.

Furthermore, potential competitive concerns are further dispelled by the right of competing banks to enter into a functionally equivalent NSA with the Postal Service. As the Commission found in the *Discover NSA* case:

Preventing similarly situated mailers from obtaining functionally agreements is potentially discriminatory. By making a functionally equivalent agreement available to DFS, the Postal Service has taken an important step in reducing the potential for competitive harm caused by this style of agreement.

MC2004-4 Op. & Rec. Decis. at 44. See also, e.g., MC2004-3 Op. and Rec. Decis. at ¶ 6114.

For these reasons, it is unsurprising that no competing bank has challenged this NSA—or any previous NSA involving a financial institution. See Capital One NSA, MC2002-2 PRC Op. & Rec. Decis. (May 15, 2003) at ¶¶ 3023-3031, 5076, 7003-7023; *id.*, ¶ 5048 (finding that concerns about competitive injury “did not apply with much force” because Capital One’s competitors “did not object to the NSA during the proceeding” and “the party most likely to represent direct competitors, the American Bankers Association, signed the Stipulation and Agreement” supporting the NSA); Discover Financial Services NSA, MC2004-4 PRC Op. & Rec. Decis. at 43-44 (same); Bank One NSA, MC2004-3 PRC Op. & Rec. Decis. at ¶ 6113, 6115-6116.

B. The APWU’s Arguments That the Terms of the NSA Are Discriminatory Are Without Merit.

APWU has argued in this proceeding that the NSA terms proposed by BAC and the Postal Service contravene the policies of 39 U.S.C. §§ 101(d), 403(c) and 404(c). See Reply of APWU To Comments Filed In Response To Notice of Inquiry No. 1, filed April 24, 2007, at 1-3 (“APWU Reply”). APWU’s arguments, however, do not withstand scrutiny.

1. 39 U.S.C. § 404(c)

APWU has contended that former 39 U.S.C. § 3623(d), recodified as 39 U.S.C. § 404(c) by Section 1010(e) of the PAEA (120 Stat. 3262), establishes a

“fundamental policy” that there be “one uniform rate for First-Class letters.” APWU Reply at 1-2. This policy, according to APWU, is “of critical importance to the validity of” the proposed NSA. *Id.* APWU, however, misapprehends both the nature of the uniformity requirement and its relevance to the proposed NSA.

39 U.S.C. § 404(c), like former 39 U.S.C. § 3623(d), states in relevant part:

The Postal Service shall maintain one or more classes of mail for the transmission of letters sealed against inspection. The rate for each such class shall be uniform throughout the United States, its territories, and possessions.

The uniformity required by this provision is geographic only: “rates for letters sealed against inspection” must “be available on the same terms *nationwide*.” PRC MC76-1 Op. (July 15, 1977) at 6 (emphasis added). Nothing in the Act forbids nonuniformity among First-Class rates with respect to *any other* physical or cost characteristic of the mail, including the quality of its addresses and barcodes. As the Commission noted in MC76-1:

No one can seriously contend that Congress intended the uniformity clause of section 3623(d) to end all rate distinctions applicable for first-class mail or to prohibit new distinctions from being used when appropriate under section 3622. Our construction gives effect to the plain meaning of the language of section 3623(d) by maintaining the requirement that rates be uniform throughout the nation.

Id. at 7-8.²⁶

²⁶ Even with respect to geographic uniformity, the Commission has held that the uniformity requirement of Section 3623(d) allows geographic rate deaveraging of First-Class Mail as long as the deaveraged rates (e.g., “local” rates) are “available on the same terms nationwide.” PRC MC76-1 Op., *supra*, at 7.

First-Class rates have varied with weight since the inception of First-Class Mail. Moreover, the Commission has recommended non-uniform First-Class rates to reflect cost differences caused by presorting, shape and other non-weight cost drivers since the 1970s. In MC73-1, for example, the non-uniformity included “both a new first-class rate differential based on mailer preparation, and prospective surcharges for first-class mail with difficult to process shapes.” PRC Op. MC76-1, *supra*, at 7. Rate deaveraging has proliferated since then, and its variations have become an integral part of the First-Class rate structure. If APWU’s extravagant reading of 39 U.S.C. § 404(c) were correct, all of these forms of rate nonuniformity, including any weight-related charges, would have to be eliminated.²⁷

Moreover, PAEA enacted 39 U.S.C. § 3622(c)(10), which authorizes the Postal Service to enter into NSAs and other non-uniform “special classifications,” and 39 U.S.C. § 3622(e), which establishes limits on certain specified “workshare discounts.” Neither the language nor the legislative history of these provisions suggest that Congress intended PAEA to expand the uniformity requirement of 39 U.S.C. § 404(c) beyond the scope of former 39 U.S.C. § 3623(d).

²⁷ APWU gains nothing by citing MC95-1 PRC Op. & Rec. Decis. ¶¶ 2048 and 3005. See APWU Reply at 2. Paragraph 2048 of that order is merely a summary of general trends in postal policy from colonial America to the present. Paragraph 3005 merely states that the “sealed against inspection” and uniformity requirements imposed by former 39 U.S.C. § 3623(d) provide an adequate basis for establishing First-Class Mail as a separate class. Neither paragraph discusses, let alone supports, the expansive notion of uniformity advocated by APWU here.

2. 39 U.S.C. §§ 101(d) and 403(c)

APWU has also described as “pertinent” the “policy requirement” of 39 U.S.C. § 101(d) that “[p]ostal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis,” and the prohibition of 39 U.S.C. § 403(c) against “undue or unreasonable preferences” in rates. APWU Reply at 2 (quoting 39 U.S.C. §§ 101(d) and 403(c)). Neither provision, however, mandates uniformity of contribution or markups, let alone forbids the Commission from recommending an NSA with discount thresholds based on system-average data.

Finally, for the reasons discussed above, the record provides no basis for any finding that the NSA would cause a loss of contribution that could in turn “result in higher rates for other mailers.” Indeed, the enactment of PAEA makes this outcome a legal impossibility.

CONCLUSION

For the foregoing reasons, Bank of America Corporation respectfully requests that the Commission recommend the Negotiated Service Agreement as proposed.

Respectfully submitted,

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