

**Report to the Postal Regulatory  
Commission on:**

**CIVIL SERVICE RETIREMENT SYSTEM COST  
AND BENEFIT ALLOCATION PRINCIPLES**

June 29, 2010

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June 29, 2010

Postal Regulatory Commission  
Attn: Ms. Margaret Cigno  
901 New York Ave., NW  
Washington, DC 20268

Dear Ms. Cigno:

We are please to present our report and recommendations with respect to the allocation of Civil Service Retirement System costs and benefits between the former Post Office Department and the US Postal Service.

Please contact us with any questions regarding this report.

Very truly yours,

A handwritten signature in black ink that reads "Thomas D. Levy". The signature is written in a cursive style with a prominent flourish at the end.

Thomas D. Levy, FSA, MAAA, EA  
Senior Vice President & Chief Actuary



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Retirement System Cost and Benefit Allocation Principles**  
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# Executive Summary

The *Postal Reorganization Act of 1970* (PRA or P.L. 91-375) established the United States Postal Service (USPS) as an autonomous Federal entity and transferred the responsibilities of the Post Office Department (POD), a US government agency, to USPS. One of the requirements was the continued participation of USPS in the Civil Service Retirement System (CSRS), thus ensuring continuity of pension coverage for postal workers. It was therefore necessary to determine how to allocate pension costs for pre-1971 service between the taxpayer-supported POD and the rate-payer-supported USPS.

CSRS has a final average salary, back-loaded benefit formula. By this, we mean that the pension is computed as a percentage of a worker's high three-year average salary, and that the percentage increases non-uniformly with additional service—the annual accrual rate is 1.50% of final average salary for each of the first five years, 1.75% for each of the next five years, and 2.00% for each year thereafter, to a maximum of 80%. The high three-year average salary is computed based on the combined compensation with POD and USPS for those whose postal employment began before the implementation of the PRA.

To date, the cost and benefit allocation has been straightforward. POD has been charged with the cost of a “frozen” benefit as of June 30, 1971, based solely on the accrued pension percentage and final rate of pay at that time. Everything else has been allocated to USPS. One argument for this approach was that any increases after that date were solely the result of decisions made by USPS, so USPS should bear the cost. This allocation has been implemented by the Office of Personnel Management (OPM).

In a report dated January 20, 2010, the USPS Office of the Inspector General (USPS-OIG) put forth the proposition that this allocation “is inequitable and has resulted in the Postal Service overpaying \$75 billion to the pension fund.”<sup>1</sup> USPS has asked the Postal Regulatory Commission (PRC) to provide its opinion on the fairness and equity of the OPM allocation methodology. This study is part of the PRC's response to that request.

To The Segal Company (Segal), this project is effectively a cost accounting analysis that requires specialized pension actuarial knowledge. Fairness and logic imply that the POD should pay the costs, including pension costs, related to service provided by postal employees before July 1, 1971, and USPS should pay those costs related to service thereafter. In 1970, the accounting profession provided little guidance as to the appropriate way to allocate pension costs to time periods. In 2010, there is a great deal of such guidance, primarily in the current set of corporate pension accounting standards—FASB ASC<sup>2</sup> 715, *Compensation – Retirement Benefits*. Additional sources are GASB 27,<sup>3</sup> the pension accounting standard for state and local governments, and SFFAS 5, the pension accounting standard for the Federal Government.<sup>4</sup>

<sup>1</sup> USPS-OIG Report Number RARC-WP-10-001.

<sup>2</sup> Financial Accounting Standards Board—Accounting Standards Codification; formerly SFAS Nos. 87 and 158.

<sup>3</sup> Statement No. 27 of the Governmental Accounting Standards Board, “Accounting for Pensions by State and Local Governmental Employers.”

<sup>4</sup> Statement of Federal Financial Accounting Standards Number 5, “Accounting for Liabilities of the Federal Government,” promulgated by the Federal Accounting Standards Advisory Board (FASAB).

The differences between OPM and USPS-OIG are primarily in two areas. OPM fully reflects the lower accrual rates during the first ten years of service and does not include any factor for increased future compensation that increases the value of pension credit earned during POD service. USPS-OIG, on the other hand, allocates costs assuming uniform benefit accruals throughout a worker's career, and assigns the value of post-POD salary increases to POD accruals based on that allocation. Segal sees both of these positions as within the range of acceptable allocations of costs and benefits to service periods. However, we do not believe that the OPM methodology is "fair and equitable" except within the context of P.L. 93-349, the 1974 legislation that underlies the OPM methodology.

Because the issue relates to a decision taken nearly four decades ago, the accumulated difference to 2010 in CSRS assets allocable to USPS has grown quite large—estimated by USPS-OIG to be \$75 billion with respect to past benefit payments and perhaps an additional \$10 billion with respect to future benefit payments. The layperson may be astonished to find that a range of this magnitude is entirely within appropriate allocation methods. As we look at the various allocation methods that have been used in the public and private sectors, however, we have observed both methodologies used in good faith, and therefore are not prepared to assert that either is inappropriate in 2010. However, our preferred approach, particularly in light of FASB ASC 715, is an allocation methodology that lies between the two methodologies.

FASB ASC 715 is quite clear with respect to the two areas of disagreement. An employer is required to reflect the actual benefit accrual formula embodied in a pension plan, as OPM does. An employer is also required to reflect the impact of future salary increases on current accruals in a "high" or "final" average salary plan, as USPS-OIG does. Neither of these requirements is discretionary. While these are private industry accounting standards, we believe that their general application to the current situation is logical and, within the objective of fairness and equity, represents our preferred set of principles as well as a reasonable compromise.

Within this model, one difficult task is the determination of the appropriate level of post-1971 salary increases that should be reflected in the POD allocation. We do not believe there is a clear answer to this question, but this report lays out some options to consider.

The above recommendation is, in essence, a 2010 fresh look, and does not attempt to deal with the history accumulated over forty years since the PRA was enacted. Should it be accepted, there are clearly major fiscal issues that will have an impact on both the Federal and USPS budgets. The political realities of addressing something of this magnitude, and the consequence of decisions that the parties have lived with for decades, are beyond the scope of this study. The stakeholders have a challenging task ahead of them in incorporating that history into an action plan.

# Historical Overview

## Background

The *Postal Reorganization Act of 1970* (PRA or P.L. 91-375) established the United States Postal Service (USPS) as an autonomous Federal entity and transferred the responsibilities of the Post Office Department (POD), a US government agency, to USPS. One of the requirements was the continued participation of USPS in the Civil Service Retirement System (CSRS), thus ensuring continuity of pension coverage for postal workers. It was therefore necessary to determine how to allocate pension costs for pre-1971 service between the taxpayer-ratepayer-supported POD and the ratepayer-supported USPS.

CSRS has a final average salary, back-loaded benefit formula. By this, we mean that the pension is computed as a percentage of a worker's high three-year average salary, and that the percentage increases non-uniformly with additional service—the annual benefit accrual rate is 1.50% of high three-year average salary for each of the first five years, 1.75% for each of the next five years, and 2.00% for each year thereafter. The final average salary is computed based on the combined compensation with POD and USPS for those whose postal employment began before the PRA.

To date, the cost and benefit allocation has been straightforward. POD has been charged with the cost of a “frozen” benefit as of June 30, 1971, based solely on the accrued pension percentage and final rate of pay at that time. Everything else has been allocated to USPS. This allocation is derived from P.L. 93-349 (1974). The apparent premise was that any increases after that date were solely the result of decisions made by USPS, so USPS should bear the cost.<sup>5</sup> This allocation has been implemented consistently by the Office of Personnel Management (OPM). There have been various funding and allocation acts subsequent to 1974, but OPM believes that none of them have explicitly altered this fundamental principle. It should be noted that USPS-OIG believes that P.L. 108-18 (2003) in particular is effectively a repeal of P.L. 93-349, and that OPM's implementation of P.L. 108-18 is incorrect.

Starting in 2003, USPS has raised questions about the equity of this allocation. In August 2004, the Board of Actuaries of CSRS, three highly respected actuaries from the private sector, described the OPM methodology as “a common practice” in the private sector and “the most appropriate way to determine the obligations of the Postal Service.”<sup>6</sup> This was followed by a letter from OPM to the Postmaster General rejecting any change.<sup>7</sup>

Subsequently, USPS-OIG retained an actuarial consulting firm, The Hay Group, to prepare a report on these issues, which report was submitted January 11, 2010.<sup>8</sup> This report was incorporated into a report from USPS-OIG dated January 20, 2010 entitled “The Postal Service's Share of CSRS Pension Responsibility.”<sup>9</sup> These documents strongly asserted that the OPM methodology is inequitable, resulted in a \$75 billion understatement of the USPS asset allocation with respect to CSRS, and must be changed.

<sup>5</sup> As discussed later, there is some question as to the validity of this proposition.

<sup>6</sup> Letter from Douglas C. Borton to Dr. Ronald P. Sanders dated August 18, 2004.

<sup>7</sup> Letter from Ronald P. Sanders to The Honorable John E. Potter dated September 16, 2004.

<sup>8</sup> U.S. Postal Service—Evaluation of the USPS Postal CSRS Fund for Employees Enrolled in the Civil Service Retirement System.

<sup>9</sup> USPS-OIG Report Number RARC-WP-10-001.

On February 23, 2010, as modified March 2, 2010, USPS requested that the PRC initiate a review of decisions made by OPM regarding USPS's CSRS assets and issues highlighted in the USPS-OIG report. The request was filed pursuant to section 802(c) of the Postal Accountability and Enhancement Act (PAEA) of 2006, P.L. 109-435, requesting PRC's opinion on the fairness and equity of the current OPM method used to apportion the CSRS obligation between USPS and POD. That eventually led to the awarding of the current contract to The Segal Company and to the preparation of this report.

On April 15, 2010, John O'Brien, Director of Planning and Policy Analysis of OPM, made a presentation to the House Committee on Oversight and Government Reform, indicating that, in OPM's view, existing legislation unequivocally required use of the OPM methodology.<sup>10</sup> He asserted, with respect to the USPS position, "Other than one technical flaw<sup>11</sup>, this is not an inconceivable approach. While it may be worthy of future consideration by Congress, OPM believes that it is not possible based upon current legislation." However, we have also received a document that posits that P.L. 93-349 has been superseded by P.L. 108-18 and the PAEA, and that implementation of the USPS-OIG methodology does not require Congressional action.<sup>12</sup>

## Legal History and Issues

As indicated above, there is a difference of opinion as to whether the existing legislation compels the omission of post-1971 pay increases in a 2010 analysis or not. Segal is not a law firm, and is therefore not in a position to render a legal opinion on this important matter. Nonetheless, we are prepared to discuss the positions and their persuasiveness.

Both USPS-OIG and OPM appear to agree that P.L. 93-349 was intended to prohibit allocating the impact of post-1971 final average salary increases to the POD. The question is primarily whether or not P.L. 108-18 and the PAEA continued that prohibition. Based on our discussions with the parties, it may not be necessary to answer this question in order to reach a conclusion on the best way to resolve the dispute. Should there be a recommendation to choose something other than continuation of the present OPM methodology, many on both sides suggest that it would be best if Congress itself were to provide the answer, and explicitly incorporate the change in new legislation. Although the ideal implementation methodology may well be new legislation if that is a realistic option, we believe the current legislative framework can accommodate a change.

USPS-OIG also presented a proposed allocation of the \$75 billion "adjustment" in their report. There is apparent agreement that this allocation is not legally permitted until 2015. Thus, any earlier change in the disposition of a reallocation would apparently require legislation.

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<sup>10</sup> Statement of John O'Brien, Director of Planning and Policy Analysis, US Office of Personnel Management before the Committee on Oversight and Government Reform, United States House of Representatives, on Who Owes Who What? An Examination of the United States Postal Service's Civil Service Retirement System Pension Contributions. April 15, 2010 (O'Brien Statement). This same testimony also has been provided to us with the title, "Continuing to Deliver: An Examination of the Postal Service's Current Financial Crisis and its Future Viability."

<sup>11</sup> "As proposed, this new methodology fails to recognize that annuities accrue more slowly during the first ten years of service." (Footnote in original)

<sup>12</sup> Statement of Vincent Giuliano on Behalf of Postcom before the Subcommittee on Federal Financial Management, Government Information, Financial Services and International Security on the Future of the U.S. Postal Service, May 5, 2010.

# Public Sector and Private Industry Models

## Public Sector Models and Accounting

Our understanding is that USPS is the only Federal employer participating in CSRS that is responsible for paying the actuarial cost for its own employees and retirees. Thus, there are no other examples at the Federal level that might shed light on the “fair” allocation of pension costs to different time periods. USPS-OIG suggests that the allocation of pension costs with respect to the District of Columbia might be relevant. In our view, that was such a specialized “rescue” situation that it cannot reasonably be taken as a precedent for other circumstances.

We have researched State and municipal spin-offs and transfers, but have not identified any situations that are useful, in our judgment, as guides to what is fair and equitable with respect to the allocation of pension costs for USPS.

Federal accounting standards, as incorporated in SFFAS 5, appear to require the use of projected salaries and a cost allocation that does not vary from year to year based on differences in accrual rates.<sup>13</sup> Thus they are most consistent with the USPS-OIG position.

State and local accounting standards, as incorporated in GASB 27, appear to require the use of projected salaries,<sup>14</sup> but allow discretion with respect to how variations in the accrual formula are reflected. GASB recently issued its “Preliminary Views” on potential changes in pension accounting, and that document, too, would not allow variations based on differences in accrual rates.<sup>15</sup>

## Private Sector Models and Accounting

Much has been made of the so-called private industry model for purchase or spin-off transactions as a source for guidance. We respectfully dissent from the view that there is much of relevance in private sector precedents—certainly there is not enough to claim the existence of a definitive model. The reasons for this are straightforward, and include:

1. It is almost unprecedented to have a transfer of ownership of a private enterprise where the buyer becomes a participating employer in the seller’s pension plan.
2. In a typical transaction involving the sale of a business unit that has a defined benefit pension plan, there is an exchange of cash and/or securities from the buyer to the seller. This represents the market value of the entire enterprise. While each party may have in mind an adjustment to the purchase price to reflect the pension plan, they may not be the same, or their individual pricing models may serve some tax or non-pension accounting purpose, or it may reflect the relative importance to one of the parties of closing the deal. In the absence of an actual market for parties buying and selling pension plans based on final average pay to others independent of anything else, we do not believe one can say with authority that the private sector has a definitive model that clearly suggests what is appropriate in the USPS situation.

<sup>13</sup> SFFAS 5, paragraph 71.

<sup>14</sup> GASB 27, paragraph 10.

<sup>15</sup> See [www.gasb.org/cs/ContentServer?c=Document\\_C&pagename=GASB%2FDocument\\_C%2FGASBDocumentPage&cid=1176156938122](http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176156938122)



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

## A Hypothetical Illustration

It is possible to describe a hypothetical situation that could be used as a model, however, and that shows how FASB's views on this subject could be useful for analyzing the current case. The financial accounting approach for spin-offs in the private sector is perhaps best demonstrated by the scenario below.

A willing buyer and a willing seller negotiate an agreed-upon price for a division of a corporation. This price reflects an ongoing business valuation. Immediately prior to the sale, both the buyer and seller realize that the division has a stand-alone partially funded final average pay defined benefit pension plan. The buyer and seller now engage in a conversation concerning the purchase price—how, if at all, should the purchase price be adjusted to reflect the existence of this defined benefit plan, which is now known to be part of the purchase?

The buyer and seller had both agreed prior to the discovery of the existence of the pension plan that the purchase price for this division reflected their best estimate using a reasonable set of assumptions as to the future profitability (and/or balance sheet) of the division without reflecting the existence of the defined benefit pension plan. Both the buyer and seller agree that, in order to maintain this future profitability (and/or balance sheet) of the division, no material changes can be made in the defined benefit plan (e.g., failure to extend the defined benefit plan coverage to employees after the transfer would cause them to leave in droves).

In this situation, under FASB purchase accounting, the buyer will be forced to have an additional entry on its opening balance sheet. The addition will be the unfunded PBO (projected benefit obligation), which is a measurement of the portion of the future benefit promise *including future salary increases and reflecting the plan's benefit accrual formula* that is allocable to service rendered prior to the acquisition.

Of course, what happens next would be the subject of negotiations, but in a theoretical accounting world, some transaction price adjustment would need to take place. Perhaps the simplest approach would be to adjust the purchase price by the unfunded PBO.

In summary, the price adjustment would be negotiated and might reflect part, all, or none of the impact of future salary increases. In reality, it is unlikely that the parties would suddenly discover a pension plan after negotiations were otherwise concluded. But the buyer's financial statements would in fact be required to reflect the impact of anticipated future salary increases on past accruals and the plan's actual benefit formula.

## FASB Requirements

The above discussion relates to transactions and the balance sheet accounting for them. FASB ASC 715 also deals with income statement accounting treatment. Since publicly traded corporations are expected to accurately report their profits and losses, this is a matter of great importance to many companies. A basic concept underlying that accounting is that the costs of producing revenues, including wages and deferred compensation such as pensions earned for service rendered, should be charged to the same time period as the resulting revenues. To us, that is the crux of this project—what pension costs should be allocated to the pre-1971 POD revenues and what pension costs should be allocated to the post-1971 USPS revenues?

FASB ASC 715 explicitly requires that the “Service Cost”—the value of new pension accruals in the current year—reflect both the plan’s benefit accrual formula (as OPM does and USPS-OIG does not do) and anticipated future salary increases to the extent that they will increase the value of the current accruals (as USPS-OIG does and OPM does not do). These accounting standards did not exist in the 1970s, but have been in place for over 20 years and are an unchallenged part of generally accepted accounting principles today. We believe that this establishes a compelling definition of cost allocation equity for 2010.<sup>16</sup>

## Compensation Calculations

If some but not all of USPS’s salary increases after June 30, 1971 are to be reflected in an adjustment to USPS’s allocated share of CSRS’s assets, it will be necessary to determine which components are to be included and which are to be excluded. These components (which are neither exhaustive nor mutually exclusive) include the following:

- Across-the-board increases due to inflation, whether or not they are the result of automatic cost-of-living adjustments (COLAs);
- Across-the-board increases due to improved productivity and changes in the skills required of postal workers;
- Increases mandated by Congress in the PRA by the requirement that postal salaries be comparable with those in private industry;<sup>17</sup>
- Increases that would have been provided had the POD continued in existence, which might or might not have been comparable to increases for other Federal employees;
- Increases due to normal movement through the postal pay structure tables with increased seniority, and changes in the period required to reach the top step; and
- Increases due to individual promotions.

The actual implementation of that determination will, we suspect, be quite complex if it is to be done accurately with respect to each individual. It may be simplest and satisfactory to use actual USPS compensation amounts as reflected in the eventual pension entitlements. Anything else requires affirmative difficult decisions as to which of the increases identified above should be included and which should be excluded, followed by the equally difficult task of quantifying those aspects.<sup>18</sup> We do note that the choice of compensation methods is material, and this issue should be considered with recognition of both the complexity and the equity issues.

<sup>16</sup> For companies that were not already accounting for pensions using these rules, there was an option of taking the difference and amortizing that amount over a period of years, adjusted for interest. That transition period has now expired for virtually all publicly traded companies.

<sup>17</sup> P.L. 91-375, Section 101(c).

<sup>18</sup> Fortunately, post-2010 increases are almost certainly immaterial, as there would be little POD service for current USPS employees.

# Critique of Methodologies and Positions

## Critique of the OPM Methodology and Position<sup>19</sup>

The “OPM Methodology” is grounded on P.L. 93-349 and its apparent mandate to allocate to USPS all pension costs except those related to pensions earned as of June 30, 1971, based on compensation as of that date.<sup>20</sup> The record indicates that this allocation was motivated by a concern that the Federal government would have no control over the future compensation of USPS employees, so USPS should bear the entire cost of such increases, including the impact on past postal accruals. OPM also believes that the 2003 legislation (P.L. 108-18) does not change this mandate. The US Government Accountability Office (GAO) told us that at the time they never considered whether that later legislation affected the allocation options.<sup>21</sup>

OPM does not claim that its methodology is the only reasonable one. However, it does claim that its methodology reflects Congressional intent and is consistent with actuarial practice. OPM believes that the Postal Service’s proposed methodology is not possible based upon current legislation. With respect to the USPS-OIG methodology, they accept that it is a reasonable alternative in most respects, but dispute its uniform allocation of pension responsibility across all years of service, claiming that allocation is flawed when the CSRS benefit accrual formula provides lower accrual rates for the first ten years of service than thereafter.

OPM does, claim, however, that its methodology “produces a fair and equitable allocation of the responsibilities regarding the payment of pensions to certain Postal employees.”<sup>22</sup> In our discussions with them, they make it clear that this is in the context of P.L. 93-349; it is not an abstract generic position. OPM cites as support for its view the Borton letter (see note 6) on behalf of the CSRS Board of Actuaries. That letter, we believe, also takes P.L. 93-349 as a given and is commenting on OPM’s implementation of that law. In short, OPM does not claim that the OPM methodology would be “the most appropriate way to determine the obligations of the Postal Service” in the absence of that law.<sup>23</sup>

As indicated previously, we do not believe that it is appropriate to have the POD allocation disregard all post-1971 compensation increases. In the absence of the PRA, the pre-1971 accruals

<sup>19</sup> See O’Brien Statement at Note 10.

<sup>20</sup> We were advised orally by OPM that the allocation to the POD uses the final rate of pay at June 30, 1971, not the final average salary at that date. This distinction is important, because there were significant postal pay increases in the three-year period preceding that date.

<sup>21</sup> Oral discussion with GAO staff, June 8, 2010. We have spoken with the GAO to ensure our understanding of their response to our questions during the Segal face-to-face meeting on June 8, 2010, and Director, Physical Infrastructure Issues, Phillip Herr’s response to Congress March 18, 2010 during the Appropriations Committee meeting with Sen. Durbin (D-IL) and Sen. Collins (R-MA). During our discussion with the GAO they told us that at the time they evaluated/reviewed the 2003 legislation (P.L. 108-18), they never considered whether that legislation affected the allocation options, and that the GAO will not speculate on the intent of Congress. Their response spoke only to the allocation policy established by Congress. GAO further stated that Director Herr responded to a question posed by Sen. Collins regarding the GAO view of the USPS-OIG study findings methodology, and that he communicated the GAO position that the OPM methodology is appropriate and that the GAO agrees with the OPM approach.

<sup>22</sup> See O’Brien Statement at Note 10.

<sup>23</sup> Oral discussion with OPM staff May 19, 2010.

would have increased in value with future compensation increases, and those increases would have been an expense of the POD. For the creation of USPS to reduce the POD obligation with respect to POD service is not explicitly contemplated by PRA and is not a logical or equitable outcome.

### Critique of the USPS-OIG Methodology and Position<sup>24</sup>

The USPS-OIG methodology suggests that fairness requires both (a) recognition of the impact on POD allocations of USPS salary increases and (b) pro-rating accruals uniformly over years of service, without regard to the actual accrual formula. They believe that the restriction with respect to application of future salary increases to POD service was lifted by P.L. 108-18.

We are supportive of the basic concept that post-1971 compensation increases are an appropriate part of a fair allocation. Had USPS never been created, the pre-1971 accruals clearly would have been increasing in value with post-1971 compensation increases. As discussed above, private sector generally accepted accounting principles demand that such increases be included in the determination of a company's profits at the time the service is rendered, not when the salary increases are given. Inclusion of anticipated future salary increases is also standard procedure in public sector accounting and contribution determinations. In effect, P.L. 93-349 gave the POD a lower pension cost for pre-1971 service because of the creation of USPS than it otherwise would have had, using FASB ACS 715, GASB 27, or SFFAS 5. We accept that the PRA was a "total package," and that there may have been other parts of the PRA that went the other way economically and warranted this outcome, but nothing we have seen or heard suggests that Congress justified the P.L. 93-349 treatment on anything other than the lack of Federal control with respect to future compensation levels. Indeed, P.L. 93-349 was passed several years after the PRA, suggesting that little consideration was given to pension cost allocation in 1970.

USPS-OIG believes that a pro-rata allocation of pension accruals without reference to the accrual formula is appropriate for many reasons. They note that they have no control over the CSRS allocation formula, and could have chosen a different pension accrual formula if the PRA had not compelled CSRS participation. They contend it is unfair for them to pay more simply because they were the second employer of the affected employees. They also contend a pro-rata allocation is consistent with the Congressional mandate that Cost-of-Living Adjustments (COLAs) be allocated pro-rata, that a pro-rata application of retiree health benefit costs is mandated by Congress, and that the OPM actuarial valuations use a methodology that does not vary the cost by which portion of the accrual formula currently applies to an individual. As we are charged with providing a "fresh look" without an objective of consistency with prior laws or practice, we do not take any of these arguments as persuasive. Rather, we think that the private sector accounting principle—that the best measure of pension cost is the value of the projected accruals as defined by the plan's formula—is persuasive.

USPS-OIG estimates that application of its methodology, including reflection of actual USPS pay increases, would result in a \$75 billion increase in the USPS asset allocation under CSRS and proposes a number of uses for this sum, all of which would have the effect of lowering USPS' cost of operations.<sup>25</sup> The estimate itself is a fairly straightforward determination prepared by The Hay

<sup>24</sup> The Postal Service's Share of CSRS Pension Responsibility, January 20, 2010.

<sup>25</sup> The proposed uses are to fully fund the CSRS actuarial liability and the retiree medical actuarial liability. We understand that neither of the proposed uses of these resources is permissible prior to 2015 in the absence of

Group through 2006 and extended by USPS-OIG through 2009.<sup>26</sup> We note that this calculation is purely retrospective. For each past year, the actual benefit payments were reallocated to POD service based on the USPS-OIG allocation proposal, and the resulting asset value was compared to the OPM value. It should be noted that future benefit payment charges would also be reduced, although by steadily decreasing amounts. Thus the estimated September 30, 2009 total economic benefit to USPS of a change to the USPS-OIG methodology would actually exceed \$75 billion by another \$10 to 11 billion under their methodology – the projected difference in future benefit payments using USPS-OIG’s methodology.

Please note that the above amounts are only rough estimates. To the extent possible, actual allocations by individual retiree should be prepared by the OPM actuaries to provide greater accuracy.

## Possible Allocation Methodologies

Actuarial literature and practice include a variety of alternatives for allocating pension costs to time periods. These generally fall into either of two broad categories—*benefit allocation methods* and *cost allocation methods*.

Benefit allocation methods start by assigning benefits to time periods, and then compute for each time period the cost of that benefit. All of the methodologies currently being discussed with respect to the postal workers’ CSRS allocation are benefit allocation methods. This is because the focus is primarily related to adjusting *assets* to reflect alternative allocations of *past benefit payments*, whereas actuarial allocation methods are primarily a forward-looking way to determine *future contributions and expense*.

The OPM methodology assigns the POD period a “frozen” benefit as of June 30, 1971 based on the CSRS benefit formula, participant service, and final rate of pay at that time. The USPS-OIG methodology assigns the POD period a pro-rata (based on service) portion of the actual benefit at time of retirement. The FASB ASC 715 methodology assigns the POD period the benefit based on the CSRS benefit formula and participant service at transition, but reflects a future final average salary rather than a frozen 1971 rate of pay. An example of the differences in these approaches is included on page 13 at the end of this section.

The cost for a participant using a benefit allocation method tends to increase fairly rapidly with increasing age (the benefit is more likely to actually be paid and there are fewer years of investment income between the accrual date and the retirement date).<sup>27</sup> Benefit allocation methods represent the prevailing practice for funding and accounting with respect to private sector single-employer pension plans. The Pension Protection Act of 2006 establishes the minimum funding standards for such plans using a benefit allocation method *with little or no allowance for the impact of future salary increases*.

legislation. Full advance funding of these obligations would be a desirable outcome, and would generally put USPS in a better financial position relative to CSRS than one would find today in private industry, state, or local pension and retiree medical plans.

<sup>26</sup> OPM provided certain input to facilitate these calculations, but has not verified the results. They indicated that they believe the result is of the correct order of magnitude, but that it would require significant effort to confirm the result. GAO responded similarly.

<sup>27</sup> Benefit allocation methods resemble the premium costs of term life insurance in certain respects.

Cost allocation methods start by determining the total amount necessary to provide a plan's promised benefits, and then allocate that cost to time periods, typically either uniformly as a percent of projected career compensation or pro-rated on service. Cost allocation methods are often used for funding and accounting with respect to public sector pension plans and private sector multiemployer plans.

The most common cost allocation method in the US is "Entry Age Normal Cost" (EANC). The present value of all the benefits a plan is expected to pay to an individual is calculated as of a participant's entry age (age at hire). That amount is then spread uniformly over the participant's projected working lifetime, generally as a level percentage of pay for a pay-related plan such as CSRS.<sup>28</sup> This is essentially the "dynamic" method currently used by OPM for its actuarial valuation of the Civil Service Retirement & Disability Fund.

We believe that the approach that both OPM and USPS-OIG are using – determining the USPS asset share in CSRS based on alternative allocations of benefit payments—is the best choice, given that most of the relevant events relate to the allocation of past benefit payments. That is, actuarial theory and practice should by-and-large be ignored. Rather, the current USPS asset allocation should be reconstructed based on whichever option is selected, and future changes in that allocation should follow that same option.

As of September 30, 2009, OPM's determination of USPS's share of CSRS's assets was \$198 billion. This amount was derived by a tracing of USPS contributions, investment income, and allocable benefit payments since 1971. The allocable benefit payments were determined by the OPM methodology – all benefit payments to postal workers except those related to pre-1971 service with no reflection of future salary increases were charged to the USPS.

USPS-OIG duplicated the OPM procedure, but the allocable benefit payments were estimated by the USPS-OIG methodology – a pro rata share of each person's actual benefit based on the ratio of USPS service to total service. This produced a USPS asset share of \$273 billion.

The difference between the two asset shares is \$273 billion – \$198 billion = \$75 billion.

Note that actuarial theory and practice are disregarded by both parties. The determinations are pure cash flow tracings. They differ only by the choice of methodology to allocate benefit payments to USPS. We concur that this is the appropriate way to do these computations.

The USPS-OIG report indicates that USPS's unfunded actuarial liability at September 30, 2009 is \$10 billion using the OPM asset figure of \$198 billion, which is consistent with a total actuarial liability of \$208 billion. A funded ratio of  $\$198/\$208 = 95\%$  would be classified as "well-funded" by both public sector and private sector standards. Using either the USPS-OIG methodology or the Segal Recommendation would not only increase the assets, but also decrease the liability.<sup>29</sup> Thus, either of those options would, without other changes, leave USPS in an overfunded position with respect to CSRS. CSRS has been closed to new entrants for many years, and the number of current

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<sup>28</sup> Cost allocation methods resemble the premium costs of whole life insurance in certain respects.

<sup>29</sup> The liability decreases because *future* benefit payments allocated to USPS will be lower. USPS-OIG estimates that the liability reduction will be roughly \$10 billion using its methodology.

USPS employees still accruing benefits under CSRS is likely to be modest. Therefore, we do not believe a large overfunding amount is required.<sup>30</sup>

### Actuarial Standards of Practice (ASOPs)

OPM has described its methodology as consistent with “generally accepted actuarial practice.” ASOP 4,<sup>31</sup> which deals with the measurement of pension obligations, merely states that, “The attribution...should bear a reasonable relationship to some element of the plan’s benefit formula or the participant’s compensation or service.”<sup>32</sup> If an allocation methodology did not meet this test, that would be important to know. In the present context, we have not heard any suggested methodology that would fail to meet our understanding of ASOP 4.

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<sup>30</sup> The actuarial liability involves assumptions as to uncertain future events. Therefore, actual future experience may reveal that the current computed liability was overstated or understated. To the extent that it turns out to have been understated, this will draw down prior overfunding, if any, or lead to increased future contribution requirements.

<sup>31</sup> [www.actuarialstandardsboard.org/pdf/asops/asop004\\_107.pdf](http://www.actuarialstandardsboard.org/pdf/asops/asop004_107.pdf)

<sup>32</sup> ASOP 4, Section 3.11b.

## Illustration of POD/USPS Allocation Options

- **Hypothetical employee characteristics**
  - 10 years of POD service, final rate of pay = \$10,000, formula accrual = 5 years at 1.5% + 5 years at 1.75% = 16.25%
  - 15 years of USPS service, final average salary = \$15,000, formula accrual = 15 years at 2% = 30%
  - Pension to be allocated—46.25% of \$15,000 = \$6,937.50
- **Benefit allocation—OPM Methodology**
  - POD: 16.25% of \$10,000 = \$1,625.00 (23% of total)
  - USPS: \$6,937.50 – \$1,625.00 = \$5,312.50 (77% of total)
- **Benefit allocation—USPS-OIG Methodology**
  - POD: (10/25) of \$6,937.50 = \$2,775.00 (40% of total)
  - USPS: (15/25) of \$6,937.50 = \$4,162.50 (60% of total)
- **Benefit allocation—Segal Recommendation**
  - POD: 16.25% of \$15,000 = \$2,437.50 (35% of total)
  - USPS: 30% of \$15,000 = \$4,500.00 (65% of total)
- **Estimated Change in USPS Asset Allocation if this is an “Average” Participant**
  - **OPM Methodology—\$0**
  - **USPS-OIG Methodology—\$75B for past allocations, \$10B for future allocations**
  - **Segal Recommendation—\$50 – \$55B for past allocations, \$6 – 8B for future allocations**

Note: The above changes in asset allocation are only rough estimates. To the extent possible, actual allocations by individual retiree should be prepared by the OPM actuaries to provide greater accuracy.



# Segal's View

## Segal's Recommendation

After due consideration of a number of options, reviewing a variety of documents, and listening to the views of other interested parties, we have concluded that, in the context of 2010 professional literature and our own experience, the FASB private sector generally accepted accounting principles applicable in the United States (and, incidentally, in most other parts of the world) with respect to pensions provide a well reasoned, widely respected, historically stable guidepost for allocating pension costs to time periods. Those principles require that benefit accruals allocated to a time period reflect a plan's accrual formula (as proposed by OPM) and the impact of future compensation increases on benefits as they accrue (as proposed by USPS-OIG). We believe that it is a fair and equitable allocation methodology, and, absent issues relating to historical legislation and practice, is an appropriate methodology for allocating CSRS benefits between those that are rightly the responsibility of USPS and those that relate back to POD service.

We do not believe that it is fair, equitable, or appropriate to disregard post-1971 compensation increases with respect to POD service except in the context of Congressional legislation and the explicit direction of P.L. 93-349.

We selected a methodology that takes the benefit accrual formula into account, as OPM does, rather than one that allocates benefits pro-rata without regard to the CSRS formula (as USPS-OIG does). We believe pension plan design typically reflects human resources objectives, and that the benefit formula allocation methodology is therefore preferable. However, we believe that a pure service-based allocation is also within the range of "fair and equitable" options.

We are not prepared to make a specific recommendation as to what compensation should be used for this allocation. This is an important and difficult matter to be considered, and it may be that using actual compensation is the most practical option.

The FASB accounting standards have a variety of other requirements related to selection of actuarial assumptions, accounting statement presentation, plan changes, and variations from expected experience. We believe that these aspects are not appropriate with respect to entities such as the Federal government and USPS that are not subject to private sector market valuations, insolvency risks, mergers, acquisitions, taxation, and other daily realities of private corporations. As a result, we believe that the dynamic actuarial model and assumptions of OPM are a better basis for determining future projections than the FASB ACS 715 model. The latter has a short-term, enterprise valuation focus that is not appropriate, in our opinion, for public sector enterprises.

With regard to past events such as retirements and other terminations of employment, which dominate the implementation of this or any other allocation change, we believe that actual experience should be reflected, subject to reasonable estimates where the required data is not readily available.

## Implementation Issues

Once there is a decision with respect to a preferred methodology for allocating pension costs between the POD period and the USPS period, there are a number of steps that we see as required if any new proposal is to be implemented, as follows:

1. OPM's actuaries will need to determine the financial impact of that proposal on the present Postal CSRS Fund. We understand that is not possible to go all the way back to 1971 to precisely reconstruct the current Fund as if any proposal put forth had always been in effect, but we believe that acceptable estimates for the early portion of that period can be generated. The estimated future impact should also be determined.
2. There will need to be discussions to determine whether there is consensus support among the stakeholders for that methodology (or, for that matter, any other methodology).
3. Postcom has indicated a belief that a change that has unanimous support can be implemented without Congressional action, as does USPS-OIG. OPM staff disagrees. There seems to be agreement that an updated recognition and disposition of any surplus, if it is to take place promptly, will require Congressional action. In light of the disagreements as to the meaning of P.L. 108-18, as a practical matter it may not be possible to move forward without new legislation that leaves no room for doubt as to what is intended.
4. Because of the economic impact to USPS of OPM's actuarial calculations, we believe that USPS should be entitled to review, at its own expense, OPM's actuarial assumptions, methods, and calculations. In the event of a dispute, there should be a reasonable and timely dispute resolution procedure.

## Conclusion

We began this project knowing that the stakeholders held strong and differing views, and that the economic impact of a change could be substantial for both USPS and the Federal government. We received an excellent education in our discussions with the staffs of the PRC, OPM, USPS-OIG, and GAO. Our mandate was to provide a similar education for the decision makers, and we believe this report fulfills that mandate. At the outset of the analysis, we did not know whether an alternative recommendation would emerge from the process, but obviously one did. We look forward to discussing these matters further as requested, to assist in reaching a conclusion on this important and challenging issue.

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