



OFFICE OF **INSPECTOR GENERAL**

UNITED STATES POSTAL SERVICE

Considerations in Structuring Estimated Liabilities

White Paper

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Observations

Retiree health care, pensions, and workers' compensation were unfunded by about \$86.6 billion.

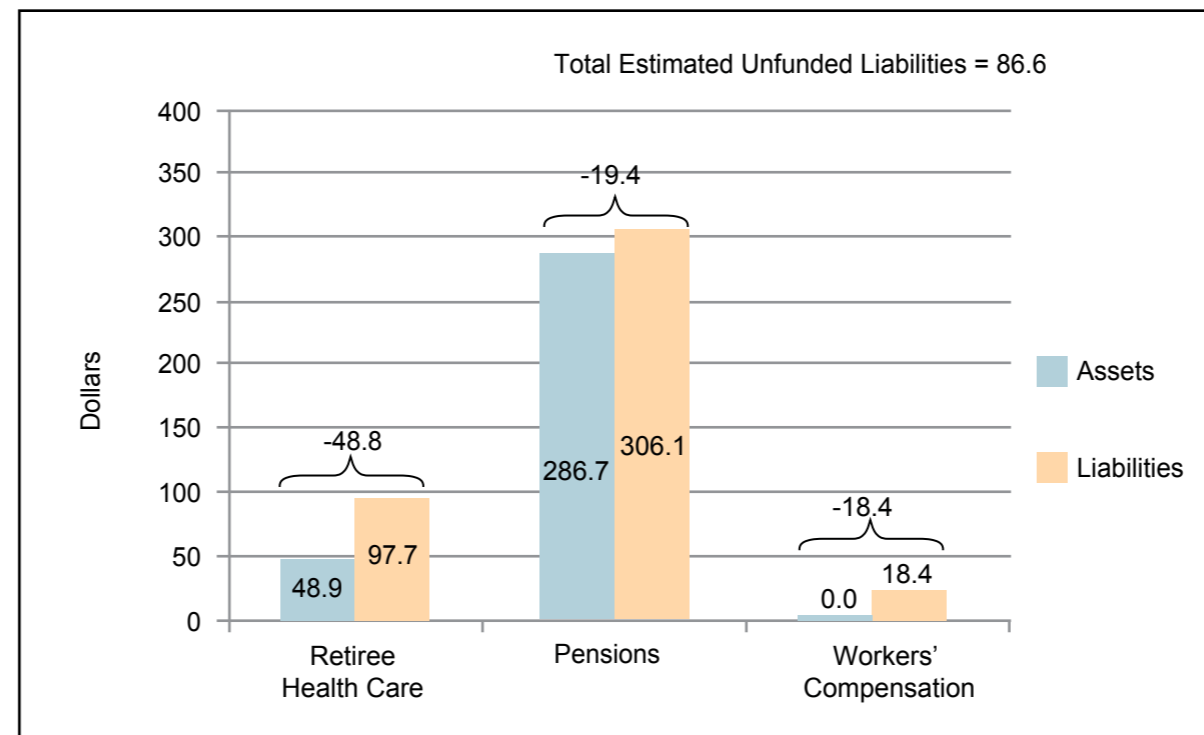
Introduction

Oversight of the U.S. Postal Service's financial crisis has been significant over the past several years (Project Number 14BG010FT000). Government Accountability Office (GAO) and U.S. Postal Service Office of Inspector General (OIG) reports, congressional hearings and correspondence, the news media, and the Postal Service's own financial reports have detailed the organization's challenges in funding its operations. As reported, from fiscal year (FY) 2007 through FY 2014, the Postal Service sustained losses totaling a staggering \$51.7 billion.

This report evaluates assumptions for Postal Service future liabilities, which have a significant impact on Postal Service finances and tabulation of its losses. It provides information that shows that the Postal Service is closer to being fully funded, or potentially overfunded, for estimated liabilities when certain assumptions are reasonably adjusted or considered. It also shows the challenges of mandating 100 percent prefunding of liabilities.

The Postal Service's **retiree healthcare and pension liabilities** are estimated at \$403.8 billion. Cash set aside for these estimated liabilities, totaling \$335.6 billion, exceeds 83 percent of the estimated future payouts for health care and pensions for retirees. In addition, the Postal Service's **workers' compensation liability** is estimated at \$18.4 billion¹. Based on these assumptions, retiree health care, pensions, and workers' compensation were unfunded by about \$86.6 billion at September 30, 2014, as shown in Figure 1.

Figure 1. Estimated Unfunded Liabilities² (in billions)



Source: Postal Service Form 10-K.

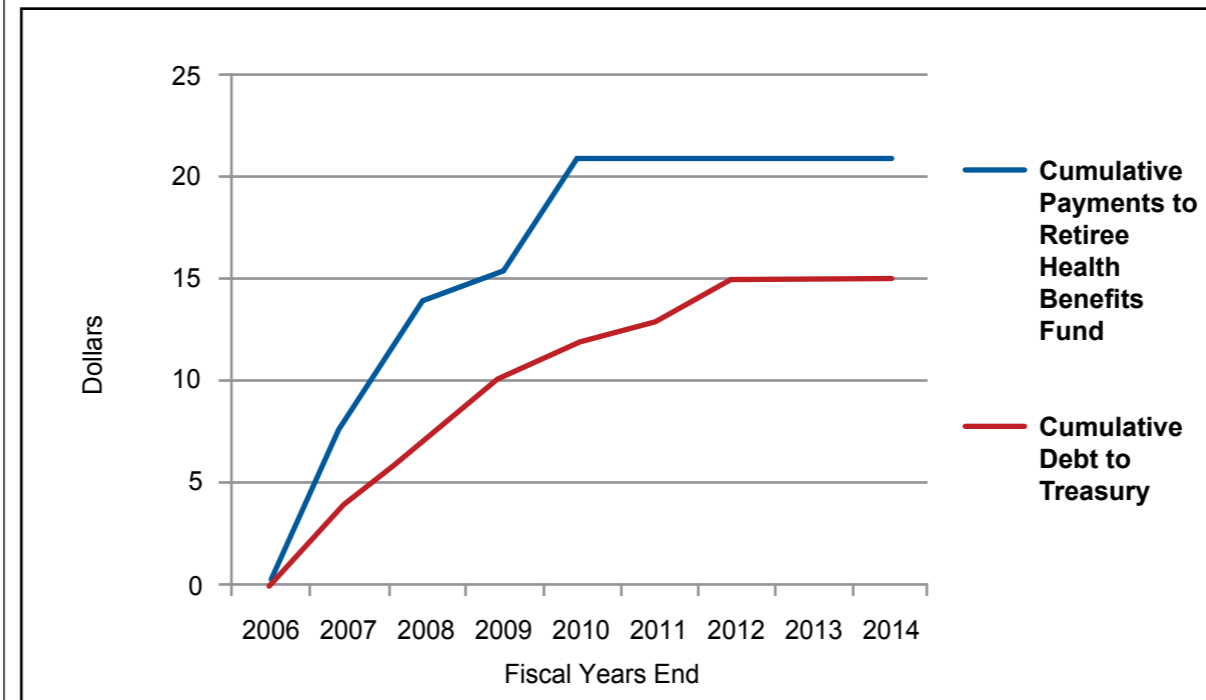
The \$335.6 billion was accumulated from employer and employee contributions, overpayments in the Postal Service's pension funds, escrow funds required by law, and interest on those assets. Determined congressional actions and responsible steps taken

¹ As of September 30, 2014.

² Amounts estimated as of September 30, 2014.

by the Postal Service led to this unprecedented accomplishment. Rapid payment schedules to prefund the liability estimates also resulted in a \$15 billion debt to the U.S. Department of Treasury (Treasury) and threatened the Postal Service's future viability. Specifically, the Postal Accountability and Enhancement Act of 2006 (Postal Act of 2006) required annual payments of about \$5.6 billion for 10 years to prefund future retiree healthcare. From FY 2006 through FY 2012, the Postal Service borrowed \$15 billion from the Treasury (the maximum it is allowed to borrow), while it paid \$21 billion to the Health Benefits Fund, as shown in Figure 2. The \$15 billion debt to the Treasury is a direct result of the prefunding mandate and has significantly added to the Postal Service's financial crisis.

Figure 2. Relationship of Prefunding and Debt to Treasury (in billions)



Source: Postal Service Forms 10-K.

The prefunding requirement began as an effort to ensure Postal Service liabilities would not become a taxpayer burden if the Postal Service were to someday cease to exist. Correctly identifying the liabilities has been, and remains, very challenging. The Office of Personnel Management (OPM) and others have made significant errors when estimating those liabilities.

Real Estate Assets

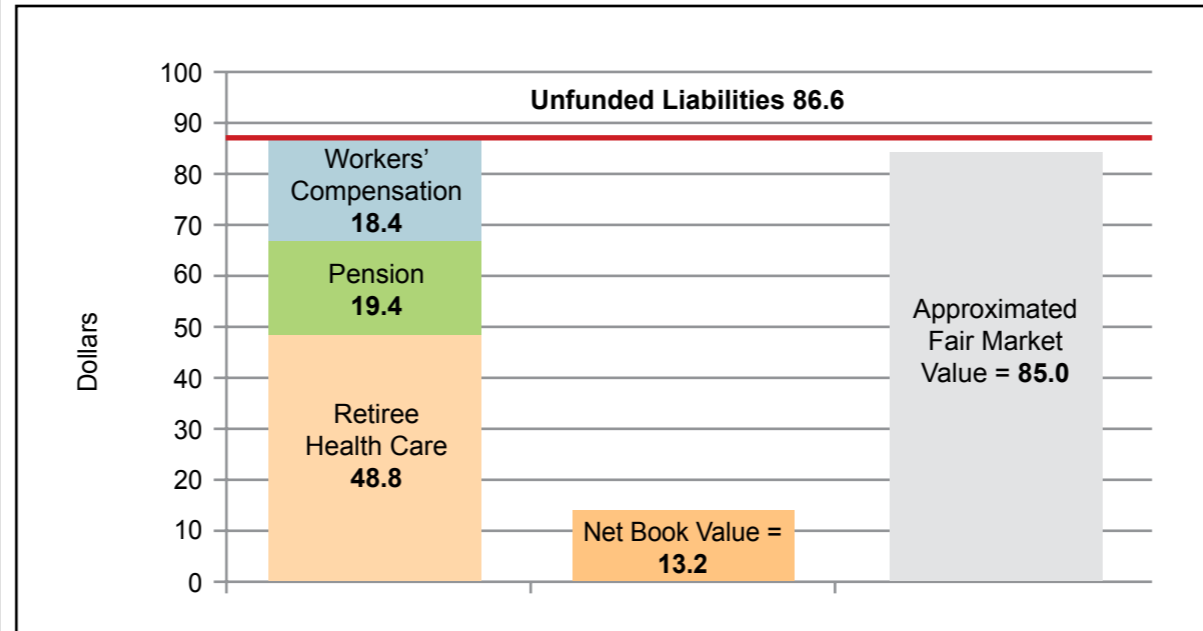
Any discussion of unfunded liabilities should take into consideration assets that could be used to satisfy the liabilities. The Postal Service currently has real estate assets that are accounted for at net book value rather than fair market value. The net book value is required by accounting principles, used in financial statements and represents the acquisition cost less depreciation. The properties would naturally sell at their fair market value, not net book value, if needed to satisfy the Postal Service's liabilities. The current net book value totals only \$13.2 billion.³ The fair market value has been estimated as high as \$85 billion,⁴ which is only \$1.6 billion less than the unfunded liabilities of the Postal Service, as depicted in Figure 3.

³ As of September 30, 2014.

⁴ The OIG reported this estimate in *Pension and Retiree Health Care Funding Levels* (Report Number FT-MA-12-002, dated June 18, 2012). This method is one of several different methodologies used to generally determine fair market value.

The fair market value has been estimated as high as \$85 billion, which is only \$1.6 billion less than the unfunded liabilities of the Postal Service.

Figure 3. Unfunded Estimated Liabilities versus Real Estate Assets' Net Book Value⁵ and Estimated Fair Market Value (in billions)⁶



Source: Postal Service Forms 10-K.

Currently, the fair market value of real estate assets are not considered in evaluating unfunded liability estimates. If they are to be considered, a more precise methodology should be used to determine the value of each asset rather than the approximated overall value. Attaining these estimates would be expensive, however, if these assets are not to be considered in mitigating the estimated liabilities.

Estimated Liability Assumptions and Actions

Using assets to offset liabilities is only one of the factors that should be considered when estimating the Postal Service's retiree health care, pensions, and workers' compensation liabilities. These liabilities are not exact or static amounts and require interest rates and demographic assumptions to estimate the future cost of these programs. The OPM is responsible for the retiree health care and pension assumptions used to compute those liabilities. The Postal Service, in turn, develops assumptions for the workers' compensation liability.

We examined three elements underlying the assumptions used in estimating the liabilities.

1. The recent, low interest rates.
2. Requiring retirees to participate in Medicare.
3. Using postal-specific demographic assumptions.

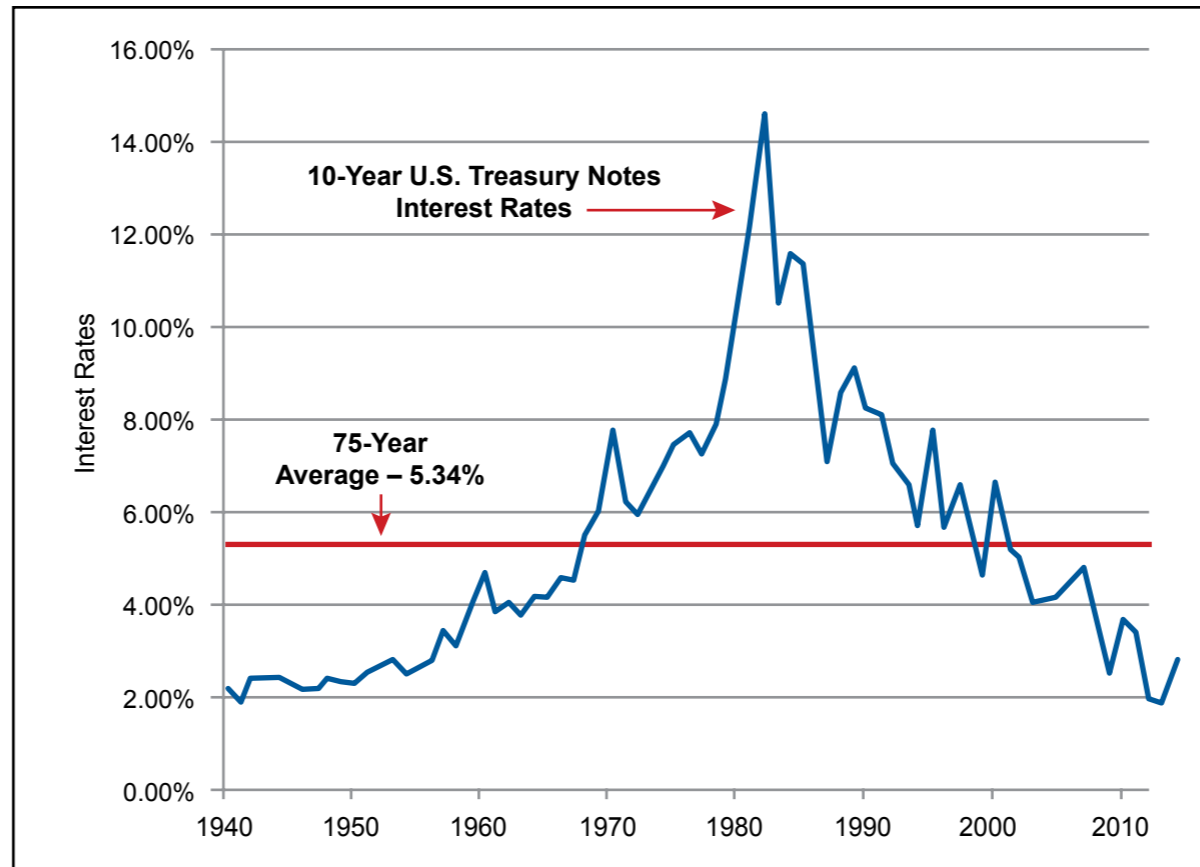
⁵ As of September 30, 2014.

⁶ As of September 30, 2014, for the liabilities. Fair market value was estimated by OIG in March 2012.

The Recent, Low Interest Rates. Interest rates significantly impact the liability estimates for retiree health care, pensions, and workers compensation. Higher interest rates would reduce or eliminate the estimated liabilities.

Over the past few years, interest rates have been at historically low levels (see Figure 4). These recent, low interest rates may significantly skew long-term assumptions. If assumptions are skewed, the results would be an inflated liability estimate.

Figure 4. Historic Interest Rates for 10-Year Treasury Notes⁷



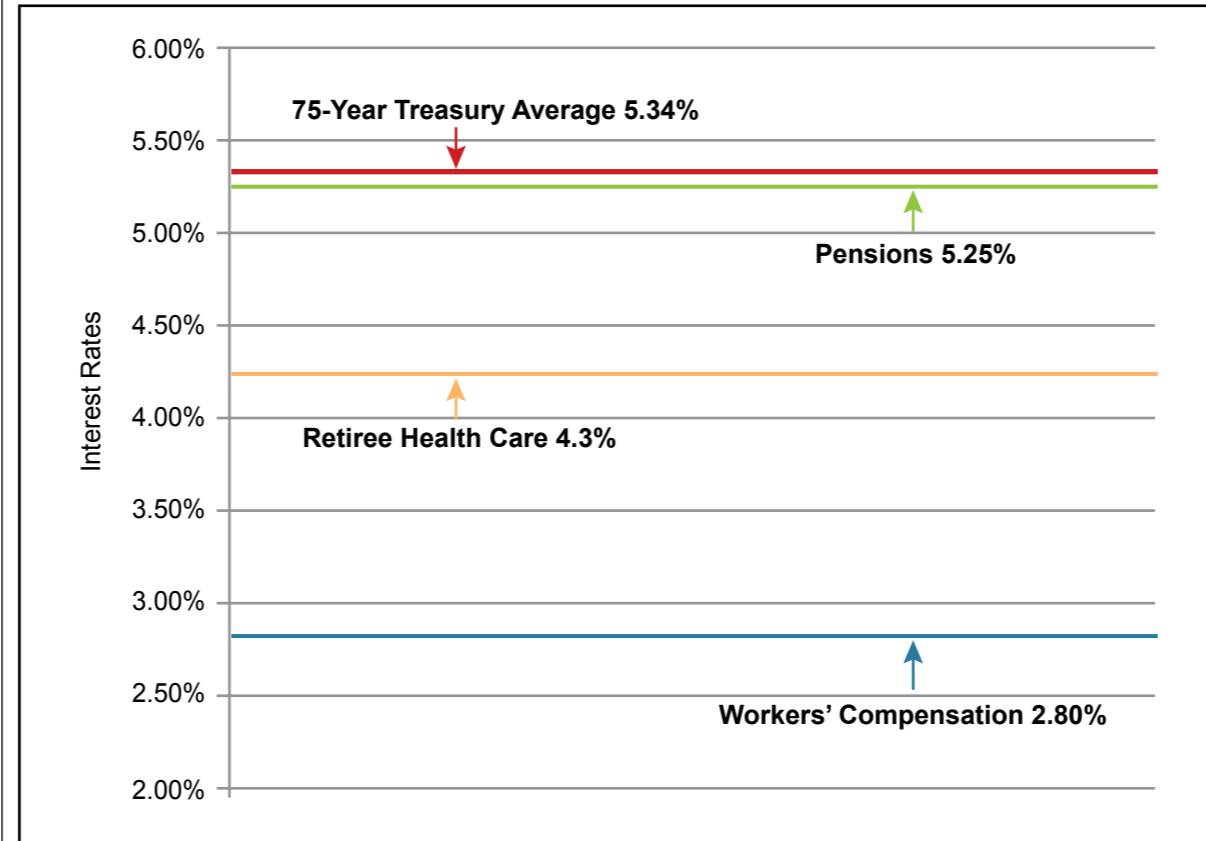
Sources: Postal Service Form 10-K, the Treasury, and *Irrational Exuberance* by Robert Shiller.

⁷ Graph covers 75 years, or roughly the conservative estimate for how long new, young employees will receive health care. For pensions, OPM calculates the liability based on 10-year historical averages. However, the interest rates used by OPM to determine funding payments differs. To calculate the workers' compensation liability, the Department of Labor uses interest rates based on a Treasury yield curve to reflect the average duration for income payments (15.1 years) and medical payments (9.9 years). For the health care liability, OPM derived the single equivalent interest rate from a yield curve based on the average of the last 40 quarters (or 10 years).

A study using health care, pension, and workers' compensation data revealed that even a modest 1.25 percent increase in the current interest rate assumptions would reduce unfunded liabilities by \$72.3 billion, significantly reducing the estimated unfunded balances.

Each of the funds has a different estimate for what the future interest rate will be, as shown in Figure 5, demonstrating the complexities of estimating future interest rates.

Figure 5. Comparison of Interest Rate Assumptions



Sources: Postal Service Form 10-K and the Treasury.

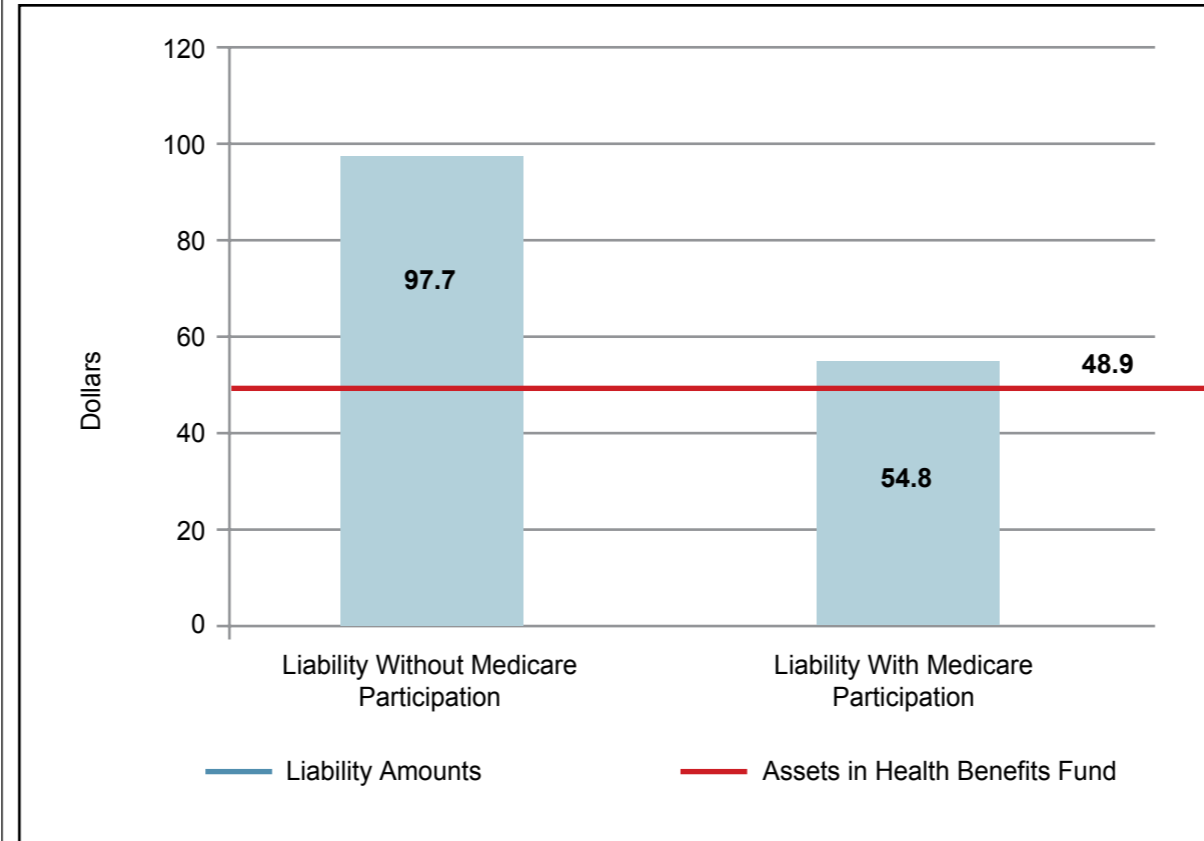
Changes in interest rates have a dramatic effect on the liabilities. A study using health care, pension, and workers' compensation data revealed that even a modest 1.25 percent increase in the current interest rate assumptions would reduce unfunded liabilities by \$72.3 billion, significantly reducing the estimated unfunded balances.⁸ Given the low interest rates in the current economic environment, increases in rate assumptions would significantly improve the Postal Service's financial outlook.

⁸ We used 1.25 percent to reflect the effect of a modest increase over the 10-year Treasury Note rate of 1.98 percent at January 1, 2015.

Requiring retiree participation in Medicare Parts A (hospital costs), B (medical care provider costs), and D (prescription drug coverage), as part of a healthcare plan the Postal Service proposed in FY 2012, would reduce the retiree healthcare liability by \$42.9 billion, from \$97.7 billion to a projected \$54.8 billion.

Requiring Medicare Participation. Requiring retiree participation in Medicare Parts A (hospital costs), B (medical care provider costs), and D (prescription drug coverage), as part of a healthcare plan the Postal Service proposed in FY 2012, would reduce the retiree healthcare liability by \$42.9 billion,⁹ from \$97.7 billion to a projected \$54.8 billion, as shown in Figure 6.¹⁰

Figure 6. Retiree Health Care Liability – Effect of Medicare Participation (in billions)¹¹



Source: OIG analysis and Postal Service Form 10-K.

The Health Benefits Fund's assets of \$48.9 billion would eliminate most of the resulting liability.

Using demographics specific to Postal Service employees would reduce the combined retiree health care and pension liabilities by \$8.5 billion.

Using Postal-Specific Demographic Assumptions. The demographic characteristics and career patterns of Postal Service employees differ from those of federal employees. However, the OPM currently does not distinguish between federal and Postal Service demographics. We found that using demographics specific to Postal Service employees would reduce the combined retiree health care and pension liabilities by \$8.5 billion.¹²

⁹ U.S. Postal Service Alternative Health Care Plan Proposal (Report Number [FI-MA-12-014](#), dated August 22, 2012).

¹⁰ In its report *Proposed Health Plan Could Improve Financial Condition, but Impact on Medicare and Other Issues Should Be Weighed before Approval* (No. GAO-13-658, dated July 18, 2013), the GAO projected that by September 2014, the Postal Service's unfunded retiree health care liability would be totally eliminated, not reduced, if Medicare Parts A, B, and D were required for Postal Service employees.

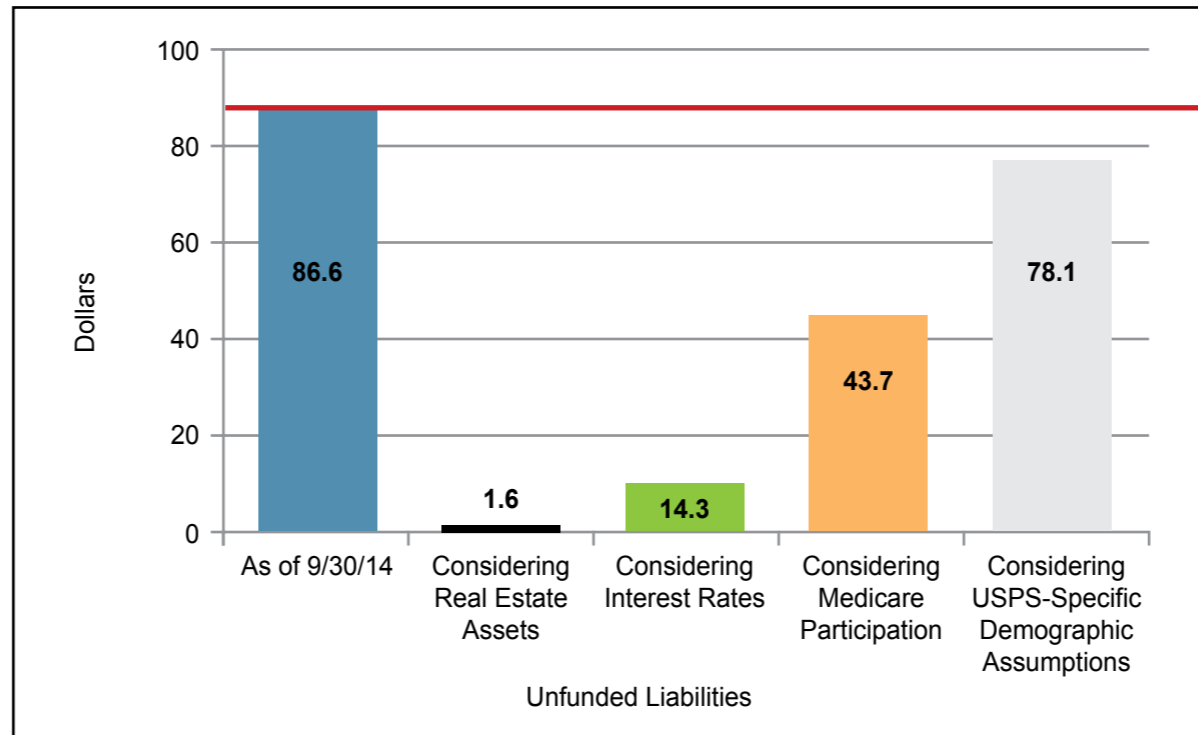
¹¹ At September 30, 2014.

¹² *Using U.S. Postal Service-Specific Assumptions for Calculating the Retiree Health Care Liability* (Report Number [FT-MA-13-022](#), dated September 27, 2013); *Using U.S. Postal Service-Specific Assumptions for Calculating the Federal Employees Retirement System Liability* (Report Number [FT-MA-13-024](#), dated September 27, 2013); and *Using U.S. Postal Service-Specific Assumptions for Calculating the Civil Service Retirement System Liability* (Report Number [FT-MA-13-023](#), dated September 27, 2013). The figure is based on our last actuarial estimate for liabilities as of September 30, 2012. The number will continue to fluctuate based on changing assumptions.

Overview of Impacts

Figure 7 depicts the impact on the current unfunded liability balance of \$86.6 billion if the items discussed in our white paper were considered. If two or more of the options discussed in our white paper were considered, the Postal Service's liabilities may be overfunded.

Figure 7. Impact of New Considerations on Unfunded Estimated Liabilities (in billions)



Source: OIG analysis and Postal Service Form 10-K.
* Factoring an increase of 1.25 percent.

Summary

Mandating 100 percent prefunding of liabilities that are frequently changing and highly uncertain, risks unnecessarily damaging the Postal Service, inflating prices, and overfunding future liabilities.

Summary

In the past 8 years, the Postal Service's financial condition has significantly worsened from making large prefunding payments for retiree health care. Postal Service customers were charged for increased postage, in part, because of these prefunding requirements.¹³ The Postal Service's research and development and infrastructure maintenance were poorly funded because of its financial condition.

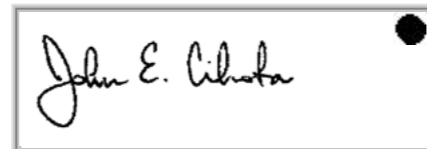
Through congressional action, the Postal Service has funded \$335.6 billion in cash towards its future retirement costs. However, mandating 100 percent prefunding of liabilities that are frequently changing and highly uncertain, risks unnecessarily damaging the Postal Service, inflating prices, and overfunding future liabilities.

The Senate's recent effort to move to 80 percent funding for future health care liabilities reduces the adverse impact of changing assumption fluctuations, such as a downsized workforce, demographics, and actualized interest rates. The Postal Service's physical assets would cover any remaining shortfall.

Additionally, Congress is considering additional provisions, including requiring Medicare participation and using Postal Service-specific versus general federal government demographics, which would further reduce the liabilities.

Finally, as the OPM is set to establish an annual payment schedule no later than FY 2017 for retiree health care liabilities, the Postal Service may want to request consideration of whether the missed prefunding payments, totaling \$22.4 billion, should continue to be reflected as a liability on the financial statements.

If you have any questions or need additional information about this report, please contact Lorie Nelson, director, Finance, or me at 703-248-2100.



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¹³ The Postal Service noted the reason for the exigent rate increase was due to the adverse impact of the Great Recession.



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