November 23, 2010

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER AND EXECUTIVE VICE PRESIDENT

MARIE THERESE DOMINGUEZ
VICE PRESIDENT, GOVERNMENT RELATIONS AND PUBLIC POLICY

SUBJECT: Management Advisory – Substantial Savings Available by Prefunding Pensions and Retirees' Health Care at Benchmarked Levels (Report Number FT-MA-11-001)

This self-initiated report presents the results of our review and benchmarking of the U.S. Postal Service's prefunding of pensions and retiree health care liabilities. Our objective was to identify and benchmark prefunding levels of public and private sector entities for both pensions and retiree health benefits and determine whether substantial cost saving opportunities for the Postal Service exist (Project Number 10BS002FT001). We will be conducting a follow up audit to determine whether the Postal Service might use its assets to address these liabilities. This report addresses financial risk. See Appendix A for additional information about this topic.

Prefunding retiree liabilities, such as pensions and health care, is a prudent way to plan for an organization's future. The process involves setting aside current funds to address liabilities that current employees will generate for the organization after they retire. However, the Postal Service is experiencing a serious financial crisis. The size of the Postal Service workforce, its extensive benefits package for employees and retirees, and the required levels of prefunding require significant attention. In testimonies before Congress[1] and elsewhere, the inspector general has discussed the concept of prefunding Postal Service pensions[2] and retirees' health care at less than 100 percent of the Office of Personnel Management's (OPM) actuarially estimated liability.

This report discusses results of our review and benchmarking of pension and health care prefunding and identifies the overfunding that results due to current requirements.

[1] The inspector general's written statement *Continuing to Deliver: An Examination of the Postal Service's Current Financial Crisis and its Future Viability*, dated April 15, 2010, to the Committee on Oversight and Government Reform and the Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia, U.S. House of Representatives.
[2] Consists of the Civil Service Retirement System (CSRS) and Federal Employees Retirement System (FERS).

Conclusion

Benchmarking results indicate the Postal Service has prefunded its pension and retiree health benefits plans at substantially higher levels than other entities. Many entities in the public and private sectors fund these future liabilities at less than 100 percent. By defining the prefunding requirements to standards set by other organizations, the Postal Service has an opportunity to substantially meet its obligation while conserving cash and improving its financial condition.

Prefund Pensions at 80 Percent and Retiree Health Care at 30 Percent

Our benchmarking results showed the Postal Service could fund pensions and the retiree health care fund at less than 100 percent of actuarial liabilities. The Standard and Poor's companies' (S&P 500) median prefunding level for pensions in 2009 was 79 percent of liabilities.[3] The aggregate prefunding for states' pensions in 2008 was also 79 percent.[4] In addition, the Government Accountability Office (GAO) reported that many experts consider at least 80 percent prefunding to be sound for government pensions.[5] Further, the Pension Protection Act of 2006 considers pensions prefunded at less than 70 percent as being "at risk" and attempts to protect such plans by commencing restrictions on corporate pension funds only when prefunding is below 80 percent. By contrast, the federal government has funded its combined CSRS and FERS pension obligations at only 41 percent of liabilities[6] and the military's prefunding for pensions is only 24 percent. From these results, we concluded 80 percent prefunding of pensions is reasonable.

Moreover, we determined the average level that Fortune 1000 companies prefund retiree health care (many do not prefund) is 28 percent with the military prefunding at 29 percent. In addition, we determined that state governments that prefund retiree health care averaged 30 percent. By contrast, the federal government does not prefund its retiree health care at all, even though its liabilities result from using the same plans as the Postal Service. Under these circumstances, we can make a strong case for the Postal Service to prefund at reduced levels, such as those found in the private and public sectors. More than simply a matter of principle, reduced prefunding would provide the Postal Service with significant financial relief.

There is no statute governing public sector pension plans or retiree health benefits that defines "prefunding." The prefunding levels established for the Postal Service are the result of the OPM setting funding requirements for the CSRS and FERS pension plans[7] and the Postal Accountability and Enhancement Act of 2006's (Postal Act of 2006)

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[3] From 2001 through 2009, S&P 500's pension median prefunding ranged from 73 to 112 percent.
[4] From 2001 through 2009, state governments' aggregate pension prefunding ranged from 59 to 90 percent.
[5] The GAO's *State and Local Government Retiree Benefits Current Funded Status of Pension and Health Benefits*, January 2008.
[6] The 41 percent does not include the Postal Service's portion of CSRS and FERS.
[7] The Postal Act of 2006 suspended funding CSRS by the Postal Service until FY 2017.

funding requirements for Postal Service retirees' health care. Although statutes governing prefunding of retirees' health care do not explicitly mandate a target prefunding level, by their operation, they will force the Postal Service to eventually prefund at or above 100 percent. Thus, 100 percent prefunding by the Postal Service for its retirement obligations is implied.

At the end of FY 2009, the OPM projected the CSRS fund balance for the Postal Service to be $197.5 billion with liabilities of $207.1 billion. The Postal Service had prefunded 95 percent of its CSRS liabilities. In addition, the OPM projected $76.1 billion in assets in the FERS plan and $69.3 billion in liabilities. The Postal Service prefunded the FERS plan at 110 percent.

We believe 80 percent prefunding for pensions and 30 percent prefunding for retirees' health care represents a reasonable level in addressing retirees' needs, yet also provides the Postal Service with a means of halting its current financial slide. During financially lucrative periods, management could choose to prefund at higher levels. Consequently, there would no longer be a need for Postal Act of 2006 funding requirements averaging $5.6 billion, as this new obligation to maintain annual funding at a 30 percent level would supersede the act's requirements. If the Postal Service implemented both prefunding levels, it would save $60.6 billion.[8] See Appendix B for our detailed analysis of this calculation and Appendix C for our detailed monetary impact calculation.

The federal government could retain this amount in the current funds; however, reducing the funding levels would eliminate the need for the Postal Service to make payments to the pension and retiree health care funds until the lowered funding threshold is reached. Relief from these payments would provide the Postal Service with much needed time to develop a strategic plan to transform itself to succeed in the new digital age.

We recommend the chief financial officer and executive vice president, in coordination with the vice president, Government Relations and Public Policy:

1. Pursue necessary changes that would permit the Postal Service to prefund pension and retiree health care funds to benchmarked levels of 80 and 30 percent, respectively, of liabilities.

[8] This amount includes $5.5 billion in savings from prefunding FERS in excess of 100 percent.

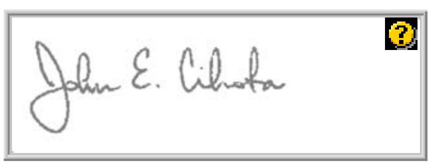
Management's Comments

Management advised they understood that the funding benchmarks we identified would put them on a more level playing field with other organizations. However, due to pending legislation that assumes 100 percent funding levels, they cannot agree with the recommendation at this time. Management will continue to work with Congress and the administration to address this matter and other OIG recommendations related to restructuring the funding provisions for Postal Service retirement plans. Management agreed with the monetary impact and plans to resolve these issues during FY 2011. See Appendix D for management's comments in their entirety.

Evaluation of Management's Comments

The OIG considers management's comments responsive to the recommendation. The purpose of the recommendation was to identify a means of improving the Postal Service's financial condition by reducing contributions to the pension and retiree health care plans to benchmarked standards. While we still believe that prefunding at benchmarked levels represents a reasonable level in addressing retirees' needs while also providing the Postal Service with a means of halting its current financial slide, we acknowledge the Postal Service's efforts to work with Congress to restructure funding provisions. Accordingly, we will not pursue this issue at this time. We will continue to monitor the progress of the Postal Service's efforts to address retiree benefits and improve its financial condition.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Lorie Nelson, director, Financial Reporting, or me at 703-248-2100.



John E. Cihota
Deputy Assistant Inspector General
for Financial Accountability

Attachments

cc: Stephen J. Masse
Kimberly A. Weaver
Corporate Audit and Response Management

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

The Postal Service has prefunded its retirees' pension[9] obligations at close to 100 percent of the OPM's actuarially estimated liabilities. These payments have contributed significantly to the Postal Service's dire financial condition.

Currently, the Postal Act of 2006 does not require the Postal Service to contribute the employer's share to the CSRS. By June 15, 2017, if any liability exists, the OPM must establish an amortization schedule that commences on September 30, 2017, and liquidates the entire supplemental liability by September 30, 2043. Based on the OPM's FY 2009 projections, the Postal Service has an unfunded liability of about $10 billion, with $197.5 billion in assets and $207.1 billion in liabilities.

With respect to FERS, the Postal Service is required to contribute to the plan pursuant to Title 5 U.S.C. § 8423. As of September 30, 2009, projected liabilities total $69.3 billion while assets were projected at $76.1 billion. The Postal Service has overfunded the plan by $6.8 billion.

For its retirees' health care, the Postal Service is increasing its prefunding level. The increase is a result of the Postal Act of 2006's requirements to prefund retirees' health care at about $5.6 billion per fiscal year from 2007 through 2016. In FY 2017, the Postal Service is required to pay current retiree health care premiums directly from the Postal Service Retiree Health Benefits Fund (PSRHBF)[10] along with payments to liquidate any liability in the PSRHBF by September 30, 2056. Although the statutes governing the PSRHBF do not explicitly mandate a target prefunding level, by their operation, they will force the Postal Service to eventually prefund the PSRHBF at or above 100 percent.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this management advisory was to identify and benchmark prefunding levels of public and private sector entities for both pensions and retiree health benefits and determine whether substantial opportunities exist for cost savings for the Postal Service. We accumulated information from inspector general testimonies to Congress, the Postal Service's 2009 annual report, benchmarking, and other sources to prepare this report. We did not rely on computer-generated data to support the opinions and conclusions presented in this report.

[9] Pensions consist of the CSRS and FERS. Prefunding levels for the two on September 30, 2009, were 95 percent and 110 percent, respectively.
[10] Currently, the Postal Service must pay current retiree health care premiums from operating funds.

We conducted this review from May through November 2010 in accordance with the *Quality Standards for Inspections*.[11] We discussed our observations and conclusions with management officials on August 13, 2010, and included their comments where appropriate.

PRIOR AUDIT COVERAGE

We issued the following reports addressing opportunities for recovering overfunded amounts related to employees and retirees benefits. Management generally agreed with our recommendations that included seeking financial relief.

Report Title	Report Number	Final Report Date	Report Results
Summary of Substantial Overfunding in Postal Service Pension and Retiree Health Care Funds	FT-MA-10-002	9/30/2010	This report summarizes the results of four OIG reports identifying overfunding issues in employee and retiree benefit funds. It recommends management develop a comprehensive legislative strategy to recover overfunded amounts and review all available data related to pensions and retiree health benefit calculations to ensure that calculations are reasonable and accurate.
Federal Employees Retirement System Overfunding	FT-MA-10-001	8/16/2010	This report identifies that the Postal Service overfunded its FERS contributions by $5.5 billion. In addition, there is no present legislation to resolve surpluses. Further, it recommends that the Postal Service's pension responsibilities be clearly delineated and separated from those of the rest of the federal government.
Civil Service Retirement System Overpayment by the Postal Service	CI-MA-10-001	6/18/2010	The report discusses the $75 billion CSRS overfunding by the Postal Service, assesses the related facts, and identifies solutions.

[11] These standards were last promulgated by the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) in January 2005. Since then, The Inspector General Act of 1978, as amended by the IG Reform Act of 2008, created the Council of the Inspectors General on Integrity and Efficiency (CIGIE), which combined the PCIE and ECIE. To date, the *Quality Standards for Inspections* have not been amended to reflect adoption by the CIGIE and, as a result, still reference the PCIE and ECIE.

Report Title	Report Number	Final Report Date	Report Results
The Postal Service's Share of CSRS Pension Responsibility	RARC-WP-10-001	1/20/2010	This report discusses the inequities of the current system of funding of the Postal Service's CSRS pension responsibility and explains that it has resulted in an overfunding of $75 billion.
Estimates of Postal Service Liability for Retiree Health Care Benefits	ESS-MA-09-001(R)	7/22/2009	This report questions the OPM's assumption that the annual health care cost inflation rate will average 7 percent annually for all future years.

APPENDIX B: DETAILED ANALYSIS

Calculation of Overfunded Pensions and Retiree Health Care Using Benchmarked Funding Levels

	Amounts in Billions	
Pensions:		
Total liabilities (projected) (CSRS plus FERS) at September 30, 2009	$ 276.4	
Add additional liabilities resulting from recent changes	1.3	
Total liabilities	277.7	
80 percent of total liabilities	222.2	
Total assets (CSRS plus FERS) at September 30, 2009	273.6	
Amount overfunded (Total assets minus 80 percent of total liabilities)		$ 51.4
Retiree Health Care:		
OPM's actuarial liability at September 30, 2009	$ 87.5	
30 percent of liability	26.3	
Assets	$ 35.5	
Amount overfunded (assets minus 30 percent of liability)		$ 9.2
Total Amount Overfunded		**$ 60.6**

APPENDIX C: MONETARY IMPACT

Current OPM funding rules state that underfunded amounts are amortized over 30 years and the annual payment represents a supplemental amount in addition to the normal cost. No provision for correcting a surplus currently exists; therefore, the current rules are described as "asymmetric." [12]

We assume the overfunded amount could be corrected in a manner analogous to OPM's funding rules for an underfunded situation whereby that amount is amortized over 30 years and the resulting annual payment is then deducted from any required Postal Service contributions to OPM. Effectively, the Postal Service would be providing OPM with a 30-year loan at 5.75 percent annual interest.

Changing the required funding levels of the funds would effectively reduce the required assets and create a combined overfunding amount of $99.8 billion.

Funds Put to Better Use[13]

Overfunded pensions and retiree health care	Amount
Annual FERS Payment Reduction Amount Resulting from Amortizing $99.8 billion in Overfunding Over 30 years[14]	($7,057,480,614)
Present Value of Cumulative Annual Reduction Amounts for a 10-year period[15]	$59,832,372,092

[12] Not identical on both sides of a central line.
[13] Funds that could be used more efficiently by implementing recommended actions.
[14] Using the OPM's current discount rate of 5.75 percent.
[15] Using the Postal Service's current cost of capital rate of 3.875 percent. OIG policy allows monetary impact to be calculated for a 10-year period.

APPENDIX D: MANAGEMENT'S COMMENTS

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER
EXECUTIVE VICE PRESIDENT

UNITED STATES POSTAL SERVICE

November 9, 2010

MS. LUCINE WILLIS
DIRECTOR, AUDIT OPERATIONS

SUBJECT: Draft Management Advisory - Substantial Savings Available by Prefunding Pensions and Retirees' Health Care at Benchmarked Levels (Report Number FT-MA-11-Draft)

Thank you for the opportunity to respond to the above referenced report. As you are aware, the Postal Service has requested that Congress take action on the Civil Service Retirement System (CSRS) over-funding that was the subject of your January 2010 report and confirmed by the Postal Regulatory Commission. Legislation has been introduced in the House and Senate, H.R. 5746 and S. 3831, that would require the Office of Personnel Management to recalculate the Postal Service's CSRS liability using an updated methodology. S. 3831 would then allow the Postal Service to use the CSRS over-funding (an amount determined after the Postal Service's CSRS obligation is fully funded) to fund the annual retiree health benefit pre-payment. S. 3831 would transfer any CSRS surplus to the Retiree Health Benefit Fund in regular intervals until 2043. The Postal Service is supportive of both bills and has urged Congress to take action on this important issue.

We understand the funding benchmarks of 80% for pension plans and 30% for retiree medical plans that you identify and believe that such levels would put the Postal Service on a more level playing field with other organizations. However, given pending legislation that assumes 100% funding levels, it would be inappropriate for the Postal Service to support revised funding levels at this time. In addition, we would note that the funding changes that you advocate for our retirement programs will represent a substantial change in public policy and will require legislation.

Recommendation:
We recommend the Chief Financial Officer and Executive Vice President, in coordination with the Vice President, Government Relations and Public Policy, pursue necessary changes that would permit the Postal Service to prefund pension and retiree health care funds to benchmarked levels of 80 and 30 percent, respectively, of liabilities.

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Response:
While management cannot agree with this recommendation at this time, we note that the recommendation requires a significant change in public policy that must ultimately be decided by Congress and the Administration. Management will continue its work with Congress and the Administration (OPM and the Office of Management and Budget) to address this matter, along with the other OIG recommendations related to restructuring the funding provisions for our retirement plans. Towards that end, we will continue to actively support H.R. 5746 and S. 3831 and work with Congress towards their passage.

Target Implementation Date:
We plan to resolve these issues related to funding of our retirement plans during fiscal year 2011.

Management agrees with the calculated monetary impact for 80% and 30% funding.

This report and management's response does not contain information that may be exempt from disclosure under the Freedom of Information Act.

Joseph Corbett
Executive Vice President and
Chief Financial Officer

Marie Therese Dominguez
Vice President, Government
Relations and Public Policy

cc: Mr. John E. Cihota, OIG
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