Postal Regulatory Commission

July 30, 2009
Executive Summary

The Postal Regulatory Commission (PRC or Commission) has undertaken an analysis of the different approaches employed by the U.S. Postal Service Office of Inspector General (OIG) and the Office of Personnel Management (OPM) to calculate the present value of the Postal Service’s obligations related to the Postal Service Retiree Health Benefit Fund (Fund). The analysis was requested by the Subcommittee on Federal Workforce, Postal Service, and the District of Columbia, Committee on Oversight and Government Reform, U.S. House of Representatives. The request was received on June 15, 2009.

The Commission contracted with Mercer Health and Benefits LLC (Mercer) for actuarial assistance on the determination of the reasonableness of the OIG and OPM assumptions and accompanying results produced by the two entities. Commission staff along with Mercer representatives met with actuaries and staff at OPM, OIG and the Hay Group, reviewed industry best practices, and analyzed data provided by OPM, OIG and the Postal Service.

The Commission finds that the two valuations were developed for different reasons and both were reasonable. The OPM estimate serves to meet an annual financial reporting requirement. In contrast, the OIG estimate is designed to estimate the funded status of the Retiree Health Benefits Fund as of 2016. The estimates differ by $57 billion in terms of full liability, and support different actuarial payment schedules.

From these differing perspectives, the two estimates assumed different health care inflation trend rates although both OPM and OIG used static trend rates rather than the more commonly used graded trend rate to arrive at their estimates. In addition, the two valuations use different estimates regarding the Postal Service workforce. Finally, the OPM and OIG estimates reflected different rates of return on assets.
Commission findings and recommendations:

- A graded trend rate is preferable because it reflects both current and future expectations of health care inflation. (See page 8.)

- The OIG’s assumption of a declining workforce is more appropriate for the purpose of estimating the liability as of 2016 because it more accurately reflects the current workforce trend and Postal Service intentions. (See page 17.)

- The OIG rates of return on assets assumptions are reasonable for determining the fund assets as of 2016 because they provide a better short-term estimate than the OPM assumption. (See page 22.)

- Under either estimate, funding of the Retirement Health Benefits Fund exceeds that of private and public sector funds. (See page 25.)

- Using the Commission’s assumptions results in a lower liability and could lead to lower payments than the OPM valuation as shown in the Table below and discussed on page 25.¹

<table>
<thead>
<tr>
<th>Payments to Achieve 73% Funded Status</th>
<th>USPS OIG</th>
<th>OPM</th>
<th>PRC Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Workforce Assumption</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health Care Inflation</td>
<td>5%</td>
<td>7%</td>
<td>Graded: 8% - 5%</td>
</tr>
<tr>
<td>Average Interest rate on assets</td>
<td>5.35%</td>
<td>6.25%</td>
<td>5.35%</td>
</tr>
<tr>
<td>Discount Rate on Liability</td>
<td>6.25%</td>
<td>6.25%</td>
<td>6.25%</td>
</tr>
<tr>
<td><strong>FY 2016 Estimated Liabilities</strong></td>
<td>$90.5</td>
<td>$147.9</td>
<td>$113.2</td>
</tr>
<tr>
<td>FY 2016 Estimated Assets</td>
<td>103.7</td>
<td>108.7</td>
<td>103.7</td>
</tr>
<tr>
<td>FY 2016 Estimated Unfunded Liability</td>
<td>(13.2)</td>
<td>39.2</td>
<td>9.5</td>
</tr>
<tr>
<td>2016 Asset Balance for 73% Funded</td>
<td>66.1</td>
<td>108.0</td>
<td>82.6</td>
</tr>
<tr>
<td><strong>Fixed Annual Payment</strong></td>
<td>$1.7</td>
<td>$5.5</td>
<td>$3.4</td>
</tr>
</tbody>
</table>

¹ Using OPM’s current valuation and the scheduled payments into the fund required by the PAEA results in a funded status of 73 percent in 2016.
• When the valuation is required to be revised under the Postal Accountability and
Enhancement Act (PAEA) P.L. 109-435, Congress may want to request a Postal
Service specific valuation that reflects use of Postal Service demographics apart
from the overall Federal government population to better determine actual costs
for the Postal Service. (See page 26.)
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Introduction

The Postal Service Retiree Health Benefit Fund (RHBF or Fund) is a Treasury fund established under Title VIII of the Postal Accountability and Enhancement Act (PAEA) of 2006. Its purpose is to cover the Postal Service’s liability for the health care costs of current and future retirees under the Federal Employees Health Benefits program (FEHB), administered by OPM.2 OPM is required by law to calculate this liability each year for the Postal Service’s financial statements. OPM calculates this liability by employing an actuarial model that uses certain economic assumptions to determine the present value of future benefits owed to active employees and annuitants.3 Federal law does not require OPM to make similar calculations for other agencies.

On June 19, 2009, the U.S. Postal Service Office of the Inspector General (OIG) issued a report which stated that OPM had overestimated the liability.4 The OIG said that under the current payment schedule mandated by law the Postal Service will have overfunded the liability in 2016 by $13 billion. OIG recommended that the Postal Service pursue legislative relief from the mandated schedule of payments into the RHBF.5 OIG used the Hay Group (Hay) to assist in its evaluation.

The Postal Regulatory Commission (PRC or Commission) was asked by the House of Representatives Committee on Oversight and Government Reform Subcommittee on Federal Workforce, Postal Service and the District of Columbia to conduct an analysis of the different approaches employed by OPM and OIG.

The Commission engaged the consulting group Mercer Health and Benefits LLC (Mercer) to provide actuarial assistance in evaluating the different approaches and outcomes. In addition to the evaluation by Mercer, Commission staff conducted further

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2 Public Law 109-435, Sec. 803.
4 This report was revised on July 22, 2009.
analysis. The Mercer report is attached along with comments on the report from OPM and OIG. (See Attachments A, B and C.)

In evaluating the different approaches employed by OPM and OIG, the Commission spoke to actuaries and staff at OPM, OIG and Hay, reviewed industry best practices, and analyzed data provided by OPM, OIG and the Postal Service. The Commission appreciates the cooperation of OPM and OIG, particularly their prompt response to data requests and inquiries.

**Analysis of OPM and OIG Calculations**

Valuations by their very nature are subjective. It is possible for two separate valuations to each have reasonable assumptions but produce significantly different results. Each valuation needs to be assessed and reviewed based upon the issue it was meant to address. To that extent, the OPM and OIG valuations serve different purposes and the results should be viewed within the context and purpose of each valuation.

The OPM valuation represents a financial snapshot designed to fulfill an annual reporting requirement and appears as an entry on the Postal Service’s notes to the Financial Statement. The valuation depicts the present value of future retiree health benefits at a specific moment in time, namely, the fiscal year for which the valuation is being calculated.

The OIG valuation was specifically designed for best estimating the Postal Service’s unfunded liability in FY 2016 given current projections for workforce complement and healthcare inflation rates. OIG utilized the OPM liability calculation but adjusted it based on its own workforce and inflation assumptions. OIG also calculated the value of the assets in the RHBF as of 2016 and determined the funded status.

The differing assumptions used by OPM and OIG – particularly in regard to the healthcare trend rate, postal workforce numbers, and rate of return on assets – resulted in different outcomes.
Health Care Trend Rates

*Discussion of fixed and graded trends*

Valuations of retiree health care benefits estimate the cost of premiums to be paid for retirees in the future, often 70 to 80 years into the future. When either the private or public sector performs valuations, the cost of health care is assumed to change each year. The amount of this assumed change is referred to as the health care trend. Fixed trend rates assume that health care will increase by the same percentage each year. A fixed trend that is above the growth rate in GDP will eventually lead to the unrealistic scenario of health care costs consuming all of the nation’s GDP. A fixed rate that does not reflect historical trends runs the risk of understating the liability unless there is reason to believe future trends will be markedly different than the past. Both OPM and OIG applied a fixed rate health care trend.

OPM adopted a fixed 7 percent rate based on an analysis of historical cost increases within the Federal Employee Health Benefits (FEHB) program. In contrast, OIG used a fixed trend rate of 5 percent based on its review of similar assumptions employed by private companies, state and local governments, and public utilities. The OIG determined that the most commonly used health care trend rate was 5 percent.

However, unlike the fixed rate used by OIG, in all cases reviewed by the Commission, the 5 percent was an ultimate trend rate applied after a grading down period of several years. These types of trends are referred to as select or graded trends. Graded trends start at a rate that reflects current health care inflation rate expectations and trend down to a rate that reflects a sustainable level of growth in health care costs. Graded trends consider both the current short-term expectation and a measure of long-term sustainability based on a reasonable view of the future. The distinction between a fixed rate and a graded trend rate is illustrated in Chart 1.
It is now common practice among both private and public sector entities to consider the sustainability of ever-increasing health care costs when determining appropriate health care cost trend rates. According to the Society of Actuaries:

*It becomes clear from reading the many papers on the future of health insurance and medical costs that some notion of a limit—be it a restriction on growth, a share of total income, or some other constraint—is relevant to any reasonable analysis of future spending.*

Models that focus on sustainability and growth limits have been developed to calculate graded trend rates. The models include various parameters, such as the consumer price index, gross domestic product (GDP), technology advancements, and other

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economic indicators. The goal of this modeling is to determine the long-term trend rate that results in national health expenditures equaling an assumed percentage of GDP at a given point in time. The reasoning behind these calculations is that at a certain point, called the resistance point, growth in health care costs that exceed growth in GDP will no longer be sustainable. The Commission finds that a graded trend rate is preferable to a fixed trend rate, as used by OPM and OIG, because it reflects both current and future expectations. The Commission reviewed historical data and industry practice to determine a reasonable starting and ending point for a graded trend. For future valuations, it may be useful to employ one of these models to determine the best trend rate for valuing the Postal Service’s liability.

**Commission Analysis of OPM Rate**

The Commission conferred with OPM on the health care trend it used in its valuation. OPM advised the Commission that its trend rate was based on historical changes in FEHB Program premiums. To test the reasonableness of OPM’s 7 percent trend rate, the Commission reviewed data showing the average monthly premiums paid by the Government, Postal Service, postal employees, and government annuitants from 1983 through 2009. Chart 2 shows the variance of annuitant premium costs over the past 23 years. The average annual increase for the government share of all annuitant premiums during that period was 7.6 percent.

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7 See Appendix A of the attached Mercer report for a more detailed explanation.
Throughout the year, OPM bills the Postal Service for its share of annuitant premiums. These payments may differ from the overall FEHB average due to differences in the mix of health insurance program selections by Postal Service annuitants. The Commission reviewed the actual payments the Postal Service made to OPM for its retiree health premiums dating back to 2003, the earliest year for which data was available. The average annual increase was 6.2 percent. Two of the years reflected draw downs on reserves that resulted in a lower rate of increase than would otherwise have occurred. Averages over the long-term reflect periods when reserves are being built up and periods when they are being drawn down. In the short-term, the effect of using reserves can distort the average increase because the build-up period may not be reflected.
Without the use of reserves, the average increase would have been 7.5 percent for this six year period.

From a strictly historical perspective, OPM’s use of a 7 percent rate appears reasonable. However, as discussed above, the Commission finds that a graded trend rate is more appropriate for estimating the Postal Service’s RHBF liability because graded trends reflect both current and future expectations of health care inflation.

**Commission Analysis of OIG Rate**

The Commission also evaluated the 5 percent fixed trend rate OIG used in its valuation. The OIG used the 5 percent rate based on its survey of Fortune 100 companies, state and local governments, and publicly owned utilities.\(^8\)

To evaluate the OIG findings, the Commission collected data from 31 Fortune 100 companies. According to the sample data, 69 percent of the Fortune 100 companies calculate employee benefit obligations using an ultimate trend rate of 5 percent.

However, the Commission also found that rather than assigning a fixed rate of 5 percent as the OIG did in its analysis, all of the sample companies began with an initial rate higher than 5 percent and declined over time to the ultimate trend rate of 5 percent.\(^9\) Chart 3 depicts the length of time between initial and ultimate rates used by various companies.

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\(^8\) According to the OIG report, 77 percent of companies and 65 percent of municipalities surveyed use 5 percent as an ultimate trend rate.

\(^9\) The initial rate for the 31 companies ranged from 7 percent to 10 percent.
**Review of Public Sector Funding Practices**

As part of its analysis, the Commission asked Mercer to review other funds to determine how their liabilities are calculated. A detailed discussion of Mercer’s analysis is found in Chapter 3 of its report. See Attachment A.
Among Mercer’s findings:

- The California Public Employees’ Retirement System (CalPERS) – a large public pension fund in the United States – requires that its participating agencies use a graded trend rate of no more than 10 years with an ultimate rate of between 4 and 5 percent.\(^{10}\)

- Federal Supplementary Medical Insurance Trust Funds (Medicare and Medicaid) use a graded trend that reaches its ultimate rate after 25 years.\(^{11}\)

In addition, the Commission reviewed the Department of Defense (DoD) TRICARE fund and several state funds. TRICARE is a regionally managed healthcare program for active duty and retired members of the uniformed services, their families, and survivors.

- In valuing the retiree benefit liability, DoD uses a graded trend rate for its various programs beginning in 2009 that reaches its ultimate rate of 6.25 percent in 2032.\(^{12}\)

- 13 of the 50 states prefund retiree health benefits. Virtually all of these funds use a graded trend that declines over 10 years to an ultimate rate of 5 percent.\(^{13}\)

Using a ten-year graded rate is consistent with CalPERS, the Fortune 100 companies and state governments. The most commonly used ultimate trend rate is 5.

**Determining an Appropriate Initial Trend Rate**

According to Mercer, the initial trend rate is generally determined in one of two fashions:

1. Overall market cost increases – this approach uses the cost changes experienced by all participants in the health care market as a starting point. The

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\(^{10}\) There is no set rate that should be used as the initial rate.

\(^{11}\) Each component of Medicare and Medicaid is modeled separately. The initial rate ranges from 4.3 percent to 8.6 percent.

\(^{12}\) DoD also models each component separately. Initial rates range from 3 percent to 10 percent.

\(^{13}\) The initial starting rate ranges from 10 percent to 14 percent.
approach assumes that over time a group will tend to demonstrate the same trends and experiences that the overall market exhibits.

2. Overall employer-specific expectations – this approach assumes that the current trend an employer is experiencing is the best starting point. The starting point, however, must exclude the impact of any events that are not sustainable and repeatable. In the Postal Service situation, for example, the FEHB reserve draw downs would be eliminated and health care “plan shifting” by retirees would be evaluated for its likelihood to continue.

Generally accepted accounting standards also dictate that assumptions should be prudent, sustainable and not overly dependent upon recent experience. This implies that a long-term view should be taken. See Attachment A for further discussion.

In determining a reasonable initial rate for a graded trend for the Postal Service valuation, the Commission reviewed documents related to both the overall health care market and Postal Service specific data. Analysis of the Fortune 100 companies showed an average health care inflation rate from 2007 to 2009 of 8.3 percent. Medicare assumes a 7.7 percent increase in health care premium costs for 2009. A study by the Robert Wood Johnson Foundation (RWJ) found that the average growth in premiums nationwide between 1999 and 2007 was 10 percent. These data suggest an initial starting point of over 8 percent.

However, data on the FEHB premiums, which Postal Service annuitants are eligible for, show the FY 2009 average increase for annuitants was 6.4 percent, lower than the increases in the market as a whole. The increase in the amount the Postal Service paid OPM for its annuitant premiums in 2009 was 7.1 percent. The average annual increase in the government share of annuitant premiums for the period 2000 through 2009 was


7.6 percent. This suggests that an appropriate initial starting rate might be lower than the 8-10 percent used in the market as a whole.

Given the accounting standards suggestion that the initial rate should not be overly dependent on recent history and the volatility of annual changes shown in Chart 2, some of which exceeded 20 percent, the Commission finds that any initial trend rate for a Postal Service valuation should be at least 7.6 percent and perhaps higher.

To further explore the appropriate initial rate, the Commission compared the nationwide premium increases from the RWJ report with the FEHB premium increases from OPM. The results are illustrated in Chart 4. On average, the FEHB increases are 0.3 percent lower than nationwide increases. The RWJ study did not include estimates for 2009; however, adjusting the 8.3 percent average premium inflation rate for Fortune 100 companies for the average difference between FEHB and other programs results in an initial rate of 8 percent.
Workforce Assumptions

Different workforce assumptions also contribute to the disparate liability valuations between OPM and OIG.

The OPM valuation reflects the actual number of Postal Service retirees and USPS active employees who are participants in the FEHB at the time of the valuation. In essence, OPM takes an employee snapshot in the current year and uses the same variables to calculate future liabilities. It does this in compliance with actuarial standards related to reporting on health liabilities.
OIG adopted a different approach. Extrapolating from FY 2007 actual work years and postal FEHB participants, OIG calculated the ratio of workyears to FEHB participants. OIG then applied this ratio to workyear estimates provided by the Postal Service. Table 1 depicts the OIG estimate of annual FEHB participants after applying the ratio to workyear estimates.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Estimated Number of Postal Employees Enrolled in FEHB</th>
<th>Workyear Estimates Provided to OIG from Postal Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>603,179</td>
<td>801,641</td>
</tr>
<tr>
<td>2008</td>
<td>581,922</td>
<td>773,391</td>
</tr>
<tr>
<td>2009</td>
<td>563,577</td>
<td>749,009</td>
</tr>
<tr>
<td>2010</td>
<td>550,021</td>
<td>730,993</td>
</tr>
<tr>
<td>2011</td>
<td>542,838</td>
<td>721,446</td>
</tr>
<tr>
<td>2012</td>
<td>536,392</td>
<td>712,880</td>
</tr>
<tr>
<td>2013</td>
<td>528,103</td>
<td>701,863</td>
</tr>
<tr>
<td>2014</td>
<td>518,879</td>
<td>689,604</td>
</tr>
<tr>
<td>2015</td>
<td>510,428</td>
<td>678,373</td>
</tr>
<tr>
<td>2016</td>
<td>502,956</td>
<td>668,442</td>
</tr>
</tbody>
</table>

**Commission Analysis of Workforce Assumptions**

The Commission reviewed several sources of data that show the actual number of postal personnel enrolled in the FEHB. Data provided by OPM shows that over the past ten years the number of postal personnel enrolled in FEHB has been declining steadily. This trend is corroborated by monthly employee statistic reports filed with the Commission by the Postal Service.

The decline in FEHB participants reflects the Postal Service’s continuing effort to reduce the career workforce in the face of declining mail volumes. Since FY 1999, the Postal

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Service has reduced its career employee workforce by over 164,000 employees. In FY 2009 alone the Postal Service has reduced its workforce by over 30,000 career employees to date. In addition, the Postal Service has stated that for the foreseeable future, it plans to continue downsizing its workforce. Most of the reduction in workforce has been accomplished through attrition.

Chart 5 shows the relationship between declines in Postal Service career employees and declines in Postal FEHB participants.\textsuperscript{17} There is a clear correlation between the number of career employees participating in the FEHB program and the number of people employed by the Postal Service.

\textsuperscript{17} Workforce numbers as reported in Postal Service annual reports from FY 1999 through FY 2008. FY 2009 figures are through June and are provided in monthly reports filed by the USPS with the Commission. The number of postal participants in the FEHB was provided by OPM.
This correlation, as well as the trend in workforce reductions and Postal Service stated workforce goals, suggests that the accuracy of the estimated 2016 valuation would be improved by incorporating expected postal workforce reductions into the calculations. The Commission finds that the 2016 valuation of the RHBF liability should reflect the trend in workforce decline because the liability is accrued only for current retirees and eligible employees. If the number of employees is overestimated in 2016 the estimated liability will be overstated.

**Estimate of Liability Using Commission Preferred Assumptions**

After careful evaluation and input from Mercer, the Commission finds that a graded trend rate with an initial rate of 8 percent and an ultimate rate of 5 percent after 10 years
is appropriate for valuing the Postal Service’s RHBF liability as of 2016. This valuation, for the purpose of determining the funded status as of 2016, also should reflect the trend in workforce reduction. Consequently, the Commission asked OIG to use its declining workforce valuation model to determine what the liability would be using the abovementioned graded trend. Table 2 compares the liability calculated using PRC alternative assumptions with the liability calculated by OPM and OIG.

### Table 2: Estimated Liability as of 2016

<table>
<thead>
<tr>
<th>Workforce Assumption</th>
<th>USPS OIG</th>
<th>OPM</th>
<th>PRC Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health Care Inflation</td>
<td>Declining</td>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>Average Interest rate on assets</td>
<td>5.35%</td>
<td>6.25%</td>
<td>5.35%</td>
</tr>
<tr>
<td>Discount Rate on Liability</td>
<td>6.25%</td>
<td>6.25%</td>
<td>6.25%</td>
</tr>
<tr>
<td>FY 2016 Estimated Liabilities</td>
<td>$90.5</td>
<td>$147.9</td>
<td>$113.2</td>
</tr>
</tbody>
</table>

### Funded Status

Funded status refers to a measure of the value of assets in relation to the accrued liabilities. A funded status of 100 percent means that the value of fund assets is equal to the projected fund obligation incurred to date. A current fund status of 100 percent does not preclude the possibility that future contributions to the plan may be necessary.

Accounting regulations do not require funding of retiree health benefit funds. The Postal Service is unique in many ways, including the PAEA requirement to prefund its retiree health benefits.

The PAEA designated the sources of initial funding for the RHBF through certain transfers related to the previous overfunding of the Postal Service’s pension liability. The transfers amounted to $17 billion. The Postal Service also paid $3 billion into the fund which represented the FY 2006 escrow payment required by P.L. 108-13. Thereafter, PAEA provided for scheduled funding of the RHBF by the Postal Service through 2016. Under this approach, for the 10-year period of FY 2007 through FY 2016,
funding is derived from a series of annual payments from the Postal Service to the RHBF in amounts specified in the PAEA. Table 3 identifies these amounts.

<table>
<thead>
<tr>
<th>Payment Required by:</th>
<th>$ (in Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 30, 2007</td>
<td>5.4</td>
</tr>
<tr>
<td>September 30, 2008</td>
<td>5.6</td>
</tr>
<tr>
<td>September 30, 2009</td>
<td>5.4</td>
</tr>
<tr>
<td>September 30, 2010</td>
<td>5.5</td>
</tr>
<tr>
<td>September 30, 2011</td>
<td>5.5</td>
</tr>
<tr>
<td>September 30, 2012</td>
<td>5.6</td>
</tr>
<tr>
<td>September 30, 2013</td>
<td>5.6</td>
</tr>
<tr>
<td>September 30, 2014</td>
<td>5.7</td>
</tr>
<tr>
<td>September 30, 2015</td>
<td>5.7</td>
</tr>
<tr>
<td>September 30, 2016</td>
<td>5.8</td>
</tr>
</tbody>
</table>

Source: PAEA Sec. 803(a)(1)(B), adding 5 U.S.C. 8909a(d)(3)(A)

In addition to these payments into the fund the Postal Service must continue to pay the annual cost of annuitant premiums from operating revenue. The annuitant premiums were $1.7 billion in 2007, $1.8 billion in 2008, and $2.0 billion in 2009.

Beginning in FY 2017, the funding stream changes in two ways. First, the Postal Service is to begin making annual payments to the RHBF equivalent to the Normal Cost of retiree health care (i.e., the estimated costs of retiree health care as these costs are accrued by current employees.) Second, the Postal Service share of health care premiums for current retirees will come out of the RHBF.

**Rate of Return on Assets**

The estimated rate of return on plan assets is an integral factor in assessing the funded status at a specific point in time. OPM assumes an annual rate of return on assets of 6.25 percent while OIG assumes a rate of return that varies between 5.3 percent and 5.5 percent. This difference in rate of return assumptions represents approximately a $5 billion difference in asset balance projected by 2016.
The Commission compared the two rates against an index fund that includes all government securities, differing in maturities and coupon rates meant to simulate the universe of bonds in the market. The index is used by bond funds as a benchmark to measure their relative performance. The fund has returned 7.56 percent since 1987. PIMCO Total Return Fund and California Employees Retirement Benefits Trust, two notable bond funds with comparable assets, have returned 8.35 percent and 7.75 percent, respectively. Based on these returns and active portfolio management, the Commission finds the OPM assumed 6.25 percent return on assets to be reasonable over the long-term.

However, for purposes of determining what the asset balance will be in 2016, a relatively short-term horizon, it may be more prudent to use recent history as a predictor. Consequently, the Commission reviewed the actual return on assets for the RHBF since its inception. In 2007, the return was 5 percent and in 2008 it was 4.75 percent. The Commission finds that the OIG rates of return are a better reflection of what the asset base is likely to be in 2016 than OPMs long-term outlook. Using the lower interest rates employed by OIG, results in an asset base that is $5 billion less than that estimated by OPM.

**Funded Status Under Current Law**

The PAEA does not mandate a funding level percentage for the RHBF. For purposes of comparing OPM and OIG estimates, the Commission asked OPM to project what its valuation would be as of 2016. OPM projected the 2016 valuation using the following formula by multiplying the 2008 valuation by 1.07 raised to the 8th power. Thus, its projection assumes the 2008 assumptions remain static.

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18 PIMCO Total Return has returned 8.35 percent since its inception (1997). CERBT, managed by CalPERS, has returned 7.75 percent since inception. CalPERS, on average, has returned a rolling geometric average of 10 percent over the last 15 years.

19 OPM projected the 2016 valuation using the following formula by multiplying the 2008 valuation by 1.07 raised to the 8th power. Thus, its projection assumes the 2008 assumptions remain static.
As shown in Table 4, funding levels are affected by changes in the underlying assumptions used to calculate the liability. The estimated liability decreases, and funding levels increase, with declining participants and/or lower health care trend rate assumptions. A lower rate of return on fund assets results in a lower asset base.

**Funded Status Under H.R. 22**

H.R. 22, a bill as amended, would allow the Postal Service share of the current retiree health premiums to be paid from the RHBF. The current version of the bill provides such relief to the Postal Service for three years, from FY 2009 through FY 2011. This lowers the asset base and, thus, the funded status.

Table 5 shows the year 2016 funding levels of the RHBF if H.R. 22 is adopted.
As shown in Table 5, H.R. 22 lowers the funded level of the RHBF across all scenarios compared to the funded level under the PAEA.

It should be noted that the funding levels calculated under all scenarios are generally higher than that found in public companies or state government entities, as shown in Table 6.

<table>
<thead>
<tr>
<th>Entity</th>
<th>Funding Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Governments that Prefund</td>
<td>30%</td>
</tr>
<tr>
<td>Fortune 100 Companies that Prefund</td>
<td>24%</td>
</tr>
<tr>
<td>CalPERS(^{20})</td>
<td>96%</td>
</tr>
<tr>
<td>Medicare(^{21})</td>
<td>&lt;1%</td>
</tr>
</tbody>
</table>

**Table 6: Average Funding Levels of Retirement Health Benefit Funds**

Payments Necessary to Achieve Funded Status Implied by PAEA

Under current law and using the OPM projected valuation, the anticipated funding level of the RHBF in 2016 is approximately 73 percent. The Commission does not endorse 73 percent as the desirable level of funding and makes no recommendation regarding the most appropriate funding level. For illustrative purposes, however, Table 7 shows what annual payments would be required to achieve that level of funding in 2016.

<table>
<thead>
<tr>
<th>Workforce Assumption</th>
<th>USPS OIG</th>
<th>OPM</th>
<th>PRC Alternative</th>
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<tr>
<td>Health Care Inflation</td>
<td>Declining 5%</td>
<td>7%</td>
<td>Graded: 8% - 5%</td>
</tr>
<tr>
<td>Discount Rate on Liability</td>
<td>6.25%</td>
<td>6.25%</td>
<td>6.25%</td>
</tr>
<tr>
<td>FY 2016 Estimated Liabilities</td>
<td>$90.5</td>
<td>$147.9</td>
<td>$113.2</td>
</tr>
<tr>
<td>FY 2016 Estimated Assets</td>
<td>103.7</td>
<td>108.7</td>
<td>103.7</td>
</tr>
<tr>
<td>FY 2016 Estimated Unfunded Liability</td>
<td>(13.2)</td>
<td>39.2</td>
<td>9.5</td>
</tr>
<tr>
<td>2016 Asset Balance for 73% Funded</td>
<td>66.1</td>
<td>108.0</td>
<td>82.6</td>
</tr>
<tr>
<td>Fixed Annual Payment</td>
<td>$1.7</td>
<td>$5.5</td>
<td>$3.4</td>
</tr>
</tbody>
</table>


\(^{21}\) 2009 Annual Report of The Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, pgs. 11 and 72. $381.6 billion in assets and $13.4 trillion in liability.
Postal Service Specific Data

Mercer suggests that any future valuation should be based upon Postal Service specific average costs and average trends and reflect Postal Service specific decrements.\(^{22}\) With nearly 600,000 enrollees, the group is credible.\(^{23}\) The Postal Service pays for the funding of its liabilities through postage rates rather than appropriations. Consequently, liabilities should be developed to reflect the actual expense of the plan.

Representatives at OPM suggested that Postal Service FEHB participants exhibit different demographics than the rest of the FEHB program. In addition, the relationship of the two populations (government-wide FEHB participants and Postal Service participants) is likely to change as the reductions in the number of Postal Service employees are implemented. These types of movements in the population and the resulting liabilities would not necessarily be fully reflected in a valuation that is based on assumptions generated by the broader FEHB population.

The PAEA requires OPM to conduct an assessment no later than June 30, 2017, of the RHBF funded status. OPM is then to compute a schedule which provides for the liquidation of any liability (or surplus) of the net present value of the Postal Service’s liability (plus interest). Whenever this valuation is recalculated, a graded trend rate should be considered. Congress may also want to consider requiring the calculation of Postal Service specific demographics.

\(^{22}\) A decrement in the census in a valuation is when the population in the valuation is decreased. The active population is decremented by withdrawals (those that leave employment prior to qualifying for retiree medical coverage), death, and retirements. The retiree population is decremented by death.

\(^{23}\) In insurance terminology, experience is said to be credible if from a statistical standpoint the outcome is a reliable predictor of the cost for the group. That is, the group is sufficiently large enough that deviations due to claims fluctuations are minimized and that future costs (in the short term) can be predicted from the most recent period.
Conclusion

The Commission has carefully reviewed the OPM and OIG valuations of the Postal Service’s liability for RHBF and finds that the primary reason for the difference is that the estimates were developed for different purposes; financial reporting requirements in the case of OPM, and estimates of funding levels in 2016 for the OIG. The Commission concludes that each report serves its intended purpose well. Moreover, funding of the RHBF by 2016, under each scenario, exceeds that of most private and public sector funds.

The key differences in the calculation of the liability are assumptions related to health care inflation trend rates and estimates regarding the Postal Service workforce. OPM and OIG also use different estimated rates of return on assets.

Both the OPM and the OIG valuations use a fixed health care inflation trend rate rather than the more generally-accepted graded trend rate. The Commission finds that a graded trend rate is preferable to a fixed trend rate because it reflects both current and future expectations of health care cost increases.

For the purposes of determining the liability in 2016, the OIG assumption of a declining workforce is more appropriate than the OPM assumption because it provides a more accurate estimate of the liability. It should be noted, however, that the OPM valuation is consistent with its intended purpose of financial reporting. Likewise, the Commission finds that the OIG rate of return on assets assumptions are reasonable for determining the fund assets as of 2016 because they better reflect the relatively short time horizon and are likely to produce a more accurate estimate.

The liability calculated using Commission assumptions of a starting rate of 8 percent trending to 5 percent over 10 years is $113.2 billion. This is less than the liability calculated by OPM. Consequently, the Postal Service could make lower payments into the fund and still achieve the level of funding that would be achieved using the OPM valuation and the scheduled payments required under current law.
The Commission suggests that when the valuation is required to be revised, Congress may want to request a Postal Service specific valuation that reflects Postal Service specific demographics, and a graded trend rate.
Attachment A
July 20, 2009

Review of OPM and OIG Retiree Medical Valuation Reports
Postal Regulatory Commission

MERCER
MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

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Report Highlights

Mercer has been engaged to review two separate valuation studies of the U.S. Postal Service’s Liability for Retiree Health Care benefits. Our objective is to provide independent third party commentary on the reasonableness of the assumptions and accompanying results produced by the separate studies. The valuation studies included in our review are the following:

- Information from the Hay Group study as summarized in a letter to Mr. Joseph Corbett dated June 19, 2009 from Mr. Darrell E. Benjamin, Jr. (attached). This shall be referenced as the Hay report within the remainder of this letter.

- Information as provided by the Office of Personnel Management (OPM) and publicly disclosed in the Postal Service’s financial statement dated September 30, 2008. This shall be referenced as OPM information within the remainder of this letter.

Valuations by their very nature are subjective. It is possible for two separate valuations to each have reasonable assumptions but produce significantly different results. Each valuation needs to be assessed and reviewed based upon the issue it was meant to address. To that extent, the OPM and Hay valuations serve different purposes and the results should be viewed within the context and purpose of each valuation.

Over time, a plan’s total cost will depend on a number of factors, including but not limited to the amount of benefits it pays, the number of people paid benefits and the amount earned on any assets invested to pay the benefits. These amounts and other parameters are uncertain and unknowable at the valuation date, but are predicted to fall within a reasonable range of possibilities.

The Hay report and the OPM valuations are each based on a single scenario from the range of possibilities. The results of that single scenario are included in the respective reports. However, the future is inherently uncertain and the plan’s actual experience will
differ from those assumptions; these differences may be significant. In addition, different assumptions or scenarios may be within the reasonable range of plausible results and create financial projections that differ significantly. Actuarial assumptions may also be changed from one valuation to the next because of mandated requirements, plan experience, changes in expectations about the future and other factors.

In this report we will review how assumptions are selected and how these assumptions may affect the resulting liability estimates. Specifically, this Mercer report will address the following issues:

- Health care trend rate
- Adjustments to the Postal Service population within the projection
- Discount rate
- Consistency of Premiums versus Health Care Trend

We are available to answer any questions on this material, or to provide explanations or further details, as may be appropriate. Collectively, the undersigned credentialed actuaries meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained in this report.

Sincerely,

Bruce A. Richards, FSA, MAAA       Robin L. Hagerty, FSA, MAAA
Background

The OPM is responsible for providing liability estimates of the retiree health fund for the Postal Service’s financial statements. These liability estimates are provided for purposes of populating the financial statements, rather than for purposes of determining funding adequacy.

The OPM valuation is based upon a projection of the fully-insured Federal Employees Health Benefit Program (FEHBP) average premium rates for single and family coverage. The premium rates are a weighted average of premiums for active employees as well as retired plan participants and reflect actual plan participant enrollment elections by plan option. Note that the Postal Service pays the same premium rates for both active employees and retirees within any given benefit plan, however the employee and retiree contribution rates by plan are different. The health care trend is applied to the average premium to estimate the expected future premium rates. The Postal Service and retirees share in the cost of coverage. The Postal Service will cover 72% of the weighted average premium of all the health care plans under the FEHBP, limited to 75% of the premium rate for any given health care plan option. A retiree pays the difference between the total cost of the plan they select and the amount the Postal Service will pay. The Postal Service contribution is adjusted downward for military service before 1971.

The funding for the Postal Service retiree health plan is based upon 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 and the requirement to hold certain funds in escrow. The PAEA funding was budget neutral to the Federal Government.

Note that the OPM valuation does not prescribe, opine on or target a particular level of funding for the retiree medical benefits. The OPM valuation is a fiscal snap shot as of a particular date under specified assumptions. Funding of the Postal Service retiree medical benefits was specified under the PAEA.
The Hay report is a projection of estimated liabilities as of 2016 which relies upon the basic information provided by OPM as of September 30, 2008 and projected Postal Service active employee headcount reductions through 2016. The Hay report provides commentary on the reasonableness of the OPM assumptions and methodologies utilized in the OPM information. Where assumptions are deemed “inappropriate”, the Hay report utilizes alternative assumptions, provides a basis for selecting those assumptions and identifies liability estimates based upon those changes.

Mercer along with Postal Regulatory Commission personnel conducted two separate meetings, one each with OPM and OIG representatives to document and understand the valuation methodologies and assumptions contained within the respective reports. Many of the valuation assumptions used by OPM have not been identified as issues within the Hay report and Hay has used these OPM assumptions. Mercer has focused most of its comments on areas where the OPM information and the Hay report differ.
Health Care Trend Rate

The OPM liabilities are based upon a static 7% health care trend assumption for all future years within the valuation. In conversations with OPM, Mercer learned that this assumption was derived based upon an analysis of the historical cost increases within the FEHBP program. The graph on the following page was summarized by the Postal Regulatory Commission (PRC) based on information provided by OPM. The graph illustrates the average premium in each year from 1983 forward. The average annual growth rate for the entire period is 6.67% for the total rate and 7.56% for the net rate after employee contributions. Both of these increases reflect employees shifting benefit options.

Note that the graph features an increasing trend line for 2008 and 2009 over the 2007 levels. The increasing trend line generates the need for caution in the selection of trend rates as the past has shown that there can be material swings in premium needs over a multi-year period. By using a longer term average, OPM has blended out the peaks and troughs and has insulated the valuation from short term swings in the premium levels.
Please note that the OPM valuation assumption for trend and retiree claims cost was actually determined based on the total FEHBP program rather than Postal Service specific experience. We would typically recommend assumptions being established based upon credible employer-specific data (Postal Service only). In reviewing the valuation that OPM must perform in 2016 under the PAEA, it is noted that the valuation is to be based upon Postal Service experience. It will be very important to have a dialog with OPM to discuss how they intend to implement the 2016 valuation – whether the current valuation process will continue unchanged or whether the valuation will be based upon Postal Service specific experience without any blending with FEHBP data. This distinction is important as a change in valuation assumptions (Postal Service data only versus FEHBP) can result in a material change in the liabilities which the Postal Service would need to recognize.

This OPM approach to trend implicitly builds in assumptions for migration to lower cost plans over time as well as changes in reserves in the fully-insured premiums. A separate GAO report (GAO-07-141) dated December 2006 reviewed cost increases in the FEHBP and noted that the average increases for 2006 and 2007 were offset by withdrawals from reserves of 2% and 5% respectively. OPM provided additional commentary that similar draw-downs of reserves were occurring in the 1994 – 1997 time period. Removing periods where actual trend increases were offset by reductions in reserves from the analysis would point toward higher average cost increases over time, including the effect of migration to less generous plan options.

The Hay report focuses on the ultimate trend rate in most of its analysis. There is commentary about the reported initial health care cost trend rates ranging from 5% to
10.3% within the Fortune 100 group with a projected decline to the ultimate rate in about 6 years. We concur with Hay that there should be an ultimate trend rate.

The Hay report identifies the 7% premium increase estimate as “unreasonably high” and benchmarks the assumption against a survey of the ultimate trend rates utilized in FAS 106 disclosure information for 61 Fortune 100 companies. This survey information was supplemented by a GASB 45 survey of ultimate trend rates used by governmental employers to report on their other postemployment benefits (OPEBs). The results of both surveys produce an expected ultimate trend rate of 5.0%. These results were used to substantiate a proposed static (all years not just ultimate) health care trend assumption in the Hay report of 5.0%. Note that the implicit assumption in this survey analysis is that the FEHBP and Fortune 100 organizations manage the benefit programs similarly, have similar benefit program designs and have similar financial requirements and needs.

In order to determine whether or not the Hay 5% static trend is reasonable, we examined the accounting guidance and as previously indicated examined historical results. The accounting guidance is highlighted below.

SFFAS No. 5 (Accounting for Liabilities of the Federal Government) has the following definition of the health care trend assumption to be used in determining Other Retirement Benefits (ORB, or health care benefits):

“a health care cost trend assumption that is consistent with Medicare projections or other authoritative sources appropriate for the covered population.”

GASB 45 (Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions) defines the healthcare trend rate as:

“The rate of change in per capita health claims costs over time as a result of factors such as medical inflation, utilization of healthcare services, plan design and technological developments.” GASB 45 also states that “the selection of all actuarial assumptions, including the healthcare cost trend rate in valuations of postemployment healthcare plans, should be guided by actuarial standards. Accordingly, actuarial assumptions should be based on the actual experience of the covered group, to the extent that credible experience data are available, but should emphasize expected long-term future trends rather than give undue weight to recent past experience.”

SFAS 106 identifies the assumption regarding health care cost increases as:

“the expected annual rates of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the demographics of the plan participants, for each year from the measurement date until the end of the period in which benefits are expected to be paid. Past and current health care cost trends shall be used in developing an employer’s assumed health
care cost trend rates, which implicitly consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants... It is appropriate for that assumption to reflect changes in health care cost trend rates over time. For example, the health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail.”

In keeping with SFFAS No. 5, we have relied upon GASB 45 and FAS 106 as one authoritative sources for guidance in establishing a suggested health care trend rate assumption. Both GASB 45 and SFAS 106 anticipate use of a select and ultimate trend assumption within retiree healthcare valuations and suggest that recent past experience not be the primary driver of the assumption.

In most SFAS 106 and GASB 45 valuations, the selection of a trend assumption would be based on the actual claims experience rather than a fully-insured premium. However, for this particular valuation, the actual liability of the Postal Service is based on payment of the fully-insured premium to the FEHBP for each participant. As such, it is reasonable to review the premium rate experience to determine a historical average of premium increases. This review would suggest that a 7% trend rate or higher would be a reasonable trend assumption and is indeed consistent with the historical results achieved.

Again turning to the GAO report (GAO-07-141), the chart on page 15 suggests that changes in cost and utilization for prescription drugs and medical generated cost increases averaging approximately 10% per year from 2000-2007. The lower observed cost increases were driven by enrollee benefit choice, changes in demographics, benefit changes and changes in reserve levels. Removing these reserve decrements from the data results in an increase of an additional 2% to cost for 2006 and 5% for 2007. Our conclusion from examining the raw components on page 15 of the highlighted GAO report suggest to us that short term premium increases for the FEHBP would increase from the low observed levels in 2006 and 2007. Consequently, if trend assumptions are to be set base on recent past experience we believe the data suggests that a graded trend scenario starting above 7% might be more appropriate in projecting short term costs.

Tables B1 through B3 of the Hay report illustrates the premium rates in 2008 and 2009. This illustration does indicate a lower trend increase accounting for migration in the 4.1% to 4.7% range. However, based upon the comments above as well as the GASB 45 guidance that undue weight should not be given to recent past experience, Mercer considers a selection of a static trend rate of 5% for the entire valuation to be too much reliance on a recent occurrence where it is known that reserve reductions have been incorporated in the overall increase. Mercer considers the Hay report selection of trend to be on the lower end of any trend assumption spectrum. In addition, Mercer would suggest that a separate migration assumption be considered rather than having the migration built in to the overall trend. While we do recognize that over time there has
been migration towards lower cost plans, we would contend that the implicit migration assumption built in to the assumption based on the recent past could not sustain those levels over the lifetime of the valuation.

Mercer also reviewed the CALPERS assumption model. The model is to be used in Other Post Employment Benefits (OPEB) actuarial valuations by employers who elect to prefund their OPEB obligations through CalPERS. It provides guidance and ranges for setting assumptions for these GASB 45 valuations. The model specifies that a graded trend rate by type of plan (Indemnity, PPO and HMO) should be used for no more than ten years of the valuation and the ultimate trend rate must be between 4% and 6%.

The final source of data which we reviewed as an authoritative source for purposes of setting assumptions is the 2009 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds (the Medicare Trustees report). This report is based upon differing assumptions for the various Medicare programs, however most of the trend assumptions within the first ten years are in excess of 6.0%. The report uses an aggregate trend assumption for all programs after the first twenty-five years. The projections after twenty-five years are based upon a graded trend analysis that is determined in such a way that the average rate of cost growth is consistent with a GDP + 1% assumption. The intermediate assumption for GDP in the projections is 4.1%. The assumed trend projections are about 1.4% above GDP estimates in 2033 and 0.2% above GDP estimates in 2083.

In short, we deem the static 5% trend assumption for all years to be optimistic and not likely a best estimate assumption.

Mercer has adopted a standard for its SFAS 106 valuation assumptions which relies upon a model that is similar to the Getzen model discussed in the Hay report and the Medicare projections mentioned above. The Mercer model approach is summarized in Appendix A. Using the Mercer model and correlating the starting trends with results before reserve reductions in the GAO report and incorporating a market based initial healthcare trend rate, reasonable assumptions regarding the healthcare cost trend factors would start at an initial rate of 8.3% and would grade down to an ultimate healthcare cost trend factor of 4.5% in 2028 and later.

The following chart compares the accumulation of the three trend tables over time. As you will note, the OPM assumption does not outpace the Mercer model until 2023. The Hay assumption does not outpace the Mercer accumulation until 2086. The impact on liabilities is a function of the timing of future cash payments of the program, however in general, the Mercer model will likely produce a cash flow weighted average trend rate in the 6.0% to 6.5% range (we did not obtain the cash flows from OPM to determine our figure exactly).
We have also reviewed the actuarial assumptions associated with the retiree medical liabilities associated with the Department of Defense (DOD). The DOD actuaries do utilize a graded trend scenario with an ultimate trend of 6.25%. The ultimate trend assumption for the DOD actuaries may be on the high end of most ranges, however the assumptions do reinforce the view of a graded trend assumption and also another vantage point on which to judge the appropriateness of the Hay selection of a 5% immediate trend figure.

We requested that OIG provide an estimate of the difference in liability using the Mercer trend assumptions and the 5% static healthcare trend assumption that was used in the Hay report. The following table summarizes the projected liabilities and assets in 2016 as provided by the Hay Group:

<table>
<thead>
<tr>
<th>Valuation Year</th>
<th>Mercer Accumulated Trend</th>
<th>OPM Trend Accumulation using 7%</th>
<th>OIG Trend Accumulation using 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>1.0825</td>
<td>1.0700</td>
<td>1.0500</td>
</tr>
<tr>
<td>2010</td>
<td>1.1697</td>
<td>1.1449</td>
<td>1.1025</td>
</tr>
<tr>
<td>2011</td>
<td>1.2617</td>
<td>1.2250</td>
<td>1.1576</td>
</tr>
<tr>
<td>2012</td>
<td>1.3586</td>
<td>1.3108</td>
<td>1.2155</td>
</tr>
<tr>
<td>2013</td>
<td>1.4604</td>
<td>1.4026</td>
<td>1.2763</td>
</tr>
<tr>
<td>2014</td>
<td>1.5673</td>
<td>1.5007</td>
<td>1.3401</td>
</tr>
<tr>
<td>2015</td>
<td>1.6793</td>
<td>1.6058</td>
<td>1.4071</td>
</tr>
<tr>
<td>2016</td>
<td>1.7964</td>
<td>1.7182</td>
<td>1.4775</td>
</tr>
<tr>
<td>2017</td>
<td>1.9188</td>
<td>1.8385</td>
<td>1.5513</td>
</tr>
<tr>
<td>2018</td>
<td>2.0457</td>
<td>1.9672</td>
<td>1.6289</td>
</tr>
<tr>
<td>2019</td>
<td>2.1769</td>
<td>2.1049</td>
<td>1.7103</td>
</tr>
<tr>
<td>2020</td>
<td>2.3123</td>
<td>2.2522</td>
<td>1.7959</td>
</tr>
<tr>
<td>2021</td>
<td>2.4516</td>
<td>2.4098</td>
<td>1.8856</td>
</tr>
<tr>
<td>2022</td>
<td>2.5945</td>
<td>2.5785</td>
<td>1.9799</td>
</tr>
<tr>
<td>2023</td>
<td>2.7406</td>
<td>2.7590</td>
<td>2.0789</td>
</tr>
<tr>
<td>2024</td>
<td>2.8895</td>
<td>2.9522</td>
<td>2.1829</td>
</tr>
<tr>
<td>2025</td>
<td>3.0410</td>
<td>3.1588</td>
<td>2.2920</td>
</tr>
<tr>
<td>2026</td>
<td>3.1944</td>
<td>3.3799</td>
<td>2.4066</td>
</tr>
<tr>
<td>2027</td>
<td>3.3493</td>
<td>3.6165</td>
<td>2.5270</td>
</tr>
<tr>
<td>2028</td>
<td>3.5009</td>
<td>3.8697</td>
<td>2.6533</td>
</tr>
<tr>
<td>2029</td>
<td>3.6584</td>
<td>4.1406</td>
<td>2.7860</td>
</tr>
</tbody>
</table>

We requested that OIG provide an estimate of the difference in liability using the Mercer trend assumptions and the 5% static healthcare trend assumption that was used in the Hay report. The following table summarizes the projected liabilities and assets in 2016 as provided by the Hay Group:

<table>
<thead>
<tr>
<th></th>
<th>Health Care Inflation</th>
<th>2016 Liabilities</th>
<th>2016 Assets</th>
<th>2016 Unfunded Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>OPM</td>
<td>7%</td>
<td>$129.4</td>
<td>$103.7</td>
<td>$25.7</td>
</tr>
<tr>
<td>Hay Group</td>
<td>5%</td>
<td>$90.5</td>
<td>$103.7</td>
<td>($13.2)</td>
</tr>
<tr>
<td>Mercer selected trend</td>
<td>Initial 8.3%, ultimate 4.5%</td>
<td>$123.1</td>
<td>$103.7</td>
<td>$19.4</td>
</tr>
</tbody>
</table>
Mercer’s recommendation would be a graded trend rate, however static trend rates could be used to approximate a similar result. While a 5% static trend rate is within the possible outcomes, most published sources would indicate a higher weighted average trend outcome when incorporating the initial trend rate and the grade-down period. The historical FEHBP information points toward a reasonable static trend assumption closer to 7%.

It is also noteworthy to mention that the funding level achieved in 2016 under either the OPM projection or the Mercer selected trend scenario is material and substantial. Although retiree medical plans funded at the 2016 level are not unheard of, they are extremely unusual especially during the current economic situation. Note that, should funding of the retiree medical liabilities at a lower level occur say in the magnitude of $5 billion in total for 2009-2016 (note however that the net change from 2009-2019 would be cost neutral), the amount of the funded liability would clearly decrease but the funding level of the plan would still be significant and material and especially given the current economic climate.

Further not that it is possible that deviations from the valuation assumptions could possible cause more variation in the percentage of the liability which is funded in 2016 than whether or not the USPS receives a reallocation of its funding requirements on a cost neutral basis from 2009-2019.
Adjustments to the Postal Service Population within the Projection

The Hay report uses projection methodologies to move the expected liability from the stated disclosure date of September 30, 2008 out to 2016. As part of that step in the projection, the Hay analysis has included an additional assumption regarding the changes in the Postal Service workers population between 2008 and 2016. It is our understanding that this adjustment was made to the projected Normal Cost between 2008 and 2016 to reflect budgeted reductions in postal workers hours during that time. The following table illustrates the initial OPM expected active employee headcount and the expected active employee headcount used in the Hay report:
The Hay report liability calculations are based on actuarial valuation quality data from 2007 and projected to 2016 using actuarially appropriate methods. While making adjustments to the population may be appropriate for planning and budgeting, actual results in the ultimate period (2016) are likely to be materially different from these estimates. An appropriate margin for estimation error should be added to these estimates before any decision is made regarding funding of the plan. It would be more appropriate to determine a range of possible results with respect to the liability shown in 2016.

An implicit assumption in the OPM valuation work is that those employees that exit the work force are deemed to have retired. It would be a prudent practice to determine if this assumption has held close to being true for Postal service employees exiting active status in 2007-2009. If employees have exited and have not elected retiree medical benefits, then it might be appropriate to reflect that fact in future OPM projections.
Discount Rate

The discount rate used in both the OPM and the OIG valuations is 6.25%. Both GASB and SFFAS No. 5 indicate that the discount rate used to discount projected benefits should be equal to the long-term expected return on plan assets if the plan is being funded. It is our understanding that the funds are invested in Federal Treasuries.

The projected return on asset information provided by the Hay Group indicates an expected return between 2009 and 2016 of 5.0% to 5.5%. These rates may be on the high end of the range of expectations given the current market turmoil. However even these estimates are lower than 6.25%.

Both valuations use the same discount rate and hence there is not necessarily a difference of opinion between the two studies, however Mercer would likely recommend a lower expected rate of return on investment than 6.25%. This would in turn increase the expected liability of the program.
Consistency of Premiums versus Health Care Trend

Mercer suggests that any valuation should be based upon Postal Service specific average costs and average trends and reflect Postal Service specific decrements. With 600,000+ employees, the group is certainly credible. It is our understanding that the Postal Service postage rates must be established to cover the actual cost of doing business and that current Postal Service customers should ideally be funding the current costs of expected retiree medical coverage. In that type of situation, liabilities should be developed to reflect the actual expense of the plan.

Representatives at OPM suggested that the Postal Service may be a more heavily male population and thus cover more dependents than the rest of the FEHBP program. In addition, the relationship of the two populations (FEHBP and Postal Service) is likely to change as the reductions in Postal Service hours are implemented. These types of movements in the population and the resulting liabilities would not necessarily be fully reflected in a valuation that is based on assumptions generated by the broader FEHBP population.
Appendix A – Mercer’s Retiree Medical Trend Rates Model

Mercer’s key premise in the model is that the annual health care cost trend for an employer-sponsored retiree plan will eventually match the annual growth in per capita National Health Expenditures (NHE) and that the NHE per capita will eventually grow at the same rate as the per capita Gross Domestic Product (GDP) for the United States.

In the current environment, of course, that is not the case:

- Individual employer trends generally exceed the growth rate in the Private Payer segment of the NHE (the difference being employer-specific excess trend)
- The Private Payer segment of the NHE is growing faster than the overall NHE due to government cost controls on Medicare and Medicaid (the difference being Private Payer excess trend)
- The overall NHE is growing faster than per capita GDP (the difference being NHE excess trend)

Our model starts with a projection of NHE and GDP through 2017 provided by the Office of the Actuary in CMS, providing us with the NHE excess trend through that date. The NHE excess trend is then scaled down to zero until we reach the point where NHE equals 22% of GDP (that percentage was estimated to be 16.3% for 2007). We then add an estimate of the Private Payer excess trend, starting at 0.5% today and grading to zero over 10 years.

The Default Trend in each year is equal to the sum of the:

- GDP growth rate, which reaches 4.5% in the long term
- NHE excess trend, which eventually grades to zero
- Private Payer excess trend, which eventually grades to zero, and
- Employer-specific excess trend
When the employer-specific adjustments for savings initiatives are included, the result is the Employer-specific Trend Table. (The model also includes a 4% minimum to prevent the development of unreasonably low trend rates.)

The following table summarizes Mercer’s recommended trend increases resulting from the Mercer model using an 80%/20% of medical to prescription drug component and underlying current medical trends of 8.0% and underlying prescription drug trends of 9.5%.

<table>
<thead>
<tr>
<th>Valuation Year</th>
<th>Premium Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>8.3%</td>
</tr>
<tr>
<td>2010</td>
<td>8.1%</td>
</tr>
<tr>
<td>2011</td>
<td>7.9%</td>
</tr>
<tr>
<td>2012</td>
<td>7.7%</td>
</tr>
<tr>
<td>2013</td>
<td>7.5%</td>
</tr>
<tr>
<td>2014</td>
<td>7.3%</td>
</tr>
<tr>
<td>2015</td>
<td>7.1%</td>
</tr>
<tr>
<td>2016</td>
<td>7.0%</td>
</tr>
<tr>
<td>2017</td>
<td>6.8%</td>
</tr>
<tr>
<td>2018</td>
<td>6.6%</td>
</tr>
<tr>
<td>2019</td>
<td>6.4%</td>
</tr>
<tr>
<td>2020</td>
<td>6.2%</td>
</tr>
<tr>
<td>2021</td>
<td>6.0%</td>
</tr>
<tr>
<td>2022</td>
<td>5.8%</td>
</tr>
<tr>
<td>2023</td>
<td>5.6%</td>
</tr>
<tr>
<td>2024</td>
<td>5.4%</td>
</tr>
<tr>
<td>2025</td>
<td>5.2%</td>
</tr>
<tr>
<td>2026</td>
<td>5.0%</td>
</tr>
<tr>
<td>2027</td>
<td>4.9%</td>
</tr>
<tr>
<td>2028</td>
<td>4.5%</td>
</tr>
<tr>
<td>2029</td>
<td>4.5%</td>
</tr>
</tbody>
</table>
Attachment B
July 24, 2009

John Waller
Director of Office of Accountability and Compliance
Postal Regulatory Commission
901 New York Avenue, N.W.
Suite 200
Washington, D.C. 20268-0001

Dear Mr. Waller:

Thank you for the opportunity to comment on the July 20, 2009, Review of OPM and OIG Retiree Medical Evaluation Reports by Mercer (Mercer Report). We hope the Postal Regulatory Commission’s (PRC) analysis of the Mercer Report and the Office of Inspector General (OIG) sponsored Hay Group Report will further the discussion of how to resolve the Postal Service’s financial crisis, which has been partially induced by legislated payments to the Postal Service Retirement Health Benefits Fund (PSRHBF).

The Postal Accountability and Enhancement Act of 2006 (the Act) mandated an aggressive payment schedule for prefunding retiree health care benefits that was not actuarially based. The Postal Service’s current financial difficulties raise the question of whether these payments are necessary and sustainable. As Mercer notes, “[e]ach valuation needs to be assessed and reviewed based upon the issue it was meant to address” (Mercer Report at 1). The purpose and context of Hay Group’s work for the OIG were to estimate the funding adequacy of various options of prefunding retiree health care benefits.

Hay Group found that the Act’s current payment schedule will overfund the Postal Service’s retiree health care liabilities by the end of 2016. A key reason for this finding was Hay Group’s decision to measure the liability using a 5 percent trend rate for health care inflation rather than the 7 percent rate used by the Office of Personnel Management (OPM).

Our comments in this letter are focused in the following areas:

- Use of 5 Percent Trend by Private Industry and State and Local Governments
- Variability and Sustainability of Historic Averages
Timeframe Used for Sloping Trend Rate
Postal Service-Specific Data
Unusual Level of Mandated Prefunding

Use of 5 Percent Trend by Private Industry and State and Local Governments

Mercer finds Hay Group’s 5 percent assumption to be optimistic but does not address the widespread use of 5 percent in other sectors by groups such as Fortune 100 companies and state and local governments, and public utilities. Unlike the federal government, these groups are like the Postal Service, in that they bear the financial consequences of prefunding liabilities. The Postal Service is the nation’s second largest civilian employer with 2008 revenues of approximately $75 billion and is mandated to operate like a business. Thus, it is appropriate to consider the health care trend rates other large business entities use to estimate their health care liabilities.

Variability and Sustainability of Historic Averages

Based on a review of the past Federal Employee Health Benefits Program (FEHBP) premium increases from 1983 to 2009, Mercer concludes that “a 7% trend rate or higher would be a reasonable trend assumption and is indeed consistent with the historical results” (Mercer Report at 8). This premise is arguable given the current focus on finding a new, less costly health care model for the United States.

Using averages also raises the issue of which averages to use. Averaging health care premium increases over different time periods yields substantially different rates. The table below was created using Hay Group data on FEHBP premium increases. It shows that historical average FEHBP premium increases over 5, 10, 15, and 20 years ending in 2008 ranged from a high of 7.95 percent to a low of 5.46 percent.

### Average FEHBP Premium Increases

<table>
<thead>
<tr>
<th></th>
<th>5-years</th>
<th>10-years</th>
<th>15-years</th>
<th>20-years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5.46%</td>
<td>7.95%</td>
<td>5.74%</td>
<td>6.74%</td>
</tr>
</tbody>
</table>

In addition, a simple linear trend line (not shown here) fit to a 1981 to 2009 time series of FEHBP premium changes (2009 is projected) shows a downward sloping line pointing at a 5 percent 2010 forecast. These results show that estimation of long term averages is highly dependent on the period and technique selected.
Moreover, Mercer does not address whether the 7-percent trend rate will be sustainable for the U.S. economy in the long term. The Hay Group found that a 7-percent trend rate suggests that 31 percent of the economy as measured by Gross Domestic Product will be consumed by health care in 2075, while currently the share is 17 percent.

**Timeframe Used for Sloping Trend Rate**

Mercer also implicitly critiques the Hay Group analysis for using a static 5 percent health care inflation ultimate trend rate rather than a range of inflation estimates trending down to 5 percent. Although Hay Group uses sloping trend rates in other work estimating Postal Service liabilities, a decision was made to use a single trend rate in this analysis for comparability with OPM’s use of a static 7 percent trend rate. Additionally, Mercer’s selected time horizon of 20 years is much longer than the typical time horizons used in the private sector. Hay Group’s benchmarking analysis showed that in the private sector these slopes typically average 6 years in length.

**Postal Service-Specific Data**

We agree with Mercer that estimation of retiree pension and health benefit costs should be based solely on Postal Service employees, not the pool of all civilian federal workers. In fact, one reason that benchmarking to other entities is useful is that postal-specific data were not available. It should be noted that Mercer’s conclusion that “[t]he historical FEHB information points toward a reasonable static assumption closer to 7%” (Mercer Report at 11) is based on data for all FEHB participants including active and retired federal employees not solely Postal Service annuitants. This information is not ideal for determining the appropriate trend rate for Postal Service annuitants.

**Unusual Level of Mandated Prefunding**

One major point of agreement between the OIG and Mercer is that the level of prefunding mandated by the current Act is unusual:

> It is also noteworthy to mention that the funding level achieved in 2016 under either the OPM projection or the Mercer selected trend scenario is material and substantial. Although retiree medical plans funded at the 2016 level are not unheard of, they are extremely unusual especially during the current economic situation. (Mercer Report at 11)
The Postal Service is aggressively funding its retiree health care benefits relative to private and public sector entities that are also prefunding. (Hay Group Report at 2)

In the current economic climate, funding at a faster pace than customary may not be affordable for the Postal Service. An appropriate prefunding plan must be financially sustainable while also ensuring that the Postal Service’s obligations to its retirees are met.

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.

Sincerely,

Tammy L. Whitcomb
Assistant Inspector General for Audit
OPM Comments on Mercer Report

Below are OPM initial comments on the Mercer Report that you sent to us yesterday evening. We would be happy to discuss with you and/or Mercer at your convenience.

Section 2, 2nd paragraph, last sentence should read: "The Postal Service contribution should be adjusted downward for civilian service before 1971 and for military service."

Section 3, 1st paragraph on page 6. We generally agree with Mercer's comments. However it would be beneficial to also note that the Postal Service participates in the larger FEHB Program in which each plan's premiums are based on their overall experience, not on Postal-specific experience.

Section 3, last paragraph on page 11 (added in the new "final" version). This paragraph could be stated more clearly.

Section 4, last paragraph on page 14 (added in the new "final" version). This statement is incorrect: "An implicit assumption in the OPM valuation work is that those employees that exit the work force are deemed to have retired." In determining the Liability and Normal Cost OPM applies a withdrawal assumption to the active workforce. Employees who withdraw are not deemed to retire. Furthermore, employees who are not currently participating in FEHB are not assumed to participate in FEHB in retirement. (When we provided you our back-of-the-envelope estimates for 2016 liabilities, we assumed that because current efforts to reduce the workforce are targeted to produce early retirement, employees induced to leave early would retain FEHB after employment. This appears to have been misconstrued in the paper – it does not reflect our overall valuation approach).