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U.S. POSTAL SERVICE

Allocation of Responsibility for Pension Benefits between the Postal Service and the Federal Government

GAO-12-146

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GAO Accountability * Integrity * Reliability

Highlights

Highlights of GAO-12-146, a report to congressional committees

Why GAO Did This Study

The Office of Personnel Management (OPM) is responsible for administering the Civil Service Retirement System (CSRS), including the United States Postal Service (USPS) CSRS benefits. Two independent agencies—USPS Office of Inspector General (OIG) and Postal Regulatory Commission (PRC)—have issued reports stating that OPM's current method of allocating responsibility for CSRS benefits allocates a disproportionately large share to USPS. The USPS OIG and the PRC proposed alternate methodologies that they estimate would shift responsibility for from $56 billion to $85 billion in CSRS benefits from USPS to the federal government.

GAO's objectives were to comment on (1) whether OPM's current methodology for allocating responsibility for CSRS benefits between USPS and the federal government is consistent with the law, (2) the analysis used by the USPS OIG and PRC to conclude that OPM should refund the CSRS contributions in question, (3) the potential impacts such a refund would have on the CSRS fund and CSRS stakeholders, and (4) the potential impacts that such a refund would have on USPS's financial outlook. GAO reviewed legislation regarding the allocation of responsibility for CSRS benefits and methodologies used in all three reports. OPM and the OPM OIG agreed with GAO's draft report, but USPS and the USPS OIG stated that OPM's methodology was not consistent with current law and they, in addition to the PRC, reiterated their views that the cost allocation is unfair. GAO continues to believe that its analysis is accurate.

View GAO-12-146. For more information, contact Lorelei St. James at (202) 512-2834 or stjamesl@gao.gov.

What GAO Found

The current methodology used by OPM for allocating responsibility for CSRS benefits between USPS and the federal government is consistent with applicable law. Congress created USPS in 1971 as an independent, self-sustaining entity, with a package of assets and obligations, as well as competitive advantages and disadvantages. In 1974, Congress explicitly allocated responsibility to USPS for CSRS benefits attributable to post-1971 USPS pay increases and, although it revised aspects of the CSRS funding process in 2003 and 2006, it did not alter the fundamental allocation of responsibility for CSRS benefits.

Although the USPS OIG and PRC reports present alternative methodologies for determining the allocation of pension costs, this determination is ultimately a policy choice rather than a question of accounting or actuarial standards. Some have referred to "overpayments" that USPS has made to the CSRS fund, which can imply an error of some type—mathematical, actuarial, or accounting. We have not found evidence of error of these types. While the USPS OIG and PRC reports make judgments about fairness, the 1974 law also implicitly reflected fairness. Congress considered that USPS was to be self-sustaining and that the federal government, which had no control over USPS pay increases, should not be liable for pension benefits attributable to those increases. Also, the USPS OIG and PRC reports assess the fairness of the allocation in isolation, looking only at pension costs. In the private sector, the fairness of the allocation of pension obligations between two businesses depends on the total package of assets and obligations—both pension and nonpension. Finally, the cost of USPS's CSRS pension allocation based on the 1974 law has already been reflected in postal rates for most of the past four decades.

The key impacts of transferring assets out of the CSRS fund to USPS based on the current proposals would be to increase the federal government's current and future unfunded pension liability by an estimated $56 billion to $85 billion. This liability would then be funded by the federal government using tax revenue, borrowing, or both. Also, CSRS beneficiaries would continue to receive their benefits under current law, even if the federal government's unfunded CSRS liability increases, but this could indirectly create pressure to reduce pension benefits. Furthermore, legislation would be required for the CSRS funds transferred under the recommendations in the PRC and USPS OIG reports to be used by USPS for purposes other than funding the Postal Service Retiree Health Benefits Fund.

Any change in the USPS's share of responsibility for CSRS benefits would provide some temporary relief from the pressures USPS faces because of declining volume, revenue, and inflexible costs, but would not by itself address USPS's long-term financial outlook. Such a transfer of CSRS funds would not be sufficient to repay all of USPS's debt and address current and future operating deficits related to USPS's inability to cut costs quickly enough to match declining mail volume and revenue. Last year, GAO issued a report (GAO-10-455) that outlined a number of options to address USPS's financial viability that Congress could consider—such as realigning its operations, networks, and workforce—so that USPS could modernize to meet changing customer needs.

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Abbreviations

CBO	Congressional Budget Office
CSRDF	Civil Service Retirement and Disability Fund
CSRS	Civil Service Retirement System
FASB	Financial Accounting Standards Board
FERS	Federal Employees Retirement System
OPM	Office of Personnel Management
OPM OIG	Office of Personnel Management Office of the Inspector General
POD	Post Office Department
PRC	Postal Regulatory Commission
USPS	U.S. Postal Service
USPS OIG	U.S. Postal Service Office of Inspector General

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

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Congressional Committees

The U.S. Postal Service (USPS) is in a serious financial crisis and, as mail volume continues to decline, has not generated sufficient revenue to cover its expenses and financial obligations. For example, the Postmaster General has testified that USPS would not be able to pay its statutorily mandated retiree health benefits payment that was due on September 30, 2011, and Congress delayed the payment due date until November 18, 2011.[1] Several legislative proposals are pending to address USPS's financial crisis and some of these include different approaches for restructuring USPS's pension benefit obligations.[2]

Disagreements have emerged about options for restructuring USPS's benefit obligations. Reports issued in January and June 2010[3] by the USPS Office of Inspector General (USPS OIG) and the Postal Regulatory Commission (PRC)—independent agencies that have oversight responsibilities over USPS—have proposed that the federal government[4] return to USPS from $50 billion to $75 billion because, in their view, the current allocation of responsibility for Civil Service Retirement System

[1]Pub. L. No. 112-36, § 124 (Oct. 5, 2011).

[2]The U.S. Postal Service Improvements Act of 2011, S. 353, 112th Cong. (2011); the Postal Operations Sustainment and Transformation Act of 2011, S. 1010, 112th Cong. (2011); the Postal Reform Act of 2011, H.R. 2309, 112th Cong. (2011); the United States Postal Service Pension Obligation Recalculation and Restoration Act of 2011, H.R. 1351, 112th Cong. (2011); and the Innovate to Deliver Act of 2011, H.R. 2967, 112th Cong. (2011).

[3]United States Postal Service, Office of Inspector General, *The Postal Service's Share of CSRS Pension Responsibility,* RARC-WP-10-001 (Arlington, Va.: Jan. 20, 2010). The USPS OIG commissioned the actuarial firm Hay Group to review the allocation of CSRS liabilities between USPS and the federal government. Postal Regulatory Commission, *Report to the Postal Regulatory Commission on: Civil Service Retirement System Cost and Benefit Allocation Principles*, by the Segal Group, Inc. (Washington, D.C.: June 29, 2010). The PRC commissioned an actuarial report by the Segal Company on the allocation of CSRS liabilities between USPS and the federal government.

[4]While USPS is part of the federal government, for purposes of this report, we differentiate between USPS, a self-sustaining, independent establishment within the executive branch, and the federal government as a whole.

(CSRS) benefits for the post-1971 service of its employees is unfair.[5] The most recent estimates of the amounts involved if responsibility for CSRS benefits were transferred were approximately $56 billion to $85 billion. The USPS OIG and PRC reports stated that the current method of allocating responsibility to USPS for the CSRS benefits that stem from post-1971 pay increases is inequitable and both reports proposed alternative allocation methodologies. USPS OIG also told us that in its view, amendments Congress made in 2003 legislation required the Office of Personnel Management (OPM) to change the allocation assigned to USPS and that OPM's current allocation, based on 1974 legislation, is inconsistent with current law. OPM, which is responsible for administering CSRS benefits, disagreed with the USPS OIG, stating that OPM does not have authority to reallocate the CSRS obligations in the manner suggested by these reports. Furthermore, OPM's Office of the Inspector General (OPM OIG) reported on this issue and stated that changing the allocation methodology would shift substantial pension funding costs from USPS to the federal government. According to the OPM OIG, using the federal retirement program as a vehicle for implementing other policy objectives, such as providing USPS with operating capital, would also be unwise, inefficient, and harmful to the program itself.[6]

Given the amount of funds at issue, the potential impact on the Civil Service Retirement and Disability Fund (CSRDF),[7] and the need to resolve conflicting information and positions about this issue, you asked GAO to (1) determine if the current methodology used by OPM for allocating responsibility for CSRS benefits between USPS and the federal government is consistent with the law, (2) comment on the analysis in the USPS OIG and PRC reports used to conclude that OPM should refund the CSRS contributions in question, (3) comment on the potential impact that such a refund would have on CSRDF and CSRS stakeholders, and (4) comment on the potential effects that such a refund would have on

[5]Responsibility for paying for the increase in retirement benefits for pre-1971 service of postal employees caused by increases in postal salaries since July 1, 1971 was transferred from the U.S. Treasury to USPS by statute in 1974. Pub. L. No. 93-349 (July 12, 1974). See table 1.

[6]U.S. Office of Personnel Management Office of the Inspector General, *A Study of the Risks and Consequences of the USPS OIG's Proposals to Change USPS's Funding of Retiree Benefits* (Washington, D.C.: Feb. 28, 2011).

[7] The CSRDF is a fund of the U.S. Treasury that provides defined benefits to retired and disabled federal employees covered by CSRS.

USPS's financial outlook. Appendix I provides a detailed discussion of the legal analysis we undertook to answer the first objective above. We were also asked to provide information on a USPS request to transfer surplus Federal Employee Retirement System (FERS) funds to USPS. Information on this proposal is presented in appendix II.

To determine if the current methodology employed by OPM for allocating responsibility for CSRS benefits between USPS and the federal government is consistent with law, we reviewed relevant laws, statutes, and legislative history. To provide commentary on the analysis used in the USPS OIG and PRC reports, we reviewed and analyzed reports on this issue by relevant agencies, government entities, actuarial firms, and industry groups including the report by the USPS OIG and the actuarial analysis it commissioned from the Hay Group, the PRC report and the actuarial analysis it commissioned from the Segal Company, and the OPM OIG report. We also reviewed testimony and correspondence by USPS, OPM, and the U.S. Civil Service Retirement System Board of Actuaries. We interviewed officials at OPM, the PRC, the USPS OIG, and the OPM OIG to obtain information on the method by which responsibility for CSRS benefits is currently allocated and the potential impacts of a CSRS payment "refund" on the CSRS fund and stakeholders. To comment on USPS's request for a FERS refund, we analyzed OPM's most recent annual report on the CSRDF, interviewed OPM actuaries, reviewed commentary by USPS OIG and OPM on this issue, and reviewed approaches to surplus pension assets applicable to private sector pension plans. To provide commentary on the potential effects of a "refund" for CSRS payments on USPS's financial condition, we reviewed and summarized prior GAO work on this subject, including reports and testimonies related to the financial condition of USPS and the actions necessary to avoid financial insolvency, and spoke with officials at USPS.

We conducted this performance audit from September 2011 to October 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix III contains a detailed discussion of our scope and methodology.

Background

The Postal Reorganization Act of 1970 (1970 Act) created USPS as an "independent establishment" of the executive branch on July 1, 1971,[8] in place of the old Post Office Department (POD), a federal agency. Congress conceived of USPS as a financially self-sufficient entity, which was expected to cover its expenses almost entirely through postal revenues.[9] The equity the U.S. government held in the former POD became the initial capital of USPS, and the U.S. government remained responsible for all the liabilities attributable to operations of the former POD.[10] See table 1 for a summary of legislation and events affecting USPS's CSRS obligations.

Table 1: Legislation and Events Affecting USPS's CSRS Obligations

Year	Event
1970	The Postal Reorganization Act of 1970 (P.L. 91-375) initiated the transition from POD to the independent USPS.
1971	USPS began operations on July 1, 1971.
1974	P.L. 93-349 required that for those employees employed by the POD before 1971 and USPS after 1971, responsibility for paying for the increase in retirement benefits resulting from increases in postal salaries after July 1, 1971 be transferred from the federal government to USPS.
2003	The Postal Civil Service Retirement System Funding Act of 2003 (P.L. 108-18) changed the method of estimating USPS's funding obligations to the CSRDF. The prior method did not project future pay or cost of living increases and used a fixed interest rate assumption. The new method uses "dynamic assumptions" which anticipate the effects of long-term future investment yields, pay increases, and price inflation and are reassessed annually.
2004	At the request of USPS, OPM and the CSRS Board of Actuaries reconsidered OPM's methodology and determined that it was consistent with congressional intent.
2006	The Postal Accountability and Enhancement Act of 2006 (P.L. 109-435) required that surpluses in the postal CSRDF be transferred to the Postal Service Retiree Health Benefits Fund in certain designated years (beginning in 2007) and that the annual determination made by OPM of the postal liability or surplus be subject to review by the PRC at the request of USPS.[a]

Source: GAO analysis.

Note: Other statutes, not relevant to the present questions, also have been passed amending USPS's CSRS responsibilities.

[a]In 2006, Congress established a 10-year schedule of USPS payments into a fund (the Postal Service Retiree Health Benefits Fund) that averaged $5.6 billion per year through fiscal year 2016. Starting in fiscal year 2017, USPS's share of the health benefits premiums for current and future retirees will be paid from this fund and USPS will also fund the actuarially determined normal cost plus an amortization of any unfunded liability. Pub. L. No. 109-435, § 803(a), 120 Stat. 3198, 3251.

[8]Pub. L. No. 91-375, 84 Stat. 719, 720.

[9]*Id.* at 760. *See also*, *Payments on Unfunded Liability by the U.S. Postal Service to Civil Service Retirement Fund: Hearing Before the Committee on Post Office and Civil Service, United States Senate, on H.R. 29*, 93rd Cong. 73-74 (statement by Post Office and Civil Service Committee Chairman Gale McGee).

[10]GAO, *United States Postal Service: Information on Retirement Plans*, GAO-02-170 (Washington, D.C.: Dec. 31, 2001).

Under the 1970 Act, all officers and employees of USPS (with the exception of those on the Board of Governors) remained covered by CSRS.[11] CSRS features a defined-benefit pension based on an employee's term of federal service (years of service) and the highest 3 consecutive year average of his or her rate of basic pay (pay is also referred to as salary in this report).[12] Employees participating in CSRS have a defined percentage of their salary withheld and contributed to the CSRDF. The USPS OIG and PRC reports address the allocation of CSRS benefits attributable to USPS employees who participate in CSRS and were employed at both the POD (prior to July 1, 1971) and USPS (after July 1, 1971).

The methods and rates at which USPS funds pension benefit costs were determined by Congress in 1974. Congress passed legislation (the 1974 Act) requiring that for those employees who have been employed by both the POD and USPS, responsibility for paying for increases in retirement benefits resulting from increases in postal salaries after July 1, 1971 be transferred from the federal government to USPS.[13] Because CSRS benefits are determined by applying the highest 3 consecutive years of salary to all years of service, pay increases can have a large effect on the amount of pension benefits. As such, the liability in the CSRDF for those USPS employees who began their careers in the POD and continued their careers in USPS grew as a result of USPS pay increases since the 1970 Act.[14]

When USPS was established as an independent federal entity in 1971, it was given a package of assets and liabilities, which included the

[11]Pub. L. No. 91-375, 84 Stat. 719, 732.

[12]*See* 5 U.S.C. §§ 8331, 8339. This calculation is often referred to as the "high-3" calculation.

[13]USPS was not to be liable for that portion of any increase in the unfunded liability attributable to its employees that resulted from new or liberalized retirement benefits provided directly by amendment of chapter 83 of title 5, and applicable generally to all persons covered by CSRS. Rather, such increases were to be financed under 5 U.S.C. § 8348(f). *See* Pub. L. No. 93-349, § 1, 88 Stat. 354 (July 12, 1974); *see also* H.R. Rep. No. 93-120, at 43 (1973).

[14]*Payments on Unfunded Liability by the U.S. Postal Service to Civil Service Retirement Fund: Hearing Before the Committee on Post Office and Civil Service, United States Senate, on H.R. 29*, 93rd Cong. 73-74 (statement by Post Office and Civil Service Committee Chairman Gale McGee).

preexisting postal infrastructure and business advantages and disadvantages. POD's last annual report covering the fiscal year ended June 30, 1971 stated that the net property, plant, and equipment of the POD transferred to USPS on July 1, 1971 was valued at about $1.4 billion (about $6.2 billion in today's dollars). Business advantages and disadvantages included a business monopoly in certain areas and exemptions from certain laws applicable to private entities, offset by various mandates and restrictions such as universal service requirements.[15] Having created USPS in 1971 as an independent, self-sustaining entity, with a package of assets and obligations, as well as competitive advantages and disadvantages, in the 1974 Act, Congress explicitly allocated responsibility for CSRS benefits between USPS and the federal government.

Stakeholders have asserted that two pieces of legislation subsequent to the 1974 Act are relevant to the allocation of USPS's CSRS liabilities: the Postal Civil Service Retirement System Funding Reform Act of 2003 (2003 Act) and the Postal Accountability and Enhancement Act of 2006 (2006 Act). We discuss the effects of these statutes below.[16]

The Methodology Used by OPM to Allocate Responsibility for CSRS Benefits Is Consistent with Law

We examined the legal requirements pertaining to the methodology used by OPM for allocating responsibility for CSRS benefits between USPS and the federal government, and found that OPM's methodology is consistent with applicable law.[17] The 1974 Act required USPS to pay for the increase in retirement costs for service at the POD attributable to pay increases granted by USPS (that is, increases since July 1, 1971). OPM has carried out this requirement by calculating the retirement costs for pre-1971 service (those that the federal government is responsible for) based on the employee's credited service and rate of basic pay on June 30, 1971, the last day the POD was in existence. In our view, the 2003 and 2006 Acts did not change the fundamental allocation made by the

[15] USPS is required by law to provide prompt, reliable, and efficient services to patrons in all areas and postal services to all communities. These and related requirements are commonly referred to as the universal service obligation. 39 U.S.C. § 101 (a).

[16] Other statutes, not relevant to the present questions, also have been enacted amending USPS's CSRS responsibilities.

[17] A detailed legal analysis of this issue is contained in app. I.

1974 Act and thus OPM's current methodology continues to be consistent with law.

As noted above, the 1970 Act established USPS as an independent, self-sustaining entity within the executive branch. The 1970 Act did not, however, explicitly assign responsibility for CSRS benefits attributable to salary increases granted by USPS after July 1, 1971. Consistent with the core principle of the 1970 Act that USPS should be self-sustaining, Congress addressed this issue in 1974 by amending the statute to allocate responsibility for these costs to USPS. As revised, the law provided that USPS "shall be liable" for such costs and that the mechanism for collection of these costs is a schedule of payments by USPS into the CSRDF of amounts determined by OPM following each USPS pay increase.

Congress revised aspects of this funding process in 2003, but it did not alter the underlying allocation of liability to USPS. In response to GAO inquiries in 2001,[18] OPM reviewed USPS's payments to the CSRDF to determine whether USPS was paying either more or less than was needed to cover its employees' retirement liabilities.[19] OPM (and later, GAO[20]) concluded that if USPS payments continued unchanged, by the time the last CSRS-related benefit would be paid, USPS would overfund projected costs by a significant margin.[21] OPM therefore proposed amendments to the statutory funding mechanism, and with some revisions, these amendments were enacted in the 2003 Act.[22]

In place of the 1974 Act's required payments into the CSRDF by USPS following each USPS pay increase, the 2003 Act instituted a funding methodology modeled on FERS, the successor to CSRS. In particular,

[18]GAO-02-170.

[19]S. Rep. No. 108-35, at 2 (2003).

[20]GAO, *Review of the Office of Personnel Management's Analysis of the United States Postal Service's Funding of Civil Service Retirement System Costs,* GAO-03-448R (Washington, D.C.: Jan. 31, 2003).

[21]Letter from John Berry, Director, Office of Personnel Management, to the Honorable Ruth Y. Goldway, Chairman, Postal Regulatory Commission, regarding the allocation of the costs of CSRS benefits paid to former POD employees, September 24, 2010.

[22]Pub. L. No. 108-18, 117 Stat. 624 (Apr. 23, 2003).

the 2003 Act required USPS to contribute the employer's share of the "dynamic normal cost" (which is a normal cost computed using dynamic assumptions),[23] plus a schedule of payments to liquidate any underfunding, called the Postal supplemental liability. The act provided that both of these amounts due from USPS would be determined by OPM.[24] Although "dynamic assumptions" included projections of future pay increases, the consequence of the 2003 Act was to leave the 1974 allocation unchanged, notwithstanding the removal of the explicit allocation provision. In other words, the 2003 Act required OPM to change the funding *methodology* for USPS, but in our view, the act did not change the underlying *allocation* of benefit responsibility between USPS and the federal government.[25]

Congress amended the USPS pension benefit provisions again in 2006, as part of the 2006 Act.[26] As with the 2003 Act, however, the 2006 Act did not change the fundamental allocation of benefit responsibility between USPS and the federal government with regard to the USPS employees and annuitants who had accrued CSRS benefits as POD employees prior to 1971. Among other things, the 2006 Act altered the Postal supplemental liability established by the 2003 Act to change the responsibility for pension costs arising out of prior military service by USPS employees (the 2003 Act had allocated the responsibility to USPS,[27] whereas the 2006 Act returned the responsibility to the federal government[28]). The 2006 Act also contemplated the possibility of a postal

[23]The normal cost is the annual growth in pension liabilities resulting from an additional year of service by plan participants. "Dynamic assumptions" is defined in subsection 2(a) of the 2003 Act as economic assumptions that are used in determining actuarial costs and liabilities in a retirement system and in anticipating the effects of long-term future investment yields, future increases in rates of basic pay, and future rates of price inflation. The prior funding methodology had used "static assumptions," which did not project future pay or cost of living increases and used a fixed interest rate assumption.

[24]Pub. L. No. 108-18, § 2(c), 117 Stat. 624, 625 (amending 5 U.S.C. § 8348(h)).

[25]The legislative history of the 2003 Act supports this conclusion. The Senate Report accompanying the 2003 Act states that the Act "continues the Postal Service's liability for the retirement costs attributable to its employees covered by the CSRS which was imposed when the Post Office Department became the self-supporting [USPS] in July 1971" S. Rep. No. 108-35, at 3 (Apr. 8, 2003).

[26]Pub. L. No. 109-435, § 802, 120 Stat. 3198, 3249 (Dec. 20, 2006).

[27]Pub. L. No. 108-18, § 2(c), 117 Stat. 624, 626.

[28]Pub. L. No. 109-435, § 802, 120 Stat. 3198, 3249.

supplemental surplus as well as a supplemental liability. It required that any postal supplemental surplus in certain designated years be transferred to a new fund for USPS retiree health benefits, and established a procedure by which USPS could request a review of OPM's determination of a liability or surplus by the PRC.

Studies Suggest Alternate Methodologies for Allocating Pension Costs, but Decisions about Allocation Are Matters for Congress

Although the methodologies suggested in the USPS OIG and PRC reports present alternatives for determining the allocation of pension costs, determining the appropriate allocation of responsibility for CSRS benefits is ultimately a policy choice rather than a question of accounting or actuarial standards. Application of the approaches proposed by the USPS OIG and PRC reports would result in a significant transfer of pension costs from USPS to the federal government and thereby to taxpayers. Some have referred to overpayments that USPS has made to the CSRS fund. The term "overpayment" can imply an error of some type—mathematical, actuarial, or accounting. We have not found evidence of error of these types. Hence, any reallocation of CSRS benefit responsibility would be a significant change from a policy that has been in place since 1974 and not a correction of any actuarial or accounting methodological error. Congress may determine that the allocation of responsibility for CSRS benefits should be revisited within the context of a package of reforms for USPS.

Approaches for Allocating Benefit Responsibility

CSRS benefits are calculated in part by applying an accrual percentage to an employee's high 3-year average salary to determine the percentage of that average that will be paid in a yearly pension benefit.[29] The accrual rates are 1.5 percent per year for each of the first 5 years of service, 1.75 percent per year for each of the next 5 years of service, and 2.0 percent per year for the 11th and subsequent years of service. Because the accrual rates are higher in the later years of an employee's career, the formula is said to be "backloaded."

The methodologies proposed by the USPS OIG and PRC reports would make changes to the formula for allocating responsibility for CSRS benefits, but differ in their approach, as shown in tables 2 and 3. The transfer of costs under both of these recommendations would have both a retrospective and a prospective component. The retrospective component

[29]There are other details of the formula that are not relevant for purposes of this analysis.

would be a reallocation of responsibility for benefit payments already made in the four decades since 1971; this is estimated to be roughly in the range of $50 billion to $75 billion. In addition, a prospective component would reallocate responsibility for another approximately $6 billion to $10 billion in benefit payments to be made in the future (for a total cost transfer of approximately $56 billion to $85 billion).[30] Table 2 summarizes the CSRS benefit allocation methodologies discussed in the reports issued by the USPS OIG, the PRC, and the OPM OIG.

[30]The proportion of prospective and retrospective costs transfers may have changed since these estimates were made with more of the cost transfer now likely to be retrospective.

Table 2: Comparison of CSRS Allocation Methodologies

	Methodology	Positions presented in USPS OIG, PRC, and OPM OIG reports	Recommendation/conclusion
U.S. Postal Service Office of Inspector General	Both the federal government and USPS are assigned responsibility for a portion of the benefit at the time of retirement in proportion to years of service under each entity.	The USPS OIG report stated the following: • The 2003 law (see table 1) completely redefined the USPS responsibility for CSRS benefits: the "dynamic actuarial model" put into place at that time anticipates the effect of inflation, which includes both increases in salary and cost of living adjustments on pensions. • Since the highest salaries earned over a career are the only salaries used to calculate the amount of an annual CSRS pension, 1971 salary levels should not be considered in the allocation of liabilities. • Unlike private sector situations, USPS does not have the ability to modify the pension benefit levels earned by its employees after 1971. • Because of the backloaded nature of the CSRS formula, a disproportionate share of the accrual percentage is allocated to USPS.	Recommends a **return of assets estimated at $75 billion** to the postal CSRS account.
Postal Regulatory Commission	Uses Financial Accounting Standards Board (FASB) standards[a] to alter the current CSRS formula by using the final average (high 3) salary, rather than the 1971 salary.	The PRC report stated the following: • The private sector pension accounting standard, although it applies to financial reporting and not the allocation of benefits, nonetheless offers a methodology that would be fair and appropriate for allocating CSRS costs between USPS and the federal government. • This methodology matches the USPS OIG recommendation in using projected salary increases, and matches the current methodology used by OPM in allocating accrual percentages.	Recommends a **return of assets estimated to range from $50 billion to $55 billion** to the postal CSRS account.
U.S. Office of Personnel Management Office of the Inspector General	The benefit responsibility of the federal government is calculated based on the employee's service and pay as of June 30, 1971.	The OPM OIG report stated the following: • It is beyond the OPM's legal authority to adopt a change in the allocation of CSRS responsibility without congressional action. • The changes proposed by the USPS OIG and PRC would shift the costs of USPS CSRS benefits from USPS ratepayers to the federal government and, ultimately, to taxpayers, without any corresponding increase in government oversight of USPS. • Congress granted USPS fiscal independence in exchange for a promise of fiscal responsibility.	Recommends **no change** without further action from Congress.

Source: GAO analysis.

[a]The PRC report states that the FASB standards provide the most "well reasoned, widely respected, and historically stable guidepost for allocating pension costs to time periods." The FASB standards apply to financial reporting. The particular standards applicable to pension benefits were developed in the 1980s, with subsequent modifications that did not alter the overall approach for assigning pension costs to time periods.

The USPS OIG has stated that the allocation of responsibility for CSRS benefits required by the 1974 law (see table 1) is not appropriate and that the effects of post-1971 salary increases on pension benefits attributable to pre-1971 service should be the responsibility of the federal government. Furthermore, as noted earlier, the USPS OIG has stated that the allocation of responsibility based on CSRS's backloaded benefit formula is similarly inappropriate. The CSRS benefit formula applies an accrual percentage to the high 3-year average salary. Because benefits are accrued at a lower rate early in an employee's career, employees who worked at both the POD and USPS would have earned smaller accrual percentages at the POD than at USPS. Thus, the costs for USPS under the current formula are greater than those for the federal government. The USPS OIG recommendation would change the allocation by prorating the total accrual percentage based on years of service with the POD and USPS, thus shifting responsibility for some of the higher accruals earned at USPS to the POD (*i.e.,* to the federal government). The USPS OIG report states that under the current methodology, USPS could, for example, "be responsible for 70 percent of the pension of an employee who worked only 50 percent of his or her career for the Postal Service." The USPS OIG report also states that "had new pension plans been created for postal employees on July 1, 1971, and the Postal Service made responsible for all liabilities, it would have paid less than under the current methodology."

The PRC report agrees with the USPS OIG report's statement that the effects of post-1971 salary increases on pension benefits attributable to pre-1971 service should be the responsibility of the federal government. However, the recommendation in the PRC report would maintain the current CSRS formula of backloading benefit accrual. This recommendation is guided by the current private sector (FASB) pension accounting standards.[31] Although the purpose of these accounting standards is financial reporting, the PRC report views their application as a fair approach for allocating responsibility for benefits between USPS and the federal government. Table 3 provides an example of how responsibility for benefits could shift between USPS and the federal government using the alternative approaches to post-1971 salary

[31]The FASB standards apply to financial reporting. The particular standards applicable to pension benefits were developed in the 1980s, with subsequent modifications that did not alter the overall approach for assigning pension costs to time periods.

increases and to the backloaded accrual formula for a hypothetical postal employee.

Table 3: Allocation of CSRS Benefits Responsibility for a Hypothetical Postal Employee under Proposed Methodologies

Hypothetical employee characteristics:			
• 10 years of POD service, 1961-1971. Final 1971 annual salary: $10,000 • 15 years of USPS service, 1971-1986. Final 1986 high 3-year average salary: $20,000			
Benefit calculations:			
• Accrual percentage for POD service = 5 years x 1.5% + 5 years x 1.75% = 16.25% • Accrual percentage for USPS service = 15 years x 2% = 30% • Total accrual percentage = 16.25% + 30% = 46.25% • Total annual benefit = 46.25% of $20,000 = $9,250			
Allocation of benefit responsibility	Current methodology	Recommendation in the PRC report	Recommendation in USPS OIG report
Methodology for federal government CSRS benefit	Based on POD accruals and POD final pay: 16.25% of $10,000 = $1,625	Based on POD accruals and career final average pay: 16.25% of $20,000 = $3,250	Based on proportion of years of service at POD: (10/25) x $9,250 = $3,700
Total annual CSRS benefit	**$9,250**	**$9,250**	**$9,250**
USPS CSRS responsibility	$7,625	$6,000	$5,550
USPS percentage	82%	65%	60%
Federal government CSRS responsibility	$1,625	$3,250	$3,700
Federal government percentage	18%	35%	40%

Source: GAO variation on example in the PRC report.

The hypothetical employee profiled in table 3 spent 40 percent of her career at the POD. Accordingly, the USPS OIG report would assign the federal government responsibility for 40 percent of her pension benefits. The PRC report would assign the federal government responsibility for a smaller portion, 35 percent of the pension benefits, to reflect the lower accrual percentages earned during service with the POD while incorporating the higher average salary earned at USPS. The current methodology in use by OPM assigns the federal government responsibility for the smallest portion—18 percent of the pension benefits—to reflect both the lower accrual percentages earned during service with the POD and the lower final salary at the POD.

Analysis of Proposed Allocations for CSRS Benefits

As discussed in further detail below, our analysis of these proposals determined the following:

- All three methodologies (current, PRC, and USPS OIG) fall within the range of reasonable actuarial methods for allocating cost to time periods. However, the allocation of costs between two entities is ultimately a business or policy decision.
- In the private sector, responsibility for benefits is generally determined by negotiation and the markets, while in the public sector such responsibility is determined by negotiation, public policy, and legal requirements.
- While the USPS OIG and PRC reports make arguments based on fairness, the 1974 law also implicitly reflected fairness. Congress considered that USPS was a self-sustaining entity and that the federal government, which had no control over USPS pay increases, should not be liable for pension benefits attributable to those increases.
- The USPS OIG and PRC reports assess fairness in isolation, looking only at the allocation of pension costs. In the formation of a new business entity, the fairness of a particular allocation of pension obligations depends also on the total package of assets and obligations—both pension and nonpension—being allocated to the new entity.
- The cost of USPS's CSRS pension allocation, based on the 1974 law, has already been reflected in postal rates for most of the past four decades, so these costs have already been included in rates paid by postal customers.

While accounting and actuarial standards may inform a decision about assignment of costs to time periods, they do not determine the policy choice of who is responsible for benefits. In its report, the USPS OIG describes its recommendation as "more equitable," but acknowledges that there is no actuarial standard for allocating retirement liabilities between two employers. Similarly, in reviewing both the current methodology and the USPS OIG's recommendation, the PRC report states that both of these methodologies are within the range of acceptable methodologies for allocation of costs and benefits. Within a single organization, relevant accounting standards must be followed to assign costs to time periods for financial reporting purposes, but they do not govern the allocation of responsibility between two separate entities. Similarly, there are actuarial

standards of practice that apply to such tasks as estimating the amount and timing of future benefit payments, estimating the value of the overall obligation, and setting up a funding schedule to cover the obligation but not for determining who is responsible for the obligation.

While the allocation of benefit responsibility between two different entities is not the purview of financial reporting standards, the PRC report views them as a useful guidepost to fairness. The PRC report stated that the FASB pension accounting standards' "general application to the current situation is logical and, within the objective of fairness and equity, represents our preferred set of principles as well as a reasonable compromise." However, while the report characterizes this private sector FASB pension accounting methodology as "an unchallenged part of generally accepted accounting principles today," which "establishes a compelling definition of cost allocation equity for 2010," there is a significant school of thought among pension experts that has challenged this private sector methodology and deems it inappropriate. For example, the American Academy of Actuaries has commented to FASB that it believes the inclusion of the effects of future salary increases is inappropriate.[32] Under this alternative view, the effects of projected future salary increases are not recognized until the salary increases actually occur. This alternative approach is consistent with the one currently used by OPM.

[32]See American Academy of Actuaries letter to Technical Director, Financial Accounting Standards Board, May 31, 2006; letter to Robert H. Herz, Chairman, Financial Accounting Standards Board, February 10, 2006; and News Release, "Actuaries Raise Concern with FASB Draft Guidance," June 7, 2006. The Academy argues that "Inclusion of the effect of future salary increases in a liability appears to be in conflict with [Accounting] Concept Statement 6," "Including future salary levels misrepresents the value of the contract," "Including future salary levels in pension liabilities does not provide shareholders with the most relevant information about the current value of their obligations," and "Including an allowance for future salary growth is inappropriate in a balance sheet liability." The Academy does note that an accounting case can be made for recognizing future pay increases where there is "an enforceable multi-period contract between the employer and the employee," which it says only exist in the government sector and for some negotiated (*i.e.,* collectively bargained) plans, but also notes that recognition of future salary increases in pension accounting "would force recognition of future salary increases for sponsors of defined benefit plans but not otherwise, a distinction for which we see no justification." The Academy points to the incongruity of recognizing future salaries for pension plans when the cost of basic compensation itself is not recognized until earned. Our overall point here is that there is debate about the appropriateness of current private sector pension accounting standards. Our more fundamental point remains that accounting standards do not govern the allocation of benefit responsibility between two entities, which is ultimately a business or public policy matter.

Both the USPS OIG and PRC reports assess fairness in isolation, looking only at pension costs. However, when USPS was formed in 1971, it was given a package of assets, and liabilities, which included the preexisting postal infrastructure and business advantages and disadvantages. Congress has made adjustments to this package since then, in 1974 and subsequently. With regard to allocation of responsibility for pension benefits, in enacting the 1974 Act, Congress focused on the fact that USPS was to function as a self-supporting entity with control over, and responsibility for, the impacts of its employees' future salaries.[33] As it reviews the current prospects of USPS, Congress can, if it chooses, make another determination about the allocation of the current assets and obligations of USPS, of which pension obligations are but one component.

One additional consideration in assessing the fairness of the current allocation of pension responsibility is whether USPS has already been compensated for these costs. The cost of USPS's CSRS pension obligation has already been reflected in postal rates for most of the past four decades, so that USPS has already received payment for these costs by postal rate payers.

Potential Impacts of a Transfer of CSRS Pension Costs to the Federal Government

The key impact on CSRDF and stakeholders of transferring costs from USPS to the federal government would be to increase the federal government's unfunded liability for nonpostal CSRS by approximately $56 billion to $85 billion, according to the recommendations made in the USPS OIG and PRC reports.[34] If responsibility for CSRS pension benefits were reallocated in accordance with either the USPS OIG or PRC recommendations, there would be a transfer of assets from the nonpostal CSRS subaccount to the postal CSRS subaccount.[35] Our analysis of potential impacts on the CSRDF and its stakeholders determined the following:

[33]See S. Rep. No. 93-947 at 3 (June 19, 1974); H.R. Rep. No. 93-120, at 4 (Apr. 11, 1973).

[34]In addition to the transfer of assets from nonpostal to postal CSRS (about $50 billion to $75 billion), there would be a transfer of liabilities for future benefits from postal to nonpostal CSRS (about $6 billion to $10 billion).

[35]The CSRDF is divided into two accounts for CSRS and FERS, which are further divided by postal and nonpostal subaccounts.

- Any assets that are transferred from the nonpostal to the postal subaccount of CSRS would increase the federal government's nonpostal CSRS unfunded liability, which must then be paid by the federal government through tax revenue, borrowing, or both.[36] For example, adoption of the recommendation in the PRC report would result in an asset transfer of about $50 billion to $55 billion, which would then need to be repaid by the federal government and taxpayers.[37]

- Beyond the substantial impacts on the federal government's unfunded liability, a reallocation of benefit responsibility from USPS to the federal government would not directly threaten the benefit security of CSRS and FERS participants under current law. Benefits are projected to continue to be paid to nonpostal CSRS participants via transfers from the nonpostal subaccount of FERS. The U.S. Treasury funds any supplemental increases in liabilities through tax revenue and borrowing.

- There is an indirect risk if the increased unfunded liability were to create pressure to reduce CSRS and FERS benefits. Any reductions in program benefits could apply to all participants, including postal participants.

- Legislation would be required to transfer CSRS funds as proposed under the PRC or USPS OIG recommendations and to allow these funds to be used by USPS for purposes other than funding the Postal Service Retiree Health Benefits Fund. The use of any CSRS funds transferred to USPS is currently restricted. Under current law, any transfer of assets from the nonpostal CSRS subaccount to the postal

[36]The precise effect of the USPS OIG and PRC recommendations would be calculated by the Congressional Budget Office (CBO), which is the legislative branch agency charged with providing cost estimates and estimates of the impact of legislation on the federal budget.

[37]Using the estimated effects of the PRC proposal as an example, the mechanism for the transfer of costs would be the following: The reallocation of responsibility for benefits already paid over the past four decades would be done via a transfer of assets from the nonpostal subaccount to the postal subaccount; the estimated amount is $50 billion to $55 billion. The reallocation of responsibility for benefits still to be paid in the future would be done via a reduction of actuarial liability for the postal subaccount and a corresponding increase for the nonpostal subaccount; the estimated amount is $6 billion to $8 billion. The overall cost to the federal government, over time, would be the sum of these two effects. Thus, the nonpostal subaccount would bear a total reduction in assets and increase in actuarial liability ranging from about $56 billion to $63 billion.

CSRS subaccount would remain in the CSRS subaccount until 2015 and could not be used to address other postal financial shortages. In 2015, any surplus assets, as determined by an actuarial analysis, would be transferred to the Postal Service Retiree Health Benefits Fund. Thus, the amount that would be transferred under either the PRC or USPS OIG proposal could be used to fund benefit obligations under the Retiree Health Benefits Program.[38]

Potential Impacts on USPS Financial Condition

Any change in the USPS's share of responsibility for CSRS benefits would provide some temporary relief from the pressures USPS faces because of declining volume, revenue, and inflexible costs, but would not by itself wholly address USPS's long-term financial outlook. If, for example, $50 billion were transferred to USPS, this could be used to fund its retiree health benefits liability. However, such a transfer of CSRS funds would not be sufficient to repay all of USPS's debt and address current and future operating deficits related to USPS's inability to cut costs quickly enough to match declining mail volume and revenue. As we have testified, resolving large funding requirements for USPS's pension and retiree health benefits is important. It is equally important to address constraints and legal restrictions, such as those related to closing facilities, so that USPS can take more aggressive action to reduce costs.[39] We have also testified that in fiscal year 2010, USPS had $67 billion in revenue and $75.5 billion in expenses, resulting in a loss of $8.5 billion, which it expects to grow to a $20 billion annual loss by 2015.[40]

These financial problems are related to customers' changing mail use combined with the fixed nature and inflexibility associated with USPS's costs. The decline of First-Class Mail—USPS's most profitable product—has accelerated as Americans shift to using electronic communications and other payment alternatives. This trend exposes weaknesses in USPS's business model, which has relied on volume growth to help cover

[38]Under existing law, USPS would still have to make the current schedule of retiree health benefit prefunding payments for 2011 through 2016, even if the benefits are fully funded after an asset transfer. Legislation would be required to alter or eliminate these required payments.

[39]GAO, *U.S. Postal Service: Legislation Needed to Address Key Challenges*, GAO-11-244T (Washington, D.C.: Dec. 2, 2011).

[40]GAO, *U.S. Postal Service: Actions Needed to Stave off Financial Insolvency,* GAO-11-926T (Washington, D.C.: Sept. 6, 2011).

costs. To meet these changing customer needs, become more efficient, control costs, and keep rates affordable, USPS must modernize and restructure. To do so, it will need to become much leaner and more flexible.[41] USPS has provided Congress with a set of comprehensive legislative proposals that would reduce costs and improve operational efficiency include reducing costs by moving to 5-day delivery, reducing excess capacity in USPS's mail processing network, adjusting its workforce mix to more part-time staff, and closing unneeded retail facilities, among others.

Last year, we issued a report that outlined a number of options to address USPS's financial viability that Congress could consider.[42] Further, we have reported that Congress needs to approve a comprehensive package of actions to improve USPS's financial viability by (1) modifying its retiree health benefits cost structure in a fiscally responsible manner; (2) facilitating USPS cost reduction, for example, by modernizing and optimizing postal networks and workforce; and (3) requiring any binding arbitration in the negotiation process for USPS labor contracts to take USPS's financial condition into account.[43]

Agency Comments and Our Evaluation

We provided a draft of this report to OPM, the OPM OIG, USPS, the USPS OIG, and the PRC for review and comment. OPM and the OPM OIG agreed with our report, but USPS, the USPS OIG, and the PRC disagreed with our analysis. Their written comments are reprinted in appendixes IV through VIII. The comments of USPS, the USPS OIG, and the PRC are summarized below, along with our responses to their comments. OPM and the PRC also provided technical comments, which we incorporated as appropriate.

USPS's main comments follow:

- USPS believed that our report did not acknowledge actuarial principles that would govern in the private sector, as well as

[41]GAO-11-244T.

[42]GAO, *U.S. Postal Service: Strategies and Options to Facilitate Progress toward Financial Viability,* GAO-10-455 (Washington, D.C.: April 12, 2010).

[43]See GAO, *High-Risk Series: An Update,* GAO-11-278 (Washington, D.C.: February 2011).

fundamental principles of fairness, and that our use of a criticism of current accounting standards by the American Academy of Actuaries is taken out of context.

- USPS stated that our report fails to describe the allegedly false assumptions underlying the 1974 law or the legal environment under which USPS operates with respect to compensation policy.

- It is USPS's view that our report fails to recognize that the effect of the 2003 and 2006 laws, when considered together, reflects congressional intent that OPM determine USPS's CSRS liabilities based on modern actuarial principles. USPS agreed with our conclusion that the 1974 Act allocated responsibility to USPS for benefits attributable to USPS pay increases after July 1, 1971, but disagreed with our conclusion that the 2003 and 2006 Acts did not change this fundamental allocation. USPS pointed to the 2003 Act's repeal of the 1974 Act's provision explicitly allocating responsibility to USPS and specifying the funding mechanism for that allocation, and its replacement with a different funding mechanism using dynamic rather than static assumptions. It also pointed to the 2006 Act's creation of a process allowing PRC review of certain OPM determinations.

- USPS also made the point that our position was flawed when we stated that a transfer of USPS pension obligations would mean that USPS would receive payment for these costs twice, once by ratepayers and once by taxpayers.

Our response follows:

1. Regarding USPS's comment that it believed our report ignored actuarial principles that would govern in the private sector, we note that both actuarial and accounting standards provide methods for allocating costs to time periods for an organization, but they do not govern the allocation of benefit responsibility between two separate entities. Ultimately, determining responsibility for benefits is a business choice (private sector) or policy choice for Congress (federal government). Similarly, as our report noted, the USPS OIG acknowledged that there is no actuarial standard for allocating retirement liabilities between two employers, and the PRC acknowledged that both the current methodology and the USPS OIG's recommendation (the PRC's recommendation is in the middle) are within the range of acceptable methodologies for allocation of costs

and benefits. While acknowledging that the FASB private sector accounting standards do not govern the allocation of CSRS benefit responsibility, the PRC report stated that these standards are a logical guidepost for determining a fair allocation of benefit responsibility; the PRC report also characterized these standards as "an unchallenged part of generally accepted accounting principles today." This characterization is the context for our citation of criticism of these standards.

2. As noted above, USPS commented that our report failed to describe the allegedly false assumptions underlying the 1974 law and commented that it did not believe the package of assets and liabilities resulting from the 1970 and 1974 laws was fair. However, our analysis shows that in enacting the 1974 Act, Congress focused on the fact that USPS was to function as a self-supporting entity with control over, and responsibility for, the impacts of its employees' future salaries. As the Senate report accompanying the 1974 Act explained, "the bill will permit the Postal Service to include the cost of financing unfunded retirement liability in its rate base for purposes of future postal rate adjustments." Further, the House report accompanying the 1974 legislation stated that "[t]he Congress now has no control—no oversight whatsoever—with respect to the pay machinery in the Postal Service. Since each future pay raise . . . will result in specific unfunded liability and a new financial drain on [CSRDF], the cost of this liability should properly and equitably be borne by the Postal Service."

3. Regarding the 2003 Act, USPS commented that the law eliminated the statutory language requiring OPM to follow the 1974 funding methodology, and required OPM to determine the benefits "attributable to the service of current or former employees of the United States Postal Service." In our view, USPS's interpretation misread the 2003 Act and overstated the role that Congress intended for actuarial and accounting methods. Although the statute as amended by the 2003 Act no longer included an explicit allocation to USPS, it did not direct any change in allocation. Further, the original allocation was still reflected in the 2003 Act's requirement for an annual OPM calculation of "Postal supplemental liability." Because this calculation was to be made using dynamic assumptions, including projected future USPS pay increases, it was unnecessary to require USPS payments after each pay increase as the 1974 Act required, so this provision was removed without changing the allocation. There was no indication in 2003 that Congress intended to alter its prior

decision, reflected in the 1970 and 1974 Acts, that USPS was to be a self-supporting entity. Regarding the 2006 Act, USPS disagreed with our conclusion that the law did not fundamentally change the 1974 law's allocation of responsibility, relying on the act's creation of a process allowing PRC review of certain OPM determinations. The provision cited by USPS does not pertain to review of allocations of responsibility for pension benefits, however, but to OPM's annual determination of the postal supplemental liability or surplus, that is, whether USPS has overpaid or underpaid its allocation in a particular fiscal year.

4. USPS did not disagree that ratepayers have already been charged, and USPS already reimbursed, for the costs of the current allocation of CSRS benefits. USPS pointed out that ratepayers in turn would deserve to benefit from any reallocation of these costs. Noting this point, we believe that who would benefit from any reimbursements is a question that would require additional analysis (for example, if a reimbursement to USPS were used to stabilize postage rates, a generation of ratepayers would benefit from such reimbursement later than the generation of ratepayers who paid for the current allocation of benefits). Accordingly, we deleted the sentence that addresses receiving payments for these costs twice, but retained the main point that the costs for the current allocation of pension benefits have already been received by USPS from postal ratepayers.

In its comments, the USPS OIG disagreed with our report regarding how the 2003 law changed the 1974 law. It stated that the 2003 law changed the allocation directive to OPM and required it to adopt current dynamic methods. Additionally, it commented that the current OPM methodology is "neither fair nor modern nor does it comply with the 2003 law."

1. The USPS OIG's comments regarding the effects of the 2003 law were similar to USPS's comments. As discussed above, although the statute as amended by the 2003 Act no longer included an explicit allocation to USPS, it did not direct any change in allocation, and the original allocation was still reflected in the 2003 Act's requirement for an annual OPM calculation of "Postal supplemental liability." As noted above, because this calculation was to be made using dynamic assumptions, including projected future USPS pay increases, it was unnecessary to require USPS payments after each pay increase as the 1974 Act required, so this provision was removed without changing the allocation. Further, contrary to the USPS OIG's comment that it is "not . . .

reasonable" to interpret repeal of the 1974 Act's explicit allocation provision as other than a change in the allocation, the Senate report accompanying the 2003 Act indicated the opposite, that Congress intended to "continue the Postal Service's liability for the retirement costs attributable to its employees by the CSRS which was imposed when the Post Office Department became the self-supporting [USPS] in July 1971." Finally, the USPS OIG's suggestion that the 2003 Act should be read as directing OPM to allocate responsibility by applying actuarial and accounting standards is not well founded because allocation is a policy choice, not a mathematical calculation.

2. The USPS OIG also stated that OPM's continued use of the 1974 allocation of responsibility for CSRS benefits despite changes by the 2003 law is either unfair or not consistent with modern pension standards that use dynamic assumptions. We concluded that OPM's methodology is consistent with applicable law and that the 2003 law did not direct OPM to make any changes in the current allocation of CSRS benefits. Further, as mentioned above, accounting and actuarial standards pertain to assignment of costs to time periods; they do not determine the policy choice of who is responsible for benefits.

The PRC agreed with our framing of this issue as a matter of policy. However, it disagreed with our characterization of the Segal Company's report. For example, it stated that the Segal report did not characterize the overfunding of CSRS liabilities as an "overpayment." It also stated that criticism we cite of private sector pension accounting standards excludes government plans. Additionally, it noted disagreement between the USPS OIG and OPM about whether the 2003 and 2006 Acts changed the 1974 Act's allocation to USPS. The PRC also disagreed with our implication that any change in the allocation would provide USPS with only limited relief from its financial pressures.

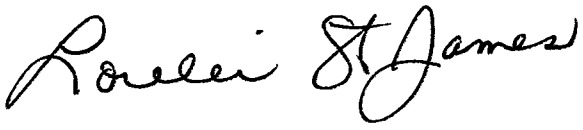
1. Regarding the PRC's comment that the Segal report did not characterize the overfunding of CSRS liabilities as an "overpayment," we reviewed the report and agree that it did not use the term overpayment. We have changed the language in our report to better reflect the Segal Company's position.
2. Regarding the PRC's comment that the cited criticism of private sector pension accounting standards excludes government plans, we modified our description and commentary about this criticism and reemphasized our main point that accounting standards

ultimately do not govern the allocation of benefit responsibility between two entities.

3. The PRC noted a "difference of opinion" between the USPS OIG and OPM about whether the 2003 and 2006 Acts changed the allocation made by the 1974 Act. Without explanation, the PRC stated its view that "the current legislative framework can accommodate a change" in the allocation by OPM if it chooses to do this. As we have stated above, the 2003 and 2006 Acts did not change the fundamental allocation made by the 1974 Act and thus OPM's current methodology continues to be consistent with law.
4. The PRC disagreed with our statement that any change in the allocation would provide USPS with only limited relief from its financial pressures. The commission noted that if the excess funds from CSRS were transferred into the Postal Service Retiree Health Benefits Fund, the fund would be almost fully funded. However, in our view, this action alone would not make USPS financially viable for the long term. USPS still needs to adjust to declining mail volume by removing excess capacity from its operations, networks, and workforce.

We are sending copies of this report to the Director of the Office of Personnel Management, the Office of Personnel Management Inspector General, the Postmaster General, the U.S. Postal Service Inspector General, the Chairman of the Postal Regulatory Commission, and other congressional committees and interested parties. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff members have any questions about this report, please contact me at (202) 512-2834 or stjamesl@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IX.



Lorelei St. James
Director, Physical Infrastructure Issues

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Appendix I: Legal Analysis of OPM's Allocation Methodology for CSRS Benefit Contributions

As part of GAO's review of the United States Postal Service's (USPS) pension benefit obligations, we examined whether the methodology employed by the Office of Personnel Management (OPM) for allocating the responsibility for Civil Service Retirement System (CSRS) costs between USPS and the federal government is consistent with applicable law. For the reasons discussed below, we conclude that OPM acted within the authority it was given by Public Law 93-349 (July 12, 1974) Public Law 108-18 (April 23, 2003), and Public Law 109-435 (December 20, 2006).

Background

The Postal Reorganization Act of 1970 (1970 Act) created USPS as an "independent establishment" of the executive branch on July 1, 1971,[1] in place of the Post Office Department (POD), a federal agency. As discussed in greater detail in this report, under the 1970 Act, all officers and employees of USPS (with the exception of those on the Board of Governors) remained covered by CSRS.[2] However, under CSRS, the payroll-withholding and employer-matching contributions[3] are insufficient to adequately fund the accrued liability to pay the benefits to which the employee is entitled. Thus, the Civil Service Retirement and Disability Fund (CSRDF) carries a partly unfunded liability to pay for future benefits for which the federal government is ultimately liable. Disagreements have emerged about the allocation of responsibility between USPS and the federal government for the unfunded liability (CSRS pension costs) attributable to USPS employees who began their careers with the POD.

The 1970 Act required USPS to withhold a defined percentage of USPS employee salaries for contribution to the CSRDF.[4] The 1970 Act was silent, however, on the question of who—USPS or the federal government—was responsible for the pension costs of USPS employees who had worked for the POD.

[1]Pub. L. No. 91-375, 84 Stat. 719, 720 (Aug. 12, 1970).

[2]Pub. L. No. 91-375, 84 Stat. 719, 732.

[3]5 U.S.C. § 8334(a).

[4]Pub. L. No. 91-375, 84 Stat. 719, 732, *codified, as amended, at* 39 U.S.C. § 1005(d). USPS was also required to contribute annually to the costs of administering CSRS, but this requirement was later repealed (see Pub. L. No. 93-349, § 2(a), 88 Stat. 354 (July 12, 1974)), and has no impact on the issues addressed here.

Congress explicitly addressed the unfunded liability allocation issue in 1974. Consistent with its previous determination that USPS should generally be self-supporting, Congress passed Public Law 93-349, 88 Stat. 354 (July 12, 1974) (1974 Act). Section 1 of the 1974 Act, codified at section 8348(h) of title 5, U.S. Code, explicitly provided that (1) USPS "shall be liable" for that portion of any estimated increase in the unfunded liability of the CSRDF attributable to USPS pay increases,[5] and (2) when USPS approved a pay increase for its employees, the Civil Service Commission (now OPM)[6] would estimate how much this pay increase changed the unfunded liability in the CSRDF, and USPS would be responsible for contributing this sum to the CSRDF, amortized over 30 annual payments.[7] Because the 1974 Act was made retroactive to the 1971 establishment of USPS,[8] USPS was required to pay for the increase in retirement costs for service at the POD (that is, pre–July 1, 1971, service) attributable to pay increases granted by USPS (that is, increases since July 1, 1971).

As the OPM Inspector General has explained, OPM calculates the retirement costs for pre-1971 service based on the employee's credited service and rate of basic pay on June 30, 1971, the last day the POD was in existence. That is, OPM calculates the annuity costs using the years of service at the POD and the salary paid during those years, meaning the cost remains the same no matter how long the employee works at USPS. Because this cost will never increase, it is sometimes referred to as a "frozen benefit." This amount, plus the cost of the annuity based on military service, is the federal government's share (federal share) and is

[5]USPS was not to be liable for that portion of any increase in the unfunded liability attributable to its employees that resulted from new or liberalized retirement benefits provided directly by amendment of chapter 83 of title 5, and applicable generally to all persons covered by CSRS. Rather, such increases were to be financed under 5 U.S.C. § 8348(f). *See* Pub. L. No. 93-349 §1, 88 Stat. 354 (July 12, 1974); *see also* H.R. Rep. No. 93-120, at 43 (1973).

[6]The Civil Service Commission ceased operations in accordance with the Civil Service Reform Act of 1978, Pub. L. No. 95-454, 92 Stat. 1111 (Oct. 13, 1978), and its responsibility to oversee civil service retirement passed to OPM.

[7]Pub. L. No. 93-349, § 1, 88 Stat. 354. *See also* S. Rep. No. 93-947, at 5 (1974).

[8]*Id.*, § 3, 88 Stat. 354.

funded by the U.S. Treasury. USPS funds the remainder of the cost of the annuity, the portion that is in excess of the federal share.[9]

As relevant here, after the 1974 Act, Congress next considered the funding of CSRS costs for postal employees in 2003.[10] In response to inquiries GAO made in 2001,[11] OPM reviewed the USPS payments to the CSRDF to determine whether USPS was paying either more or less than was needed to cover the retirement liabilities of its employees.[12] OPM's analysis, along with a subsequent GAO review,[13] concluded that if USPS payments continued unchanged, by the time the last CSRS-related benefit would be paid, USPS would overfund projected CSRDF costs by a significant margin.[14] This projected overfunding resulted in part because the amortized contributions that USPS was making pursuant to the 1974 Act were calculated by OPM assuming a flat 5 percent interest rate, while the return on pension investments had generally been—and, according to OPM projections at the time, would continue to be—higher than that.[15] Because changes needed to address this projected overfunding could not be made under the existing law,[16] OPM sent a legislative proposal to

[9]U.S. Office of Personnel Management, Office of the Inspector General, *A Study of the Risks and Consequences of USPS OIG's Proposals to Change USPS's Funding of Retiree Benefits: Shifting Costs from USPS Ratepayers to Taxpayers* (Feb. 28, 2011), 28-29.

[10]Congress passed other statutes amending USPS's CSRS responsibilities. *See* GAO, *Review of the Office of Personnel Management's Analysis of the United States Postal Service's Funding of Civil Service Retirement System Costs*, GAO-03-448R (Washington, D.C.: Jan. 31, 2003), 44-47.

[11]GAO, *United States Postal Service: Information on Retirement Plans*, GAO-02-170 (Washington, D.C.: Dec. 31, 2001).

[12]OPM's analysis is discussed in the Senate report accompanying the Postal Civil Service Retirement System Funding Report Act of 2003, S. Rep. No. 108-35, at 2 (2003).

[13]GAO-03-448R.

[14]Letter from John Berry, Director, Office of Personnel Management, to the Honorable Ruth Y. Goldway, Chairman, Postal Regulatory Commission regarding the allocation of the costs of CSRS benefits paid to former Post Office Department employees, September 24, 2010; *see also* S. Rep. No. 108-35, at 2-3.

[15]S. Rep. No. 108-35 at 3.

[16]*Id.*

Congress, which, with amendments, was enacted as the Postal Civil Service Retirement System Funding Reform Act of 2003 (2003 Act).[17]

The 2003 Act replaced the 1974 Act's explicit provision pertaining to allocation and funding with a funding methodology for USPS's CSRS obligations that was modeled on the way in which employing agency costs are calculated under the Federal Employees Retirement System (FERS), the retirement plan for federal employees that replaced CSRS.[18] In place of the matching of employee withholding required of most employing agencies and the 1974 Act's required payments following any pay increase, the 2003 Act required USPS to contribute to the CSRDF the "normal cost percentage" of each employee's pay, as calculated by OPM using generally accepted actuarial practice and standards and using dynamic assumptions.[19] The term "dynamic assumptions" was defined in subsection 2(a) of the 2003 Act as economic assumptions that are used in determining actuarial costs and liabilities in a retirement system and in anticipating the effects of long-term future investment yields, future increases in rates of basic pay, and future rates of price inflation. This method is comparable to the way employing agency funding for FERS is determined.

Because these dynamic assumptions include projections of future pay increases, the consequence of the 2003 Act was to leave the underlying 1974 allocation unchanged, notwithstanding the removal of the explicit allocation provision. In place of the express allocation provision, Congress enacted a new concept called the Postal supplemental liability.[20] As of September 30, 2003, OPM was required to calculate the present value of benefits payable to present or future CSRS annuitants that are "attributable to the service of current or former employees of [USPS]," as determined by OPM, and as offset by assets such as the present value of future employee contributions, the portion of the CSRDF balance that is attributable to past payments by USPS and its employees,

[17]Pub. L. No. 108-18, 117 Stat. 624 (Apr. 23, 2003).

[18]FERS covers most federal employees who started their careers on or after January 1, 1984.

[19]Pub. L. No. 108-18, § 2(b), 117 Stat. 624, 625.

[20]Pub. L. No. 108-18, § 2(c), 117 Stat. 624, 625 (amending 5 U.S.C. § 8348(h)).

and the earnings on those payments.[21] If OPM found a liability, USPS was required to pay that sum to the CSRDF, based on a 40-year amortization schedule. If OPM found a surplus, the Postmaster General was required to report to Congress with a proposal on how USPS would utilize this surplus.[22] OPM was to recalculate the Postal supplemental liability each fiscal year. Thus, although the 2003 Act required OPM to change the funding *methodology*, in our view, it did not change the method of *allocating* the funding responsibility between USPS and the federal government with regard to the USPS employees and annuitants who had accrued CSRS benefits as Post Office Department employees prior to 1971.[23] The federal government's share with regard to those employees and annuitants remained frozen at a level based on credited service and the rate of basic pay of POD employees at the time when USPS was established.

A few months after enactment of the 2003 Act, in July 2003, OPM submitted to Congress its plan identifying the actuarial methods and assumptions directed by the 2003 Act by which OPM would make its determinations. In 2004, OPM and the U.S. Civil Service Retirement System Board of Actuaries reconsidered OPM's methodology at the request of USPS and concluded that OPM's methodology was in accordance with congressional intent.[24] OPM also rejected an alternative methodology offered by USPS.

Congress amended the USPS pension benefit provisions again in 2006, as part of the Postal Accountability and Enhancement Act of 2006 (2006

[21]Although the 2003 Act was passed based partly on a finding that USPS had overfunded CSRS, that law gave specific direction to USPS on the use of savings resulting from the act—specifically, savings in fiscal years 2003 and 2004 were to be used to repay USPS debt held by the U.S. Treasury, and savings for fiscal year 2005 were to be used both to reduce postal debt and to delay a planned postal rate increase. Pub. L. No. 108-18, § 3(a), 117 Stat.624, 627.

[22]*Id.*§ 3(f), 117 Stat. 624,629.

[23]GAO, *U.S. Postal Service: Strategies and Options to Facilitate Progress toward Financial Viability*, GAO-10-455 (Washington, D.C.: Apr. 12, 2010), 27-28.

[24]Letter from Douglas C. Borton, Chairman, Board of Actuaries for United States Civil Service Retirement System, Office of Personnel Management, to Dr. Ronald P. Sanders, Associate Director for Strategic Human Resources Policy, Office of Personnel Management, August 18, 2004.

Act).[25] Among other things, the 2006 Act altered the "Postal supplemental liability" established by the 2003 Act to change the responsibility for pension costs based on prior military service by USPS employees (the 2003 Act had allocated the responsibility to USPS,[26] whereas the 2006 Act returned the responsibility to the federal government).[27] The 2006 Act also required that any postal supplemental surplus in certain designated years be transferred to a new fund for USPS retiree health benefits and established a procedure by which USPS could request a review of OPM's determination of a liability or surplus by the Postal Regulatory Commission (PRC). As with the 2003 Act, however, the 2006 Act did not change the fundamental allocation of benefit responsibility between USPS and the federal government with regard to the USPS employees and annuitants who had accrued CSRS benefits as Post Office Department employees prior to 1971.

In January 2010, the USPS Office of Inspector General (USPS OIG) issued a report stating that OPM's allocation of responsibility for CSRS benefits with respect to postal employees and retirees who had worked for the POD prior to July 1, 1971 is inequitable and has resulted in USPS overpaying into the CSRDF by $75 billion.[28] In testimony a few months later, the USPS OIG stated that the 2003 Act's repeal of the 1974 Act's express allocation provision constituted a rejection of that allocation by Congress and that the 2003 Act's addition of the requirement that OPM use dynamic assumptions necessitated, as a matter of fairness, the adoption of a more equitable actuarial allocation methodology.[29] The USPS OIG suggested an alternate methodology, the same one that OPM rejected in 2004.[30] USPS then asked the PRC to review OPM's allocation

[25]Pub. L. No. 109-435, § 802, 120 Stat. 3198, 3249 (Dec. 20, 2006).

[26]Pub. L. No. 108-18, § 2(c), 117 Stat. 624, 626.

[27]Pub. L. No. 109-435, § 802, 120 Stat. 3198, 3250.

[28]United States Postal Service Office of Inspector General, *The Postal Service's Share of CSRS Pension Responsibility*, RARC-WP-10-001 (Arlington, Va.: Jan. 20, 2010).

[29]*An Examination of the Postal Service's Current Financial Crisis and Future Viability*, *Hearing before the House of Representatives Committee on Oversight and Government Reform and the Subcommittee on the Federal Workforce, Postal Service, and District of Columbia*, 111th Cong., (Apr. 15, 2010) (Statement of David C. Williams, Inspector General, USPS).

[30]*Id.*

determination. According to the PRC contractor responding to this request, both OPM's and the USPS OIG's methodologies are within the range of acceptable allocations of costs and benefits to service periods based on current actuarial standards and practices, but in the contractor's view, OPM's methodology is not "'fair and equitable' except within the context of P.L. 93-349, the 1974 legislation that underlies the OPM methodology."[31]

Analysis

At issue here is whether OPM's methodology for allocating responsibility for CSRS pension costs for USPS employees who worked for both USPS and the POD is consistent with applicable law.

We begin with the 1974 Act, which established the allocation of responsibility for CSRS pension costs between USPS and the federal government. As discussed above, the 1974 law explicitly directed USPS to pay for CSRS costs attributable to pay increases granted by USPS after July 1, 1971. The 1974 Act created a new subsection 8348(h) of Title 5, U.S. Code, stating the following:

"(h)(1) Notwithstanding any other statute, [USPS] *shall be liable* for that portion of any estimated increase in the unfunded liability of [CSRDF] which is attributable to any benefits payable from [CSRDF] to active and retired Postal Service officers and employees, and to their survivors, when the increase results from an employee-management agreement under title 39, or any administrative action by the Postal Service taken pursuant to law, which authorizes increases in pay on which benefits are computed.

"(2) The estimated increase in the unfunded liability, referred to in paragraph (1) of this subsection, shall be determined by the Civil Service Commission. The [USPS] shall pay the amount so determined to the Commission in thirty equal annual installments with interest computed at the rate used in the most recent valuation of the civil service retirement system, with the first payment thereof due at the end of the fiscal year in which an increase in pay becomes effective."[32]

[31]Postal Regulatory Commission, *Report of the Postal Regulatory Commission on: Civil Service Retirement System Cost and Benefit Allocation Principles,* by the Segal Group, Inc. (Washington, D.C.: June 29, 2010), 2.

[32]Pub. L. No. 93-349, § 1, 88 Stat. 354, *formerly codified at* 5 U.S.C. § 8348(h)(1) (emphasis added).

The express language of subsection (h)(1) made clear that regardless of any prior federal service by USPS employees, Congress determined that USPS was to bear responsibility for the entire change in the liabilities of the CSRDF arising from a USPS pay increase (that is, a pay increase after July 1, 1971). The legislative history of this provision explains the logic behind this language. The House report accompanying the legislation stated that "[t]he Congress now has no control—no oversight whatsoever—with respect to the pay machinery in the Postal Service. Since each future pay raise . . . will result in specific unfunded liability and a new financial drain on [CSRDF], the cost of this liability should properly and equitably be borne by the Postal Service."[33] The Senate report explained further that "the bill will permit the Postal Service to include the cost of financing unfunded retirement liability in its rate base for purposes of future postal rate adjustments."[34] Thus at the time of the 1974 Act, Congress clearly allocated the full cost of any future pay increases to USPS, both for employees who had worked for the POD and USPS as well as for USPS-only employees.[35]

The 2003 Act did not direct any change in this allocation. As discussed above, the 2003 Act required OPM to use more realistic "dynamic assumptions" rather than static assumptions in its annual calculation of USPS's CSRS funding obligation. Because these dynamic assumptions included projections of future pay increases, the consequence of the 2003 Act was to leave the underlying 1974 allocation unchanged, notwithstanding the removal of the explicit allocation provision. The 2003 Act amended 5 U.S.C. § 8348(h) by replacing both the explicit assignment of liability to USPS in subsection (h)(1) and the responsibility for calculation of this liability by OPM after each USPS pay increase in subsection (h)(2) with the "Postal supplemental liability" concept. This new method of calculation is based upon the present value of benefits payable to present or future CSRS annuitants that are "attributable to the service of current or former employees of [USPS]," as determined by

[33]H.R. Rep. No. 93-120, at 4 (Apr. 17, 1973).

[34]S. Rep. No. 93-947, at 4 (June 19, 1974).

[35]GAO, in commenting on the proposed 1974 Act, also noted that requiring USPS to pay for such unfunded liability "vindicates the policies of the Postal Reorganization Act, while preserving the integrity of the fund." Letter from the Deputy Comptroller General of the United States, to the Chairman of the Committee on Post Office and Civil Service, U.S. Senate, B-130441 (May 30, 1974).

OPM, as offset by assets such as the present value of future employee contributions and the portion of the CSRDF balance that is attributable to past payments by USPS and its employees.[36]

Because of CSRS's then-static assumption methodology, which did not project future inflation or pay increases, in order to change USPS' CSRDF contributions to account for pay increases, USPS would be required to make a schedule of additional contributions each time it increased employee pay, as the 1974 Act had done. When the 2003 Act shifted to dynamic assumptions, it became unnecessary to require a schedule of additional USPS payments after each pay increase. The Senate report accompanying the 2003 Act provided the following explanation:

"Because the dynamic normal cost of CSRS includes the effects of future employees' pay raises and retiree COLAs, the separate payments that USPS is required to make under current law to fund the future increases in CSRS annuities that result from pay raises and COLAs would no longer be necessary. Consequently, S. 380 would repeal the provisions of law that require the Postal Service to amortize over 15 years the increases in future CSRS annuities that result from annual employee pay raises and retiree COLAs."[37]

While the statute no longer included the prior explicit statement regarding allocation to USPS, there was no indication in 2003 that Congress intended to alter the overriding principle, reflected in the 1970 and 1974 Acts, that USPS was to be self-supporting and that the full cost of funding its pension liabilities was intended to be included in the operational costs to be supported by postal revenues.[38] Further, because USPS is an "independent establishment," the 1970 Act requires that USPS obligations shall "not be obligations of, nor shall payment of the principal thereof or

[36]Pub. L. No. 108-18, § 2(c), 117 Stat. 624, 625.

[37]S. Rep. No. 108-35, at 2.

[38]The conclusion that the 2003 Act did not change the allocation made by the 1974 Act is supported by the 2003 Act's legislative history. The Senate report accompanying the 2003 Act states that the act "continues the Postal Service's liability for the retirement costs attributable to its employees covered by the CSRS which was imposed when the Post Office Department became the self-supporting [USPS] in July 1971." S. Rep. No. 108-35, at 3 (Apr. 8, 2003). *See also Payments on Unfunded Liability by the U.S. Postal Service to Civil Service Retirement Fund: Hearing Before the Committee on Post Office and Civil Service, United States Senate, on H.R. 29*, 93rd Cong. 73-74 (statement by Post Office and Civil Service Committee Chairman Gale McGee).

interest thereon be guaranteed by, the Government of the United States," absent a determination by the Secretary of the Treasury (which has not been made) that it would be in the public interest to do so.[39]

Finally, the 2006 Act, like the 2003 Act, directed no change in the fundamental allocation of benefit responsibility related to post-1971 pay increases. As noted above, the only allocation change made by the 2006 Act pertained to responsibility for pension costs arising out of prior military service by USPS employees; responsibility for all other retirement costs remained unchanged. The fact that Congress changed the allocation from USPS to the federal government for this one circumstance but not others, and that Congress did not use the occasion of legislating about postal pension benefits to direct OPM to change the direction it had taken in carrying out the 2003 Act, support the conclusion that the 2006 Act did not direct a change in the 1974 allocation.

[39]Pub. L. No. 91-375, 84 Stat.719, 741 (Aug. 12, 1970), *codified as amended at* 39 U.S.C. §§ 2005(d)(5), 2006(c).

Appendix II: Issues and Options Related to the Postal FERS Surplus

According to the most recent actuarial analysis, as of September 30, 2009, the FERS postal subaccount had a surplus of $6.9 billion. USPS has requested a refund of this surplus. In considering this request, several issues are significant.

- While USPS has a FERS surplus of $6.9 billion, it also has a CSRS deficit of $7.3 billion (under the current allocation of CSRS benefit responsibility). However, OPM expects the fiscal year 2011 year-end[1] fund report to show improvement (i.e., a lower CSRS deficit and a higher FERS surplus) because of the lack of a cost of living increase and relatively low salary increases since the prior calculation.

- Each year, USPS incurs additional FERS liabilities from an additional year of service of FERS participants. This component of annual growth in liability is known as the normal cost. USPS had been contributing its share[2] of the normal cost to the fund each year, thereby offsetting the growth in liabilities with compensating assets; the amount is currently about $3 billion per year.[3] However, USPS ceased making such contributions this past summer.[4] Absent such contributions, the surplus would be depleted over time as participants earn additional years of service.

Another factor to consider is that actuarial estimates of surplus or deficit contain a degree of uncertainty and could change over time (as exemplified by OPM's expectation of a significant change in the surplus and deficit amounts when the results of the most recent actuarial valuation are complete). Further, the ability of USPS to make any future contributions necessitated by "adverse experience" (for example, higher-than-estimated cost of living increases that create losses for the fund) is a consideration in any disposition of the surplus in the fund. We have identified four approaches to addressing the FERS surplus proposal and their corresponding implications:

[1]The fiscal year 2011 yearend report will update the actuarial valuation to September 30, 2010.

[2]Part of the normal cost is funded by the employee contributions of 0.8 percent of payroll.

[3]USPS's contribution in fiscal year 2010 was $2.9 billion.

[4]USPS and OPM have told us that they are seeking the views of the Department of Justice's Office of Legal Counsel concerning the USPS decision to cease making these contributions.

1. Current law. Under current law, USPS cannot access a FERS surplus and must continue to contribute approximately $3 billion, which is USPS's share of the normal cost. Conversely, when there is a FERS deficit, USPS must contribute both its share of the normal cost and a 30-year amortization payment to work toward funding the deficit. The treatment of surpluses and deficits is asymmetric and arguably unfair.
2. Amortization of the surplus. Earlier this year, the administration's budget proposal would have allowed USPS to reduce its FERS contribution by a 30-year amortization of the surplus. That would have reduced the required contribution by about $0.5 billion, from about $3 billion to $2.5 billion. The proposal would have made the treatment of surpluses symmetric with the treatment of deficits.
3. Funding holiday. In the private sector, when surpluses exceed the normal cost, a "funding holiday" (the cessation of contributions) is permitted until the surplus is used up.[5] This is essentially the approach USPS unilaterally adopted this summer when it stopped contributing to FERS. With a $6.9 billion surplus and an unfunded normal cost of $3 billion, this funding holiday, if it continued, would use up the surplus in a little over 2 years. With OPM's expectation that the surplus has increased, the funding holiday would last somewhat longer than that. Of course, the amount of surplus (or deficit) could change yet again next year, lengthening or shortening any funding holiday.
4. Reversion. A reversion refers to the actual return of money from the pension plan to the plan sponsor (as opposed to a cessation of contributions). In the private sector, a reversion is only allowed upon plan termination, when the surplus measure is final. It is important to note that a reversion of the entire $6.9 billion surplus (or of an updated surplus amount) to USPS should mean that USPS would then need to resume contributing its share of the normal cost of $3 billion per year; otherwise, the fund would go into deficit. Given that the FERS surplus has accumulated over a number of years with no reductions in USPS's contributions, OPM supports a reversion of the surplus to USPS over a 2-year period.

[5]The private sector approach has sometimes been driven by multiple considerations, not just pension policy—for example, not allowing an excessive amount of funds to be tax-sheltered, and revenue considerations.

Appendix III: Objectives, Scope, and Methodology

To determine if the current methodology employed by OPM for allocating responsibility for CSRS benefits between USPS and the federal government is consistent with law, we reviewed relevant laws, statutes, and legislative history.

To provide commentary on the actuarial analysis that the USPS Office of Inspector General (USPS OIG) and Postal Regulatory Commission (PRC) used in stating that OPM should refund the CSRS contributions in question, we reviewed and analyzed opinions and studies on this issue by relevant agencies and government entities including USPS, the USPS OIG, OPM, and the OPM OIG. We also reviewed and analyzed studies and opinions by actuarial firms and industry groups, including the Hay Group, the Institute for Research on the Economics of Taxation, and the Segal Company, Inc. To gain information on the method by which responsibility for CSRS benefits is currently allocated and the potential impacts of a CSRS payment refund on the CSRS fund and stakeholders, we interviewed officials at OPM. To gain information on the extent to which CSRS benefit costs have been recovered by USPS through postal rates to date, we interviewed officials at the PRC. To comment on USPS's request for a FERS refund, we analyzed OPM's most recent CSRDF annual report, interviewed OPM actuaries, reviewed commentary by USPS OIG and OPM on this issue, and reviewed approaches to surplus pension assets applicable to private sector pension plans.

To provide commentary on the potential impacts of a refund of CSRS payments to USPS, we reviewed and summarized prior GAO work on this subject, including reports and testimonies related to the financial condition of USPS and the actions necessary to avoid financial insolvency. We also spoke with officials at USPS to gain information on USPS's current financial condition, and we interviewed officials at OPM to gain information on the legal requirements applying to any transfer of CSRS assets and the potential impacts on plan participants.

We conducted this performance audit from September 2011 through October 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix IV: Comments from the Office of Personnel Management

UNITED STATES OFFICE OF PERSONNEL MANAGEMENT
Washington, DC 20415

Office of the Director

October 11, 2011

Lorelei St. James
Director, Physical Infrastructure Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. St. James,

Thank you for sending us GAO's draft report entitled, *U.S. Postal Service: Allocation of Responsibility for Pension Benefits Between the Postal Service and the Federal Government,* (GAO-12-146). Staff from the Office of Personnel Management have reviewed the report and concur with your findings and recommendations.

OPM has consistently maintained that it has followed the law with respect to the allocation of responsibility for pension benefit payments between the Postal Service and the Federal Government. Your report supports this longstanding position.

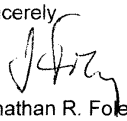
In Appendix II of the report, the authors outline four approaches to addressing the surplus in the FERS fund attributable to Postal Service employees. In describing the fourth approach, a one-time reversion of the surplus, the authors note: "Given that the FERS surplus has accumulated over a number of years with no reductions in USPS's contributions, OPM supports a one-time reversion to USPS as a "re-set" of the fund back to 100% funded." (p. 37)

The President's Deficit Reduction proposal, "Living Within Our Means and Investing in the Future," would "provide USPS with a refund over two years of the $6.9 billion surplus in Postal contributions to the FERS program." (p. 23)

We suggest that the OPM position be stated as supporting a "reversion of the surplus to USPS over a two year period."

Thank you for providing OPM with the opportunity to comment.

Sincerely,



Jonathan R. Foley
Director
Planning and Policy Analysis

Appendix V: Comments from the Office of Personnel Management, Office of the Inspector General

Office of the
Inspector General

UNITED STATES OFFICE OF PERSONNEL MANAGEMENT
Washington, DC 20415

October 11, 2011

MEMORANDUM FOR LORELEI ST. JAMES
Director, Physical Infrastructure Issues
Government Accountability Office

FROM: PATRICK E. McFARLAND
Inspector General

SUBJECT: Response to GAO Draft Report No. GAO-12-146

Thank you for the opportunity to comment upon the draft report produced by your office entitled "U.S. Postal Service: Allocation of Responsibility for Pension Benefits Between the Postal Service and the Federal Government," GAO-12-146.

We agree with the legal conclusions contained in the draft report and find the policy questions raised to be very insightful. Specifically, we appreciate the analysis of the financial impact that various policy options would have upon the trust funds administered by the U.S. Office of Personnel Management. Protection of the financial integrity of these trust funds is our office's paramount concern.

We expect that Congress will find this report useful as it works to develop a comprehensive plan to address the U.S. Postal Service's current financial situation.

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Appendix VI: Comments from the U.S. Postal Service

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER
EXECUTIVE VICE PRESIDENT

UNITED STATES POSTAL SERVICE

October 12, 2011

Ms. Lorelei St. James
Director, Physical Infrastructure Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548-0001

Dear Ms. St. James:

Thank you for the opportunity to provide comments on the Government Accountability Office (GAO) report, Allocation of Responsibility for Pension Benefits between the Postal Service and the Federal Government (Report).

The Postal Service is disappointed that the GAO has rejected the arguments of the Postal Service Office of Inspector General (OIG) and the Postal Regulatory Commission (PRC) and their independent actuaries to reach a conclusion that, in our view, ignores actuarial principles that would govern in the private sector, as well as fundamental principles of fairness, by perpetuating the inequitable allocation of pension obligations under the Civil Service Retirement System (CSRS) for Postal Service employees who also worked for the Post Office Department (POD). In doing so, the Report fails to describe the false assumptions underlying the 1974 law, or the legal environment under which the Postal Service operates with respect to compensation policy. The Report also mistakenly endorses the Office of Personnel Management's (OPM's) position that the repealed 1974 law, rather than generally accepted actuarial practices and principles, should govern the determination of the Postal Service's CSRS liabilities under current law.

The Report does not attempt to refute that the actuarial methodologies employed by the OIG and the PRC are standard actuarial methodologies typically employed in the private sector for the allocation of pension liabilities.[1] This point is further underscored by the credibility and stature of the two actuarial firms employed by the OIG and the PRC. No independent actuary has endorsed OPM's approach, which is predicated on fundamentally unrealistic assumptions. Rather, the only basis cited by the GAO for the "fairness" of the pension cost allocation methodology used by OPM is its consistency with the 1974 law.

GAO's discussion of why the 1974 law is "fair" fails to account for the specifics of postal law, and is only understandable if GAO believes that the Postal Service and Congress negotiated at arms-

[1] The Report's criticism of the Segal Report at the bottom of page 16 and continuing on to page 17 is fundamentally misguided. The statement in the letter from the American Academy of Actuaries has been taken out of its original context. The American Academy of Actuaries' comment letter to FASB dealt with the measurement of the liability for balance sheet purposes. The comment has nothing to do with the allocation of pensions earned by two related employers.

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length over the terms of the law. GAO's discussion of the "fairness" of the current methodology is flawed and incomplete for the following reasons:

- GAO does not provide an example in which the methodology set forth in the 1974 law would have been accepted by a party in the Postal Service's position as part of an arms-length transaction. This is not surprising, because no rational party would accept an allocation as part of an arms-length transaction in which—using GAO's example—an employee would spend only 60 percent of his career with that party, but the party would shoulder 82% of the pension costs, while completely lacking any authority to address the size of those costs. In a similar calculation, based on an employee with 15 years of service, including ten with the POD and five with the Postal Service (i.e., 2/3 POD and 1/3 Postal Service), the Postal Service would already be responsible for 53 percent of the individual's pension. Outcomes such as these would only have made sense if significant benefits were received for accepting that allocation methodology. The Postal Service, on the other hand, did not receive any such benefits as part of the 1974 law.

- While GAO claims that one must consider the allocation of the pension costs in light of the "total package of assets and obligations" that were involved in the creation of the Postal Service, much greater context must be provided to achieve fair and balanced coverage. Full consideration of all assets, liabilities, and obligations argues against GAO's conclusion. In 1971, the Postal Service received assets in need of substantial upgrading, a workforce that it inherited from the POD along with its associated legacy costs, costly mandates (e.g., those regarding universal service, pay, and benefits), and a longstanding gap between revenues and costs.

- Most relevant here, the Postal Service was formed, in large part, because employee wage demands led to wildcat strikes and associated service disruptions. Congress and the President agreed to an eight percent pay raise as part of the Postal Reorganization Act, in order to ensure employee support for the Act, on top of a six percent increase that had earlier been enacted to end the work stoppage. In addition, the Act required the Postal Service to provide its employees with pay and benefits comparable to those paid in the private sector for comparable work, and imposed a mandatory interest arbitration process for labor negotiations when management and labor failed to reach agreement. As such, the pension cost methodology currently used by OPM penalizes the Postal Service for doing what was made inevitable by the Act: an increase in wages. In addition, because the 1974 methodology was made retroactive, the Postal Service bears full responsibility for the eight percent pay raise for Postal Service employees negotiated prior to passage of the Act and put in effect by that law.

- For these reasons, the articulated basis for the 1974 law—that the Postal Service was entirely responsible for its post-1971 wage increases, and thus should have to finance the effect of those increases on its pension costs—is also fundamentally in error. Congress did not give the Postal Service such control, either over its wages or over its pension costs. First, Congress required in the Postal Reorganization Act that Postal Service employees remain covered in CSRS. Thus, the Postal Service had no ability to address the design of its pension benefits or the size of its pension costs. Second, Congress required that that Postal Service pay wages and benefits comparable to those in the private sector, and required that any failure to achieve a negotiated agreement on wages result in binding interest arbitration. The consequences of this decision were made abundantly clear four years after passage of the 1974 law, when an interest arbitrator in 1978 required that Postal Service wage COLAs be uncapped, just as the country began experiencing double-digit inflation.

- GAO's statement that addressing the allocation methodology would allow the Postal Service "to receive payment for these costs twice" is also flawed. Most fundamentally, it is mailers who have been overcharged for these costs, and who therefore deserve to benefit from correction to the overpayment. In addition, to the extent that the overpayments are used to finance retirement health benefits—as current legislative proposals endorse—they would be used to pay costs that were *not* part of the Postal Service's rate base for most of the time period after 1971, even though the benefits were being earned by its employees.

Current law does not in any way preclude OPM from effectuating a fair and reasonable allocation of these liabilities, such as the approach set forth in the Segal Report. In concluding to the contrary, GAO ignores the effects of Public Law No. 108-18 of 2003 and the Postal Accountability and Enhancement Act of 2006 (PAEA), Public Law No. 109-435. The 2003 law eliminated the statutory language requiring OPM to follow the 1974 allocation methodology, and required OPM to determine the benefits "attributable to the service of current or former employees of the United States Postal Service."[2] GAO does not dispute this, but claims that because Congress did not expressly mandate a change to that methodology, OPM has no authority to adopt a contrary methodology. However, the 2003 and 2006 laws, when considered together, reflect intent on the part of Congress that OPM determine the Postal Service's CSRS liabilities based on modern actuarial principles, rather than the statutorily-imposed principles underlying the prior funding mechanism, in order to ensure that the Postal Service fully funds, but does not overfund, those liabilities. Congress assigned to OPM the authority to determine which actuarial practices are proper when determining the Postal Service's CSRS liability: Section 802(c) of the PAEA stated that any determination by OPM of the Postal Service's CSRS liabilities could be subject to review by the PRC, employing an independent actuary, who is required to review that determination "in accordance with generally accepted actuarial practices and principles." OPM is then required to reconsider its determination "in light of such report," and to "make any appropriate adjustments." Clearly, then, Congress intended that OPM determine the Postal Service's CSRS liabilities based on "generally accepted actuarial practices and principles," and gave OPM the authority to do so. As such, OPM's methodology must be defended on whether it meets that requirement, not whether it is consistent with a repealed, and fundamentally unfair, law.

Finally, the Postal Service appreciates GAO's recognition that reallocation of a CSRS pension surplus would not by itself solve Postal Service financial problems or eliminate its debt, as such a conclusion would be far from correct. The Postal Service's comprehensive legislative proposals, were articulated most recently in Postmaster General Donahoe's testimony on September 6, 2011:

- Resolve the pre-funding of Retiree Health Benefits;
- Return the $6.9 billion overfunding of the Postal Service's obligations to the Federal Employees Retirement System;
- Grant the Postal Service the authority to determine delivery frequency;
- Allow the Postal Service the flexibility to restructure its healthcare and pension systems;
- Permit the streamlining of pricing and product development.

As stated in that testimony, the Postal Service believes that its non-legislative initiatives and requested legislation must reduce annual expenses by $20 billion by 2015. These aggressive cost reductions are designed to address prospective future declines in mail volume and revenue, and place the Postal Service on a path to long-term financial sustainability. It is only through a

[2] This "attributable" language was similar to that in another section of the U.S. Code (5 U.S.C. § 8406(g), as well as to the repealed CSRS COLA provisions, under which OPM used a different allocation methodology.

combination of efforts, designed to ensure that the Postal Service's cost structure is sustainable, that the Postal Service's financial problems can be resolved.

In conclusion, the Report offers no room for compromise, relying almost entirely as it does on the mistaken assumption that the 1974 law represented Congress' final determination on the fairness of the allocation of pension costs between the Postal Service and the U.S. Treasury. In fact, Congress' direction, as expressed in the 2003 and 2006 laws, indicates otherwise. Furthermore, the Report fails to support the reasonableness of the 1974 law under current actuarial standards, which govern OPM's determination of the Postal Service's CSRS liabilities. The fact that two independent actuaries have determined that a fair, rational, and actuarially-sound allocation of the CSRS liability would return between $50 billion and $75 billion to the Postal Service suggests that a sound and fair result would achieve a more rational balance between those costs allocated to the Postal Service and those costs that are properly the responsibility of the U.S. Treasury. We believe a more balanced report by GAO would include a more objective analysis and provide compromise options for the Congress to consider.

Sincerely,

Joseph Corbett

cc: Mr. Donahoe
Mr. Stroman
Ms. Gibbons
Mr. Vegliante
CARM Manager

Appendix VII: Comments from the U.S. Postal Service, Office of Inspector General

OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

October 11, 2011

Ms. Lorelei St. James
Director, Physical Infrastructure
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. St. James:

Thank you for the opportunity to comment on the Government Accountability Office's report titled "Allocation of Responsibility for Pension Benefits Between the Postal Service and the Federal Government."

We disagree with the major conclusions of the report. Your review focuses on the 1974 law (P.L. 93-349), which is not in dispute. All parties agree that the 1974 law made the Postal Service responsible for funding the additional CSRS liabilities resulting from pay increases after 1971.

The issue in question surrounds the CSRS Funding Reform Act of 2003 (P.L. 108-18) as it pertains to the Office of Personnel Management's (OPM) share of CSRS liability. Your report fails to recognize how the 2003 law changed the 1974 law. We do not understand your assertion that the "consequence of the 2003 Act was to leave the 1974 allocation unchanged, notwithstanding the removal of the explicit allocation provision." If, as you state, the allocation provision was removed, it does not seem reasonable to assume the intent of Congress was that the allocation remain unchanged.

In fact, the 2003 law changed the directive to OPM. As the legislative history shows, it was intended to "repeal" the 1974 law (Senate Report No. 108-35, page 6). OPM was required to adopt modern dynamic methods. Dynamic methods dictate that OPM take into account the effect of future salary increases on the total liability. Using these methods, OPM was to capture the size of the postal liability and the respective responsibilities of the Postal Service and OPM to satisfy the liability. Instead, OPM applied dynamic assumptions solely to the Postal Service's share of the liability — not to its own share. It appears that OPM failed to follow the 2003 law and now must agree to do so or be compelled by law for a second time.

Two separate and independent reviews have found that OPM's continued use of the 1974 methodology for its own share is either unfair or not consistent with modern pension standards that use dynamic assumptions and that are required in the 2003 law:

- Our review, conducted with the assistance of the actuarial firm, the Hay Group, argued that the CSRS liability for employees with service prior to 1971 should be split between the Postal Service and the federal government on a years-of-service basis. A years-of-service basis was used to split the liability of retirees' cost-of-living adjustments (COLA) between OPM and the Postal Service prior to the 2003 law. Additionally, we found that the Postal Service's retiree health benefits are also allocated between the Postal Service and OPM on a years-of-service basis, which is instructive regarding the proper structuring of the CSRS benefits. We estimated that the Postal Service had been overcharged $75 billion from fiscal years 1972 to 2009 for its share of CSRS pension benefits.

- The Postal Regulatory Commission's independent actuary, The Segal Company, advocated a methodology based on private sector accounting standards. Like our methodology, it takes into account the effect of future salary increases on the liability, but it does not split the costs evenly by years of service. Instead, it follows the CSRS pension formula, which provides a higher benefit for later years of service. Under this methodology, Segal estimated the Postal Service overpayment to be $50 to $55 billion. The Office of Inspector General believes that this method, though more moderate, represents a second rational approach to implement the 2003 law.

We believe OPM can now, if it chooses, apply dynamic assumptions to the federal share since it has been directed to do so since 2003. Under 5 U.S.C. § 8348, the Postal Service is responsible for the full amount of retirement benefits that are "attributable to civilian employment with the Postal Service." However, it is responsible only for that portion that is attributable to Postal Service employment. The Postal Service is not responsible for the amount attributable to service prior to 1971.

Post Office Department (POD) service prior to 1971 is properly the responsibility of the federal government. The 2003 law established that these amounts should be calculated dynamically as the liability increases with inflation and other factors. As a result, both the Postal Service and federal shares should include the expected salary increases that are part of the final pension benefit. Non-postal federal salaries have also risen since 1971, and OPM accounts for and is responsible for meeting those increased liabilities. OPM's failure to pay the full

CSRS cost of postal service prior to 1971 leaves a hole in the fund. The Postal Service and its employees have been forced to fill the gap. OPM's position, however, is that it needs to be directed more clearly to apply dynamic assumptions to the federal share by a new piece of legislation.

Applying dynamic standards to only part of the liability is not only inconsistent with the law and with modern actuarial standards, but it also results in the extraordinarily unfair assignment of the largest share of the liability to the Postal Service. Under this methodology, the Postal Service could be responsible for 70 percent of the CSRS pension costs for an employee whose service was split evenly (50-50) between the Postal Service and the POD. By using the 1974 static method for the federal share, OPM is leaving a deficit in the CSRS funding by not paying for inflation or pay increases attributable to POD service. To make up the deficit, OPM has overcharged postal ratepayers. Your report argues that no change is necessary since postal ratepayers have already paid these costs, but we believe that these ratepayers have been overcharged long enough. A correction is long overdue.

The current OPM methodology is neither fair nor modern nor does it comply with the 2003 law. We agree with you that action from Congress is necessary to settle this issue once and for all. We believe Congress did just that in 2003. If OPM cannot be convinced of the need to change its methodology, the only alternative is for Congress to compel OPM to act by adding even more explicit reform language to the legislation currently being prepared.

Sincerely,

David C. Williams
Inspector General

Appendix VIII: Comments from the Postal Regulatory Commission

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

RUTH Y. GOLDWAY
CHAIRMAN

October 11, 2011

Lorelei St. James
Director, Physical Infrastructure
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. St. James:

Thank you for the opportunity to comment on the Government Accountability Office's review of the U.S. Postal Service contributions to the Civil Service Retirement System (CSRS).

Your report correctly frames the CSRS issue as a matter of policy. However, it stops short of offering any guidance to inform that policy decision. The Commission has previously provided advice on this issue and believes that its advice remains relevant.

The Commission's involvement in this matter arose from a Postal Service request, filed under section 802(c)[1] of the Postal Accountability and Enhancement Act (PAEA), to review the fairness and equity of the method used by the Office of Personnel Management (OPM) to apportion the CSRS obligation between the Postal Service and the Post Office Department (POD).[2] The Commission contracted with The Segal Company (Segal), a member in good standing of the American Academy of Actuaries, to study this issue. Segal issued its report on June 29, 2010.

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[1] Section 802(c) requires the Commission, upon receiving a request for review, to procure the services of an actuary who is a member of the Academy of American Actuaries and is qualified in the evaluation of pension obligations, to conduct a review in accordance with generally accepted actuarial practices and principles. Upon approving the report, the Commission is required to provide it to the Postal Service, OPM and Congress. Section 802 (c) further states that, upon receiving the report from the Commission, OPM shall reconsider its determination of the pension liability and make any appropriate adjustments in light of the report.

[2] Docket No. PI2010-2, Request of the United States Postal Service for the Commission to Conduct a Review Pursuant to PAEA Section 802(c) of OPM Determinations Regarding CSRS, February 23, 2010.

Contrary to your assertion, the Segal report did not characterize the overfunding of CSRS liabilities as an "overpayment" and did not imply that errors were made in the calculation of the liability. Segal considered the OPM allocation a reasonable methodology for implementing legislation enacted in 1974 (P.L. 93-349). However, viewed in the context of modern actuarial and accounting standards, the methodology provides an inequitable allocation of responsibilities for the Postal Service's share of the CSRS assets.

Segal notes that there was very little guidance during the 1970s regarding the allocation of pension costs to time periods. Since that time, significant attention has been given to that issue, primarily in the current set of corporate pension accounting standards—FASB ASC2 715, Compensation – Retirement Benefits. Additional sources reviewed by Segal include GASB 27, the pension accounting standard for state and local governments, and SFFAS, the pension accounting standard for the Federal government. Segal's report was, in essence, a fresh look at how the allocation would be made using modern generally accepted principles.

According to Segal, the use of actuarial or accounting methods provides meaningful guidance in the proper allocation of CSRS benefits between the POD and the Postal Service. The accounting standard, FASB ASC 715, provides a logical and reasonable compromise that is fair and equitable in the current situation. An employer is required to reflect the actual benefit accrual formula embodied in a pension plan, as OPM does. Additionally, an employer is also required to reflect the impact of future salary increases on current accruals in a "high" or "final" average salary plan, as the United States Postal Service Office of Inspector General (USPS OIG) does. This is consistent with current actuarial standards, generally accepted accounting principles, and public sector accounting standards.

Your report claims that a significant body of pension experts deems the inclusion of the effects of salary increases on pension liabilities inappropriate. As an example, you cite comments submitted by the American Academy of Actuaries (the Academy), in early 2006, in response to FASB's Exposure Draft to Improve Accounting for Postretirement Benefit Plans.[3]

[3] In September 2006, the Board issued a final standard, SFAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, completing the first phase of its ongoing two phase pension accounting project. SFAS 158 amends the prior accounting standards SFASs 87 and 106 by requiring recognition of the projected benefit obligation by a pension plan.

Review of the Academy's comments, in their entirety, reveals that they explicitly exclude government plans.[4]

Your report also claims that the allocation of pension liabilities made in 1974 implicitly reflects fairness because upon establishment in 1971, the Postal Service was given a "package of assets and liabilities, which included the preexisting postal infrastructure and business advantages and disadvantages."[5] Your report implies that this package is akin to the formation of a new business where pension liabilities would be part of negotiations. The Segal report highlighted important differences between the formation of the Postal Service and the formation of a private business. At page 6 of its *Report to the Postal Regulatory Commission on: Civil Service Retirement System Cost and Benefit Allocation Principles*, Segal states:

> 1. It is almost unprecedented to have a transfer of ownership of a private enterprise where the buyer becomes a participating employer in the seller's pension plan.
>
> 2. In a typical transaction involving the sale of a business unit that has a defined benefit pension plan, there is an exchange of cash and/or securities from the buyer to the seller. This represents the market value of the entire enterprise. While each party may have in mind an adjustment to the purchase price to reflect the pension plan, they may not be the same, or their individual pricing models may serve some tax or non-pension accounting purpose, or it may reflect the relative importance to one of the parties of closing the deal. In the absence of an actual market for parties

[4] The letter states, "We assume that salary and total compensation are under the control of employer and employee, and that salaries are set to keep total compensation competitive. So long as both parties stick to ABO pricing, both parties emerge each year with a fair exchange. Increases in pension value can be easily coupled to increases in compensation. Consider what happens with PBO pricing. The employer will have 'paid' more than the employee will have 'received' for a year of service. The employer may freeze or terminate the plan and take a curtailment gain. This moral hazard, from the employee's point of the view, is only avoidable if there is an enforceable multi-period contract between the employer and the employee. Except in the government sector and in some negotiated plans (which are usually not salary-based), recent experience confirms that such multi-period contracts don't exist or are not enforceable. Thus, there is no basis for the employee to assume that he will be entitled to anything more than his accrued benefit and, if he does so, he will have accepted lower current pay in return for a renegable promise of his employer." *See* American Academy of Actuaries letter to Robert H. Herz, Chairman, Financial Accounting Standards Board, February 6, 2006, at 2 (footnote omitted).

[5] *See* General Account Office, Allocation of Responsibility for Pension Benefits Between the Postal Service and the Federal Government, GAO-12-146 (October 2011) at 6.

buying and selling pension plans based on final average pay to others independent of anything else, we do not believe one can say with authority that the private sector has a definitive model that clearly suggests what is appropriate in the USPS situation.

3. Another typical private sector transaction is a spin-off of part of an enterprise into its own separate company. Most often, this does not result in the new company continuing to participate in the original enterprise's pension plan, because the whole objective is separation. In any event, however, this is not normally an arms-length transaction, because immediately after the separation the shares of the new company are allocated to the original enterprise's shareholders in exactly the same proportion as they held in the original enterprise. While this may be the closest analogy to the spin-off of the POD as a stand-alone entity, each allocation reflects the unique goals of the original parent (subject, of course, to the intervention of laws such as ERISA and those governing the sale of securities to the public that constrain private-sector transactions).

The Postal Service was not established as a totally separate self-sustaining entity, but rather as a self-sustaining entity within the executive branch of the government. This implies that the Federal government, not the Postal Service, sets the policies and basic management structure of the Postal Service, in addition to providing oversight over the organization in return for some monopoly power in the marketplace and exemption from some local laws and regulations. The Postal Service was given basic management control of government assets and liabilities related to the provision of those mail services.

Your report also asserts that the Postal Service has already received payment for current and future pension obligations from ratepayers and that transfer of CSRS assets would constitute a double payment. The Commission respectfully disagrees with that assertion. The purpose of a break-even requirement, as it stood before the passage of the PAEA, was to charge users of mail services the full cost of providing those services. The attribution methodologies established by the Commission allocated these costs to mail products. Prices were set to recover all costs of the Postal Service. If Congress were to change the current allocation of CSRS pension costs in the manner recommended by the Segal report, the Postal Service would receive a refund of past payments to the Federal government. It was the ratepayers, not the taxpayers, who paid for those past costs and it will be ratepayers who will benefit from the recommended allocation, going forward, through more stable rates and more reliable, accessible services.

This is similar to what occurred after it was discovered that the CSRS funding mechanism established in 1974 under Public Law 93-349 would cause a significant overfunding of the Postal Service's share of the CSRS liability for pension benefits. That finding resulted in enactment of Public Law 108-18, which significantly changed the Postal Service's CSRS funding requirements and resulted in substantial cost savings to the Postal Service. The Postal Service was required to use a portion of the savings to hold postage rates down, a benefit for ratepayers.

The Commission also disagrees with the implication that any change in the allocation would provide the Postal Service with only limited relief from its financial pressures. In its *Section 701 Report: Analysis of the Postal Accountability and Enhancement Act of 2006,* [6] released on September 22, 2011, the Commission identified the CSRS as one of the areas where key adjustments to postal laws could help address the liquidity crisis facing the Postal Service. Adjustments would improve the Postal Service's current financial situation in the near term and provide an opportunity to more fully assess long-term solutions. The Commission noted that if the excess funds from the CSRS were transferred into the Postal Service Retiree Health Benefit Fund, the fund would be almost fully funded.

Finally, there is a difference of opinion as to whether the existing legislation compels the omission of post-1971 pay increases in a 2010 analysis. Both USPS OIG and OPM appear to agree that Public Law 93-349 was intended to prohibit allocating the impact of post-1971 final average salary increases to the POD. The question is primarily whether or not Public Law 108-18, enacted in 2003, and the PAEA, enacted in 2006, continued that prohibition. Should there be a determination by OPM to choose something other than continuation of the present methodology, we believe the current legislative framework can accommodate a change.

[6] Under the PAEA, P. L. 109-435, 120 Stat. 3198 (2006), section 701, "[T]he Postal Regulatory Commission is required to (a) [S]ubmit a report to the President and Congress concerning—(1) the operation of the amendments made by this Act [PAEA]; and (2) recommendations for any legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States. (b) Postal Service Views.–A report under this section shall be submitted only after reasonable opportunity has been afforded to the Postal Service to review the report and to submit written comments on the report. Any comments timely received from the Postal Service under the preceding sentence shall be attached to the report...."

In conclusion, the Commission agrees that the ultimate decision on allocation of pension costs between the Postal Service and the POD is a matter of policy. As requested by the Postal Service, the Commission sponsored the Segal report to provide guidance on this matter. The Commission believes that Segal's guidance remains both sound and relevant. The present allocations, deemed reasonable before the development of modern practices, do not reflect application of current generally accepted practices and principles.

Sincerely,

Ruth Y. Goldway

Appendix IX: GAO Contact and Staff Acknowledgments

GAO Contact

Lorelei St. James, (202) 512-2834 or stjamesl@gao.gov

Staff Acknowledgments

In addition to the contact named above, Teresa Anderson, Barbara Bovbjerg, Fred Evans, Jeanette Franzel, Kimberly Granger, Katie Hamer, Susan Irving, Jason Kirwan, Hannah Laufe, Kate Lenane, Kimberly McGatlin, Diane Morris, Susan Poling, Susan Ragland, Susan Sawtelle, Kate Siggerud, Ken Stockbridge, Frank Todisco, and Crystal Wesco made key contributions to this report.