POSTAL PENSION FUNDING REFORM

Issues Related to the Postal Service’s Proposed Use of Pension Savings
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What GAO Found

The Service’s report presented two proposals for how it would use the “savings,” and GAO found both to be generally consistent with P.L. 108-18. The first proposal assumes that responsibility for military service pension costs shifts to the Treasury Department and proposes prefunding retiree health benefits for retirees and current employees. The second proposal assumes that the Service retains responsibility for military service pension costs and proposes prefunding retiree health benefits only for new employees. Both proposals assume that the Service would pay down debt and fund capital investment through inflation-based rate increases.

Under both proposals, the Service proposes that the escrow requirement be eliminated, so that the Service would not have to include $3 billion as a mandated incremental operating expense beginning in fiscal year 2006. The Service cannot use the escrow funds unless Congress eliminates the escrow requirement or specifies by law how these funds may be used. If no action is taken, the Service believes that it would have to raise rates higher than would otherwise be necessary. The escrow requirement provides Congress an opportunity to review how the Postal Service will address a number of long-term challenges, such as progress toward transformation and funding its retiree health benefits obligation. Once Congress is satisfied, it could repeal the escrow requirement so that an escrow account is not needed.

GAO assessed the Service’s two proposals according to their fairness, affordability, and the ability to achieve transformation goals, as follows:

Fairness: Proposal I strikes a more equitable balance of allocating costs between current and future ratepayers, because benefits earned by today’s employees will be built into the current rate base. Under Proposal II, much of the retiree health benefits obligation would remain unfunded, thereby placing the burden of the benefits being earned today on future ratepayers.

Affordability: The Service’s proposals attempt to balance short-term rate mitigation with some level of prefunding to address its long-term obligations. The first proposal would require a larger postal rate increase than the second proposal and would prefund more of the retiree health benefits. The second proposal focuses more on rate mitigation. Given the Service’s uncertain financial future, its ability to raise revenues, reduce costs, and improve productivity and efficiency is critical to affordability.

Transformation goals: Although the Service believes it can pay down debt and fund the capital investments associated with its transformation initiatives, this is not clear because the Service has not yet presented a comprehensive, integrated infrastructure and workforce rationalization plan. GAO has previously recommended that the Service provide Congress with such a plan and periodic reports on its transformation progress. The Service disagrees with GAO that the escrow repeal should be tied to a plan.
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Abbreviations

CBO    Congressional Budget Office
CSRS   Civil Service Retirement System
CSRDF  Civil Service Retirement and Disability Fund
FASB   Financial Accounting Standards Board
OPM    Office of Personnel Management
PRC    Postal Rate Commission

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November 26, 2003

The Honorable Susan M. Collins
Chairman
The Honorable Joseph I. Lieberman
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

The Honorable Tom Davis
Chairman
The Honorable Henry A. Waxman
Ranking Minority Member
Committee on Government Reform
House of Representatives

The Postal Service (Service) faces significant financial challenges, including declining mail volume, the need to fund productivity improvement and cost saving initiatives necessary to transform itself into a more efficient organization, and a growing obligation for retiree health benefits that the Service estimated will reach $54 billion by the end of fiscal year 2003. In April 2003, Congress enacted the Postal Civil Service Retirement System (CSRS) Funding Reform Act of 2003 (P.L. 108-18), which afforded the Service the opportunity to address some of these challenges by lowering the annual payment the Service is required to make into the Civil Service Retirement & Disability Fund (CSRDF) by over $2.5 billion annually beginning in fiscal year 2003. The legislation specified how these savings were to be used for fiscal years 2003-2005. It also required the Service to begin making payments into an escrow account beginning in fiscal year 2006 in an amount equal to the difference between the estimated CSRS payments prior to, and after, enactment of the legislation. The amount of the payments into the escrow account would have to be included in the Service's rate base. Under the legislation, the Service cannot use the funds in the escrow account unless Congress eliminates the escrow requirement or specifies by law how the escrow funds may be used.

In our view, this escrow requirement provides Congress an opportunity to review how the Service will address a number of long-term challenges, including debt repayment, capital projects, and its unfunded retiree health benefits obligation. The legislation also required the Service to report by September 30, 2003, on how it proposes to use these pension savings and required GAO to evaluate the Service’s submission and present our findings.
to the appropriate oversight committees. The legislation states that not later than 180 days after receiving our report, the Congress shall revisit the issue of how the savings accruing to the Service as a result of enactment of the legislation should be used.

P.L. 108-18 also transferred responsibility for CSRS pension benefits attributable to military service in the amount of $27 billion from the Department of the Treasury (Treasury) to the Postal Service. The law required the Service, the Office of Personnel Management (OPM), and the Treasury to prepare reports by September 30, 2003, articulating who should be responsible for these costs in the future. The Postal Service's report on this issue recommended that the responsibility for military service costs be transferred back to the Treasury. However, the joint report of Treasury and OPM recommended that the Postal Service should be responsible (1) for all pension costs related to military service for its employees that were hired after the Service's reorganization in 1971 and (2) for a portion of the military service costs for employees hired before 1971. Further, the legislation required GAO to review these reports and submit our findings to the appropriate oversight committees, which we are providing in a separate report (GAO-04-281) also issued on this date.

To guide the Service in its proposed use of pension-related savings beginning in fiscal year 2006, the legislation included specific “Matters to Consider” and a “Sense of Congress.” The “Matters to Consider” included the following matters: (i) debt repayment; (ii) prefunding of postretirement health care benefits for current and former postal employees; (iii) productivity and cost-saving capital investments; (iv) delaying or moderating increases in postal rates; and (v) any other matter. The “Sense of Congress” stated that

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“the savings accruing to the Postal Service as a result of the enactment of this act will be sufficient to allow the Postal Service to fulfill its commitment to hold postage rates unchanged until at least 2006;

because the Postal Service still faces substantial obligations related to postretirement health benefits for its current and former employees, some portion of the savings . . . should be used to address those unfunded obligations; and

none of the savings . . . should be used in the computation of any bonuses for Postal Service executives.”

In addition, the legislation stated that the Service should also consider the work of the President’s Commission on the United States Postal Service (the Commission), whose report, issued in July 2003, identified the need for the Service to operate more efficiently. The Commission’s report recommended, among other things, that

“the Service should review its current policy relating to the accounting treatment of retiree health care benefits, and work with its independent auditor to determine the most appropriate treatment of such costs in accordance with applicable accounting standards and in consideration of the Postal Service’s need for complete transparency in the reporting of future liabilities;

the Postal Service should consider funding a reserve account for unfunded retiree health care obligations to the extent that its financial condition allows; and

responsibility for funding Civil Service Retirement System pension benefits relating to the military service of Postal Service retirees should be returned to the Department of the Treasury.”

The Service’s report on the use of the savings contained two proposals that are linked to the outcome of the military service issue. The first proposal (Proposal I) is predicated on the assumption that the Service is relieved of responsibility for military service costs and proposes that the Service

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would prefund retiree health benefits for retirees and current employees. In its second proposal (Proposal II), the Service assumes that it retains responsibility for the military costs and proposes that it would prefund retiree health benefits only for new employees, pay down debt, and finance selected capital investments. The Service also stated that this proposal would have what the Service characterized as an “indirect benefit” of mitigating rate increases. By using most of the pension savings to fund normal operating expenses, the only additional rate increase needed would be a 0.3 percent increase over the rate of inflation to cover the prefunding for its new employees.

This report addresses four objectives. First, it evaluates whether the Postal Service’s report on the use of the pension savings is consistent with P.L. 108-18. Second, it evaluates the issues surrounding the impact of the escrow requirement that the Service identified in its report. Third, it assesses the Service’s two proposals according to the following questions, which are based upon our previous work:

- Are these proposals fair and balanced between current and future ratepayers and taxpayers?
- Can the Service afford to do as it proposes in light of its financial challenges?
- Do these proposals help promote and accelerate the Service’s transformation efforts, including related cost savings and productivity improvement efforts?

Finally, our report discusses other pertinent issues, such as how the proposals might be implemented, that we identified in the course of our review. Our work is based on our review of Postal Service documents, the report of the President’s Commission on the United States Postal Service, our prior reports, and interviews with officials at the Postal Service and the Congressional Budget Office (CBO). A more detailed discussion of our objectives, scope, and methodology is included in appendix I. We requested comments on a draft of this report from the Postal Service, and its comments are discussed later in this report and reproduced in appendix II.

Results in Brief

Both proposals are generally consistent with the Sense of Congress expressed in P.L. 108-18 because they address, to varying degrees, prefunding the retiree health benefits obligation. They also address some of
the Matters to Consider outlined in P.L. 108-18, including rate mitigation and, to a lesser degree, debt repayment and productivity and cost-saving capital investments. In addition, the proposals are generally consistent with the Commission’s recommendations and our previous work. In considering the Service’s proposals, we note that this legislation, by significantly reducing the Service’s pension costs, has provided an opportunity for the Service to address some of its long-standing challenges, including prefunding its retiree health obligations and accelerating its transformation to a more efficient and viable organization. While the Service’s proposals addressed the prefunding obligation, and the Service has indicated that it can support its transformation initiatives through normal rate increases, the extent to which it would be able to support or accelerate its transformation was not clear. Consequently, careful monitoring of the Service’s financial situation and the pace of its progress in implementing its transformation initiatives will be necessary.

One of the issues we considered in evaluating these proposals was the impact of the escrow requirement. The Service’s report proposes that the escrow requirement be eliminated, because the Service cannot use these funds unless Congress eliminates the escrow requirement or specifies by law how the escrow funds may be used. If no action were taken, the Service would not realize a reduction in its annual operating expense of over $3 billion beginning in fiscal year 2006. Consequently, the Service believes it would have to raise rates higher than would otherwise be necessary. In our view, the escrow requirement could be one means to direct funding for specific purposes that Congress may believe to be especially important. Once Congress is satisfied, it could repeal the escrow requirement so that an escrow account is not needed, or it could indicate its preferences through means other than an escrow requirement.

Moreover, it is critical to the Service’s future viability that it continue to make progress on addressing its financial challenges, such as prefunding retiree health obligations, repaying debt, and financing capital needed to implement its transformation initiatives. We believe that Congress will need to have sufficient information to determine that the Service is making or accelerating progress in achieving its transformation goals. In this regard, we have already recommended that the Service provide periodic reports on the status of its transformation initiatives and other Commission recommendations, which the Service recently provided to its congressional oversight committees. In addition, the Chairman of the Senate Committee on Governmental Affairs and Senator Carper sent a letter to the Postmaster General dated November 19, 2003, asking for a comprehensive plan by
early April 2004 that lays out how the Postal Service intends to optimize its infrastructure and workforce.

We also assessed Proposals I and II according to their fairness, affordability, and how they address the Service's transformation efforts, including its cost saving and productivity improvement initiatives, as follows:

- **Fairness**: Proposal I strikes a more equitable balance of allocating costs between current and future ratepayers because benefits being earned by today's employees would be built into the current postal rate base. Under Proposal II, a substantial portion of the retiree health benefits obligation would remain unfunded, thereby placing the burden of the retiree health benefits being earned today on future ratepayers. Fairness between ratepayers and taxpayers is also an issue, because P.L. 108-18 transferred $27 billion in pension costs related to military service from the Treasury Department to the Postal Service—or in effect, from taxpayers to ratepayers—but required further study of who should be responsible for these costs. This issue is discussed in more detail in GAO's related report.

- **Affordability**: The Service's proposals attempt to balance both short-term rate mitigation and some level of prefunding to address its long-term obligations. Given the Service's uncertain financial future, the affordability of these proposals is tied to the Service's ability to raise revenue, cut costs, and improve productivity and efficiency. In recent years, the Service has made some progress in cutting its costs and improving productivity but has had trouble raising sufficient revenue to offset declines in First-Class Mail volume. Under both proposals, the Service assumes that it can pay down debt and fund capital investment needs through periodic rate increases within normal inflationary trends. The Service's proposals for prefunding some level of its retiree health benefits obligation would require modest additional rate increases over the amount needed to cover inflationary cost increases. The Service estimated that Proposal I would require an additional rate increase in fiscal year 2006 of 2 percent over the rate of inflation, while Proposal II would require only an additional increase of 0.3 percent over the rate of inflation since it is funding a smaller portion of the retiree health benefits obligation. The Service did not estimate the impact of either proposal on postal rates beyond fiscal year 2006. Furthermore, the Service did not propose to fully fund its retiree health benefits obligation in a specified time period under either proposal. However,
even moderate rate increases to prefund some portion of the retiree health benefits obligation now could help the Service avoid more dramatic postal rate increases later.

- Transformation: In passing P.L. 108-18, several Members of Congress expressed the need for the Service to continue its modernization efforts to transform itself into a more efficient and effective organization. Further, the Commission and GAO have reported on the need for the Service to enhance its efficiency through such efforts as standardization of its mail processing operations, improving retail access, and rationalizing its infrastructure and workforce. The Service has begun implementing a number of its transformation initiatives to improve its efficiency and has made meaningful progress in a number of areas, including reducing its workforce, cutting costs, and improving productivity. To achieve additional results, sufficient capital investment will need to be made. Both proposals assume that the Service can raise sufficient capital through inflation-based rate increases. Although the Service has provided some information to us showing what capital investments it plans to make related to its transformation goals, it has not yet prepared a comprehensive, integrated plan showing how it plans to rationalize its infrastructure and workforce and the funding that would be needed to implement such a plan, as well as the savings or additional revenue the plan would be expected to generate. Without such a plan, and periodic updates on the status of transformation initiatives as we have previously recommended, as well as their cost and funding, it is not clear whether the Service’s planned funding would be sufficient.\(^5\)

Under both proposals, we also identified technical issues related to implementation of prefunding retiree health benefits obligation, including whether the Service should explore the implications of fully funding its retiree health benefits obligation over a specific time period; the proper demographic and economic assumptions to employ in estimating the obligation; and what agency should be responsible for making these decisions.

To ensure continuing progress in addressing the Service’s financial challenges, we suggest that Congress consider the following:

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• Repealing the escrow requirement after receiving an acceptable plan from the Service describing how it intends to rationalize its infrastructure and workforce and is confident that the Service is making satisfactory progress on transforming itself into a more efficient organization and implementing its transformation goals.

• Directing the Service to fund specific purposes that Congress believes are especially important—such as prefunding the retiree health benefits obligation or supporting and possibly accelerating the Service’s transformation efforts—if the Service does not provide an acceptable plan for rationalizing its infrastructure and workforce, or show satisfactory progress in implementing transformation, or if Congress wants greater assurance that the Service will spend funds in a particular manner. In this regard, we have already recommended that the Service provide periodic reports on the status of its transformation initiatives and other Commission recommendations.

• Addressing implementation issues related to prefunding the retiree health benefits obligation. For example, one key issue that would need to be further explored is what options may be available that would allow the Service to amortize its unfunded retiree health benefits obligation over a specified time period (e.g., 20-40 years) and prefund the retiree health benefits obligation for future retirees.

In commenting on a draft of our report, the Service disagreed with our Matters for Congressional Consideration that repeal of the escrow requirement should be tied to an acceptable plan. We agree that establishing an escrow account without allowing the Service to use the funds would not be a desirable outcome and that is one of the reasons why we suggested that Congress consider repealing the escrow requirement. On the other hand, contrary to the Service’s view, we believe the escrow requirement is an opportunity for Congress to review how the Service plans to address a number of long-term challenges, including debt repayment, capital projects, its unfunded retiree health benefits obligation, and its progress toward transformation. If the Service provides Congress with an acceptable plan in the next several months and Congress finds the plan and the Service’s transformation progress satisfactory, we believe Congress should have sufficient time to repeal the escrow requirement so that an escrow account would not be needed. Thus, the Service would not have to include the operating expense associated with the escrow requirement in its rate base for the next rate case filing.
Background

In April 2003, Congress enacted P.L. 108-18, which reduced the Service's annual payment into the CSRS pension fund, in part, to reflect a reduction in the Service's estimated unfunded obligation for prior years' service from about $30 billion to about $5 billion. The difference between the Service's CSRS payment required prior to enactment of P.L. 108-18 and the payment after enactment is labeled the “savings” in the legislation. However, P.L. 108-18 requires the Service to use the savings in fiscal years 2003 and 2004 to pay down outstanding debt and in fiscal year 2005 to extend the current rate cycle. Therefore, according to the Service, all of the overfunding generated by current rates will be completely consumed by the end of fiscal year 2005. In fiscal year 2006, the Service is required to begin making payments into an escrow account that it cannot use until otherwise provided for by law. The amount of the payments into the escrow account would have to be included in the Service's rate base. The Service's report recommended that the escrow requirement be repealed, and provided two proposals for use of the “savings.” A brief description of each proposal is given below.

Proposal I

Transferring the military costs from the Service to the Treasury, as detailed in Proposal I, increases the projected overfunding of the postal CSRS pension fund from $78 billion to $105 billion. This would result in an overall cost reassignment of $27 billion and a $10 billion overfunding of the postal CSRS pension fund as of the end of fiscal year 2002. The Service proposes that the $10 billion in overfunding would remain in the pension fund, in a separate account designated as the “Postal Service Retiree Health Benefit Fund (Retiree Health Fund).” The Service made a payment of about $1.3 billion for its pension obligation into the CSRS pension fund in fiscal year 2003. Under current legislation, it would continue to make payments of $2.2 billion in fiscal year 2004 and $2.1 billion in fiscal year 2005. If responsibility for all military service costs is transferred back to the Treasury, the resulting overfunded status would negate the need for further Postal Service annual CSRS payments. The Service proposes that the CSRS payments it made in fiscal year 2003, and will make in fiscal years 2004 and 2005, remain in the CSRDF in the newly designated Retiree Health Fund. Beginning in fiscal year 2006, the Service proposes to make annual

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Postal employees would continue to make their contributions to the CSRS fund, which are currently 7 percent of pay.
payments into the Retiree Health Fund. This new fund would be used to pay retiree health insurance premiums in the future.

This proposal assumes that the escrow requirement would be eliminated. However, the Service estimates that the expense for prefunding retiree health obligations would add $1.2 billion to its expenses in fiscal year 2006. The Service estimates that this expense would require a rate increase that would be 2 percent higher than would be necessary to cover inflationary expense growth. Otherwise, the Service believes it can pay down debt and finance its capital investment needs through its normal cycle of inflation-based rate increases.

Proposal II

Proposal II, other than funding a small amount of the retiree health benefits obligation, results primarily in rate mitigation. This proposal is based on the assumption that the escrow requirement would be repealed and that the Service would remain responsible for military service costs. Under this scenario, the Service proposes to prefund the retiree health benefits cost for employees hired after fiscal year 2002. It would not fund the retiree health benefits cost already incurred for current and former employees, which comprises most of the obligation. The Service estimates that the expense created to prefund retiree health benefit costs for new employees would require a rate increase in fiscal year 2006 that would be 0.3 percent higher than necessary to cover normal inflationary expense growth. Although the Service’s proposal stated that some funds would be used to pay down debt and fund capital investments, postal officials have told us that the proposed debt repayment and capital investment costs are equal to what they had planned to spend regardless of enactment of P.L. 108-18. Consequently, the Service believes that, absent the escrow requirement, it would be able to continue to pay the retiree health premium costs for current and former employees on a pay-as-you-go basis, pay down debt, and finance its capital investment needs through normal rate increases that would correspond with general inflation trends.

Both Proposals Are Generally Consistent with P.L. 108-18

We believe that both proposals are generally consistent with the “Sense of Congress” expressed in P.L. 108-18, that some portion of the savings should be used to address the Service’s unfunded obligations. However, Proposal I goes much further in this area because it proposes prefunding a substantial portion of retiree health benefits for all current and former employees, while Proposal II would prefund these costs only for employees hired after
fiscal year 2002. Both proposals also address, to varying degrees, the
Matters to Consider, outlined in P.L. 108-18. Proposal I addresses, almost
exclusively, matter (ii)—prefunding of postretirement health benefits for
current and former employees. Proposal II addresses matter (ii) to a
limited extent, and matter (iv)—delaying or moderating increases in postal
rates. Under both proposals, the Service believes that it can address matter
(i)—debt repayment—and matter (iii)—productivity and cost saving
capital investments—through inflation-based rate increases.

The legislation also directed the Postal Service to consider the work of the
Commission. The Commission recommendations, like our previous work,
stressed the significance of funding the retiree health benefits cost to the
extent that the Service’s finances permit. The Commission pointed out that
the pension obligation is funded as benefits are earned and recovered
through rates, but the retiree health benefits obligation is funded as the
benefits are paid and not as they are earned. The Commission strongly
urged the Service to consider funding a reserve account to begin paying
down the retiree health benefits obligation so future ratepayers are not
forced to pay for costs associated with postal services delivered today. The
Commission also stated that raising rates should be the last recourse, not
the first, to cover rising costs. In our November 2003 testimony before the
Senate Committee on Governmental Affairs, we also raised concerns about
rate increases, stating that raising rates may provide an immediate boost to
the Service’s revenues but would likely accelerate the transition of mailed
communications to electronic alternatives. In addition, the Commission
expressed concern regarding the Service’s ability to repay its debt and
stressed the importance of the Service improving its operational efficiency.
Another important recommendation of the Commission was that the
Service should review its current policy relating to the accounting
treatment of retiree health care benefits, and work with its independent
auditor to determine the most appropriate treatment of such costs in
accordance with applicable accounting standards and in consideration of
the Postal Service’s need for complete transparency in the reporting of
future liabilities. We have also discussed these issues in our previous
work. Proposal I addresses the issue of funding retiree health benefits to a

7GAO-04-108T.
8U.S. General Accounting Office, Major Management Challenges and Program Risks: U.S.
Postal Service, GAO-03-118 (Washington, D.C.: January 2003); and U.S. Postal Service:
Deteriorating Financial Outlook Increases Need for Transformation, GAO-02-355
greater extent than Proposal II, while Proposal II addresses the matter of mitigating rates to a greater extent than Proposal I.\(^9\) Both proposals address the issue of debt repayment and capital investment through inflation-based rate increases.

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**Escrow Requirement Places Pressure on Rates**

The Service recommended in its report that Congress eliminate the escrow requirement, because of its negative impact on postage rates and the mailing industry, the general public, and the economy as a whole. The Service estimates that it would need an additional rate increase of 5.4 percent, including 2 cents on the 37-cent First-Class stamp, in order to generate the $3.2 billion required to be placed in an escrow account in fiscal year 2006. This is because P.L. 108-18 requires all “savings” attributable to fiscal years after 2005 to be considered an “operating expense” and placed into an account that the Service cannot use until Congress specifies how the funds may be used. All of the “savings” accruing under current rates would likely be expended or absorbed by inflationary cost increases by the end of fiscal year 2005. Thus, in order to pay this “operating expense” the Service would need to include the $3.2 billion in its rate base in fiscal year 2006 and collect the money from its ratepayers or lower expenses by a corresponding amount. The Service has taken steps to reduce its total expenses over the past 2 fiscal years, and we believe it is important for the Service to continue its cost-cutting efforts. However, setting aside unused funds in an escrow account that must be considered an “operating expense” would serve to lessen the financial benefits of the Service’s cost-cutting efforts.

For fiscal years after 2006, an increasing amount—estimated to eventually reach a peak of $8.7 billion—would have to be placed annually in the escrow account. This would be in addition to its operating expenses, such as compensation and retiree health premiums, as well as any amounts needed to pay down debt or fund capital investments. The Service estimates that it would require additional biannual rate increases between 1 percent and 1.5 percent to cover the required escrow amount. Frequent rate increases of this magnitude would likely hasten the decline in First-

\(^9\)It should be noted that Proposal I, by funding retiree health benefits for current and former employees only if it is relieved of responsibility for military service costs, also addresses rate mitigation because funding this obligation for current and former employees, while retaining responsibility for military service costs, would result in even higher rate increases.
In our view, the escrow requirement could be viewed as one means to direct funding for specific purposes that Congress may believe to be especially important. We also believe it is critical to the Service’s future viability that it continue to make progress on addressing its financial challenges, such as prefunding retiree health obligations, repaying debt, and financing capital needed to implement its transformation initiatives. Several options include (1) tying the repeal of the escrow requirement to congressional review of the Service’s progress on transformation, which could include the Service providing Congress with an acceptable plan for realigning its infrastructure and workforce; (2) repealing the escrow requirement but specifying the use of funds; or (3) repealing the escrow requirement and allowing the Service to fund activities as specified in its proposals. Another option would be to retain the escrow requirement and direct funding for specific purposes, which would likely require Congress to periodically revisit the use of funds. We believe this option could be problematic if an impasse arose, which could make the funds unavailable to the Service to spend on specific purposes.

If Congress does not want to specify by law the purposes and amounts that should be funded, but rather permit the Service to decide which activities to fund, we believe that Congress would need to have sufficient information to determine that the Service is making or accelerating progress in achieving its transformation goals. In this regard, we have already recommended that the Service provide periodic reports on the status of its transformation initiatives and other Commission recommendations that fall within the scope of its existing authority. The Chairman of the Senate Committee on Governmental Affairs, along with Senator Carper, requested in a letter to the Postmaster General dated November 19, 2003, that the Service provide the Committee with a comprehensive plan that lays out how the Service intends to optimize its infrastructure and workforce. Further, the letter requested biannual updates on the status of implementing transformation initiatives and recommendations of the Presidential Commission. In November 2003, the Service provided the congressional oversight committees with a progress report on its transformation initiatives.
We also assessed the Service’s two proposals in the context of three key issues emerging from our previous work and the Commission’s recommendations. The first issue is whether the proposals are fair and balanced between current and future ratepayers regarding who pays for employee benefits earned today. Another aspect of this issue is fairness between ratepayers and taxpayers regarding responsibility for military service costs and the effect of the proposals on the federal budget. The second issue is whether the proposals are affordable in light of the Service’s current financial situation. Given declining First-Class Mail volume, rising compensation costs, and a significant retiree health benefits obligation, if the Service’s proposals greatly exacerbate these financial challenges, affordable universal service could be jeopardized. The third issue is how these proposals assist the Service in achieving or accelerating its transformation initiatives. The importance of this issue lies in the need for the Service to become a more efficient and effective organization in order to remain financially viable.

One factor that should be kept in mind when evaluating these proposals is the issue of maintaining an equitable balance between the postal costs paid for by current and future ratepayers and the impact of these proposals on taxpayers. As we noted in our November 2003 testimony, under the Service’s current accounting and rate-setting methods, current ratepayers have not fully covered the total costs of the postal services they have received. Further, future ratepayers are likely to face more significant and frequent rate increases to cover the cost of benefits being earned by current employees. The equity of this arrangement should be considered in evaluating these proposals. Likewise, the effects of these proposals on the federal budget—which specifies the spending and financing of the federal government—and whether these effects are equitable to both ratepayers and taxpayers, should also be considered.

Proposal I strikes a better balance between current and future ratepayers by prefunding the retiree health benefits obligation for both retirees and current employees and providing a mechanism for better aligning current expenses with current revenues. Therefore, benefits being earned by today’s employees would be built into the current rate base.

Fairness Issues

**Key Issues Used to Assess the Postal Service’s Proposals**

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While Proposal II does partially address the issue of striking a balance between current and future ratepayers in regard to the retiree health benefits obligation, it does not go as far as Proposal I in this area. By only prefunding the retiree health benefits cost for new employees, it leaves a sizable portion of this obligation unfunded. This means that future ratepayers will still be required to pay for most of the retiree health benefits earned by today’s workforce. In addition, mailers argue that prior to enactment of P.L. 108-18, they were paying too much for the CSRS obligation; therefore, mitigating rate increases now is merely recompense. However, while mailers may have been paying more than necessary to fund the pension obligation, they were paying less than necessary to fund the retiree health benefits obligation.

Another important consideration is the effect these proposals would have on the federal budget and, therefore, the taxpayer. An issue currently before Congress is who should be responsible for paying the military service pension costs of postal employees covered by CSRS. Proposal II is predicated on the assumption that current ratepayers pay for pension costs related to military service, much of which was vested prior to creation of the Postal Service and had already been paid by Treasury. If Congress decides that the Service should retain responsibility for these costs, the postal ratepayers would bear the costs. If Congress determines that the Treasury should be responsible for these costs, then the costs would be borne by taxpayers. The Service has stated that the impact on the federal budget of transferring these costs under Proposal I would likely be minimal. The budgetary effects of the Service’s proposals have not been scored by CBO. However, based on its scoring of the Postal Civil Service Retirement System Funding Reform Act, we believe that Proposal I might be scored as having little effect on the deficit in the short term. In the long term, it could have an effect when the Service’s cash flow changes in later years as the prefunded benefits are paid. However, insufficient detail has been provided on both proposals to determine their overall budget effects.

The CBO is required to “score,” or estimate, the budgetary effects of legislation reported out of committees, so it has not scored the Service’s proposals. However, the CBO scoring report on the bill that resulted in the pension legislation provides some insight into how this proposal might be scored.

CBO scoring considers both on-budget and off-budget effects of legislative proposals. As an off-budget entity, any payments that the Service makes to
the retirement trust fund (an on-budget entity) are considered offsetting receipts; reducing those payments would reduce on-budget receipts. Under P.L. 108-18, after fiscal year 2005, savings resulting from the act are to be considered operating expenses of the Service. Therefore, these expenses would be included in rate setting, even though the Service’s actual expenses would decline by the amount placed in escrow. As a result, net off-budget outlays of the Postal Service would decline by the same amount as the savings from lower pension payments, beginning in fiscal year 2006. This is reflected in the CBO scoring report. These lower off-budget outlays would offset the on-budget impact of lower payments to CSRS. Thus, any proposal that uses the escrowed savings could affect the overall federal budget deficit.

Scoring of the Service’s proposals hinges on what the Service would do with the escrowed savings. Proposal I, in shifting the cost of military service back to the Treasury, would result in a reduction in on-budget receipts. But Proposal I, in using most of the savings to prefund retiree health benefits, would also keep those amounts in a separate CSRS account. The combined impact might be scored as having little effect on the deficit in the short term. However, in the long term, it could have an effect because at some point, the prefunded benefits would be paid out, resulting in changes in cash flows in later years. In addition, Proposal I would use a small amount of the savings for debt reduction, which would cause on-budget interest receipts to be lower.

Under Proposal II, which assumes that the Service would retain responsibility for the military service costs, the Service said it would fund its retiree health benefits obligation only for its employees hired after fiscal year 2002 and then fund, in priority sequence, debt repayment and capital investments to improve productivity and cost-savings. This proposal also raises issues related to the federal budget. The continuation of payments for military service costs would mean that there would be no reduction in on-budget receipts. In the short term, prefunding some retiree health benefits could have a small positive effect on the budget, because the Service would be collecting revenue that would not be immediately paid out. In general, any reduction in the Service’s debt would reduce on-budget interest receipts. Any additional capital investments would increase off-budget outlays. However, if the Service can provide credible support that

11Proposal I specifies that any overfunding not be withdrawn from the separate account. If it were withdrawn, there would also be on-budget outlays.
the investments would result in cost savings, the scoring may show increased outlays initially and savings subsequently.

Affordability of Proposals Is Unclear

The Service believes that its proposals are affordable, meaning they would not cause rate increases that irreparably harm volume, or hinder the Service’s ability to sustain current operations and implement transformation initiatives. We are concerned that the Service may not be able to achieve all of these goals if its financial situation worsens. Therefore, we believe it is imperative for the Service to continue addressing its key financial challenges—long-term obligations and debt, difficulty raising revenue, and aggressive cost-cutting measures—to the extent that it is able. The Service faces a difficult challenge in trying to balance all of these issues. The Service’s proposals attempt to balance both short-term rate mitigation and some level of prefunding of retiree health obligations to address its long-term obligations, while also providing for debt repayment and capital investment. However, the Service did not present an analysis of how its proposals would affect the overall financial condition of the Postal Service. Consequently, it is difficult to assess which, if either, of these proposals would improve the long-term financial situation of the Postal Service or ensure its future financial viability. Therefore, we believe that the Service’s financial situation will need to be closely monitored to ensure that its proposals are indeed affordable.

The affordability of these proposals to ratepayers is also a consideration, as is the effect of rate increases on volume because, as we have previously reported, the Service faces uncertainty regarding its future revenue stream.\textsuperscript{12} Since fiscal year 2000, the Service’s total mail volume has declined by almost 6 billion pieces and is estimated to continue declining. In a report for the Commission, the Institute for the Future developed a mail volume estimate that shows a gradual 10 percent decline from 202.8 billion pieces in fiscal year 2002 to 181.7 billion pieces in 2017. Also, First-Class Mail volume, which provides the bulk of the Service’s revenue, has been declining and shows no sign of rebounding. Declines in First-Class Mail are particularly troublesome to the Service, because First-Class Mail pays almost 70 percent of the Service’s institutional costs. These costs, which are approximately 40 percent of all postal expenses, include some administrative, facility, postmaster, and supervisor costs, and a large

\textsuperscript{12}GAO-04-108T.
portion of the expanding delivery network costs. Therefore, if First-Class Mail volume continues to decline, it would become more difficult for the Service to fund its institutional costs without raising postal rates.

Historically, when the Service has raised postal rates, mail volume growth declined in the fiscal year immediately following the rate increase but rebounded in the next fiscal year. However, over the last 3 years this has not been the case. The Service raised rates twice in fiscal year 2001 and once in fiscal year 2002. Total estimated mail volume at the end of fiscal year 2003 was almost 6 billion pieces lower than total mail volume was in fiscal year 2000. In this climate, rate increases may lead to further volume declines, which in turn would necessitate additional rate increases and begin a cycle often referred to as the “death spiral.”

The Service’s first proposal would require a larger rate increase than the second proposal. Under Proposal I, the Service estimates that prefunding retiree health benefits would add $1.2 billion to its expenses in fiscal year 2006 compared with its expenses in that year under the current law, assuming the escrow requirement were eliminated. According to the Service, this additional expense would require a rate increase in fiscal year 2006 that is 2 percent higher than the increase that would be necessary due to inflationary expense growth alone. In fiscal years after 2006, the Service would continue to make these additional payments and future rate increases would likely be marginally higher than would be necessary to reflect inflationary pressures alone. Figure 1 shows the annual additional amount the Service proposes to spend on prefunding under Proposal I.

13It is important to note, however, that rate increases would not be higher than they would have been if P.L. 108-18 had not lowered the Service’s annual CSRS pension payments.
If the Service’s mail volume continues to decline and the Service is unable to cut costs accordingly, or if the Service is faced with higher retiree health premium costs than estimated, the Service may not be able to afford to continue prefunding the retiree health benefits obligation. Therefore, the Service’s financial condition must be carefully monitored under this proposal.

Proposal II would require a lower rate increase than Proposal I in fiscal year 2006, and thus would likely have less of an impact on postal volumes in the short term. However, in the long-term it may require larger rate increases that could have a negative impact on future volumes. As seen in figure 2, the estimated retiree health premium expense will eventually outpace the estimated difference between the CSRS payment prior to enactment of P.L. 108-18 and the payment required under the legislation. Consequently, in order to pay the retiree health premiums in the future, the
Service would need to raise additional revenue through rate increases or lower its operating expenses.

The Postal Service is required to pay the retiree health premiums regardless of whether it prefunds some or all of these costs, and the annual costs are expected to increase over the next 20 years. If prefunding retiree
health benefits for new employees proves to be more costly than estimated, or if the premiums for current retirees continue to grow rapidly, the Service could find itself facing a significant obligation at a time when revenues are shrinking. It seems prudent to set aside funds now, while they are available, to address escalating future costs rather than waiting until costs are higher and adequate revenue may not be forthcoming. Because Proposal II would result in a smaller rate increase in fiscal year 2006 than Proposal I, it raises the question of whether it would be possible for the Service to increase its proposed level of prefunding retiree health benefits under Proposal II. By setting aside an additional $1 billion in funding for this obligation, the Service would need an additional rate increase of 2 percent, the same increase the Service proposes under Proposal I. The Service has stated that the decision to prefund only retiree health benefits for new employees arose from the desire to have a logical basis for its funding proposal. Because the legislation was enacted in fiscal year 2003, the Service decided to begin prefunding with a corresponding time period. While this may provide a baseline, we agree with the Commission that the Service should address its retiree health benefits obligation to the extent that its financial situation allows. Again, we believe the Service’s financial situation will have to be carefully monitored to ensure that this option remains affordable.

Another factor associated with the affordability of the proposals concerns how they address the Service’s outstanding debt level, which in fiscal year 2002 was close to statutory limits and was threatening the Service’s ability to fund capital improvements. The Service made significant progress in reducing its outstanding debt in fiscal year 2003, from $11.1 billion to an estimated $7.3 billion, and plans to continue paying down its debt in fiscal years 2004 and 2005. The Service has estimated that debt outstanding as of the end of fiscal year 2005 will be $3 billion. Under both proposals, the Service proposes to repay the same amount of debt in fiscal years 2006-2010. As seen in table 1, the Service estimates that its outstanding debt will be paid off by 2010. These estimates assume that the Service would raise rates when necessary to break even for each of the fiscal years 2006 through 2010. If this break-even assumption is not correct, or if the Service faces unforeseen financial problems, the Service may not be able to pay down the amount of debt it proposes, and may, in fact, have to borrow more.
The affordability of these proposals is also tied to a separate matter currently before Congress—who should bear responsibility for military service pension costs and how these costs should be determined. If Congress determines that the Treasury should bear responsibility for military service costs, then the Service believes that it can afford to prefund retiree health care costs for all of its current and former employees. If Congress determines that the Service should retain responsibility for the military service costs, then the Service believes that it can only afford to prefund the retiree health benefits cost for employees hired after fiscal year 2002, which would leave the obligation for current and former employees unfunded.

As both the Commission and we have noted, the Service has had limited success in its pursuit of new revenue streams. Therefore, to counter the loss in revenue due to declining mail volume without resorting to frequent rate increases, the Service must aggressively cut costs. To its credit, the Service has decreased work hours, reduced its workforce, and closed some facilities. However, we do not believe that these incremental savings will be enough to ensure a financially viable Postal Service over the longer term, especially if mail volumes continue to decline. For this reason, we believe the Service must continue to make progress in implementing its transformation goals.

Table 1: Estimated Debt Repayment and Capital Investment under Proposal II

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Beginning debt balance</th>
<th>Estimated debt payment</th>
<th>Ending debt balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$3,000</td>
<td>$776</td>
<td>$2,224</td>
</tr>
<tr>
<td>2007</td>
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<td>540</td>
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<td>2008</td>
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<tr>
<td>2009</td>
<td>1,073</td>
<td>521</td>
<td>552</td>
</tr>
<tr>
<td>2010</td>
<td>552</td>
<td>559</td>
<td>(7)</td>
</tr>
</tbody>
</table>

Source: U.S. Postal Service.
In assessing these proposals, we also considered how the Service would be able to fund cost saving and productivity initiatives needed to successfully transform itself into a viable organization for the 21st century. In April 2002, in response to a GAO recommendation and a request by the Senate Committee on Governmental Affairs, the Postal Service prepared a Transformation Plan that outlined strategies for transforming the organization into an efficient and performance-based entity. Among those initiatives were plans to standardize operations, increase customer access, and realign the processing and distribution network. The Commission’s report also made suggestions for improving postal efficiency. We agree with the Commission that the Service must continue to pursue aggressive cost-cutting strategies and productivity gains in an effort to become more efficient. We also believe that the mandate for the Service to report on the potential use of savings from P.L. 108-18 was an opportunity for the Service to present its plans in this area, and the Service’s proposals must be evaluated with the need for cost-cutting and productivity gains in mind.

Under both proposals, the Service believes it can finance capital investments related to upgrading existing assets and the investment needed to implement transformation initiatives through inflation-based rate increases. We are concerned that the Service’s financing plan may not be adequate to provide for its capital investment needs, because historically, the Service has found it problematic to finance its capital needs with operating revenues. Thus, it has often resorted to borrowing to finance its capital needs. In contrast, under both proposals, the Service would finance its capital needs while continuing to pay down debt through inflation-based rate increases. Another possible source of capital funds could be the proceeds from the sale of excess property. However, the Service did not discuss this issue in its report.

We are also concerned with the Service’s lack of specifics on capital investments under both proposals. While the Service stated that its capital investments for productivity gains and cost saving initiatives were related to its Transformation Plan, it has provided little detail on any of these initiatives in its pension savings report, its Five-Year Strategic Plan FY 2004-2008, or its Five-Year Strategic Capital Investment Plan 2004-2008. The Service did provide a breakdown of some capital investments related to its Transformation Plan initiatives, but did not provide sufficient back-up data.

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or description to enable us to determine to what transformation initiatives these investments were related or to what extent they would meet transformation goals.

In our November 2003 testimony, we also noted our concern that since the Service issued its Transformation Plan in April 2002, it has not provided adequate transparency on its plans to rationalize its infrastructure and workforce; the status of initiatives included in its Transformation Plan; and how it plans to integrate the strategies, timing, and funding necessary to implement its plans. While the Postal Service is moving forward with its Transformation Plan initiatives, and has made meaningful progress in a number of areas, it is not clear how it will be able to finance these initiatives within inflation-based rate increases, especially if mail volume continues to decline. Therefore, we recommended in our November testimony that the Postmaster General develop a comprehensive and integrated plan to optimize the Service’s infrastructure and workforce, in collaboration with its key stakeholders, and make it available to Congress and the general public. We also recommended that the Postmaster General provide periodic reports to Congress and the public on the status of implementing its transformation initiatives and other Commission recommendations that fall within the scope of its existing authority. Postal officials have agreed to develop a comprehensive and integrated plan to optimize its infrastructure and provide periodic reports on the implementation of its transformation initiatives and make them available to Congress and the public. As previously mentioned, the Service provided its congressional oversight committees with a progress report on its transformation initiatives in November 2003. The infrastructure and workforce plan and the periodic reports on the status of transformation initiatives will be critical to oversight in this area.

Issues Related to the Implementation of Proposals I and II

During our review, we identified implementation issues that Congress may want to consider if it determines that the Service should prefund some or all of its retiree health benefits obligation. Under Proposal I, implementation issues involve the method that would be used to fund the retiree health benefits, and the demographic and economic assumptions that would be used to determine the amount of the total obligation as well as the annual funding amount. Under Proposal II, the question arises as to

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how the annual cost of retiree health benefits for employees hired after fiscal year 2002 would be calculated. In addition, neither proposal ensures that the Service would continue to prefund the retiree health benefits obligation. Additional questions arise about the Service’s accounting treatment for retiree health benefits under both proposals.

If Congress decides to accept one of the proposals, technical issues related to implementing the proposal would need to be addressed. Under Proposal I, the Service would fund the retiree health benefits obligation by making payments into a fund currently maintained by OPM. Postal officials raised questions about which agency—the Service or OPM—should determine the amount of the obligation, and what economic and demographic assumptions should be used. In addition, we have questions about the Service’s proposed funding mechanism, because it does not amortize the obligation over a specific time period. In Proposal II, the Service would maintain control of the retiree health benefits fund. Under both proposals, the Service would continue to make payments into the respective funds after 2010; however, under P.L. 108-18, the Service would be under no obligation to prefund the retiree health benefits obligation.

Technical Issues Related to Proposal I

One issue pertains to the assumptions used by the Service to estimate its retiree health benefits obligation. If these assumptions change, then the future funded status of the obligation would also change. This estimated obligation is based on several assumptions, such as premium costs, retirement rates, termination rates, mortality assumptions, disability assumptions, plan enrollment, and coverage election that could change annually and may differ between the Postal Service and other agencies. These assumptions materially affect the future funded status of the obligation. An illustration of the practical effect of using different assumptions can be seen in the estimate of the Service’s total retiree health benefits obligation. A postal estimate of its retiree health benefits obligation as of the end of fiscal year 2003 differs from an estimate for the same period prepared by OPM by about 4 percent, or $2.2 billion. According to the Service, the difference in these two estimates is primarily due to differences in the measurement date, the discount rate, the health care trend rate, the cost basis, and the attribution method used. The Service’s estimate was actuarially certified as reasonable. However, a different set of results could also be considered reasonable actuarial results, because the actuarial standards describe a “best-estimate range” for each assumption rather than a single best-estimate value.
In addition, the Service said it would not amortize the retiree health benefits obligation within a specified time frame. Instead, the proposed funding that the Service calculates to address its retiree health benefits obligation is the amount that would be required to fund the annual retiree premium cost plus the estimated future cost of retiree health premiums for current employees (service costs), and interest expense on both the outstanding obligation and the new service cost. According to the Postal Service, while it is the Service’s intention to eventually fully fund its retiree health benefits obligation under Proposal I, this proposal does not fully fund all prior years’ service costs—the $54 billion obligation—within a specified time period. In fact, because the proposed funding under Proposal I includes a beginning asset balance of $10 billion, but does not amortize any of the retiree health benefits obligation, approximately $45 billion of the obligation would not be funded. The Service’s proposed funding for the retiree health benefits obligation is modeled after the funding method used by some utilities to prefund their retiree health benefits. However, other options might allow the Service to amortize its existing obligation and prefund the retiree health benefits obligation for future retirees. While postal officials indicated that under these proposals the Service intends to make annual payments for prefunding, the Service would be under no obligation to do so. Consequently, if Congress wanted to ensure that the Service prefunds its retiree health benefits, legislative action would be required.

In considering Proposal I, we identified the following unresolved questions:

- Should prefunding Postal Service retiree health benefits be mandated by Congress, or left to the Service’s discretion?
- Should the Postal Service, OPM, or another entity determine the amount of the Service’s total retiree health benefits obligation?
- Who should determine the proper funding mechanism for the retiree health benefits obligation?
- Should the Postal Service be required to amortize its prior years’ service obligation within a set time frame? If so, what is the appropriate time frame?
- What economic and demographic assumptions should be used to determine the current obligation, service costs, and asset balance, and future estimates of these amounts? Furthermore, how often should
these assumptions be updated, and what process should be used to update future estimates?

- What recourse, if any, should parties have if they disagree with this funding mechanism?

- What oversight, if any, is needed in this area?

### Technical Issues Related to Proposal II

According to postal officials, unlike Proposal I, in Proposal II the Service would maintain control of the funds used to prefund the retiree health benefits cost for new employees. These officials have also stated that the Service would be responsible for determining the proper economic and demographic assumptions to be used in calculating the annual fund amount. However, questions arise about how the Service estimated these costs for fiscal years 2006-2010. For example, the Service provided us with estimates of these costs that ranged from $214 million in fiscal year 2006 to $687 million in fiscal year 2010. The Service then adjusted these numbers downward to $100 million for fiscal year 2006 and to $300 million for fiscal year 2010. According to postal officials, this downward adjustment was made to reflect attrition. Although we attempted to verify the method used to lower these estimated costs, we were unable to obtain the necessary data in the time available to complete our work. As with Proposal I, while the Service has said that it intends to fund this obligation for employees hired after fiscal year 2002, it is not currently required to prefund. Questions similar to those raised in Proposal I would also relate to consideration of this proposal, including the following:

- Should prefunding retiree health benefits for new employees be voluntary or legislatively mandated?

- How should the annual funding amount be determined?

- What oversight, if any, is needed in this area?

### Questions Remain about the Accounting Treatment of the Retiree Health Benefits Obligation

Regardless of which proposal is adopted, questions remain about how the retiree health benefits obligation should be reflected in the Service’s financial statements. The Service currently uses a pay-as-you go basis of accounting for its retiree health benefits obligation. We previously reported that we believe the Service should consider whether the accrual basis of accounting is both the acceptable and appropriate method for this
obligation, especially considering the importance of giving full consideration to economic realities as the Service attempts to transform itself in order to respond to major operational and financial challenges. Postal Service management and the Board of Governors, the Postal Rate Commission, Congress, and other stakeholders need to have a clear understanding of the Service’s true financial condition as difficult transformation decisions are being considered.

It is our understanding that the Service would not adopt the accrual basis of accounting under either of the proposals presented, but would disclose the amount of its retiree health benefits obligation in the footnotes to its financial statements. While enhanced disclosure would be a positive step, we continue to believe that accrual accounting is needed in order to provide all stakeholders with the soundest and most transparent basis for decisionmaking. In our view, the enactment of P.L. 108-18 could be viewed as a significant event that triggers the need to reassess the accounting treatment currently used by the Service with respect to these obligations, and even more strongly reinforces our view that full accrual accounting should be adopted for financial statement reporting purposes. Given the unique nature of the Postal Service retiree health benefits obligation and the impact of P.L. 108-18, it may be prudent for the Service and its auditors to consult with the Financial Accounting Standards Board (FASB) on the appropriate accounting treatment for this obligation for financial statement reporting purposes.

A postal official has expressed concern that accrual accounting for this obligation would result in immediate rate increases of significant magnitude. We recognize that such an approach may initially result in higher rate increases than would otherwise be the case under a pay-as-you-go basis; however, rate increases would likely be more moderate in the longer term. Various options may exist for addressing the effect of recognizing this obligation, including possible amortization of any current unfunded obligation over a reasonable time period, such as 20-40 years. To further explore these options, we believe that the Service should work with the Postal Rate Commission and other appropriate stakeholders to determine options for phasing in any potential effect on postal rates.

We will be assessing the impact of the accounting treatment for the retiree health benefits obligation for whichever proposal is adopted, as well as for the Service’s pension obligation, as part of our ongoing work.

**Conclusions**

The Service faces an uncertain future. First-Class Mail volume continues to decline, and new revenue sources are not apparent. The Service faces significant unfunded obligations, the largest of which is for retirees, which must be addressed. Further, decisions must be made as to whether current or future ratepayers, or taxpayers, should be responsible for paying these obligations. The Service has acknowledged that it needs to reduce its operating costs to deal with the decline in First-Class Mail volume and meet its obligations. The most direct way for the Service to do this is to become more efficient by standardizing its operations and reducing excess capacity in its network as part of an integrated strategy to rationalize its infrastructure and workforce. The Service has stated that it plans to reduce its debt and finance capital investment necessary to transform itself from rate increases within the rate of inflation. It also proposes to prefund at least some of its retiree health benefits obligation. However, it is not clear based upon available information from the Postal Service whether it can accomplish these goals. If sufficient funding for transformation initiatives is not available, or if it does not achieve additional cost savings, significant additional efficiency gains may not be achieved. In addition, if larger postal rate increases are needed, further declines in mail volume could result. These scenarios could thereby threaten the Service’s future financial viability.

It is against this backdrop of fairness to current and future ratepayers and taxpayers, affordability, and the ability of the Service to achieve its transformation goals that the Service’s proposal to eliminate the escrow requirement and its two funding proposals must be weighed. We believe that the continuation of the escrow requirement after fiscal year 2005 without allowing the Service to use the funds has the potential for significantly raising postal rates unnecessarily. Rate increases of the magnitude necessary to fund this escrow requirement in the future may precipitate further declines in mail volume and could hinder the Service’s ability to achieve other financial goals. Furthermore, Congress has other means by which it can direct or guide the Service in its use of funds if it chooses to do so.

Both funding proposals presented by the Service are generally consistent with the provisions of P.L. 108-18. Proposal I, which is preferred by the
Service, hinges on transferring the responsibility for military service pension costs from the Service to the Treasury. Proposal I would result in a greater postal rate increase and would shift more of the responsibility for the retiree health benefits obligation to current ratepayers. Proposal II, on the other hand, would require less of a postal rate increase, focus more on rate mitigation, and shift less of the responsibility for the retiree health benefits obligation to current ratepayers than Proposal I. This would leave future postal ratepayers with more of the burden of paying for costs unrelated to products and services they receive.

Under both proposals, a portion of the retiree health benefits obligation would remain unfunded, and the Service currently does not intend to account for or report on its retiree health benefits obligation on an accrual basis under either proposal. Thus, the full extent of the Service’s obligation would not be recognized on its financial statements. Finally, the Service anticipates that it will be able to pay down debt and fund capital investments through inflation-based rate increases under both proposals.

In our view, the Service needs to begin addressing its retiree health benefits obligation as soon as it can afford to do so, and to the extent it can. The most substantive way it will be able to do this, as well as enhance its overall financial viability, is by effectively implementing the transformation goals it and the President’s Commission set forth, particularly by becoming more efficient and rationalizing its infrastructure and workforce. It is therefore critical for the Service to have the capital funding needed for transformation. Although the Service believes it would be able to generate enough funds, this is not clear because the Service has not yet presented a comprehensive integrated infrastructure and workforce rationalization plan. However, the Service has agreed to do so, as well as report periodically on its progress in implementing its Transformation Plan.

Finally, a number of technical issues need to be considered that are associated with the Service’s two funding proposals, including the implementation of any prefunding of the Service’s retiree health benefits obligation and the manner in which the Service should amortize and report on its obligation.

Matters for Congressional Consideration

To ensure continuing progress in addressing the Service’s financial challenges, we suggest that Congress consider the following:

- Repealing the escrow requirement after receiving an acceptable plan from the Service describing how it intends to rationalize its infrastructure and workforce and is confident that the Service is making
satisfactory progress on transforming itself into a more efficient organization and implementing its transformation goals.

- Directing the Service to fund specific purposes that Congress believes are especially important—such as prefunding the retiree health benefits obligation or supporting and possibly accelerating the Service’s transformation efforts—if the Service does not provide an acceptable plan for rationalizing its infrastructure and workforce, or show satisfactory progress in implementing transformation, or if Congress wants greater assurance that the Service will spend funds in a particular manner. In this regard, we have already recommended that the Service provide periodic reports on the status of its transformation initiatives and other Commission recommendations.

- Addressing implementation issues related to the retiree health benefits obligation. For example, one key issue that would need to be further explored is what options may be available that will allow the Service to amortize its unfunded retiree health benefits obligation over a specified time period (e.g., 20-40 years) and prefund the retiree health benefits obligation for future retirees.

Agency Comments and Our Evaluation

The Postal Service provided comments on a draft of this report in a letter from the Chief Financial Officer dated November 21, 2003. These comments are summarized below and reproduced in appendix II. The Service’s letter stated the following:

- It was pleased that our report found its proposals to be consistent with P.L. 108-18, and that its preferred proposal presented a more equitable balance of costs between current and future ratepayers.

- It would have to raise rates to generate funds for the escrow requirement.

- The issue of the affordability of the proposals should be viewed as a question of whether the ratepayers can afford them.

- It was concerned with our recommendation that Congress repeal the escrow requirement after it receives an acceptable plan from the Service concerning rationalization of its infrastructure and workforce, and if Congress believes that the Service is making satisfactory progress on its transformation goals.
The Service believes that it already provides adequate information to Congress for reviewing its plans and progress on transformation. Thus, the Service believes that using the escrow as an oversight mechanism is not necessary and will result in forcing the Service to raise rates.

It believes that its Proposal I is in the best interest of the taxpayers and postal stakeholders.

In response to the Service’s comment regarding the affordability issue, we agree that affordability to ratepayers is an important consideration and discuss the impact of these proposals on rate increases and volume. We have also added language to our report to clarify this point.

Regarding the Service’s concern about tying the escrow requirement to an acceptable infrastructure and workforce rationalization plan, we understand the Service’s concern that if the escrow requirement is not repealed, it would have to raise rates unnecessarily. We agree that establishing an escrow account without allowing the Service to use the funds would not be a desirable outcome, and that is one of the reasons why we suggested that Congress consider repealing the escrow requirement. On the other hand, contrary to the Service’s view, we believe the escrow requirement is an opportunity for Congress to review how the Service plans to address a number of long-term challenges, including debt repayment, capital projects, an unfunded retiree health benefits obligation, and its progress toward transformation. If the Service provides Congress with an acceptable plan in the next several months and Congress finds the plan and the Service’s transformation progress satisfactory, we believe Congress should have sufficient time to repeal the escrow requirement so that an escrow account would not be needed. Thus, the Service would not have to include the operating expense associated with the escrow requirement in its rate base for the next rate case filing. Alternatively, if Congress is not satisfied, it could direct the Service to fund specific activities or purposes through means other than an escrow requirement.

Finally, the Service believes that using the escrow requirement for additional oversight is not needed, because it has provided Congress with adequate information on its plans and progress toward transformation. While we agree that the Service provides a variety of reports and plans to Congress, including its November 2003 Transformation Plan Progress Report, the Service has not provided Congress with a comprehensive and integrated infrastructure and workforce rationalization plan. We believe such a plan is needed because the Service’s rationalization of its
infrastructure and workforce is among the most important initiatives in the Service’s Transformation Plan since it will significantly affect the Service as well as so many employees, mailers, and communities. Recognizing the widespread interest and potential controversy associated with any changes in this area, it is critical that the Service inform Congress and the public about its rationalization strategies and plans. We, as well as the President’s Commission, believe that these initiatives are also key to the Service’s efforts to cut costs and become more efficient. Accordingly, we believe oversight in this area is necessary, and that information related to the cost of these initiatives and the Service’s ability to fund them will be needed to assure Congress that the Service is continuing to make progress in implementing its Transformation Plan.

We will send copies of this report to the Chairmen and Ranking Minority Members of the House and Senate Committees on Appropriations, as well as Representative John M. McHugh, Chairman of the House Special Panel on Postal Reform and Oversight; Representative Danny K. Davis, Senator Daniel K. Akaka, Senator Thomas R. Carper, the Postmaster General, the Secretary of the Treasury, the Director of the Office of Personnel Management, the Director of the Office of Management and Budget, the Chairman of the Postal Rate Commission, and other interested parties. We will also make copies available to others on request. In addition, this report will be available at no charge on GAO’s Web site at http://www.gao.gov.

Staff acknowledgments are included in appendix III. If you have any questions about this report, please contact Bernard L. Ungar, Director, Physical Infrastructure Issues, at (202) 512-2834 or at ungarb@gao.gov.

David M. Walker
Comptroller General of the United States
Our objectives for this report were to fulfill our legislative mandate to evaluate the Postal Service’s proposal for use of the savings accruing to the Service from enactment of pension reform legislation. We evaluated the report based on its consistency with P.L. 108-18. We also addressed the escrow requirement that the Service identified as an issue in its report, and identified issues based upon our previous work that Congress may want to consider in assessing the Service’s proposals, including the fairness and affordability of the proposals, and the ability of the proposals to help the Service achieve its transformation goals. Finally, we discussed other pertinent issues that we identified in the course of our review.

To assess whether the proposals were consistent with the provisions of P.L. 108-18, we reviewed the legislative history of P.L. 108-18. We then assessed how well each of these proposals addressed the Sense of Congress and the Matters to Consider expressed in that legislation. We also reviewed the Commission recommendations to determine if the proposals were consistent with this work.

To assess the escrow requirement, we reviewed the Service’s report, interviewed postal officials, and analyzed the Postal Service’s financial data to assess the impact of the escrow requirement on the Service’s financial situation. We also interviewed congressional staff to discuss the purpose of this account.

To identify issues we had previously reported on, we reviewed our previous work. To assess how well each proposal addressed fairness issues, we reviewed Postal Service documents and interviewed Postal Service officials. We also assessed the affordability of each proposal by obtaining and analyzing Postal Service documents, including the Five-Year Strategic Plan FY 2004-2008, the Integrated Financial Plan for Fiscal Year 2004, the Five-Year Strategic Capital Investment Plan 2004-2008, annual reports, and materials provided by the Service in support of its proposals. We did not independently verify any of the financial data provided by the Postal Service. We also reviewed actuarial reports regarding the retiree health benefits obligation, and analyzed the Service’s proposed funding mechanism. We did not independently verify any of the actuarial reports. We also reviewed the Service’s April 2002 Transformation Plan to assess progress in this area. To assess the impact on the federal budget, we reviewed the federal budget and documents prepared by the Congressional Budget Office related to the effect of P.L. 108-18 on the federal budget, and we conducted interviews with officials from the Congressional Budget Office.
To identify other pertinent issues that Congress may want to consider, we reviewed Postal Service documents, the Commission's report, and our previous work. We also conducted interviews with congressional staff, OPM, and Postal Service officials.

The Service raised another issue in its report that was not within the scope of our review. The Service has expressed concern with the method that OPM used to determine the amount of the postal CSRS fund. The Service believes that OPM's methodology assigns an unreasonably low portion of the retirement benefit to the federal government, so it provided OPM with two alternatives to consider. OPM did not agree with the first alternative and did not respond to the second alternative. P.L. 108-18 required OPM, in consultation with the Postal Service, to develop the methodology used to determine the amount of the postal CSRS fund. The law also afforded the Service the opportunity to appeal OPM's methodology to the Board of Actuaries of the Civil Service Retirement System, which the Service is currently considering. Thus, we did not include this issue in the scope of our review.

We conducted our review at Postal Service headquarters in Washington, D.C., from October 1, 2003, through November 25, 2003, in accordance with generally accepted government auditing standards.
November 21, 2003

Mr. Bernard L. Ungar
Director, Physical Infrastructure Issues
United States General Accounting Office
Washington, D.C. 20548-0001

Dear Mr. Ungar:

Thank you for providing the Postal Service the opportunity to review and comment on the General Accounting Office (GAO) draft report, Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings (GAO-04-238).

We are cognizant of the tight timeframe you are under and appreciate the draft you provided on November 19 for our review. We have not had sufficient time, however, to solicit input on these important issues from the Postal Service Governors.

We are pleased that the GAO’s review of our proposals found that both proposals were consistent with the Postal Service Civil Service Retirement System Funding Reform Act of 2003 (P.L. 108-18). In particular, we note that in terms of fairness, GAO found that our preferred proposal which recognized OPM’s determination that we were $10 billion overfunded under the old statute, resulted in a more equitable balance of costs between current and future ratepayers. We further note that affordability should not be viewed as an issue of whether the Postal Service can afford the proposals; rather, it is a question of whether the ratepayers can afford them. The mailing industry needs to have rates that generate volumes that in turn will generate revenues for the Postal Service.

We also stress, as GAO indicated on page 7 of its report, “[T]he Service would not realize a reduction in its annual operating expense of over $3 billion beginning in fiscal year 2006.” The escrow in FY 2006 can only be generated by new rates and, in fact, accelerates the need for further increases, thus contributing to the “death spiral” referenced on page 24 of the GAO report.

We are concerned with the recommendation contained in the report that Congress only repeal the escrow requirement after if it receives an acceptable plan from the Postal Service concerning rationalization of its infrastructure and workforce, and if Congress believes that the Postal Service is making satisfactory progress on its transformation goals. In fact, we believe that Congress currently has a variety of adequate avenues for reviewing the Postal Service’s plans. The Postal Service publishes a Five-Year Strategic Plan and fully complies with the Government Performance and Results Act. Moreover, beyond these statutorily-mandated reports and consistent with prior GAO recommendations to Congress, the Postal Service undertook an unprecedented effort to develop a comprehensive Transformation Plan. The Transformation Plan reflects a consensus of all interested parties on the steps necessary for the Postal Service to remain a viable enterprise well into the future. The Postal Service has aggressively pursued implementation of Transformation Plan goals. In fact, a Transformation Plan Progress Report...
was just issued. That report emphasizes the progress made on improvements in customer satisfaction, cost reductions, and elimination of career positions, among other things, since the plan was released in April 2002. We believe that using the escrow requirement as an additional oversight mechanism simply is not necessary and further will force the Postal Service to raise rates to generate billions of dollars in revenues over which it will exercise little control.

Finally, the Postal Service believes that its preferred proposal, under which military pension costs are the responsibility of the Department of the Treasury and the Postal Service prefunds retiree health benefits, is in the best interests of the American taxpayers as well as all postal stakeholders. As the GAO report recognizes, this proposal achieves a fair balance between current and future ratepayers while allowing the Postal Service to prefund a greater portion of its long-term obligations.

If you or your staff would like to discuss any of these comments, we are available at your convenience.

Sincerely,

[Signature]

Richard J. Strasser, Jr.
Appendix III

GAO Contact and Staff Acknowledgments

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