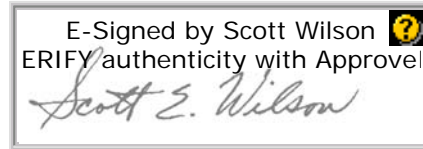




June 22, 2006

MEMORANDUM FOR JOHN E. POTTER, POSTMASTER GENERAL,  
CHIEF EXECUTIVE OFFICER



From: David C. Williams  
Inspector General

Subject: White Paper – USPS Cost Burdens  
(Product Number MS-WP-06-001)

This White Paper describes the U.S. Postal Service Office of Inspector General's research into five major Postal Service cost burdens (Project Number 06YS004MS000). We have defined cost burdens as mandates that are wholly or partially unfunded and borne by the Postal Service due to legislation or other constraints; not borne by any other business; and considered by Postal Service management to be outside the Postal Reorganization Act's directives. In this White Paper, we describe, quantify, and suggest ways to mitigate each cost burden.

These cost burdens are briefly described in our March 2006 *Semiannual Report to Congress*. This paper provides a more detailed description of these issues.

If you have any questions, please contact me at (703) 248-2300.

Attachment

cc: Patrick R. Donahoe  
Board of Governors

# White Paper – USPS Cost Burdens

## Introduction

The U.S. Postal Service is an independent establishment of the Executive Branch almost completely financed by postal ratepayers rather than by taxpayers. The Postal Service's status often raises questions about its responsibilities and who must pay for them. One aspect of this is that ratepayers sometimes must bear costs unrelated to the Postal Service's core purpose. For the purposes of this paper, we call this a "cost burden."

We have developed a three-part definition of a cost burden: (1) it is a mandate, wholly or partially unfunded and borne by the Postal Service due to legislation or other constraints; (2) it is not borne by any other business; and (3) it is considered by the Postal Service's management to be outside the Postal Reorganization Act's directives.<sup>1</sup> The intent of the Postal Reorganization Act is to allow the Postal Service to provide universal postal service in a businesslike manner. Since the Postal Service is mandated to operate efficiently and ratepayers finance it, cost burdens become an issue. It is one thing to ask ratepayers to pay the extra costs of activities directly related to the Postal Service's core functions – such as delivering mail to remote areas or operating post offices in small towns where there are no alternate means of service – but another to ask them to pay for activities outside this mission.

This paper focuses on five major cost burdens we consider significant, not all of which are easily quantifiable:

1. The Postal Service may not be able to receive the rebate available to other employers who provide qualified prescription drug coverage to their annuitants (Medicare Part D).
2. The Postal Service must provide air bypass service in Alaska (Alaska Bypass).
3. Current laws prevent the Postal Service from freely contracting for international mail air transportation (International Air Transportation).
4. The Postal Service must place the overfunding of its Civil Service Retirement System (CSRS) obligations in an escrow account (CSRS Escrow Account).
5. The Postal Service must pay CSRS costs associated with retirees' previous military service (CSRS Military Service).

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<sup>1</sup> . . . The Postal Service shall have as its basic function the obligation to provide postal services to bind the Nation together through the personal, educational, literary, and business correspondence of the people. It shall provide prompt, reliable, and efficient services to patrons in all areas and shall render postal services to all communities. . . .  
39 U.S.C. § 101(a) (Postal Reorganization Act Sec. 101(a))

We conducted a limited review of the five burdens. We interviewed Postal Service officials and reviewed secondary research (see Appendix 1). In this paper we discuss how well each issue fits our definition of a cost burden and whether it is possible to quantify and mitigate the burden. A summary table highlighting each burden, its cost, and possible ways to mitigate it appears in Appendix 2.

## **Medicare Part D**

### ***What is it?***

Eligible employees who retire from the Postal Service can continue participating in the Federal Employees Health Benefits (FEHB) program, and the Postal Service is responsible for the employer's share of the premiums (roughly 72 percent). FEHB premium costs have risen rapidly in recent years due, in part, to an increase in the cost of prescription drugs. In 2005, Postal Service payments for retiree and survivor health benefits totaled \$1.5 billion.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) established a new voluntary prescription drug program (Part D) for those eligible for Medicare. Effective January 1, 2006, Medicare participants are able to purchase prescription drug coverage for an additional premium. To encourage employers to keep providing prescription drug coverage for retirees, the MMA also includes a rebate provision. Sponsors of qualified retiree plans can receive a rebate for each Medicare participant who chooses not to enroll in Part D. Government plans, including FEHB plans, that meet the requirements are eligible to receive the rebate, but the Office of Personnel Management (OPM) has announced that the federal government will not request it.

### ***How is it a burden?***

OPM's decision makes sense for most federal agencies, as taxpayers fund the prescription drug coverage either through Medicare or the FEHB program. We believe Postal Service ratepayers, however, are entitled to the same relief available to private sector companies and state and local governments. Without the rebate, the Postal Service's core mission of delivering mail will be more expensive than necessary.

### ***Can it be quantified?***

The Centers for Medicare & Medicaid Services (CMS) have estimated the rebate will average \$668 per covered retiree in 2006. This could save postal ratepayers \$250 million per year. In the long term, the Postal Service believes the rebate could reduce its annuitant health benefit obligations by more than \$6 billion.

### ***Can it be mitigated?***

Most employers have three options for responding to the new prescription drug benefit: dropping their current coverage, designing coverage to work around the new Part D benefit, or requesting the rebate. The least disruptive option for Postal Service retirees is for the Postal Service to receive the rebate. The Postal Service applied for the rebate, but CMS, in consultation with OPM, rejected the Postal Service's application. CMS and OPM could reconsider their decision and allow the Postal Service to receive the rebate.

### **Alaska Bypass Service**

#### ***What is it?***

Alaska Bypass Service provides a way for businesses to send large shipments of commodities (such as food) from Anchorage and Fairbanks to remote areas of Alaska. The shipments, arranged on 1,000 to 2,500 pound pallets, bypass all Postal Service facilities (thus the name "Bypass") and go directly to eligible air carriers on a rotating basis. Shippers pay parcel post rates to the Postal Service, which in turn reimburses air carriers for flying the pallets to remote communities where recipients can pick up their items. The Postal Service and air carriers worked with Alaska legislators to develop the service in the late 1960s and early 1970s when wholesalers inundated the Anchorage General Mail Facility with grocery mailings. The intent of the service is for the Postal Service to subsidize both passenger transportation and the delivery of items to remote communities.

#### ***How is it a burden?***

Alaska Bypass is a unique service the Postal Service does not offer anywhere else in the United States. Additionally, it operates at a significant loss, which postal ratepayers must cover. There are also restrictions preventing the Postal Service from implementing the service in the most businesslike manner. For example, the Postal Service cannot negotiate with air carriers. Instead, air transportation rates are set by the Department of Transportation (DOT).

#### ***Can it be quantified?***

According to Senator Ted Stevens (R-AK), the Postal Service was losing \$100 million per year on air service in Alaska as of 2002. Congress has passed a number of changes since 2002 aimed at reducing the burden on the Postal Service and providing for better passenger transportation. Current estimates of the annual direct loss to the Postal Service are \$50 to \$60 million.

### ***Can it be mitigated?***

There are at least four possible ways to further reduce the burden to the Postal Service of providing Alaska Bypass Service. First, the Postal Service could be allowed to charge rates higher than Parcel Post rates (e.g., Priority Mail rates) for this expedited air service. Second, the Postal Service could be allowed to contract for Alaska air transportation directly rather than paying the rates set by the DOT. Third, Congress could give the Postal Service more flexibility to operate the service efficiently. Congress could set out specific goals for Alaska Bypass Service and give the Postal Service complete freedom to achieve them. The Postal Service would, of course, be accountable for the results, but it could take advantage of innovations such as finding alternative methods of transportation, building more transportation hubs, and extending delivery times to produce similar results at less cost. Fourth, any remaining excess of costs over revenues could be covered by appropriations from Congress similar to the appropriations for free mail for the blind.

## **International Air Transportation**

### ***What is it?***

The Postal Service carries most outbound international mail requiring air transportation at rates set by the DOT. The Postal Service can contract for international air transportation only when there is not sufficient capacity on a route or when shipments are at least 750 pounds and contain no more than 5 percent letters. Additionally, the law generally requires the Postal Service to use U.S.-flag carriers where available. By contrast, the Postal Service can contract for all domestic air transportation except within Alaska.

### ***How is it a burden?***

The Postal Service believes the rates set by the DOT are far higher than those it would pay on the free market and regulation hinders its ability to negotiate the best service from carriers. The Postal Service would prefer to have the same freedom to contract for air transportation internationally as it has domestically.

### ***Can it be quantified?***

The Postal Service spent \$241 million on air transportation for international mail in fiscal year (FY) 2005.<sup>2</sup> It paid approximately 82 percent of this amount to U.S.-flag carriers. A recent, validated estimate of the cost under the current rules does not exist. The Postal Service previously estimated that it could save \$40 to \$50 million annually if it were permitted to contract for international air

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<sup>2</sup> The international air transportation of military mail cost an additional \$468 million in FY 2005. The Department of Defense reimburses the Postal Service for this cost.

transportation. In 2004 Postmaster General John E. Potter testified before a congressional hearing that deregulating international air transportation rates would save the Postal Service about \$100 million annually

The Postal Service also offers anecdotal support for its belief that regulated rates are too high. Foreign postal administrations competing with the Postal Service for outbound international mail volumes pay less to transport mail abroad. Also, the Postal Service can contract transportation for outbound international parcels and they cost much less per pound to transport than letters paying the regulated rates. Parcels, which are less dense than letters, actually ought to be more costly per pound.

### ***Can it be mitigated?***

Congress could remove this burden by lifting all restrictions on the Postal Service's freedom to contract for international mail air transportation. The Postal Service is mandated to operate in a businesslike manner, and we believe purchasing air transportation for international mail should be no exception. We believe the Postal Service should be free to negotiate its rates directly with any carrier it deems appropriate.

## **CSRS Escrow Account**

### ***What is it?***

The CSRS covers most federal employees, including Postal Service employees, hired before 1984. The Postal Service must make payments to cover the future costs of CSRS benefits. In December 2001, the Government Accountability Office (GAO) questioned whether the Postal Service's payments were sufficient to cover these obligations, and OPM calculated the Postal Service's liabilities separately from the rest of the federal government and changed some assumptions. OPM estimated the Postal Service would overpay the fund by \$78 billion over the life of the CSRS.

Congress passed the Postal Civil Service Retirement System Funding Reform Act of 2003 (Public Law 108-18), reducing the Postal Service's annual payments for FY 2003 to FY 2005. During these 3 years, the Postal Service saved \$9.2 billion in payments, which the law required it to use for reducing debt and keeping postage rates steady. Starting in FY 2006, the Postal Service must place any savings into a separate escrow account and not use it until future legislation authorizes it.

***How is it a burden?***

The funds scheduled for the escrow account are no different from any other revenue raised from postal ratepayers. Segregating them into a separate account is an arbitrary exercise. In general, the Postal Service is not permitted to charge its customers more than it needs for its expenses, but in January 2006 ratepayers began paying a 5.4 percent increase as a result of the escrow requirement. We believe the Postal Service should be able to use the CSRS savings in accordance with law as it sees fit. Monies generated from Postal Service revenues should not be subject to outside control since they are not tax dollars. Instead, they should be subject to normal usage for operations and capital investment.

***Can it be quantified?***

The size of the escrow payment is the difference between what the Postal Service would have paid had Public Law 108-18 not been enacted and the contributions required under the act. It varies every year. For FY 2006, the amount is estimated to total \$3.1 billion.

***Can it be mitigated?***

Allowing the Postal Service to freely use the monies scheduled for the escrow account would remove the cost burden. This removal would require legislation. The Postal Service has proposed using the savings to keep postal rates low and to prefund retiree health benefits.

**CSRS Military Service**

***What is it?***

Public Law 108-18, which reduced the Postal Service's annual CSRS payments, also required the Postal Service to fund the value of CSRS benefits attributable to the military service of current and former employees. These costs, previously the responsibility of the Treasury and funded through appropriations, relate to military service performed before the individuals became postal employees. According to the Postal Service, employees earned more than 90 percent of these obligations before the creation of the Postal Service on July 1, 1971.

### ***How is it a burden?***

Almost no other federal agency pays CSRS military service costs.<sup>3</sup> We believe it is not appropriate for Postal Service customers to pay, through postage, for these costs when the military is clearly an obligation of the federal government. The use of stamps to pay defense costs is, in essence, a “hidden tax” on Postal Service customers. Both the President’s Commission and stakeholders in the mailing industry have supported returning these costs to the Treasury.

In its proposal regarding military service payments requirements, the Postal Service gives several additional reasons why it should not pay for CSRS military service costs. Military service and civilian service are separate and distinct and, historically, the Treasury has borne the CSRS costs of military service. Also, most of the creditable service years were earned prior to the creation of the Postal Service and the transfer of these costs to the Postal Service is retroactive. Moreover, the Postal Service believes it is not appropriate to transfer military service costs in exchange for giving the Postal Service the benefit of its CSRS overpayment. They are unrelated and there is no justification under actuarial or financial practice for relating them. The Postal Service should get proper credit for its own contributions without any penalty.

### ***Can it be quantified?***

The total CSRS military service liabilities transferred to the Postal Service under Public Law 108-18 equal \$27 billion. The Congressional Budget Office has estimated that removing this obligation will save the Postal Service \$1.8 billion in FY 2006.

### ***Can it be mitigated?***

CSRS costs associated with military service could be transferred back to the Treasury. We believe ratepayers should not have to pay for a common obligation of U.S. citizens through postage.

### **Conclusion**

Two of five cost burdens – Alaska Bypass Service and DOT regulation of international air transportation rates – have operational implications. The Postal Service can make estimates, but the true costs cannot be known until they are fixed. Providing Alaska Bypass Service is not necessary to carry out the Postal Service’s mission of universal mail service, but it is at least related to it. Additionally, Congress has recently introduced new laws to reduce the burden of

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<sup>3</sup> According to the GAO, Power Marketing Administrations, self-supporting entities under the Department of Energy, have agreed to pay military service costs. The Metropolitan Washington Airports Authority also pays these costs for certain employees who transferred from the Federal Aviation Administration. Many other self-supporting entities, however, do not.



Alaska Bypass Service on the Postal Service. There is, however, no compelling reason for the continued regulation of international mail air transportation rates, particularly since most domestic air transportation rates have long been deregulated.

The Medicare Part D, CSRS escrow account, and CSRS military service issues relate specifically to the way Postal Service and federal government costs are commingled. The Postal Service can measure these costs. Lifting them may require administrative changes, but not operational changes.

All of these burdens are political. Most affect the federal budget. They all raise important questions as to whether Postal Service ratepayers should pay for unique, politically controlled costs unrelated to universal postal service.

To run in a businesslike manner, the Postal Service should not be burdened with costs unnecessary for core operations, and these costs are not negligible. They constitute a combined annual cost of approximately \$5.2 billion. To put this in perspective, removing these five burdens would be equivalent to avoiding a three-cent increase in the First-Class stamp price. Ratepayers deserve to pay only the costs essential to the Postal Service's core mission.

## Appendix 1: References

### Medicare Part D

#### United States Postal Service publications

*2004 Annual Report.*

*2005 Annual Report.*

“Postal Service Applies as Medicare Part D Provider,” United States Postal Service News Release No. 05-093, November 3, 2005.

#### GAO publication

*Retiree Health Benefits: Options for Employment-Based Prescription Drug Benefits under the Medicare Modernization Act*, Report Number GAO-05-205, February 14, 2005.

#### Other publications

Congressional Budget Office, *A Detailed Description of CBO’s Cost Estimate for the Medicare Prescription Drug Benefit*, July 2004.

Department of Health and Human Services, Centers for Medicare & Medicaid Services, *Medicare Program; Medicare Prescription Drug Benefit; Final Rule*, 70 Fed. Reg. 4193-4741, January 28, 2005.

### Alaska Bypass Service

#### USPS Office of Inspector General publication

*Intra-Alaska Bypass Mail Service*, Product Number CQ-OT-02-005, August 2, 2002.

#### Other publications

“Changes in bypass mail bury some, buoy others,” *Alaska Journal of Commerce*, Melissa Campbell, July 17, 2005, available at [www.alaskajournal.com/stories/071705/hom\\_20050717019.shtml](http://www.alaskajournal.com/stories/071705/hom_20050717019.shtml).

“Stevens Legislation to Improve Bypass Mail System Passes Senate,” Senator Stevens’ Press Release, July 24, 2002.

## **International Air Transportation**

### USPS Office of Inspector General publication

*Department of Transportation's Regulation of International Mail Air Transportation Rates (draft).*

### GAO publication

*International Mail Air Transportation: Proposed Changes to the Rate-setting Process, Report Number GAO-05-529R, April 8, 2005.*

### Other publication

H.R. 22 The Postal Modernization Act of 1999 Section-by-Section Analysis, available at [lobby.la.psu.edu/021\\_Postal\\_Service\\_Reform/frameset\\_postal.html](http://lobby.la.psu.edu/021_Postal_Service_Reform/frameset_postal.html).

## **CSRS Escrow Account and Military Service**

### United States Postal Service publication

Direct Testimony of William P. Tayman, Jr. on Behalf of United States Postal Service (USPS-T-6), Postal Rate Commission Docket No. R2005-1, April 8, 2005.

### USPS Office of Inspector General publication

*Postal Service's Funding of the Civil Service Retirement System, Product Number FT-OT-04-002, April 9, 2004.*

### GAO publications

*United States Postal Service: Information on Retirement Plans, Report Number GAO-02-170, December 2001.*

*Review of the Office of Personnel Management's Analysis of the United States Postal Service's Funding of Civil Service Retirement System Costs, Report Number GAO-03-448R, January 31, 2003.*

*Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings, Report Number GAO-04-238, November 26, 2003.*

*Postal Pension Funding Reform: Review of Military Service Funding Proposals, Report Number GAO-04-281, November 26, 2003.*

### Other publications

Congressional Budget Office, *The Effects of S. 662 on the Long-Term Financial Outlook of the U.S. Postal Service*, September 1, 2005.

Congressional Budget Office, *Cost Estimate of S. 662, Postal Accountability and Enhancement Act*, July 1, 2005.

Congressional Research Service, *Funding Postal Service Obligations to the Civil Service Retirement System*, Report Number RL31684, February 25, 2003.

Statement of the Honorable Dan G. Blair, Deputy Director Office of Personnel Management, at a Hearing of the Subcommittee on Transportation, Treasury and Independent Agencies Committee on Appropriations, U.S. House Of Representatives, on Proposed Legislative Changes in U.S. Postal Service Payments to Fund Retirement Benefits for Postal Employees under the Civil Service Retirement System, March 27, 2003.

United States Senate Committee on Governmental Affairs, *Postal Civil Service Retirement System Funding Reform Act of 2003*, Senate Report No. 35, 108th Congress, 1st Session, April 8, 2003.

## Appendix 2: Summary Table

| Issue                                   | Burden  | Cost  | Possible Mitigation   |
|---|---|---|---|
| <b>Medicare Part D</b>                  | CMS, in consultation with OPM, has rejected the Postal Service's application for the new prescription drug rebate available to sponsors of qualified prescription drug coverage. Therefore, Postal Service ratepayers cannot benefit from the rebate. | \$250 million annually <sup>[a]</sup>           | CMS and OPM could allow the Postal Service to receive the Medicare Part D rebate.             |
| <b>Alaska Bypass Service</b>            | The Postal Service provides bypass mail service for commodities in Alaska at a loss; the DOT sets transportation rates.   | \$50 million annually <sup>[b]</sup>            | The Postal Service could receive compensation for this service or more freedom to perform it. |
| <b>International Air Transportation</b> | The Postal Service generally must pay DOT-regulated rates for international mail air transportation and use U.S.-flag carriers.   | \$40 million annually as of 1999 <sup>[c]</sup> | The Postal Service could be allowed to contract for international mail air transportation.    |
| <b>CSRS Escrow Account</b>              | The Postal Service overpaid its CSRS obligations. Congress allowed it to reduce its payments until 2006 when the savings is placed in escrow.   | \$3.1 billion for FY 2006 <sup>[d]</sup>        | The Postal Service could be allowed to use the funds in escrow as it sees fit.                |
| <b>CSRS Military Service</b>            | The Postal Service is now responsible for paying the CSRS costs associated with its retirees' military service.   | \$1.8 billion for FY 2006 <sup>[e]</sup>        | The Treasury could again assume the obligation for retirees' military service.                |

[a] United States Postal Service News Release No. 05-093, November 3, 2005.

[b] *Alaska Journal of Commerce*, Melissa Campbell, July 17, 2005, available at [www.alaskajournal.com/stories/071705/hom\\_20050717019.shtml](http://www.alaskajournal.com/stories/071705/hom_20050717019.shtml).

[c] H.R. 22 The Postal Modernization Act of 1999 Section-by-Section Analysis, available at [lobby.la.psu.edu/021\\_Postal\\_Service\\_Reform/frameset\\_postal.html](http://lobby.la.psu.edu/021_Postal_Service_Reform/frameset_postal.html).

[d] Direct Testimony of William P. Tayman, Jr. (USPS-T-6) in Docket No. R2005-1, p. 11.

[e] Congressional Budget Office, *Cost Estimate of S. 662, Postal Accountability and Enhancement Act*, July 1, 2005, Table 2, CSRS on-budget effects.