Office of Inspector General

April 9, 2004

MEMORANDUM FOR JOHN E. POTTER, POSTMASTER GENERAL, CHIEF EXECUTIVE OFFICER

FROM: /s/ (Scott Wilson for)
David C. Williams
Inspector General

SUBJECT: Postal Service's Funding of the Civil Service Retirement System (Product Number FT-OT-04-002)

This memorandum presents our opinion on the issues surrounding the Postal Service's funding of the Civil Service Retirement System (CSRS) (Project Number 03XD009FT005). The objective was to analyze the outstanding issues pertaining to the Postal Civil Service Retirement System Funding Reform Act of 2003 (Public Law 108-18) and to provide our perspective on how the legislation affects the Postal Service and its stakeholders. We have included the differing viewpoints and positions that have been generated by affected groups, including the Department of the Treasury (Treasury), the Office of Personnel Management (OPM), the General Accounting Office (GAO), the Postal Rate Commission, the President's Commission on the United States Postal Service (the President's Commission), mailers, competitors, and the Postal Service.

GAO discovered that the Postal Service's amortized payments to OPM for its CSRS liability were too large. Had the overpayments continued, the Postal Service would have overpaid its obligation by over $100 billion.

When OPM acknowledged the overpayment schedule, the Postal Service was given legislative relief under Public Law 108-18. However, additional burdens were placed on the Postal Service not previously required for CSRS pension costs and not levied against other federal government entities. The decision to include additional obligations associated with CSRS, such as requiring the Postal Service to fully fund military service costs for its employees, brings into question whether Postal Service revenues are being used to fund costs not traditionally borne by federal agencies.

1735 N Lynn St
Arlington, VA 22209-2020
(703) 248-2100
Fax: (703) 248-2256

The proposal to place additional liabilities on the Postal Service is wrong, in our opinion. The Postal Service did not envision it would pay these charges for CSRS pension costs. The Office of Inspector General (OIG) finds that the timing of adding these charges points to an effort to keep higher payments coming into the Civil Service Retirement and Disability Fund (the fund).

Additionally, after fiscal year (FY) 2005, the law requires that "savings" from lowered CSRS payments be held in a separate account not to be used by the Postal Service until new legislation is passed. The OIG believes that Postal Service customers should be the beneficiaries of the lowered payments. All of the Postal Service's funding is derived from its customers' purchases of Postal Service products and it is not allowed to charge customers more than it needs for its expenses. The Postal Service was overcharging customers based on its prior payment schedule.

The Postal Service must now reevaluate its expenses and return the savings to its customers, and has several options for doing so. It may retire debt and cover other retirement costs not previously funded, or it may submit new cost data to the Postal Rate Commission that will ensure proper postage rates are set.

The money should not be given to OPM to subsidize appropriated tax dollars. This would constitute a hidden tax for Postal Service customers that has not been appropriated by Congress.

Background

Postal Service employees generally participate in one of two OPM-administered retirement programs: CSRS and the Federal Employees Retirement System (FERS).[1] Although both retirement programs are funded by employee and employer contributions, the contributions alone are not enough to fully finance the benefits of CSRS from the fund.

The fund, administered by OPM, is supported through employer and employee contributions, investment earnings, and appropriations. For the Postal Service, however, employer contributions to the fund come from revenues generated by its business. These contributions were not segregated from other federal agency contributions but combined to pay benefits to all CSRS retirees.

The fund also allows military service time to be added to an employee's government pension. Previously, all CSRS pension costs related to military service benefits were paid by Treasury through appropriations (taxpayers).

[1] In 2003, over 29 percent of Postal Service employees participated in CSRS, while nearly 70 percent participated in FERS.

The Postal Service traditionally was required to pay OPM for projected increases in pension costs due to pay increases to current CSRS employees, as well as cost-of-living adjustments to present retirees and their survivors. The requirement to make these additional contributions to OPM was unique to the Postal Service. The Postal Service paid these annual costs, with interest,[2] over periods of 30 years for current employees and 15 years for retirees. As a result, in FY 2002, these costs resulted in an increase in retirement benefits of nearly $2.5 billion, with the Postal Service paying $1.2 billion over 30 years and $1.3 billion over 15 years. At the close of FY 2002, the Postal Service reported it had nearly $48 billion in projected future CSRS pension obligations.

In FY 2002, GAO questioned whether the payments made by the Postal Service were sufficient to cover the benefits expected to be paid for Postal Service employees. In response to the GAO report, OPM noted that the Postal Service had fully complied with the law and was adequately funding its retirement obligations. Accordingly, OPM had no further studies underway. However, based on a request from GAO, OPM recalculated the Postal Service's expected pension costs separately from other federal agencies.

Based on those calculations, the Postal Service was notified that its CSRS pension contributions were too large and would exceed the amount OPM expected to pay in retirement benefits to Postal Service employees. It was estimated that the Postal Service would overpay the fund by $105 billion over the life of CSRS primarily due to higher than expected interest earnings. However, $27 billion was charged/transferred to the Postal Service to cover military service benefit costs, not included in prior legislation, which reduced the overpayment to $78 billion over the life of CSRS.

Because the pension costs were computed over the life of CSRS, the Postal Service had not actually overpaid the fund. As of September 30, 2002, OPM estimated that the Postal Service still owed nearly $4.8 billion for pension costs associated with prior years' service.[3] Although the Postal Service had made significant contributions to the fund, it had not yet paid all its pension obligations. The legislation allowed the Postal Service to "slow down" its payment on those obligations because of the estimated overpayments in future years. Appendix A describes, in part, the methodology used by OPM to calculate the estimated potential overpayment.

As a result of OPM and GAO's work, the President signed the Postal Civil Service Retirement System Funding Reform Act of 2003 on April 23, 2003 (Public Law 108-18). The legislation modified the way OPM estimated the Postal Service's contribution to the fund to halt the overpayment. The act:

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[2] The interest rate used in determining the payments over the 30- and 15-year period was 5 percent.
[3] OPM and the Postal Service are currently debating the amount the Postal Service has contributed. OPM believes the Postal Service still owes about $5 billion, while the Postal Service believes it has overpaid the fund by $81 billion for prior years' service.

- Required the Postal Service to continue contributing to the CSRS pension fund, but reduced the amount of its annual payment into the fund:

Fiscal Year	Fund Payment (in billions)	Estimated Savings (Payment Reduction) (in billions)
2003	$1.3	$3.4
2004	$2.2	$2.7
2005	$2.1	$3.1
TOTAL	$5.6	$9.2

The estimated savings, defined as the difference between what would have been paid by the Postal Service had Public Law 108-18 not been enacted and the contributions required under the act, are required to maintain current postage rates through FY 2005 and reduce outstanding debt in FYs 2003 and 2004. After FY 2005, the Postal Service is required to place any savings into a separate account, which cannot be used until authorized in future legislation.

- Made the Postal Service the only agency in the federal government responsible for paying CSRS pension costs attributable to the military service[4] of its employees.[5] Prior to this legislation, Treasury was responsible for paying these costs, which was funded through appropriations (taxpayers).

  As a result, the Postal Service (and its customers) became responsible for an estimated $27 billion in military service pension costs.

  Because of this change, the legislation allowed the Postal Service, OPM, and the Treasury to reevaluate who they believed should be responsible for these benefits and develop alternative proposals. GAO analyzed the proposals and gave Congress a written evaluation, suggesting that Congress consider treating all self-supporting entities like the Postal Service consistently.

- Required the Postal Service to pay all the costs of future CSRS benefits,[6] similar to FERS.[7] For example, the Postal Service now pays 17.4 percent of current

[4] The law also required the Postal Service to fund the value of CSRS benefits attributable to volunteer service, such as the Peace Corps.
[5] The Postal Service is required to fund the value of CSRS benefits attributable to military service of its employees first hired into government service after June 30, 1971, and a portion for employees hired before July 1, 1971, the effective date of the Postal Reorganization Act.
[6] These costs include the expected impact of future investment earnings, increases in basic pay, and inflation, less the amount of employee contributions. These costs are referred to as the dynamic normal cost.
[7] Only a few entities, including the Metropolitan Washington Airports Authority and the Power Marketing Administrations, have been required by law or voluntarily chose to fully fund future benefits (including military service costs).

employees' wages directly to the fund, up from 7 percent of basic pay.[8] The 17.4 percent employer contribution includes the full cost of all military service.

OPM is also responsible for annually recalculating the Postal Service's CSRS pension costs to ensure the Postal Service is continuing to fully fund future benefits. According to Public Law 108-18, OPM is required to make a recalculation of the Postal Service's expected CSRS pension costs by June 30, 2004. Based on the results of the recalculation, the annual payment will be adjusted, if necessary.

See Appendix B for prior audit coverage related to the Postal Service's funding of CSRS.

Results

The Postal Service celebrated its most successful financial year ever in fiscal year (FY) 2003, realizing almost $4 billion in net income. A key component of this financial turnaround was the passage of Public Law 108-18, which reduced the Postal Service's payments into CSRS by an estimated $105 billion for prior and future years. However, $27 billion in military benefit costs were transferred to the Postal Service as part of the law. The legislation required the Postal Service to use the savings to reduce its debt and delay any rate increases until at least FY 2006. However, it allows for the Postal Service, OPM, Treasury, and Congress to revisit the issues surrounding the legislation. Specifically, work remains to be done on three issues:

1. Determining who will be responsible for funding CSRS benefits related to military service performed by Postal Service employees and retirees.
2. After FY 2005, determining how the "savings" created by the reduction in contributions to the CSRS fund would be used.
3. Calculating the Postal Service's CSRS pension costs.[9]

Determining Who Will Be Responsible for Funding CSRS Benefits Related to Military Service Performed by Postal Service Employees and Retirees

The law requires the Postal Service to fund the value of CSRS benefits attributable to military service of its employees first hired into government service after June 30, 1971, and a portion for employees hired before July 1, 1971.

As a result, the Postal Service and its customers are now responsible for about $27 billion in military service pension costs, costs that are not related to workers'

[8] The law did not change the contribution amount for Postal Service employees participating in CSRS – currently 7 percent.
[9] The legislation makes the Postal Service responsible for funding the "supplemental liability," which is the excess of expected future benefits paid over expected future contributions.

employment with the Postal Service. These costs were previously the responsibility of Treasury and were funded through annual appropriations (taxpayers).

The Postal Service, the Administration, Congress, and stakeholders have debated extensively whether the Postal Service or the federal government should fund the full value of military service benefits. For example, when the pension reform bill was introduced, Congress was not convinced that the Postal Service, which is supposed to run like a business, should be paying the costs of military service for employees in CSRS.

In addition, the President's Commission, along with several stakeholders in the mailing industry, recommended that taxpayers, not Postal Service customers, finance military pensions. The President's Commission reported that it was not appropriate for the Postal Service to fund costs that would not be borne by any private sector corporation.

The legislation also required the Postal Service, OPM, and Treasury to develop a proposal detailing who should be responsible for paying this benefit. The Postal Service proposed that the responsibility be returned to Treasury, commenting no other federal agencies, besides Treasury, were required to pay this cost. Rather, it proposed using the estimated overpayment to date (about $10 billion of the $27 billion in transferred costs) for paying postretirement health benefits for its employees and retirees. The Postal Service would also make annual payments to cover those obligations.

OPM and Treasury proposed that pension costs for Postal Service employees should be borne by the Postal Service, including those related to prior military service.[10] They noted that payment of military service costs is consistent with the funding of FERS. When FERS was enacted in 1984, federal agencies, including the Postal Service, were responsible for paying the cost of benefits attributable to military service. OPM and Treasury also commented that it is the Postal Service's reorganization goal to ensure that all costs associated with the Postal Service are paid through postage revenue. The Postal Service has stated that military service has no relationship to Postal Service operations, on which postage rates are based.

GAO analyzed the proposals and gave Congress a written evaluation, suggesting that Congress consider treating all self-supporting entities like the Postal Service consistently.

The OIG believes that taxpayers should pay the costs for military service benefits, not Postal Service customers, and the liability, therefore, should be transferred back to Treasury. It is not appropriate for Postal Service customers to pay, through postage, for these costs when military service protects all Americans. As such, all taxpayers have a responsibility to bear the costs of a common defense through tax dollars. The use of stamps to pay defense costs is, in essence, a "hidden tax" on Postal Service customers.

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[10] OPM and Treasury did propose that the federal government pay a portion of the CSRS pension costs attributable to military service for Postal Service employees first hired into government service before July 1, 1971.

This concept is also inconsistent with law that requires the Postal Service, with the Postal Rate Commission, to establish postage rates to only recover the cost of Postal Service operations.

Determining How the Postal Service Would Use the "Savings" Created by the Reduction in Contributions to the CSRS Fund

The Postal Service was required to use any difference between what it would have paid if Public Law 108-18 had not been enacted, and the contributions required under the act (referred to as savings), for debt reduction and keeping postage rates steady through FY 2005.

After FY 2005, however, the Postal Service is required to begin making payments for the amount of the OPM-determined savings into a separate account. These savings cannot be used for any purpose until new legislation is passed detailing how those savings are authorized to be used by the Postal Service.

To compensate for not being able to use the savings to offset other business expenses, the Postal Service expects that it will have to raise postage rates over 5 percent, including 2 cents for First-Class Mail. Additionally, the Postal Service anticipates periodic postage rate increases of 1.0 to 1.5 percent just to fund this provision after FY 2006.

As required by the Public Law 108-18, the Postal Service provided a proposal on the use of the savings. Specifically, it recommended making annual payments to cover one of its major operating costs - postretirement health benefits - for all employees and retirees, currently estimated at $47 to $57 billion. Under this proposal, the Postal Service would be the only federal agency to fully pay all pension and postretirement health benefits for its employees and retirees.

If the Postal Service retains responsibility for the costs associated with military service, it has proposed paying the full costs of postretirement health benefits for new employees only. Therefore, not all postretirement health benefit obligations would be funded and rates may have to rise to cover these costs for current employees and retirees.

Generally, Postal Service stakeholders agree that Congress should repeal the requirement to hold OPM-determined savings, with some limitations. For example, GAO recommended that Congress direct how the savings should be spent only after the Postal Service provides an acceptable plan addressing its infrastructure and workforce. Competitors and mailers generally agreed that savings should mitigate future rate increases or be used as directed by Congress.

The Postal Service should use savings created by the reduction in contributions to the CSRS fund to run its operations, as it does with Postal Service revenue. The monies generated from Postal Service revenues should not be subject to outside control, since these revenues are essentially "other peoples money," not tax dollars, and should be subject to normal usage for operations and capital investment.

Calculating the Postal Service's CSRS Pension Costs

The methodology employed by OPM to calculate the Postal Service's CSRS pension costs may not be reasonable and equitable for the Postal Service. For example, Public Law 108-18 generally required the Postal Service to pay all future retirement costs of current employees regardless of their prior government service at other federal agencies. The Postal Service is the only federal agency required to fully pay all pension costs, including those associated with military service, and has recommended modifications to the calculation. Based on this approach, the impact on the Postal Service is a $4.8 billion CSRS underpayment to pay costs associated with years of service prior to September 30, 2002.[11] Using the Postal Service's proposed methodology changes the calculated underpayment to an overpayment of $81 billion.

Public Law 108-18 requires OPM to annually compute the Postal Service's share of CSRS pension costs to ensure the Postal Service fully covers all future benefits payable to its employees. However, the legislation did not detail how OPM should calculate the Postal Service's share but allowed the Postal Service to request a review of OPM's calculation. There are various interpretations of what should be included in this calculation. The Postal Service, the mailing industry, OPM, and GAO have all commented on the calculation.

In July 2003, the Postal Service formally proposed to OPM a change to the formula, including using provisions used in prior methodologies. OPM did not agree with the Postal Service's proposal and cited a GAO report affirming its calculation. OPM noted that its methodology was used as the basis for the passage of Public Law 108-18. OPM also commented that this legislation made prior provisions obsolete and were no longer appropriate.

Although the methodology was used as a basis for passage of Public Law 108-18, GAO identified issues with the formula and forwarded those concerns to Congress. For example, GAO questioned why the calculation was different from other federal agencies, such as the appropriateness of transferring military costs to the Postal Service. As a result, OPM did adjust its calculation, although it continued to include the transfer of military costs to the Postal Service.

However, Public Law 108-18 included provisions that allowed the Postal Service to request the CSRS Board of Actuaries to reconsider and review the OPM formula. This

[11] OPM considers the $4.8 billion amount as the Postal Service's supplemental liability as of September 30, 2002.

provision highlights the fact that questions about the methodology remained after the legislation was passed.

Further, in response to the Postal Service's proposal, OPM did not believe it was appropriate to establish a new methodology that would result in even greater cost to the government. However, the OIG believes it is imperative that a methodology be developed, in consultation with OPM, the Postal Service, and Congress, that appropriately separates costs between the federal government (and its taxpayers) and the Postal Service (and its customers).

In January 2004, the Postal Service formally requested the CSRS Board of Actuaries to reconsider the OPM's methodology. The Postal Service recommended its costs be based on the percentage of years the employee worked for the Postal Service compared to the total years of government service, to include military service. The Postal Service cited several factors in OPM's computation, including the inconsistency with common practices used for transfers of pensions in the private sector, minimizing the impact of early career service, and the inconsistency with prior OPM calculations.

There is merit in the Postal Service's request for actuarial review to ensure the current OPM methodology is reasonable and equitable for the Postal Service and its customers.

Conclusion

The Postal Service was given legislative relief when it was determined that it would overfund contributions by an estimated $105 billion over the life of CSRS. However, additional burdens were placed on the Postal Service, such as the requirement to fund military retirement costs associated with Postal Service employees and to pay all the costs of future CSRS benefits, similar to FERS. The Postal Service, as a government agency, is tasked with the responsibility to provide universal mail service and run like a business. To run like a business, the Postal Service should not be burdened with costs unassociated with its operations. There are strong arguments in favor of transferring the military retirement costs back to the Treasury, removing the provision to hold savings created by the reduction in contributions to the CSRS fund, and reevaluating the calculation used for the Postal Service's CSRS pension costs.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact John M. Seeba, assistant inspector general for audit, (703) 248-2207 or me at (703) 248-2300.

cc: Governors
Richard J. Strasser, Jr.
Mary Anne Gibbons
John A. Rapp
William T. Johnstone
Donna M. Peak
Jon T. Stratton
William P. Tayman
Joseph K. Moore
Susan M. Duchek

Appendix A – Calculation of the Potential Overpayment of CSRS Pension Costs

The following describes, in part, the methodology used by OPM to calculate the estimated potential overpayment (as of the end of FY 2002):

- Used Postal Service and OPM accounting records to determine actual, where available, and estimated, as necessary, Postal Service and employee contributions.
- Included earnings on the contributions using the interest rate earned by the entire CSRS pension fund. The rates earned on the fund ranged from 5.64 percent to 11.71 percent, exceeding the rate paid by the Postal Service (5.0 percent).
- Estimated the total retirement benefit payments made to Postal Service employees.
- Estimated future retirement benefit costs using economic and demographic assumptions used for the entire CSRS pension fund.
- Changed the formula to include the costs of military service for Postal Service employees, consistent with what is currently done for FERS.
- Allocated all the future retirement benefit costs to the Postal Service for employees hired on or after July 1, 1971, even if the employee had other civilian government service outside the Postal Service.
- For employees hired before July 1, 1971, the federal share included benefits that would be paid if those employees did not receive pay raises and did not increase their years of service after June 30, 1971. In prior methodologies, OPM incorporated expected cost-of-living allowances.
- When computing benefits, credits early years of civilian service less than later years of civilian service (1.5 percent per year of the high-3 average salary for the first five years of service, 1.75 percent per year for each of the next five years, and 2 percent per year for each year of service over ten).

Appendix B – Prior Audit Coverage

GAO has issued several reports on the Postal Service's pension funding issues, including the following:

- U.S. Postal Service: Accounting for Postretirement Benefits, Report Number GAO-02-916R, September 12, 2002. GAO recommended the Postal Service carefully reassess its overall accounting treatment for pension and postretirement health obligations and reaffirmed that the Postal Service should enhance its disclosure of its postretirement health benefit obligations in its financial statements. The Postal Service addressed its pension and postretirement health obligations in the Management Discussion and Analysis section of its 2003 Annual Report.

- U.S. Postal Service Actions to Improve Its Financial Reporting, Report Number GAO-03-26R, November 13, 2002. The report detailed the need for transparency in financial reporting and reaffirmed the recommendations made in GAO Report Number GAO-02-916R, based on the announcement that the Postal Service could significantly reduce its CSRS pension liabilities pending congressional action. The Postal Service provided additional transparency by discussing its pension and postretirement health obligations in the Management Discussion and Analysis section of its annual report.

- Review of the Office of Personnel Management's Analysis of the United States Postal Service's Funding of Civil Service Retirement System Costs, Report Number GAO-03-448R, January 31, 2003. The report detailed the review of OPM's methodology to compute the Postal Service's contributions and costs associated with CSRS pension benefits. GAO noted several issues that needed either legislative consideration or refinement of OPM's methodology. For example, GAO noted that current law did not include the cost of military service in determining CSRS costs. In addition, GAO recommended OPM use actual rather than estimated data in some instances. OPM modified its methodology based on its refinements and GAO suggestions to identify a potential overpayment of $78 billion, with the costs of military service included.

- Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings, Report Number GAO-04-238, November 26, 2003. The report discussed the Postal Service's proposals on how it would use the savings identified in the April 2003 legislation. GAO found both proposals to be generally consistent with Public Law 108-18. The first proposal assumed that the responsibility for military service pension costs shifted to Treasury and proposed the prefunding of retiree health benefits for retirees and current employees. The second proposal assumed that the Postal Service retained responsibility for military service pension costs and proposed the prefunding of retiree health benefits only for new employees. Both proposals assumed that the Postal Service would pay down debt and fund capital investment through inflation-based rate increases. In both cases, the Postal Service proposed that the escrow requirement be eliminated. One of GAO's suggestions was that Congress consider repealing the escrow requirement only after the Postal Service provides an acceptable plan addressing its infrastructure and workforce. The Postal Service disagreed with GAO that the escrow repeal should be tied to a plan. This issue is currently being debated in Congress.

- Postal Pension Funding Reform: Review of Military Service Funding Proposals, Report Number GAO-04-281, November 26, 2003. This report assessed proposals prepared by the Postal Service, Treasury, and OPM detailing whether and to what extent the Treasury and the Postal Service should fund the benefits attributable to the military service of the Postal Service's current and former CSRS employees. Based on its analysis, GAO noted inconsistencies in how the Postal Service was being treated compared to other self-supporting agencies. GAO suggested Congress consider requiring all other self-supporting agencies to pay all the costs of future CSRS pension benefits,[12] as the Postal Service does. Additionally, GAO suggested that if Congress required the Postal Service to fund the military service component of CSRS benefits, other self-supporting agencies should fund the military service benefits as well. This issue is currently being debated in Congress.

[12] Referred to as the "dynamic normal cost."