



July 22, 2009

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER AND EXECUTIVE VICE PRESIDENT

SUBJECT: Final Management Advisory Report – Estimates of Postal Service Liability for Retiree Health Care Benefits (Report Number ESS-MA-09-001(R))

This report presents the results of our self-initiated review of the estimates of the U.S. Postal Service's Liability for Retiree Health Care Benefits (Project Number 09RO013ESS000). Our objective was to assess the reasonableness of the assumptions used to estimate the liabilities. See [Appendix A](#) for additional information about this review.

Assumption of 7 Percent Health Care Cost Inflation is Unreasonably High

The work of U.S. Postal Service Office of Inspector General's (OIG) actuarial consultant, Hay Group, determined that the Office of Personnel Management's (OPM) assumption that the annual health care cost inflation rate will average 7 percent annually for all future years is unreasonably high. Therefore based on OPM's assumptions and methodology, the Postal Service's future retiree health care liabilities will be overestimated.

If the Postal Service continues the payment schedule required by the Postal Accountability and Enhancement Act of 2006 (the Act), our calculations indicate that the Postal Service could overfund its retiree health care liability by \$13.2 billion by the end of fiscal year 2016. The Postal Service could pay on average \$4.0 billion less each year from FYs 2009 to 2016 to prefund its retiree health benefits and still achieve the same level of funding anticipated under OPM's assumptions. The net present value of the interest savings from the reduced payments is \$5.95 billion. We will report the \$5.95 billion monetary impact as funds put to better use¹ in our *Semiannual Report to Congress*. See [Appendix B](#) for our detailed analysis of this topic, [Appendix C](#) for our detailed analysis of the monetary impact, and [Appendix E](#) for the Hay Group report. (The Hay Group report deals with the general issue of funding the Postal Service Retiree Health Benefits Fund (PSRHBF) and addresses a wide range of related subjects.)

Postal Service officials have informed us that they have briefed various congressional stakeholders as well as OPM to seek relief from the current Act payment schedule. We believe the Postal Service should, based on the results of this review, further pursue

¹ Funds that could be used more efficiently by implementing recommended actions.

relief from the burdensome payments currently required. Therefore, we are making the following recommendation:

We recommend the Postal Service Chief Financial Officer and Executive Vice President:

1. Pursue legislative relief from the mandated schedule of payments into the Postal Service Retiree Health Benefit Fund.

Management's Comments


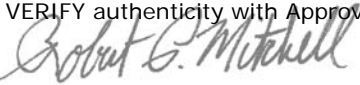
Management concurred with our finding and recommendation. Management stated that they will use this information to help support their continuing discussions with OPM, the Postal Regulatory Commission, and Congress. Management did not validate the funds put to better use, but agreed the savings would be substantial. See [Appendix D](#) for management's comments, in their entirety.

Evaluation of Management's Comments

This is a reissued report due to a calculation error by the contractor found in the initial study. The contractor corrected the error and the correction resulted in a \$1.1 billion change to the monetary impact. The management comments to the initial report were responsive to our finding and recommendation and the actions planned should correct the issues identified in the report.

The OIG considers the recommendation significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective action(s) are completed. These recommendations should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendation can be closed. We will report \$5.95 billion in funds put to better use in our *Semiannual Report to Congress*.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Mohammad Adra, Executive Director, Risk Analysis Research Center, or me at (703) 248-2100.

E-Signed by Robert Mitchell 
VERIFY authenticity with ApproveIt


For Darrell E. Benjamin, Jr.
Deputy Assistant Inspector General
for Revenue and Systems

Attachment

cc: Marie T. Dominguez
Katherine S. Banks

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

In December 2006, President Bush signed the Act into law. The new legislation required the Postal Service to prefund its retiree health benefits by paying an average of \$5.6 billion per year for 10 years into a newly-created Department of Treasury fund: the Postal Service Retiree Health Benefits Fund (PSRHBF).

In 2003, Congress passed legislation (P.L. 108-18) giving the Postal Service pension relief, because it was on track to overfund its Civil Service Retirement System (CSRS) pension obligations. For 3 years, the Postal Service was allowed to retain the difference in the reduced payments in the pension fund, but starting in FY 2006, the Postal Service was required to place the difference in escrow. The Act ended the escrow and also removed the Postal Service's obligation to pay for military service credits earned by its CSRS employees.

Because the Administration and Congress required the new law to be budget neutral, the Act also required the Postal Service to make 10 payments to the Department of Treasury, approximately equal to the annual amount of the reduced payment from the escrow and military service relief, for the purpose of prefunding the Postal Service's retiree health care liability.

The PSRHBF was initially funded with the calculated amount by which the Postal Service had already overfunded its CSRS liability (\$17.1 billion) and the FY 2006 escrow payment (\$3 billion). The Postal Service made the first of the 10 payments (\$5.4 billion) on September 30, 2007, and its second payment (\$5.6 billion) on September 30, 2008. It is scheduled to make a \$5.4 billion payment on or before September 30, 2009.

In FY 2008, the Postal Service recorded a net loss of \$2.8 billion. Had it not been for the Act requirement to pay \$5.6 billion into the PSRHBF at the end of FY 2008, the Postal Service would have had a net income of \$2.8 billion dollars. As of Quarter 2, FY 2009, the Postal Service had a year-to-date net loss of \$2.3 billion dollars. One-half of the required September 30, 2009 Act payment, \$2.7 billion, has been expensed for Quarter 1 and Quarter 2 revenue. Had these charges not been expensed the Postal Service would have had a net income of approximately \$400 million as of the end of Quarter 2, FY 2009.

The projected final FY 2009 Postal Service financial performance is bleak. The following is taken from the Postal Service's Quarter 2, FY 2009, Postal Service Form 10-Q, Quarterly Financial Conditions and Results Report:

. . . we have an obligation to pay \$5.4 billion into the Postal Service Retiree Health Benefit Fund (PSRHBF), as required by the Postal Accountability and

Enhancement Act, P.L. 109-435. . . . We are also required to pay approximately \$1.1 billion to the Department of Labor (DOL) for Workers' Compensation in September 2009. *We do not expect to generate sufficient cash flow from operations in the second half of 2009 to enable us to fully fund these obligations.*

Although we can fund some of these obligations through increased debt, our annual net increase in debt is limited by statute to \$3 billion. We currently project increasing net debt outstanding this year by \$3 billion but do not expect this to be sufficient to fund all our obligations. Without legislative change, described below, we project a cash shortfall of approximately \$1.5 billion on September 30, 2009. *If this happens, the Postal Service may be unable to pay certain obligatory payments due in September 2009.* (Emphases added.)

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to assess the reasonableness of the assumptions used to estimate the Postal Service's liability for retiree health benefits. To make this assessment, we contracted with Hay Group, an actuarial firm that specializes in liability estimates. Hay Group reviewed OPM's assumptions for their reasonableness and benchmarked OPM's trend assumptions against other entities in the public and private sector. Hay Group also calculated estimates of the Postal Service's liabilities using OPM's assumptions and other more commonly used assumptions.

We conducted this review from February through June 2009 in accordance with the President's Council on Integrity and Efficiency, *Quality Standards for Inspections*. Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our objective. We discussed our observations and conclusions with management officials on June 16, 2009, and included their comments where appropriate.

PRIOR AUDIT COVERAGE

There have been no prior audit reports related to the specific objectives of this review.

APPENDIX B: DETAILED ANALYSIS

Assumption of 7 Percent Health Care Cost Inflation is Unreasonably High

Health Care Inflation Assumptions

The Hay Group conducted a survey to determine the average health care inflation rate used by organizations when they estimate future retiree health care liabilities. They did this for (a) Fortune 100 companies; (b) state and local governments; and (c) publicly owned utilities.

Private Sector: Statement of Financial Accounting Standard (SFAS) 106 was issued by the Financial Accounting Standards Board in 1990. It requires employers to account for the cost of promised retiree medical and life insurance benefits ("postemployment benefits other than pensions" — Other Post-Employment Benefits or OPEBs) on an accrual accounting basis. Firms were not required to prefund the obligation. Under SFAS 106, the employer selects the health care inflation rate used to project current health care costs. Hay found the average health care inflation rate used by reporting Fortune 100 companies was 5 percent.

Public Sector (excluding federal): Governmental Accounting Standards Board (GASB) Statement 45 was issued in 2004. This statement requires governmental employers to report on their OPEBs. They are not required to prefund the benefits. Hay found the average health care inflation rate used by reporting public sector entities was approximately 5 percent.

Publicly Owned Utilities: Many of the publically owned utilities sampled by the Hay Group report under GASB 45, although, unless their regulator requires it, no accounting board body sets standards for their OPEB reporting. Hay found the average health care inflation rate used by reporting utilities was approximately 5 percent.

Postal Service Retiree Health Care Liabilities Under Hay Group Assumptions

Table 1 presents the Postal Service retiree health care liability and PSRHBF funding data developed by the Hay Group. The discount rate and the average asset earnings rate are assumed to be 6.25 percent and 5.35 percent, respectively.

The "OPM" row shows the Hay estimates using the OPM 7-percent health care inflation rate assumption. At the end of FY 2016, the estimated retiree health care liability is expected to be \$129.4 billion. The PSRHBF assets are expected to be \$103.7 billion and the unfunded liability is \$25.7 billion (80 percent funded).

Using the Hay Group assumptions, Table 1 ("Hay Group" row) shows that at the end of FY 2016 the Postal Service will have a retiree health care liability of \$90.5 billion and asset funding of about \$103.7 billion. Given the more reasonable health care inflation

rate assumption, the Postal Service will have over-funded its retiree health care liability by \$13.2 billion (115 percent funded).

Hay Group Alternative: We assumed that the Postal Service needs to achieve the same FY 2016 unfunded liability (\$25.7 billion) as estimated under the OPM scenario.

Table 1 shows that under the Hay Group alternative assumptions this is achieved by having the Postal Service pay \$1.57 billion per year in FYs 2009 to 2016. This would improve the Postal Service's net income on average by about \$4.0 billion per year. In this alternative, the funded liability percentage would be 72 percent at the end of FY 2016.

House of Representatives bill, H.R. 22, (H.R. 22) provides for the Postal Service's annual payments for current retiree health benefit costs to be paid from the PSRHBF rather than by the Postal Service.² In the row titled "Hay with H.R. 22" we assume that the Postal Service needs to achieve the same 2016 funded liability percentage (80 percent) as estimated under the OPM assumptions and methodology. Table 1 shows that under the Hay assumptions this can be achieved by having the Postal Service continue to pay the average \$5.6 billion per year into the PSRHBF while having the fund pay current period retiree health benefits from FYs 2009 to 2016 (approximately \$3.1 billion per year). This improves the Postal Service's net income by approximately \$3.1 billion per year. Under this scenario, the funded liability percentage is 82 percent.

² The H.R. 22 scenario in this report describes the initial version of H.R. 22. The bill was amended on June 24, 2009, after the first issuance of this report. Under the amended version of H.R. 22, Postal Service retiree health benefits will be paid from the fund from FYs 2009 to 2011. The Postal Service will then resume payments for current retirees from FYs 2012 to 2016.

**Table 1. Prefunding Postal Service Retiree Health Care Benefits
(Dollars in billions)**

	Work Force	Health Care Inflation (Percent- age)	Year 2016 Liabilities	Year 2016 Assets	Year 2016 Unfunded Liability	Year 2016 Percent Funded	Avg. Annual Payment to PSRHBF	Notes
OPM	Declining	7	\$129.4	\$103.7	\$25.7	80	\$5.60	
Hay Group	Declining	5	\$90.5	\$103.7	(\$13.2)	115	\$5.60	Over- funded by \$13.2B
Hay Group- alternative	Declining	5	\$90.5	\$64.8	\$25.7	72	\$1.57	
Hay Group with H.R. 22	Declining	5	90.5	74.6	15.9	82	\$5.60	Percent Funded Similar to OPM

APPENDIX C: COST SAVINGS CALCULATION

The OIG identified \$5.95 billion as funds put to better use by altering the pre-funding schedule of the PSRHBF as per the Hay Group Study Alternative (See Appendix B).

Table 2. Total Monetary Impact

Fiscal Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Cumulative
The Act-required prefunding payments (millions)	\$5,400	\$5,500	\$5,500	\$5,600	\$5,600	\$5,700	\$5,700	\$5,800	\$0	\$0	\$44,800
Proposed pre-funding payments (millions)	\$1,570	\$1,570	\$1,570	\$1,570	\$1,570	\$1,570	\$1,570	\$1,570	\$0	\$0	\$12,560
Payment savings (millions)	\$3,830	\$3,930	\$3,930	\$4,030	\$4,030	\$4,130	\$4,130	\$4,230	\$0	\$0	\$32,240
Cumulative payment savings (millions)	\$3,830	\$7,760	\$11,690	\$15,720	\$19,750	\$23,880	\$28,010	\$32,240	\$32,240	\$32,240	
Interest expense saved/interest revenue gained @3.5%/yr	\$134	\$272	\$409	\$550	\$691	\$836	\$980	\$1,128	\$1,128	\$1,128	
Interest expense savings discounted at 3.5% /yr (millions)	\$134	\$262	\$382	\$496	\$602	\$704	\$798	\$887	\$857	\$828	\$5,950

Notes:

- (1) Net present value of cumulative interest expense savings (millions): \$5,950
- (2) Postal Service cost of borrowing/discount rate: 3.50%
(Source: http://blue.usps.gov/cape/_pdf/May%202009.pdf)

Technical explanation/assumptions:

- 1. The payment savings shown previously will presumably have to be paid at some future indefinite date. Therefore, the monetary benefit of the reduced payment schedule flows from the "time value of money," either the interest expense saved or the interest revenue gained, depending, in any year, on whether Postal Service is a net debtor. The payment savings would be used to avoid current

borrowing, pay down existing debt, be deposited into Postal Service bank accounts or other investments, or any combination.

2. The interest rate and the discount rate are assumed to be the current published Postal Service Cost of Borrowing, 3.5 percent per year.
3. The Act prefunding payments are those required by current law. The proposed prefunding payments are derived from information in the Hay Group study.
4. OIG policy provides for a 10-year time frame for discounted cash flow calculations.
5. The net present value of the interest rate savings, \$5.95 billion, will be reported as funds put to better use in the OIG *Semi-annual Report to Congress* (SARC). This represents the opportunity cost of not having the funds available for use in those years.

APPENDIX D: MANAGEMENT'S COMMENTS

JOSEPH CORBETT
CHIEF FINANCIAL OFFICER
EXECUTIVE VICE PRESIDENT



June 19, 2009

Lucine M. Willis
Director, Audit Operations
1735 North Lynn St.
Arlington, VA 22209-2020

Dear Ms. Willis:

Thank you for the opportunity to review and comment on the draft management advisory report entitled: "Estimates of Postal Service Liability for Retiree Health Care Benefits (Report Number ESS-MA-09-DRAFT)." We have reviewed the report and find it provides good additional support for the efforts that we have already begun to achieve relief from our current obligations for Retiree Health Care Benefits under the Postal Accountability and Enhancement Act of 2006 (PAEA). We have met with both the Office of Personnel Management (OPM) and the Postal Regulatory Commission (PRC) to discuss our concerns regarding the current liability estimates and the PAEA funding schedule.

We have not had the opportunity to validate the \$4.88 billion funds put-to-better-use amount that will be reported in the *Semiannual Report to Congress* due to the one-day turnaround time of this management response. However, in principle, we agree that if Congress were to legislate a change in the prescribed payment schedule, a substantial savings may result.

As previously described, we have already begun actively pursuing a reduction in our Retiree Health Care Benefit payments. Evidence of this effort is House Resolution 22 which resulted from discussions the Postal Service had with Congress. It provides for the Postal Service's annual payments for current retiree health benefit costs to be paid from the Postal Service Retiree Health Benefit Fund rather than by the Postal Service.

In response to the following recommendation made in the report, we are providing our response below.

We recommend the Postal Service Chief Financial Officer and Executive Vice President:

Recommendation 1: Pursue legislative relief from the mandated schedule of payments into the Postal Service Retiree Health Benefit Fund.

Response: We agree with this recommendation, however, please note that the legislative effort will be led by Government Relations. We will use this information to help support our continuing discussions with the OPM, the PRC, and with Congress. We will provide them with a copy of the Hay Group Report no later than July 2, 2009. We will also offer to hold discussions with them if they would like once they've had a chance to review the report.

We do not believe that any of the information should be exempt from disclosure under the Freedom of Information Act.

Sincerely,



Joseph Corbett

cc: Marie Therese Dominguez
Vince DeVito
Stephen Masse
Katherine Banks
Richard Loutsch

475 L'ENFANT PLAZA SW
WASHINGTON, DC 20260-5000
202-268-5272
FAX: 202-268-4364
www.usps.com

[APPENDIX E: HAY GROUP REPORT](#)

July 22, 2009

United States Postal Service
Retiree Health Benefits

HayGroup®



Submitted by:

4301 N. Fairfax Drive
Suite 600
Arlington, VA 22203
Phone: 703-841-3100
Fax: 703-841-3108





Contents

Introduction.....	1
Executive Summary.....	2
Discussion of the PAEA Plan to Prefund Postal Retiree Health Benefits.....	4
Discussion of OPM's Assumed 7 Percent Long Term Health Care Trend Rate.....	7
Review and Benchmarking Of OPM Assumptions and Liability Calculations.....	12
Summary of Policy Options for Funding the USPS Retiree Health Care Liability.....	22
Appendix A: ASOP No. 6 - Cost Allocation Policies.....	29
Appendix B: USPS Current Plan Provisions.....	31
Appendix C: About Hay Group.....	37



Introduction

Hay Group was retained by the USPS Office of Inspector General to prepare a White Paper benchmarking and reviewing assumptions used in estimating retiree health care liability, with a focus on funding the Postal Service Retiree Health Benefits Fund (PSRHBF).

Examined in this paper are

1. The Postal Accountability and Enhancement Act (PAEA) provisions to advance fund the postal retiree health care benefits.
2. Office of Personnel Management (OPM) assumptions used in measuring the retiree healthcare liability.
3. Retiree health care benefit assumptions used by private sector and public sector sponsors in measuring and funding their benefits.
4. Options for funding the USPS retiree health care liability.

Reliance

The timely completion of the White Paper was possible with the cooperation and assistance of actuaries and other professional staff including Margot Kaplan ASA, MAAA, Health Actuary, Department of Defense (DoD) Office of the Actuary, who provided background data on the Medicare Eligible Retiree Health Care Fund.



Executive Summary

Based on the examination conducted we conclude

- The PAEA sections that established the funding plan for the PSRHBF have several features that make the arrangement unusual and contribute to the Postal Service's current liquidity problems.
- OPM's assumption of a 7 percent long term health care trend rate is unreasonably high when compared to assumptions used by other public sector and private sector entities and when tested for reasonableness in terms of the share of GDP devoted to healthcare.
- Under the PAEA advance funding plan, the Postal Service is on track to overfund the PSRHBF by about \$13.2 billion at the end of FY 2016.
- Using the OPM's 7 percent long term health care trend rate, the PAEA funding plan projects a \$25.7 billion unfunded liability at the end of FY 2016. The Postal Service could reach this 2016 funding goal by paying, on average, \$4 billion per year less than the required PAEA payments in the FY 2009 to FY 2016 time period, when measuring the liability using a more reasonable healthcare cost trend rate assumption of 5 percent.
- The provisions of H.R. 22¹, if enacted, would relieve the Postal Service of, on average, payments of \$3.1 billion per year in the FY 2009 to FY 2016 time period, while still reaching a funded status of 104 percent by the end of FY 2016.
- The Postal Service is aggressively funding its retiree health care benefits relative to private and public sector entities that are also prefunding.

¹ The H.R. 22 scenario in this report describes the amended version of H.R. 22. The bill was amended on June 24, 2009, after the first issuance of this report. Under the amended version of H.R. 22, Postal Service retiree health benefits will be paid from the fund from FYs 2009 to 2011. The Postal Service will then resume payments for current retirees from FYs 2012 to 2016



- Other options exist for funding the USPS retiree health care liability. Ideally, an actuarially determined funding method should be used.



Discussion of the PAEA Plan to Prefund Postal Retiree Health Benefits

The PAEA plan to fund the retiree health benefits of USPS employees has several features that make the arrangement unusual. The funding amounts for fiscal years after the PSRHBF was established bear no relationship to the liabilities nor to the unfunded liability of the PSRHBF. The amounts are not actuarially calculated.

On December 20, 2006, President Bush signed into law the Postal Accountability and Enhancement Act (PAEA) that governs the operation of USPS regarding the cost of pensions and health care benefits of retired workers.

PAEA established an on-budget fund – the Postal Service Retiree Health Benefits Fund (PSRHBF). The Act established payments to the PSRHBF from several sources, including the following amounts in FY 2007:

1. Transfer from the Civil Service Retirement and Disability Fund (CSRDF) of the excess of assets in the Postal Fund account over the Actuarial Accrued Liability as of September 30, 2006. The amount of the surplus was determined as \$17,100 million.
2. Payment of the 2006 escrow amount of \$2,958 million, which was contributed on April 6, 2007.
3. The first of the annual payments stipulated in the Act in the amount of \$5,400 million contributed on September 28, 2007.

During the 2009-2016 period, PAEA requires that USPS make specific annual payments to the PSRHBF (see Table 1.1) and continue to make payments to OPM for the USPS share of the health premiums program incurred by current retirees each year to the FEHB program.

Starting in 2017, the USPS will begin paying to the PSRHBF the estimated costs of retiree health care as such costs are accrued by current workers (i.e. the Normal Cost). Starting from 2017, the Postal Service's share of health care premiums for current retirees will be paid out of the PSRHBF.



In addition, as of June 30, 2017 (and each year thereafter) the unfunded actuarial liability will be determined by OPM and the Postal Service will be required to amortize the unfunded actuarial liability by September 30, 2056 (or over 15 years if longer). In the event that the assets exceed the actuarial liability, the surplus will be amortized over the same period and this amount will offset the Normal Cost.

Table 1.1
Future Funding to the Postal Service Retiree Health Benefits Fund

Not Later than September 30 in	Amount of Required Funding (\$millions)
FY 2009	\$5,400
FY 2010	\$5,500
FY 2011	\$5,500
FY 2012	\$5,600
FY 2013	\$5,600
FY 2014	\$5,700
FY 2015	\$5,700
FY 2016	\$5,800

Under PAEA, OPM is required to prepare a valuation of the CSRDF unfunded liability at the end of each fiscal year. If there is an unfunded liability on September 30, 2016 then the USPS will be required to make payments to amortize that unfunded liability beginning on September 30, 2017. If there is a surplus as of September 30, 2015, the amount of that surplus will be transferred to PSRHBF. Amortization payments, if required, will be made over a period of 40 years as of September 30, 2017. Subsequent valuations will re-measure the unfunded liability and amortization payments will be made over an amortization period decreasing by one year until the term reaches 15 years.

The funded status of the CSRDF will be re-measured every year. At the end of fiscal years 2025, 2035, and 2039 additional transfers from the CSRDF to the PSRHBF will be made if there is a surplus of Postal Service Assets over Postal Service Liabilities in the CSRDF.

The PAEA plan to fund the retiree health benefits of USPS employees has several features that make the arrangement unusual.



1. The initial funding is not based on the PSRHBF liabilities, but instead on the surplus in the CSRDF attributable to Postal employees. The closest parallel to this arrangement is private sector employers with overfunded pension plans that have been permitted to make annual transfers from their pension plan to fund that year's retiree health care benefits (under Section 420 of the Internal Revenue Code).
2. Under these Section 420 transfers the employer is relieved of the cash cost of the year's retiree health care costs. Under PAEA, the Postal Service transfer of surplus from CSRDF did not relieve the Postal Service of the cash cost for current retirees health care costs, as those costs needed to be paid on top of the pension surplus transfer.
3. The funding amounts for the first 10 years after the PSRHBF was established bear no relationship to the liabilities nor to the unfunded liability of the PSRHBF. The amounts are not actuarially calculated.
4. The fixed payments over those ten years are higher than other funding options and equivalent to amortizing the unfunded liability over 13 years (using 7 percent health care trend rate assumption) or 7 years (using 5 percent health care trend rate assumption). Both periods are substantially shorter than the average remaining service period to retirement.
5. While the PAEA law includes provisions for additional transfers of surplus amounts in the CSRDF to be made to the PSRHBF, the law does not include any adjustment to reflect the funded status of the PSRHBF. Thus, the Postal Service would be required to continue making Normal Cost payments even if the PSRHBF has a surplus of assets over accrued liabilities as of September 30, 2016.



Discussion of OPM's Assumed 7 Percent Long Term Health Care Trend Rate

OPM's measurement of Postal Service retiree healthcare obligations uses a 7 percent ultimate health care trend rate. This assumption is unreasonably high when benchmarked against other assumption sets.

Statement of Financial Accounting Standard Number 106 (SFAS 106) was issued by the Financial Accounting Standards Board in 1990, with an effective date of 1993 (fiscal years beginning after December 15, 1992). SFAS 106 requires private sector employers to account for the cost of promised retiree medical and life insurance benefits ("postretirement benefits other than pensions") on an accrual accounting basis.

Under SFAS 106, the employer selects the health care cost trend rate for use in projecting the current health care costs. Hay Group gathered information on the health care cost trend rates used by Fortune 100 companies. Table 2.1 shows that the most commonly selected ultimate health care cost trend rate was 5.00 percent.

Rate	Number
4.50%	3
5.00%	47
5.10%	1
5.25%	2
5.50%	3
5.80%	1
6.00%	3
8.00%	1

The reported initial health care cost trend rates range from 5 percent to 10.3 percent with an average of 8.2 percent. These initial health care cost trend rates are then projected to decline to the ultimate rate in about 6 years.



The Governmental Accounting Standards Board (GASB) issued Statement 45 in 2002. This Statement requires governmental employers to report on their other postemployment benefits (OPEBs) for fiscal years beginning after December 15, 2006.

Table 2.2 shows the results from a survey of the states reporting on GASB 45 ultimate trend rate used in the measurement of other postretirement obligations. The survey shows the most commonly selected health care cost trend rate was 5 percent, with a range from 3.5 percent to 6 percent.

Table 2.2
GASB 45 Survey of Ultimate
Trend Rates

Trend Rate	Frequency
3.50%	1
4.00%	3
4.25%	1
4.50%	5
5.00%	34
5.50%	3
6.00%	5

Assessing the reasonableness of health care cost trend rates

OPM assumptions use a 7 percent ultimate health care trend rate. This rate appears to be unreasonably high when benchmarked against other assumption sets.

Currently, health care expenditures in the United States consume 17 percent of the Gross Domestic Product. If health care expenditures increase at a faster pace than other parts of the economy, the proportion of GDP devoted to health care will increase. To assess the reasonableness of the various health care cost trend rates used in projections of retiree health care costs, Hay Group used the Society of Actuaries-Getzen (SOA-Getzen) model.

The Society of Actuaries (SOA) contracted with Professor Thomas Getzen to develop a model for projecting long term health care cost trends.



The purpose of the SOA project *Modeling Long Term Health Care Cost Trends for Valuation* is to provide a benchmark projection of medical cost increases as one element in the estimation of retiree health benefits liabilities and premium increases for the next 5 to 75 years, and to provide a user-friendly model for making alternative projections. It does not attempt to encompass all of the elements needed for cost projections (benefit limits, numbers of eligibles and dependents, mortality rates, age and tenure classes, tax considerations, etc.) but only the future percentage increases in per-person medical costs.

A long-run model designed for estimating costs and liabilities twenty to fifty years in the future is not intended or appropriate for refining short-run estimates for the next few years. The model and the baseline projection are based on an econometric analysis of historical U.S. medical expenditures and the judgments of experts in the field.

The model, long run (2011 – 2099) baseline projections, and suggested high-low ranges for input variables were developed by Professor Getzen with the assistance of a SOA project oversight group of distinguished actuaries with expertise in the area. The project oversight group, while diverse in its opinions, considered the baseline projections and ranges to be reasonable. Obviously, any such modeling exercise begins with the assumption that the past trends provide a reasonable basis for future projections.

Table 2.3 shows the input factors used in the model. In it, we list the SOA-Getzen inputs taken from six federal entities' assumptions: OPM; the Department of Defense's Medicare-Eligible Retiree Health Care Fund; the DoD fund excluding pharmaceutical costs; the Centers for Medicare & Medicaid Services (CMS); and the Postal Service.

Table 2.3
Input Parameters for SOA-Getzen Model

	OPM	DOD	DOD Med Only	CMS	USPS High	USPS Base
2011 Income share	17.5%	17.5%	17.5%	17.5%	17.5%	17.5%
Inflation	3.5%	3.0%	3.0%	2.8%	3.0%	3.0%
Income growth	1.9%	1.8%	1.8%	1.6%	2.0%	1.2%
Income multiplier	1.25	1.23	1.21	1.00	1.20	1.20
Excess growth	1.0%	1.0%	0.9%	1.0%	0.5%	0.5%
Resistance share	25%	25%	25%	25%	25%	25%
no growth year	2075	2075	2075	2075	2075	2075



Using the SOA-Getzen model with the above input parameters produced the projections shown next in Table 2.4.

Year	Alternative Assumptions					
	OPM	DOD	DOD Med Only	CMS	USPS High	USPS Base
Ultimate	7%	6.25%	6.25%		6%	5%
2012	17.8%	17.7%	17.7%	17.7%	17.7%	17.6%
2015	18.5%	18.5%	18.4%	18.2%	18.1%	18.0%
2020	19.8%	19.7%	19.5%	19.1%	18.9%	18.7%
2025	21.1%	20.9%	20.6%	19.9%	19.7%	19.3%
2030	22.4%	22.1%	21.7%	20.8%	20.5%	20.0%
2035	23.7%	23.3%	22.8%	21.6%	21.3%	20.6%
2040	25.0%	24.5%	24.0%	22.5%	22.1%	21.3%
2045	26.1%	25.7%	25.1%	23.4%	22.9%	21.9%
2050	27.1%	26.7%	26.0%	24.2%	23.6%	22.5%
2075	31.0%	30.5%	29.7%	27.7%	27.1%	25.7%

The table above shows the projected share of Gross Domestic Product that would be consumed by health care under the various assumptions.

The OPM assumptions use a 7 percent ultimate health care trend rate and imply 27.1 percent of GDP being attributable to healthcare in 2050.

The DoD assumptions use a 6.25 percent ultimate health care trend rate. This implies 26.3 percent of GDP (on average) being attributable to healthcare in 2050

The Medicare Trustees (CMS) assumptions result in 24.2 percent of GDP devoted to health care in 2050.

The USPS high and base assumption sets (which use a 6 and 5 percent ultimate health care cost trend rate respectively) result in 23.6 percent and 22.5 percent of GDP in 2050 respectively.



The GASB 45 and FAS 106 assumption sets, which are reviewed by outside auditors when the employer's financial results are audited, have consistent average ultimate trend rates of 5 percent.

The OPM assumptions have an ultimate health care cost trend rate of 7 percent. This is 75 basis points higher than the ultimate trend rate used by the Department of Defense in the measurement of the Medicare-Eligible Retiree Health Care Fund. In the 25 years from 2007 to 2032, the DoD trend for Purchased Care Pharmacy benefits is higher than the medical benefits trend. The MERHCF has a much heavier weight of pharmacy benefits compared with the USPS PSRHBF. The MERHCF Medical Only projection shows the health care assumptions for medical benefits only. The USPS mix of benefits lies between the MERHCF projection and the MERHCF Medical Only set.

USPS prepared results on two sets of assumptions. USPS High uses an ultimate health care cost trend rate of 6 percent, while USPS Base uses an ultimate health care cost trend rate of 5 percent. The 5 percent rate was in line with the average rate used by States in their GASB 45 measurement of 4.98 percent and the average rate used by firms in their FAS 106 measurement of 5.04 percent.

The 7 percent long-term health care trend rate used by OPM appears to be unreasonably high benchmarked against the other assumption sets. When this 7 percent assumption rate is applied to all US health care expenditures it would result in the share of GDP attributable to health care being over 27 percent of GDP in 2050, while the current GDP share is 17%.



Review and Benchmarking Of OPM Assumptions and Liability Calculations

The Department of Defense's Medicare-Eligible Retiree Health Care Fund (MERHCF) is prefunded on an actuarial basis, unlike the PSRHBFB. Benefit payments are made directly from the DoD Fund, whereas under PAEA for years prior to FY 2017, Postal Service pays the retiree medical premiums in addition to the contribution amounts.

The PSRHBFB had a funded liability percentage of 41% at end-of-year FY 2008 (33% at end-of-year FY 2007). The Medicare Eligible Retiree Health Care Fund had a funded liability percentage of 23% for 2007. Comparable numbers for Fortune 100 firms and state and local governments that fund their retiree health care benefits are about 20% and 10%, respectively.

Having reviewed assumptions of long term health care costs, we now review other actuarial assumptions and methods underlying the measurement of the Postal Service retiree health care liability. These assumptions are benchmarked against those used in monitoring and projecting

1. Other federal retiree health care benefits, namely the Medicare Trustees' Report and the Department of Defense Medicare Eligible Retiree Health Care Fund.
2. Private sector entities reporting under SFAS 106.
3. Non-federal governmental employers reporting under GASB 45.

Federal Government Advance Funding of Retiree Medical Benefits

In analyzing the Postal Service Retiree Health Benefits Fund (PSRHBFB), one useful benchmark or comparator is the Medicare-Eligible Retiree Health Care Fund (MERHCF).

U.S. Code (USC) Chapter 56, title 10 established the Department of Defense Medicare-Eligible Retiree Health Care Fund (MERHCF). The purpose of the MERHCF was to accumulate funds needed to finance on an actuarially sound basis, liabilities associated with uniformed services retiree health care programs for Medicare-eligible beneficiaries. Health



care benefits (primarily medical and pharmacy benefits) were provided to Medicare-eligible retirees and dependents of the uniformed services beginning October 2001. The MERHCF was established in 2002.

The following elements of the MERHCF are examined here and compared with the PSRHBF.

1. The approach used for funding, including the actuarial cost method, how the initial unfunded actuarial accrued liability is being amortized, how actuarial gains or losses are recognized, and how the fund's assets are used to pay benefits.
2. The actuarial assumptions, including demographic and economic assumptions.
3. The development of the per capita claims costs and health care cost trend rate assumptions.
4. The governance structure, including the use of an external appointed Board of Actuaries.

Funding Approach

The contributions to the MERHCF are actuarially determined. Funding consists of a Normal Cost and Amortization payments. The Normal Cost is paid by the various branches of the Uniformed Services while Treasury funds the amortization payments of the unfunded initial liability.

Both funds use the Aggregate Entry-Age Normal Cost method. OPM uses a version of the Aggregate Entry-Age Normal where "entry date" is determined based on participation in the Federal Employees Health Benefit Fund, rather than entry into service. This has the effect of shortening the accrual period and attributing the Normal Cost only to those employees enrolled in the health care program as active employees.

The MERHCF initial unfunded actuarial accrued liability is amortized over a fixed period of 50 years. The approach used for determining the amortization payments is a level percent of payroll, with amortization payment amounts increasing annually with the expected increase in payroll. Changes in the actuarial accrued liability resulting from experience differing from that assumed, from assumption changes, and from benefit changes are amortized over 30 years.



In contrast, the Postal Service Fund has contribution amounts prescribed in the PAEA legislation for all years prior to FY 2016. These amounts were not actuarially determined from the retiree health care liabilities. For FY 2017 and later years the funding is actuarially determined and comprises the Normal Cost plus amortization payments to fund the remaining unfunded actuarial accrued liability.

The Postal Service Fund amortization period is 40 years beginning in FY 2017, decreasing by one year each year until 15 years minimum is reached. Annually from FY 2018, the unfunded actuarial accrued liability will be re-measured and a new amortization payment determined.

Benefit payments are made directly from the DoD Fund, whereas under PAEA for years prior to FY 2017, Postal Service pays the retiree medical premiums in addition to the contribution amounts.

Actuarial Assumptions

Table 3.1 lists the actuarial assumptions used in the latest valuations.

Actuarial Assumptions	MERHCF	PSRHBF
Discount rate	5.75%	6.25%
Health Care Cost Trend Rates		
Ultimate rate	6.25%	7%
Year ultimate reached	25 years	1 year

Table 3.2 shows the progress of the MERHCF since its inception in 2003. The fund increased with payments of the normal costs (increasing from \$8 billion in FY 2003 to \$11 billion in FY 2007) and amortization payments (ranging from \$14.4 billion in FY 2003 to \$16.6 billion in FY 2006) as well as investment income. Benefit payments were paid from the fund. The benefit payments increased from \$4.3 billion in FY 2003 to \$7.6 billion in FY 2007.



Table 3.2
Assets
DoD Medicare-Eligible Retiree Health Care Fund
(Amounts in \$Billions)

Fiscal Year	Fund Beg of Year	Normal Cost	Amortization Cost	NST Fund	Investment Income	Benefit Payments	Fund End of Year
2003	\$0.0	\$8.2	\$14.4		\$0.2	\$4.3	\$18.5
2004	\$18.5	\$8.1	\$16.3		\$0.9	\$5.2	\$38.6
2005	\$38.6	\$10.5	\$15.7		\$2.2	\$6.3	\$60.7
2006	\$60.7	\$11.1	\$16.6		\$3.2	\$7.1	\$84.5
2007	\$84.5	\$11.5	\$15.6	\$0.2	\$4.4	\$7.6	\$108.6

Table 3.3 shows the funded ratio of the fund. After five years of funding, the MERHCF is 23 percent funded.

Table 3.3
Funded Ratio
DoD Medicare-Eligible Retiree Health Care Fund

Fiscal Year	Assets at End of Year \$Bn	MERHCF Liability End of Year \$Bn	Funded Ratio End of Year (Assets / Liability)
2003	\$18.50	\$464.70	4%
2004	\$38.60	\$501.80	8%
2005	\$60.70	\$503.20	12%
2006	\$84.50	\$485.30	17%
2007	\$108.60	\$471.10	23%

Table 3.4 shows the buildup of the assets in the PSRHBF. The table shows actual asset growth through September 30, 2008 and projected asset growth based on PAEA contributions and expected investment earnings on average of 5.35 percent.



Table 3.4
Assets
Postal Service Retiree Health Care Benefit Fund
(Actual through FY 2008, Projection thereafter)

Amounts \$Millions

Fiscal Year ending 9/30/	Assets at Beginning Of FY*	USPS Contribution at End of FY**	Interest Earned	Payment of the Unfunded Liability	Benefit Payments	Assets at End Of FY
2007	\$17,100	\$8,358	\$287	\$0	\$0	\$25,745
2008	\$25,745	\$5,600	\$1,364	\$0	\$0	\$32,709
2009	\$32,709	\$5,400	\$1,719	\$0	\$0	\$39,828
2010	\$39,828	\$5,500	\$2,096	\$0	\$0	\$47,424
2011	\$47,424	\$5,500	\$2,500	\$0	\$0	\$55,424
2012	\$55,424	\$5,600	\$2,939	\$0	\$0	\$63,963
2013	\$63,963	\$5,600	\$3,429	\$0	\$0	\$72,992
2014	\$72,992	\$5,700	\$3,950	\$0	\$0	\$82,642
2015	\$82,642	\$5,700	\$4,498	\$0	\$0	\$92,840
2016	\$92,840	\$5,800	\$5,109	\$0	\$0	\$103,749

Table 3.5 shows the funded ratio of the PSRHBF. The table shows the actual funded ratio through September 30, 2008 and the projected funded ratio based on the assets in Table 3.4 and the projected liability on a roll-forward basis. Two years after its establishment the funded ratio is at 41 percent and is projected to increase to 80 percent by FY 2016.



Table 3.5
Funded Ratio
Postal Service Retiree Health Care Benefit Fund
(Actual through FY 2008, Projection thereafter)

Fiscal Year Ending Sept 30	Assets (End of Year) \$Millions	Liability (End of Year) \$Millions	Funded Ratio
2007	\$25,745	\$76,929	33%
2008	\$32,709	\$78,888	41%
2009	\$39,828	\$84,510	47%
2010	\$47,424	\$90,302	53%
2011	\$55,424	\$96,278	58%
2012	\$63,963	\$102,470	62%
2013	\$72,992	\$108,887	67%
2014	\$82,642	\$115,514	72%
2015	\$92,840	\$122,349	76%
2016	\$103,749	\$129,396	80%

Next, we review other assumptions employed by the OPM Office of the Actuary in their measurement of the Postal Service retiree health care liability and benchmark them to large private sector employers' actuarial assumptions used for reporting under SFAS 106 accounting requirements. We also examine how non-federal governmental agencies have complied with the GASB 45 accounting standard.

SFAS 106

Statement of Financial Accounting Standard Number 106 (SFAS 106) was issued by the Financial Accounting Standards Board in 1990, with an effective date of 1993 (fiscal years beginning after December 15, 1992). SFAS 106 requires employers to account for the cost of promised retiree medical and life insurance benefits ("postretirement benefits other than pensions") on an accrual accounting basis. To aid comparability between employers, the accounting rules required firms to use the same actuarial cost method (projected unit credit) and to discount obligations using a market-based discount rate selected by examining the yield on high quality corporate bonds of similar duration. Upon adoption of the standard firms had a choice of amortizing the unrecognized transition obligation over 20 years or immediately through a reduction in retained earnings. Subsequent to adoption the annual expense included up to four elements:



1. Service Cost – which measures the value of benefits earned in the year by active employees,
2. Interest Cost – the accrual of interest on the discounted accumulated postretirement benefit obligation (APBO),
3. Amortization Cost – the sum of actuarial (gain)/loss amortization and Prior Service Cost amortization, and
4. Expected Return on Plan Assets.

Firms were not required to fund the obligation. Those that chose to fund were able to reduce the ongoing SFAS 106 expense by the expected (long-term) return on plan assets. To be counted as assets, funds had to be dedicated for use only to pay benefits for retirees. Several funding vehicles are available to support the funding including an IRC Section 401(h) account – which can only be established for firms that had defined benefit pension plans as it is a sub-account of the pension plan; and a Voluntary Employees' Beneficiary Association (VEBA).

An examination of the Fortune 100 companies 10-K's shows that 71 of the firms reported FAS 106 obligations and expenses. Of these over half (36) reported plan assets. Table 3.6 shows the summary of plan asset and liability information.

	Count	Assets	Obligations
Funding	36	\$41,706	\$200,568
Not Funding	35	\$0	\$27,831
Total	71	\$41,706	\$228,399

Table 3.7 shows that only one firm has assets greater than the obligation and four other firms have assets covering half of the obligation.



Table 3.7
Funded Percent of Fortune 100 Companies

Over 100%	1
75 to 99%	1
50 to 74%	3
25 to 49%	9
1 to 24%	22
No funding	35
Fortune 100	71

GASB 45

The Governmental Accounting Standards Board (GASB) issued Statement 45 in 2002. This Statement requires governmental employers to report on their other postemployment benefits (OPEBs) for fiscal years beginning after December 15, 2006. Delayed adoption dates applied to smaller employers.

Governmental employers could choose the actuarial cost method from one of six approved methods. The unfunded actuarial accrued liability is required to be amortized over a period not exceeding 30 years.

The amortization cost could be determined using a fixed annual payment amount, or it could be determined as a level percentage of payroll. Under the level percentage of payroll approach the amortization cost increases in amount with increases in the government's covered payroll.

Employers also had the option of using a closed amortization period or an open period. Under the open amortization approach employers would be able to re-amortize the unfunded actuarial accrued liability annually at each re-measurement.

Table 3.8 shows the summary of the actuarial cost methods chosen for measurement

Table 3.8
Actuarial Cost Method

	Entry Age Normal	Frozen Entry Age	Projected Unit Credit
Count	29	2	24



The discount rate used in the measurement is selected based on the expected earnings on the assets used to pay the benefits. Thus if a government chose to advance fund the obligation, the discount rate used in the calculation would be based on the expected long-term rate of return on the plan assets. Table 3.9 shows the summary of the discount rates used in the measurements.

**Table 3.9
Discount Rates**

Discount Rate	Frequency
3.50% - 3.76%	2
3.75 - 3.99%	2
4.00% - 4.24%	8
4.25% - 4.49%	3
4.50%	11
4.75%	1
5.00%	5
5.25%	2
5.50%	3
6.00%	2
6.40%	1
6.50%	1
7.00%	2
7.50%	1
7.80%	1
8.00%	4
8.25%	2
8.50%	3

The reporting of disclosure requirements for governmental employers includes a statement of funding progress as well as a disclosure of the plan assets and actuarial accrued liabilities.

Table 3.10 shows the summary of assets and liabilities reported in the most recent Consolidated Annual Financial Reports. Several States reported liabilities separately for general employees and teachers, therefore the count of the number of plans exceeds the number of states. The survey also included the liabilities for two cities (New York and Chicago).



Table 3.10
Summary of Assets and Liabilities
Amounts in \$Millions

	Count	Assets	Liabilities
Funding	27	\$25,953	\$258,662
Not funding	32	0	\$274,859
Total	59	\$25,953	\$533,521



Summary of Policy Options for Funding the USPS Retiree Health Care Liability

An actuarial-based approach is the best way to fund the PSRHBFB if the policy goals are stable funding payments and avoidance of intergenerational equity. Such an approach would lower the Postal Service's current PAEA-required costs. Given the current PAEA funding requirements, the Postal Service is on-track to over fund the PSRHBFB by about \$13.2 billion at the end of 2016. Other approaches exist that target certain funding levels that could be used in place of the current PAEA payment amounts. Two of these approaches are presented in this section.

In this section, various policy options for funding the USPS retiree health care obligation are enumerated.

- Option 1 – Use an actuarially determined funding method.
- Option 2 – Target fully funding the accrued cost based on current health care costs increasing in line with consumer price increases.
- Option 3 – Target funding level or funded ratio.
- Option 4 – Create standalone health care program and then fund actual costs using an actuarially determined funding method.
- Option 5 – Revert to same method as the federal government.



OPTION 1 – Use an actuarially determined funding method

Under this approach the amount the USPS funds each year would relate to the cost of the program. Contributions would be determined based on the expected cost for current employees and their costs accrued over their working life times.

Option 1 – Use an actuarially determined funding method	
Advantages	Disadvantages
<ul style="list-style-type: none"> Stable pattern of funding 	<ul style="list-style-type: none"> Higher costs than Pay As You Go (PAYGO)
<ul style="list-style-type: none"> Avoids intergenerational inequity - so rates charged to current Postal customers include the accrual cost for retiree medical benefits being earned by current employees 	<ul style="list-style-type: none"> Amount varies from year to year due to remeasurement of the liabilities and assets
<ul style="list-style-type: none"> Lower cost than current law 	

In the context of ensuring fair inter-generational accounting, benefit payments made to retired employees should be accrued over the working lifetime of the employees. When the true long-term cost of the benefits are included in the total compensation costs of the employees, then the costs of the postretirement benefits will be charged to the users of the employee’s services.

Actuarial Standard of Practice No. 6 – (Measuring Retiree Group Benefit Obligations), contains a section on cost allocation policy that ensures fair inter-generational accounting. The cost allocation policy considerations mentioned are:

1. Criteria for an acceptable actuarial cost method;
2. Taking into account dedicated assets;
3. Amortization methods; and
4. Cash-flow adequacy.



An actuarial cost (or funding) method spreads the cost over an employee’s working lifetime. Thus, all actuarial funding methods have the same goal – to fund the present value of future benefits by the point in time when the employee retires.

Cost allocation considerations from ASOP 6 are shown in Appendix A.

OPTION 2 – Target fully funding the accrued cost based on current health care rates increasing in line with consumer price increases

Under this approach, the amount the USPS funds each year would relate to the current cost of the program, with costs growing in line with expected increases in consumer prices. Contributions would be determined based on the expected cost for current employees and their costs accrued over their working life times.

Option 2 – Target fully funding the accrued cost based on current health care rates increasing in line with consumer price increases	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Stable pattern of funding in line with PRC limits on revenue increases 	<ul style="list-style-type: none"> • Higher costs than PAYGO
<ul style="list-style-type: none"> • Reduced intergenerational inequity 	<ul style="list-style-type: none"> • Amount varies from year to year due to remeasurement of the liabilities and assets
<ul style="list-style-type: none"> • Reduced risk of overfunding the plan 	
<ul style="list-style-type: none"> • Lower cost than current law 	
<ul style="list-style-type: none"> • Rates charged to current Postal customers include the accrual cost for retiree medical benefits being earned by current employees, within the PRC limits on revenue growth 	



OPTION 3 – Target Funding Level or Funded Ratio

When funded plans have assets greater than liabilities there is a moral hazard risk that benefits will be enhanced as the improvements will be deemed to have “no cost.” Furthermore, measurements of retiree healthcare benefits are subject to significant overstatement if public policy changes increase the provision of benefits from the government and reduce the obligation of employers. This “benefit reduction” measurement change occurred recently with the enactment of the Medicare Modernization Act of 2003.

For these and other reasons, plan sponsors that choose to advance fund their obligations usually target a funding level below 100 percent.

Approach	PAEA	PAEA	Target Unfunded Liability	Current Year Premiums Paid From Fund	PAEA with HR 22
1. Work Force	Declining	Declining	Declining	Declining	Declining
2. Health Care Inflation	7%	5%	5%	5%	5%
3. 2016 Liabilities	\$129.4	\$ 90.5	\$ 90.5	\$ 90.5	\$ 90.5
4. 2016 Assets	\$103.7	\$103.7	\$ 64.8	\$ 74.6	\$ 93.7
5. 2016 Unfunded Liability	\$ 25.7	\$(13.2)	\$ 25.7	\$ 15.9	\$ (3.3)
6. 2016 Percent Funded	80%	115%	72%	82%	104%
7. Avg. Annual Payment to PSRHB	\$ 5.60	\$ 5.60	\$ 1.57	\$ 5.60	\$ 5.60



Four scenarios are presented in Table 4.1, two of which are examples of approaches that could be implemented to save the Postal Service some portion of the high annual PAEA payments it has to make.

All projections in the table use the realistic assumption that the Postal Service will reduce its workforce and work hours between 2009 and 2016. The first column (PAEA) shows Hay Group's calculation of the 2016 liabilities and PSRHBf using the OPM 7 percent health care trend rate assumption. On this basis, the Postal Service is projected to have liabilities of \$129.4 billion and assets of \$103.7 billion at the end of FY 2016, resulting in an unfunded liability of \$25.7 billion. On this assumption the benefits are projected to be 80 percent funded.

The second column shows Hay Group's calculation of the same funding arrangements but using a 5 percent health care trend rate assumption – a rate in line with assumptions adopted by other large employers as reported in their FAS 106 or GASB 45 disclosures. Using this assumption set and PAEA funding, the Postal Service is on track to overfund the PSRHBf by \$13.2 billion.

The third column shows the approach that targets the same unfunded liability under the first column (\$25.7 billion as of the end of FY 2016). The Postal Service can reach this unfunded liability target by paying \$1.57 billion per year annually over the FY 2009 - FY 2016 time period. The USPS would continue to fund annual retiree costs in addition to these amounts.

The fourth column shows the projected position if premiums are paid from the fund. Under this funding approach, USPS would continue to make the fixed annual payments pursuant to PAEA, but would pay the retiree healthcare payments from the fund, rather than in addition to PAEA. The table shows the projected position assuming payments were paid from the fund since its inception. Under this approach, current retiree health benefit costs would be paid from the PSRHBf and the Postal Service would continue to pay the average \$5.6 billion annual PAEA payments. This would save the Postal Service the approximately \$3.1 billion annually it expects to pay in the 2009 - 2016 time period for current period retiree health benefit costs, thus saving the Postal Service about \$3.1 billion per year. The projected funded ratio is 82 percent at the end of FY 2016.

The fifth column shows the projected position if HR-22 is enacted. HR-22 would allow the Postal Service to pay premiums from the fund for FY



2009, FY 2010, and FY 2011. The projected funded ratio is 104 percent at the end of FY 2016.²

OPTION 4 – Form a standalone retiree health plan

Under this approach USPS would form a separate health care plan. Costs for non-Medicare retirees would be higher than the current blended rates in FEHBP; however, the rates for Medicare-eligibles would likely be lower due to complete integration with the Medicare Part D program.

Option 4 – Separate Retiree Health Plan	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Stable pattern of funding in line with PRC limits on revenue increases 	<ul style="list-style-type: none"> • Higher costs than PAYGO
<ul style="list-style-type: none"> • Reduced intergenerational inequity 	<ul style="list-style-type: none"> • Amount varies from year to year due to remeasurement of the liabilities and assets
<ul style="list-style-type: none"> • Reduced the risk of overfunding the plan 	<ul style="list-style-type: none"> • Current retirees would likely remain covered by FEHB
<ul style="list-style-type: none"> • Lower cost than current law 	
<ul style="list-style-type: none"> • Postal customers pay for Postal Service costs 	

^[2] The H.R. 22 scenario in this report describes the amended version of H.R. 22. The bill was amended on June 24, 2009, after the first issuance of this report. Under the amended version of H.R. 22, Postal Service retiree health benefits will be paid from the fund from FYs 2009 to 2011. The Postal Service will then resume payments for current retirees from FYs 2012 to 2016



OPTION 5 – Revert to same method as in the federal government (Pay As You Go)

Option 5 is the approach used by the federal government. Currently, the federal government funds retiree health care benefits on a pay-as-you-go basis. One option is for the Postal Service to revert to this method.

Option 5 – Revert to the same approach as the federal government	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Consistent approach to the federal government 	<ul style="list-style-type: none"> • Potential for inter-generational inequity
<ul style="list-style-type: none"> • Minimizes current year expenditures 	<ul style="list-style-type: none"> • Costs for retiree health care likely to grow faster than CPI, creating an increasing strain on resources
<ul style="list-style-type: none"> • Assets in PSRHBFB could be used to fund retiree premiums for next 14 years 	



Appendix A: ASOP No. 6 - Cost Allocation Policies

Actuarial Standard of Practice No. 6 – (Measuring Retiree Group Benefit Obligations), contains a section on cost allocation policy.

3.9 Selecting a Cost Allocation Policy—When the measurement involves the allocation of an obligation to different time periods (including measurements that take into account plan assets, plan amendments, or actuarial gains and losses), the actuary should select a cost allocation policy, based on the following considerations:

3.9.1 Criteria for Acceptable Actuarial Cost Methods—The actuary should select an actuarial cost method that meets the following requirements:

- a) Limits on Allocation Period—The period over which the allocation is made for an active participant should begin no earlier than the date of employment and should not extend beyond the last assumed retirement age. This period may be determined for each participant individually or for the active participant group as a whole.
- b) Reasonableness of Allocation Basis—The allocation basis should be reasonable and produce an orderly allocation of the actuarial present value of future plan benefit costs.

3.9.2 Dedicated Assets—In measuring the unfunded obligation and allocating costs to time periods, the actuary should take into account dedicated plan assets, if any.

- a) The actuary should collect data regarding the amounts and types of dedicated assets held.
- b) In general, the actuary should value the dedicated assets using a method that takes into account market value, unless constrained to use an asset valuation method prescribed by law or regulation. Asset valuation methods include market value; market-related methods that smooth out the effects of short-term volatility in market value; and methods that discount the future cash flow of the underlying investments. The use of book or cost value may be



prescribed for some specific purposes (for example, in determining tax on trust income under Section 512 of the Internal Revenue Code).

- c) The actuary should obtain sufficient details regarding insurance policies held as dedicated assets to determine an appropriate value, reflecting the nature of the contractual obligations upon early termination of the policies, as well as the costs of continued maintenance of the policies. If the cash surrender value of the policies is not readily determinable, the actuary should rely on his or her professional judgment to develop an appropriate value, depending on the purpose of the measurement.

3.9.3 Amortization Methods—Unless already reflected in the actuarial cost method, the actuary should select a reasonable and systematic amortization method to recognize changes in plan obligations arising from plan amendments (including plan initiation), actuarial gains and losses, changes in assumptions, or changes in the actuarial cost method.

3.9.4 Cash Flow Adequacy—Absent regulatory or legal restrictions, where a cost allocation policy is used to determine funding requirements, the actuary should select a policy that accumulates assets such that, absent experience losses, adequate funds are on hand to pay benefits included in the measurement when due. Notwithstanding the above criteria, the actuary may be required to use a prescribed cost allocation policy for a particular purpose (for example, for financial reporting purposes under SFAS No. 106 the actuary is required to use the Projected Unit Credit Cost Method and a defined approach to recognize changes in obligation arising from plan amendments and actuarial gains or losses (see section 3.11))



Appendix B: USPS Current Plan Provisions

The USPS participates in the Federal Employees Health Benefits Program (FEHBP), which offers employees, retirees and their survivors a selection of health care plans. USPS employees who are eligible, as well as their eligible family members, may continue health care coverage in FEHBP at retirement. The following describes the provisions of FEHBP for USPS retirees.

Eligibility

USPS employees may continue health care coverage at retirement if the following requirements are met:

1. The employee retires on an immediate annuity, which begins no later than one month after date of final separation; and
2. The employee has been enrolled in the health benefits program:
 - a. for five years immediately preceding retirement, or
 - b. if less than five years, enrolled for the full period in which eligible for coverage.

An employee who is covered by the Federal Employees' Retirement System (FERS) and is eligible for an immediate annuity at separation from USPS service may postpone receiving his or her annuity to avoid the age reduction. Retirees who elect to postpone their annuity and meet the above eligibility requirements for continuing health care coverage may reenroll at a later time when they begin to receive the postponed annuity.

Other employees who retire early from CSRS/FERS and begin receiving deferred annuity benefits at age 62 are not eligible to enroll in FEHB.

The eligibility conditions for FERS and CSRS are as follows:

An employee is eligible for retirement if the employee meets one of the following age and service requirements:		
CSRS Employee AGE is at least	FERS Employee Age is at least	And CREDITABLE SERVICE is at least
62	62	5 years
60	60	20 years
55	MRA	30 years



MRA (Minimum Retirement Age) varies by date of birth from 55 for employees born before 1948 to 57 for employees born after 1969.

Spouse Eligibility

Spouses of retirees are eligible to continue health care coverage as long as the USPS retiree was enrolled in family coverage while an employee immediately prior to retirement.

In addition, surviving spouses and children (survivor annuitants) and former spouses of deceased USPS employees receiving survivor annuities may continue coverage as well. If the surviving spouse or former spouse remarries, the spouse will continue to be eligible for coverage if:

1. the spouse remarries before age 55 and the spouse was married to the deceased USPS retiree for 30 years or more; or
2. the spouse remarries after age 55.

Dependent Eligibility

Eligible dependent children include:

1. Unmarried dependent children under age 22, including:
 - legally adopted children, stepchildren, foster children and recognized children born out of wedlock who live with the retiree; or
 - court order to provide coverage to show that you provide regular and substantial support for child; or
2. Unmarried disabled children age 22 and over incapable of self-support because of a disability that began before age 22 (and is expected to last more than one year).

Enrollment

Eligible retiring employees must make a positive election at retirement to continue their health care enrollment. The Office of Personnel Management (OPM) makes the final determination of eligibility for health care enrollment as a retiree. Retirees are entitled to the same health benefits as active employees.



The main types of health care plans are Fee-for-Service (FFS) and Managed Care plans. The insurance carriers and plans available to choose from vary among the states. The options that a retiree has will depend on where he or she lives.

The types of FFS plans offered are Preferred Provider Organizations (PPO) plans. Under a FFS plan, the insurance carrier contracts with a network of providers to provide services to plan participants at negotiated fees. These FFS plans have two benefits levels, in-network and out-of-network. In-network benefits have lower out-of-pocket costs to plan participants. Out-of-network benefits have higher out-of-pocket costs. These plans are designed to encourage plan participants to use the participating providers.

The managed care plans are Health Maintenance Organizations (HMO). HMO plans only offer one level of benefits. Plan participants must coordinate all of their care with their designated primary care physician and use participating providers in order to receive benefits under the plan. The services received are subject to plan copayments.

In addition, some of the health care plans available may have two options. For example, a retiree may choose between a Standard Option PPO plan and a Basic Option PPO plan from Blue Cross/Blue Shield. The benefits vary in coinsurance, copayments and deductible amounts. Not all plans available will have both a High Option and Standard Option.

Retirees are able to change their health care coverage. They may change coverage during the FEHBP open season or during the year if they experience a qualifying life event, such as change in family status (i.e. marriage, divorce, birth, death), become eligible for Medicare, or the retiree moves out of the service area of his or her plan.

Retirees enrolled in FEHBP who become eligible for Medicare will not have their FEHBP coverage terminated. However, they may elect to cancel FEHBP enrollment if they are enrolling in a Medicare Advantage plan. They may then reenroll at a later time if they choose to cancel their Medicare Advantage plan enrollment.

Coverage

There are only two types of coverage options:

- Self Only (Self)



- Self and Family (Family)

Retirees may continue to cover their eligible dependents only if they were enrolled in Family coverage immediately before retirement. However, if a retiree has Self coverage and acquires a new dependent (through marriage, birth, adoption, or foster child), he or she may change from Self to Family coverage due to the qualifying life event.

Retiree Contribution

The retiree is responsible for the difference between that USPS premium contribution and the premium rate of the health care plan option elected. The retiree contributions are deducted from annuity payments.

The cost of health care coverage is shared between the annuitants and the USPS. For retirees whose full career was with the Postal Service, USPS will pay 72 percent of the weighted average premiums of all the health care plans under FEHB Program, limited to 75 percent of the premium rate for any given health care plan option. Thus, if a retiree is enrolled in a health plan whose premium is greater than the average premium, the USPS pays 72 percent of the weighted average premium and the retiree pays the balance. If a retiree is enrolled in a health plan whose premium is significantly lower than the average, the USPS pays 75 percent of the actual plan premium.

Table B-1 illustrates how these rules apply to different health benefit plans. The table shows that the USPS portion of the premium can vary from as low as 48 percent to as high as 75 percent.



Table B-1 — 2008 Monthly Premium Rates for Future Retirees — Self Coverage

Plan	Plan Premium	72% of Average FEHBP premium	75% of Plan premium	USPS Portion [smaller of (3) or (4)]	USPS Portion as a percent of Plan Premium
(1)	(2)	(3)	(4)	(5)	(6) = (5) / (2)
BlueCross BlueShield Standard Benefit Plan	\$339.17	\$318.54	\$254.38	\$254.38	75.00%
GEHA Benefit Plan	\$512.43	\$318.54	\$384.32	\$318.54	62.16%
Health America	\$626.96	\$318.54	\$470.22	\$318.54	50.81%
Supermed HMO (Ohio)	\$653.53	\$318.54	\$490.15	\$318.54	48.74%

This contribution policy combined with annual open enrollment leads to a migration pattern from generally higher cost plans to lower cost plans. The 2008/2009 experience is shown in the following tables. We compared the 2008 FFS enrollment with the 2009 FFS enrollment. If all participants stayed in the same plan in 2009 that they were enrolled in for 2008, then the USPS cost increase would have been 5.8 percent – and the participant contribution increases would have been 19.6 percent (on average).

After open enrollment, many participants changed plans to avoid a steep increase in rates. The result after migration was a 4.1 percent increase in costs to USPS and a 13 percent increase in costs for participants (on average), as shown in Table B-2.

**Table B-2
FFS Plan Cost Changes from 2009 Open Enrollment**

FFS Plans		USPS Bi-weekly Cost	Retiree Bi-weekly Cost
2008 Enrollment	2008 rates	\$ 312.06	\$ 65.31
2008 Enrollment	2009 rates	\$ 330.32	\$ 78.10
2009 Enrollment	2009 rates	\$ 324.85	\$ 73.77
Rate increase before plan migration		5.8%	19.6%
Rate increase after plan migration		4.1%	13.0%



Table B-3 shows the same analysis for participants enrolled in HMO plans in 2008.

Table B-3 HMO Plan Cost Changes from 2009 Open Enrollment			
HMO Plans		USPS Bi-weekly Cost	Retiree Bi-weekly Cost
2008 Enrollment	2008 rates	\$ 303.63	\$ 78.41
2008 Enrollment	2009 rates	\$ 323.14	\$ 95.18
2009 Enrollment	2009 rates	\$ 317.83	\$ 85.27
Rate increase before plan migration		6.4%	21.4%
Rate increase after plan migration		4.7%	8.8%



Appendix C: About Hay Group

The Hay Group is an international human resources consulting firm. We have more than 7,000 clients around the world. With 85 offices in 47 countries, Hay Group can partner with clients anywhere in the world.

Hay Group clients come from the private, public, and not-for-profit sectors, across every industry. Their diverse business challenges mean we help them recognize and face their unique issues, as well as their unique cultures.

About the Principal Author

The principal author of the report is Adam Reese, FSA, FCA, MAAA, EA.

Adam Reese is the Practice Leader in Hay Group's Washington, DC office. Mr. Reese has over twenty-five years experience as a retirement benefits consultant with expertise in the design, funding and accounting of retirement income and retiree health care programs.

Delivering results for clients

Mr. Reese's current clients include Alameda County, City of Baltimore, Commonwealth of Pennsylvania, Harris Corporation, Inova Health System, New York State Teachers Retirement System, and Port Authority of New York and New Jersey. His federal clients include United States Coast Guard, the Department of Commerce National Oceanic and Atmospheric Administration Corps, and the Department of Health Public Health Service (PHS) Commissioned Corps.

Retiree Health and the Actuarial Profession

Mr. Reese served on the GASB 45 Implementation Task Force and currently serves on the American Academy of Actuaries Joint Committee on Retiree Health, having served as Co-chair from 2001 to 2008.

Mr. Reese served on the Society of Actuaries Project Oversight Group for the development of the SOA-Getzen healthcare model.



Mr. Reese was one of seven actuaries who served on the Actuarial Standards Board Task Force that updated the Actuarial Standard of Practice No. 6 – *Measuring Retiree Group Benefit Obligations*.

Mr. Reese is the author of two prize-winning papers on retiree health. His first paper, *The Valuation of Retiree Medical Benefits* was awarded the L. Ronald Hill Memorial Prize for the Best Employee Benefits Paper of 1989. This paper was previously part of the Society of Actuaries curriculum for over a decade.

His paper, *Healthcare Costs in the Last Year of Life* was published in Actuarial Research Clearing House as well as the Conference of Consulting Actuaries Proceedings and received honorable mention from the Actuarial Education Research Foundation.

Mr. Reese served on the American Academy of Actuaries Committee on Qualifications from 2001 to 2002.

Mr. Reese currently serves on Board of the Conference of Consulting Actuaries and is a member of the Board's Executive Committee.

Areas of expertise

Mr. Reese's areas of expertise include the design, valuation, and accounting for pension and postretirement medical benefits. Mr. Reese has in-depth knowledge and expertise of the Medicare marketplace, including Medicare Advantage plans and the Medicare Part D program.

He has provided expert witness testimony in a range of settings including arbitration hearings, court cases and bankruptcy cases.

Adam's Education and Affiliations

Prior to joining the Hay Group, Mr. Reese's consulting career included consulting positions with Towers Perrin (Washington, DC and London, England) and Watson Wyatt (Washington, DC and London, England).

Mr. Reese received his Bachelors of Science degree from the London School of Economics and Political Science.

Mr. Reese is a Fellow of the Society of Actuaries, a Fellow of the Institute of Actuaries of Great Britain, a Fellow of the Conference of Consulting



Actuaries, a Member of the American Academy of Actuaries and an Enrolled Actuary under ERISA.

Contact

Email: Adam_Reese@haygroup.com

Tel: 1-703-841-3119