

**Before the President's Commission  
on the United States Postal Service**

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**COMMENTS OF  
THE EMA FOUNDATION INSTITUTE  
FOR POSTAL STUDIES**

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**COMMENTS OF THE  
EMA FOUNDATION INSTITUTE  
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The EMA Foundation Institute for Postal Studies (“EMA Foundation”) respectfully submits these comments to the President’s Commission on the United States Postal Service.

**I. INTRODUCTION**

**A. Identity and Interests of the EMA Foundation**

The Envelope Manufacturers Association (“EMA”) was formed in 1933. The purpose of EMA is (1) to share knowledge of envelope manufacturing among members of the EMA, (2) to produce programs to improve manufacturing efficiency, and (3) to minimize the negative impact of government regulations and other activities on the business of envelope manufacturing.

The EMA has been actively involved in Postal Service matters for over thirty years. In fact, the Association has worked with the Postal Service and its predecessor, the Post Office Department, from 1914 to the present. This involvement has included founding membership on the Mailer's Technical Advisory Committee of the Postal Service, and frequent participation in hearings and technical groups to revise Postal Service regulations. The EMA has also expanded its efforts in public affairs. It has monitored legislation which restricts the volume of advertising mail, authorizes competition between the government and the private sector, establishes environmental compliance requirements, as well as other legislation deemed by the Public Affairs Committee of EMA to affect the interests of the industry.

The EMA Foundation, a separate non-profit entity that was incorporated in 1997, sponsors research and education concerning the paper-based communications industry and its

customers. The efforts of the EMA Foundation include (1) identifying and analyzing major trends affecting the industry, especially the health and future of postal administrations both in North America and throughout the world; (2) developing key relationships with academic institutions and allied industry partners to monitor and to support focused research in a variety of countries relating to paper-based communication and its inter-relationship with electronic media; (3) encouraging career participation in the paper-based communications industry by those most likely to excel at such work; and (4) positioning paper-based communications as a key participant in the information age.

## **B. Purpose of These Comments**

The EMA Foundation submits these comments because the business model of the Postal Service is becoming increasingly dysfunctional and unsustainable. The Postal Service has been regulated since its inception in 1970 with much of the apparatus of traditional public utility regulation: universal service obligations, cost-of-service ratemaking, and rent-seeking behavior by unions, localities, and other interest groups.

This model may have been optimal thirty years ago. But the pricing power that sustains such a business model is eroding. As the Commission is aware, the Postal Service is suffering an increasing erosion of its volume in the face of competition. First-Class Mail faces increasing competition from business e-mail and electronic bill payment. Standard Mail faces increasing competition from print/broadcast media and internet advertising. Periodicals Mail volume has been limited by social and economic changes that have reduced the average number of periodical

subscriptions per household. And Package Mail faces intense competition from UPS and other package carriers.<sup>1</sup>

The ability of the Postal Service to recover its costs from mailers appears to have reached its limit. Recent rate increases have caused a marked drop-off in piece volume, a migration from more profitable to less profitable postal services, and a decline in the average weight per piece. A classic regulatory death spiral is an increasing threat.<sup>2</sup>

The EMA Foundation believes in the continued importance of the Postal Service's role in holding the American society and economy together through a universal service network. It also believes in the "sanctity of the mailbox"—the reservation of the mailbox for mail, without which exclusivity the mailbox could become cluttered and corrupted by the equivalent of the spam that now clogs many consumers' e-mail in-boxes. Nevertheless, reform is urgently needed.

### **C. Summary of Recommendations**

The most serious and immediate threats to the Postal Service's health involve its cost structure, not its rate structure. Although the standards and procedures for setting postal rates raise a number of complex and longstanding issues, they are far less critical than the need to reduce the Postal Service's costs to efficient levels.

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<sup>1</sup> USPS Briefing for the President's Commission on the United States Postal Service 25 (Jan. 8, 2003).

<sup>2</sup> U.S. GAO, GAO 03-118, *Major Management Challenges and Program Risks: U.S. Postal Service* 2-6 (Jan. 2003) ("*GAO Major Management Challenges Report*") ; see also USPS Fiscal Year 2002 Annual Report, Management Discussion & Analysis 1-3 ("*USPS 2002 Annual Report*").

## 1. The Postal Service's Deferred Liabilities Crisis

The Postal Service Transformation Plan presents the President's Commission with a myriad of problems. One particular problem, however, the Commission must address immediately. The issue is the Postal Service's deferred liability for pension and retirees' health care costs, now \$32 billion and \$45 billion, respectively, and growing fast. Without a solution to this problem, nothing else the Commission may do will prevent the inevitable financial disaster that looms before the Postal Service.<sup>3</sup> On the bright side, if the Commission can address this single problem and effectuate a change, it will have put the Postal Service almost immediately back in the black, giving it essential breathing room to devise solutions for its longer run problems in a more considered fashion.

The Postal Service is in a financial crisis, with decreasing volumes of mail and two particularly serious problems: \$32 billion of unfunded pension liability<sup>4</sup> and \$45 billion of unfunded retirees' health care liability.<sup>5</sup> Postal employees face uncertainty about the financial soundness of their retirement funds. Another rate increase to cover these retirement costs will drive Postal Service ratepayers to other providers of delivery service and accelerate the trend of declining mail volume.

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<sup>3</sup> The other sections of this submission address the specific issues of labor-related and pricing problems, as requested by the Commission. However, the efficiency or inefficiency of the Postal Service's operations is dwarfed in significance by the enormous financial problem presented by the unfunded liabilities described here. To focus just on the operational issues would be like rearranging the deck chairs on the Titanic.

<sup>4</sup> The \$32 billion represents the amount of future minimum payments the Postal Service must make in order to fund CSRS benefits and retirees' COLAs as of September 30, 2002. It does not include an additional \$16 billion in interest payments due. *USPS 2002 Annual Report* 47.

<sup>5</sup> The \$45 billion is an estimate based on a finding by an actuarial consultant hired by the Postal Service that the present value of future premium payments for retirees' health benefits is between \$40 and \$50 billion for Postal Service employment since 1971. *Id.* at 26.

Because of a greater than expected return on investments, however, the Office of Personnel Management (“OPM”) has discovered a projected overfunding of the Postal Fund portion of the Civil Service Retirement and Disability (“CSRD”) Fund in the amount of \$71 billion. The General Accounting Office (“GAO”) has estimated that this amount is actually \$103.1 billion. The larger amount recognizes the effect of existing law, which holds Treasury and not the Postal Service responsible for the costs of military service pensions.

Crediting the Postal Service with these overpayments will require legislation. Recognition of these overpayments and reduction of the Postal Service’s future deferred liabilities in and of itself will have no effect on the size of the budget deficit: The adjustment would be merely an intragovernmental transfer from the Postal Service to the Civil Service pension fund. The Congressional Budget Office (“CBO”), however, has determined that if the Postal Service uses its savings from reduced pension payments to postpone the next set of postal rate increases, the unified budget deficit may be negatively impacted by \$10 – \$15 billion over the next five years (because postage and fees paid by the mailing public are classified as government revenue in the overall deficit calculation).

There exists a solution, however—one agreed upon in large part by almost all of the stakeholders, including the Postal Service and the Administration.<sup>6</sup> The Administration has already drafted legislation that would recognize the OPM estimate of \$71 billion of overfunding by reducing the Postal Service’s \$32 billion pension payments to \$5 billion, to be paid over 40 years. GAO’s differing estimate of \$103.1 billion of projected overfunding and CBO’s finding of a negative impact on the unified budget have created some controversy. We thus propose a

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<sup>6</sup> The areas of disagreement will be examined in detail in Section II(C). It is essential that these disagreements not derail the passage of some form of legislation.

compromise that will result in an overall win-win situation for the federal government, postal employees, ratepayers, and most importantly the Postal Service itself:

1. **Congress should recognize the entire overpayment amount of \$103.1 billion** and refrain from imposing the additional costs of military service on the Postal Service.
2. **In exchange, the Postal Service would use the amount attributable to the military service issue to pay down its retirees' health care obligations**, thus ensuring that these costs are adequately funded. A portion of this amount should be allocated to changing the Postal Service's accounting method from pay-as-you-go to accrual accounting, as urged by both GAO and CBO. Because the Postal Service's payment to the Federal Employees Health Benefits ("FEHB") Fund is an intragovernmental transfer, this transaction would have no negative impact on the unified budget.
3. Assuming the remaining \$71 billion of projected overpayment is recognized by reduced payments under OPM's proposed schedule, the Postal Service would realize \$3.5 billion of savings in 2003 and \$2.7 billion in 2004. **The Postal Service should use a portion of the first year's \$3.5 billion savings to redeem part of its outstanding Treasury debt of \$11.1 billion.**<sup>7</sup> To further decrease the negative effect on the budget, the Postal Service may also choose to use part of the 2004 savings to pay down the Treasury debt or to make additional payments to the FEHB Fund. The Postal Service would realize further savings from eliminating the interest payments on the debt paid off in advance.
4. **The assumed 2004 rate increase should be postponed to prevent further erosion of the Postal Service's revenue base.** As the Postal Service undertakes its Transformation Plan, aided by the savings from reduced pension payments, it will develop new products and services, increase efficiency and productivity, and become more competitive in the delivery services market. This in turn will result in increased volumes of mail and greater receipts, thus having a long term positive effect on the federal government and the budget. Foregoing a destructive rate increase in 2004 in order to restore the financial health of the Postal Service will benefit not only the Postal Service and its users but also the federal government, which will no longer have to face the specter of a future bail-out of the Postal Service.

Under this solution, ratepayers will not have to shoulder the extraordinary costs of continued overpayment into the pension fund; postal employees will be able to trust in a financially solid fund; the Postal Service will be able to resolve both parts of its deferred liabilities problem, to pay down its debt, and to implement the Transformation Plan without an

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<sup>7</sup> The Postal Service has already indicated that it intends to use a portion of the savings to pay down its Treasury debt.

immediate rate increase; and the federal government will be relieved of the future costs of guaranteeing Postal Service retirement benefits.

With such a fair and lasting solution within reach, the Commission should do everything possible to effectuate the passage of some form of legislation to recognize the overfunding. The Commission stands in a unique position to urge the Administration to carry out its proposal and to educate Congress and the public as to the magnitude of the deferred liabilities problem. Although the Administration has already acknowledged the Postal Service's overpayment, Congress may lose its political will to adopt this legislation because the accounting change may increase the unified budget deficit. However, without formal legislation, the Postal Service would have to continue making burdensome payments, resulting in another rate increase to take effect in twelve months, followed by large and frequent additional rate increases in the future. No clairvoyance is required to foresee the diversion of customers to other forms of delivery, and the Postal Service death spiral that is likely to ensue. The federal government would also lose: It is projected that as early as 2004, the Postal Service may hit its statutory debt ceiling, and be unable to pay its employees. Since it would be unthinkable for the United States mail to go undelivered, the federal government would have to step in and bail out the Postal Service—at a much greater cost to taxpayers than the present accounting correction. The Commission will win a major victory for the Postal Service and all stakeholders if it can effectuate the immediate passage of legislation to recognize the overfunding.

## **2. Labor and Employee Issues**

Any meaningful effort to rein in the Postal Service's operating costs must deal with its escalating personnel costs, which now account for well over 75 percent of the Postal Service's annual operating expenses. We urge the Commission to recommend reforms that focus on the

root causes of the problem: a wage rate structure that appears to be out of line with market conditions; a workforce that is larger than necessary for productive operations; and a working environment that breeds acrimony and conflict.

Under new leadership, the Postal Service has recently taken useful steps to resize its workforce through attrition. But such incremental progress is not enough. The Commission should recommend reforms that permit and encourage the Postal Service to further reduce the size of its workforce, including closing unneeded and inefficient postal facilities and relocating necessary work to more efficient facilities.

The Commission likewise should encourage the Postal Service to make greater efforts to outsource those functions that can be performed more efficiently by private contractors. To this end, the Postal Service should be freed from federal statutory and regulatory requirements that discourage or impede cost-effective outsourcing, including the Service Contract Act. Application of those restrictions is a vestige of the Postal Service's pre-reform monopoly status; today's Postal Service should have the same flexibility to outsource functions and thereby better manage the size of its workforce, as do its private competitors.

Existing Postal Service employees should be allowed to compete for the new business opportunities made possible through outsourcing. The effects of any displacement of existing employees can be mitigated in appropriate ways, using one or more of the various approaches that have been employed in other industries undergoing rationalization of their workforces.

It is also critical for the Commission to pursue reform of the current collective bargaining regime. More than 85 percent of the Postal Service's workforce is covered by labor agreements, which govern wages and benefits and prescribe work rules that restrict operational flexibility.

Any meaningful progress in reducing the Postal Service's cost structure demands reform of the process by which these agreements have been made.

The current bargaining scheme, which relies on voluntary fact-finding and mandatory interest arbitration, is not working. It has proven a roadblock to compromise and negotiated agreements and has generated hostile labor-management relations. Individual arbitrators have virtually unlimited discretion to prescribe contract terms, guided only by the undefined statutory directive that the Postal Service pay wages comparable with those in the private sector, which has functioned as a one-way ratchet, contributing to spiraling wage increases.

The following reforms should be considered as ways to create incentives for meaningful negotiations and foster responsible, cost-efficient outcomes if there is an impasse:

1. **Mandatory mediation:** The current fact-finding process, which the parties ordinarily bypass, should be replaced by mandatory mediation. This would foster constructive negotiations and compromise and increase the chances for agreement before arbitration.
2. **New arbitration standards:** Arbitrators should be required to consider the interests of the public and of ratepayers when adopting labor agreement terms—including the effects of such terms on the Postal Service's ability to carry out its responsibilities and the Postal Service's ability to pay for any future increases in wages and benefits. Formal standards should impose needed discipline, resulting in more balanced arbitral outcomes, and may result in fewer arbitrations, as each side would be less confident of holding an advantage.
3. **Other Modifications to the Arbitration Process.** (i) Arbitration boards should be made up of three neutral decisionmakers, as this is likely to promote more reasoned arbitral outcomes. (ii) Arbitration awards should be made subject to judicial (and perhaps administrative) review, as this would give force to substantive arbitration standards. (iii) The Commission might consider adopting some form of final-offer arbitration, in which arbitrators would be required to select the final offer of one side, without modification. (The choice would be between each side's entire bargaining proposal as a package, or it could proceed issue-by-issue.) Such a winner-take-all approach would provide a forceful incentive for the parties to settle their differences rather than risk a complete loss in arbitration. (iv) The Commission might also consider adopting a "Med-Arb" scheme, in which the neutral would initially act as a mediator but, failing agreement, turn into an arbitrator and impose a binding settlement. This could encourage the parties to compromise and settle at the mediation stage.

4. **Railway Labor Act Model:** The Commission should consider incorporating elements of the Railway Labor Act (“RLA”), a time-tested regime specifically designed for industries which, like the Postal Service, perform functions vital to the nation’s economy. The experience of the railroad (and airline) industry suggests that the RLA scheme has successfully balanced the interests of labor and management with the public’s interest in uninterrupted commerce and that adopting features of the RLA model could facilitate future Postal Service negotiations.

### **3. Rationalizing the Postal Service’s Physical Plant**

A streamlined process for closing uneconomic post offices and mail processing facilities could help the Postal Service provide more effective and affordable service. The most significant constraints on infrastructure rationalization are political, including the threat of congressional intervention.

The military has faced similar problems in connection with base closures, and the Defense Base Closure and Realignment Act of 1990 has provided a workable solution that might serve as a model for the Postal Service. Key features of a streamlined process modeled on the Act would include:

1. Development of an overall rationalization plan.
2. Submission of the plan and a list of facilities to be downsized to a neutral tribunal.
3. Congressional and Presidential approval of the recommended list on an all-or-nothing basis.

### **4. Pricing and Unbundling Issues**

Although pricing and unbundling issues are less urgent than cost control, it would be useful for the Commission to recommend appropriate standards for deciding (1) what prices the Postal Service should charge for nonregulated postal services, and (2) what implicit prices should be set for unbundled intermediate outputs of the Postal Service, such as mail acceptance, sorting, and transportation. The appropriate rules of decision in these two areas are similar. To avoid the

cross-subsidization of competitive, nonregulated services by monopoly postal services, the revenue requirement to be recovered from the latter services should exclude any shortfalls created by the failure of nonregulated services to cover their attributable and average incremental costs. Likewise, for unbundled intermediate outputs (*e.g.*, collection, sorting and transportation), the implicit price for the unbundled service (in postal parlance, the “work-sharing discount”) should at least cover the estimated costs attributed to the provision of that service by the Postal Service itself.

## II. THE DEFERRED LIABILITIES CRISIS

Like the proverbial tail wagging the dog, the deferred liabilities crisis has been the driving force in the Postal Service's financial distress.<sup>8</sup> In FY 2002, the Postal Service posted a \$676 million loss, despite a net income from operations of positive \$1.229 billion. Approximately \$1.6 billion went to paying the interest alone on the unfunded pension liability. The attached Table 1 shows that for the years 2000, 2001, and 2002, the interest expense alone pushed the Postal Service into red ink. The total payments for Civil Service Retirement System ("CSRS") liability was \$4.6 billion in FY 2002.<sup>9</sup> By 2010, this expense could grow to \$8 billion annually. The present value of the unfunded CSRS pension liability is approximately \$32 billion and growing. By 2004, the Postal Service is projected to reach its debt ceiling of \$15 billion,<sup>10</sup> and with these astronomical payments, it may not be able to make payroll for its 850,000 employees.

This section first examines the magnitude of the deferred liabilities crisis regarding pensions. It also discusses the related problem created by the unfunded liability for retirees' health care benefits. Second, it describes several proposed reform efforts and explain the limitations of these approaches. Third, it explains OPM's recent findings, its proposed legislation, and the positions of the parties involved. Finally, we propose a compromise solution, one that would address both the pension and retirees' health care funding problems, that should

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<sup>8</sup> As described below, there are two parts to the deferred liabilities problem: (1) the unfunded pension costs and (2) the unfunded retirees' health care costs.

<sup>9</sup> *USPS 2002 Annual Report* at 47. Another \$1.0 billion was paid for "retiree health insurance premiums" for a total of \$5.6 billion. *GAO Major Management Challenges Report* at 20, Table 3. The retirees' health benefit liability is not addressed directly by the proposed OPM legislation and thus continues to be a major drain on Postal Service resources. GAO has estimated the deferred health care obligation to be \$45 billion. See Section II(D) for our proposal on this issue.

<sup>10</sup> *GAO Major Management Challenges Report* at 19.

**Table 1: USPS Financial Statements from Annual Reports of FY 2000, 2001, 2002**

**Statements of Operations**

**Year Ended September 30**

<i>(dollars in millions)</i>	2002	2001	2000
Operating revenue	\$66,463	<b>\$65,834</b>	\$64,540
Operating expenses:			
Compensation and benefits	\$51,557	<b>\$51,351</b>	\$49,532
Transportation	\$ 5,132	<b>\$ 5,056</b>	\$ 4,709
Other	<u>\$ 8,545</u>	<u><b>\$ 9,233</b></u>	<u>\$ 8,751</u>
Total operating expenses	\$65,234	<b>\$65,640</b>	\$62,992
Income from operations	\$ 1,229	<b>\$ 194</b>	\$ 1,548
Interest and investment income	\$ 46	<b>\$ 35</b>	\$ 41
Interest expense on deferred retirement liabilities	(\$ 1,601)	<b>(\$ 1,603)</b>	(\$ 1,568)
Interest expense on borrowings	(\$ 340)	<b>(\$ 306)</b>	(\$ 220)
Emergency Preparedness Appropriations	\$ 179		
Emergency Preparedness Expenses	<u>(\$ 189)</u>		
Net Income (Loss)	(\$ 676)	<b>(\$ 1,680)</b>	(\$ 199)

be acceptable to all parties, and that would put the Postal Service back on a solid financial footing.

**A. Background: The Creation and Scope of the Deferred Liabilities Problem for Pension and Health Care Benefits**

The Postal Service's deferred liabilities problem concerns two similar but technically distinct funds: the Civil Service Retirement System fund and the Federal Employees Health Benefits fund. To understand the severity of the deferred liabilities problem, one must appreciate the basic workings of (1) the pension fund and the historical causes for the present pension crisis; and (2) the retirees' health benefits fund and the evolution of its financial crisis. Only by wading through some of the details of the funding problem will the Commission be able to appreciate the magnitude of the problem, the limitations of piecemeal reform efforts, and the significance of the OPM findings.

**1. A Few Basic Principles of Pension Finance**

Most pension plans fall under one of two basic types: "defined contribution" plans or "defined benefit" plans. Under a *defined contribution* plan, the employee and/or the employer contributes to the plan and these contributions are invested. When the employee retires, he receives the value of all principal contributions and their earnings, much like a 401(k) plan. Because the benefit which the employee receives is based solely on the amounts contributed to the plan and the net earnings on those contributions, defined contribution plans are by definition fully funded.

In contrast, *defined benefit* plans run the risk of being underfunded because they calculate the employee's retirement benefit based on an established formula that incorporates the

average salary and years of service. For example, the Civil Service Retirement System (“CSRS”) calculates the promised benefit as a function of the employee’s “high three” years of service<sup>11</sup> and total length of employment. For a defined benefit plan to be fully funded, the employer must set its contributions at a level which, when added to the projected net earnings on those contributions, will later yield the benefits payable under the plan’s formula. The employer’s annual contribution thus depends on a variety of factors, *e.g.*, the investment performance of existing assets, actuarial assumptions as to how long employees will work and live, assumptions about future interest rates, and projections of employee salary increases. If a defined benefit plan falls behind in funding, the shortfall will increase over time because the plan will not achieve the assumed earnings of a fully funded plan. The consequence of underfunding of a defined benefit plan is obvious: When the deferred liability comes due, there are no funds to pay retirees.

Federal law prevents such disastrous consequences in the case of private employers. ERISA<sup>12</sup> bars *private* employers from underfunding defined benefit plans. However, *governmental* employers are under no such restraint. Some governmental employers have fully funded their defined benefit pension plans, but others continue to pay current retirement benefits out of their general revenues without making sufficient contributions into their pension funds to pay the ultimate pension liabilities. This “pay-as-you-go” approach fails to fund retirement benefits in full as they accrue over the employee’s working life, thus creating huge “deferred liabilities” and exposing the governmental employer to enormous future expenses for which no reserve has been established.

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<sup>11</sup> The “high three” years are the three years in which the employee’s earnings were greatest.

<sup>12</sup> Employee Retirement Income Security Act, 29 U.S.C. §§ 1001-1461, commonly known as “ERISA”.

## 2. Creation of the Postal Service's Obligation for Pension Payments

Federal employees participate in one of three retirement plans: The Civil Service Retirement System, the Federal Employees Retirement System ("FERS"), or the CSRS Offset Plan.<sup>13</sup> The FERS and CSRS Offset plans are not at issue in this discussion.<sup>14</sup> The CSRS covers employees hired prior to January 1, 1984;<sup>15</sup> it is a defined benefit plan, which provides a basic annuity<sup>16</sup> to participants based on the "high three years" of service and total length of employment. Congress created the Civil Service Retirement and Disability Fund ("CSRD Fund") in 1970<sup>17</sup> to finance the retirement payments for federal employees and designated the Office of Personnel Management ("OPM") to administer the fund.

Each year the Postal Service pays into the CSRD Fund<sup>18</sup> (1) its standard contribution, which in FY 2002 was \$740 million; and (2) surcharges imposed by Congress, which in FY 2002 were \$3.873 billion, including interest. These special charges are not imposed on any other executive branch agency.<sup>19</sup> In addition, the Postal Service pays (3) the costs of current retirees'

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<sup>13</sup> U.S. GAO, GAO-02-170, *U.S. Postal Service: Information on Retirement Plans 3* (2001) ("*GAO Retirement Report*").

<sup>14</sup> The FERS employees' retirement benefits are already fully funded under statutory provisions that require payment of the full cost of future benefits on a current basis and periodic actuarial evaluations to ensure the continued ability to pay those benefits. Letter from OPM to the Postmaster General (Nov. 1, 2002).

<sup>15</sup> In 2001, of total career employees, 263,383 employees (33.5 percent) participated in CSRS. *GAO Retirement Report* at 4.

<sup>16</sup> An annuity is a stream of equal periodic amounts paid to the retiree according to a specified formula.

<sup>17</sup> 5 U.S.C. § 8348 (2002).

<sup>18</sup> The CSRS payments are in addition to payments for the FERS and CSRS Offset plans. All three payments totaled \$7.6 billion in FY 2002 (plus \$1.5 billion in Social Security costs). *USPS 2002 Annual Report* at 47.

<sup>19</sup> There are no divisions of the fund to reflect the Postal Service portion or that of any other federal agency and until recently, the Postal Service's contributions and earnings were not tracked. *See* Section II(C).

annuities through its operating revenues. In contrast, other federal agencies contribute to the CSRD Fund 7 percent of salaries (plus contributions by employees) and pay neither surcharges nor the costs of current retirees; Congress appropriates money to cover the costs of current retirees. The Postal Service has never received any of these appropriated funds.<sup>20</sup> This is how the current system of payments evolved:

**a) Historical Evolution of the Postal Service Pension Payments**

When the Postal Service commenced operations on July 1, 1971, under the Postal Reorganization Act of 1970 (P.L. 91-375),<sup>21</sup> it did not have any unpaid liabilities to OPM for retirement benefits. Postal Service employees were to participate in the CSRS, with the same benefits as other federal employees, with their future retirement benefits to be paid by OPM based on Postal Service and employee contributions under the CSRS law.<sup>22</sup> However, over time, Congress has changed the operation of the CSRD Fund and the amounts owed by the Postal Service:

**b) Additional Postal Service Payments to Reflect Pay Increases**

In 1974, Congress realized that the CSRD Fund was significantly underfunded because agencies had failed to increase their contributions to reflect steady pay increases. Since the

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<sup>20</sup> That the Postal Service has been singled out for unique treatment historically prevents other agencies from seeking to have OPM account for their own CSRS contributions in hope of finding an overfunding.

<sup>21</sup> The Postal Service is an “independent establishment of the executive branch with a goal to operate on a break-even basis and cover its expenses almost entirely through postal revenue.” *GAO Retirement Report* at 3. With over 850,000 employees at the end of FY 2002, it ranked as the second largest employer in the United States.

<sup>22</sup> “The Postal Service shall withhold from pay and shall pay into the Civil Service Retirement and Disability Fund the amounts specified in or determined under such chapter 83 and subchapter II of such chapter 84, respectively.” 39 U.S.C. § 1005(d)(1).

retirement benefit was calculated based on the “high three years” of service, an increase in salaries required a corresponding increase in employers’ contribution to the CSRD Fund. Congress determined that the Postal Service had received an “indirect subsidy” from the federal government for this “gap” in the Fund, even though its liability was in the future. Congress thus required the Postal Service to begin to pay off its unfunded liability at rates sufficient to cover the gap resulting from employee-management agreements or administrative actions that increased the pre-retirement salaries of Postal Service employees. Today, whenever the Postal Service increases a CSRS employee’s pay under a collective bargaining agreement, it must pay OPM the present value of the additional future retirement benefits as a result of the pay increase. By statute, the Postal Service must pay this incremental liability in thirty annual installments with interest.<sup>23</sup> The interest rate for calculating the present value of the incremental liability and for amortizing the payments has been 5 percent for the last thirty years.<sup>24</sup> Figure 1 shows the “Changes in Retirement Liability Attributable to Pay Increases.”

***COLA Funding Introduced and Backdated to 1986.*** In 1989, the Omnibus Budget Reconciliation Act (“OBRA”) imposed further charges on the Postal Service by mandating that the Postal Service pay for Cost of Living Adjustment (“COLA”) increases occurring in the future and retroactively to 1986.<sup>25</sup> In addition, interest at 5 percent was charged to the Postal Service for the amount that would have been paid as of October 1, 1986. Payments were to be made in fifteen annual installments.

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<sup>23</sup> 5 U.S.C. § 8348(j).

<sup>24</sup> OPM calculates the incremental costs due to pay increases on a “static” basis, *i.e.*, assuming no future inflation and no future general schedule salary increases. OPM’s Board of Actuaries has recommended a 5 percent discount rate for this static valuation. “OPM does not make the calculations on a ‘dynamic’ basis, which would include an assumed annual rate of inflation, future salary increases, and a provision for an assumed percentage rate of return on plan investments.” *GAO Retirement Report* at 17.

<sup>25</sup> By law, CSRS retirees and their survivors receive yearly COLAs.

***COLA Funding Backdated to 1977.*** In the OBRA of 1990, Congress again increased the charges to the Postal Service for COLA payments by pushing back the applicable date to 1977. These payments were to be made in fifteen equal annual installments at 5 percent interest. Figure 2 shows “Changes to Retirement Liability Due to Increases in Retiree COLAs.”

***Lump Sum Payment by the Postal Service.*** In the OBRA of 1993, Congress required the Postal Service to pay OPM \$693 million over three years from 1996 to 1998, 5 percent interest. This lump sum payment was for past interest which had accrued as a result of the unfunded liability for COLAs and health benefits. Figure 3 shows the combined effect of payments for pay increases, COLAs, and interest costs over the years.<sup>26</sup> Figure 4 shows the combined annual CSRS payments in relation to the surcharge payments for pay increases, COLAs, and interest, and the projected increase in total payments through 2010.

**c) Impact of the Postal Service’s Liability for CSRS Pension Costs**

For the past thirty years, the Postal Service has paid these extraordinary installment payments plus 5 percent interest.<sup>27</sup> For FY 2002, the Postal Service paid a standard annual CSRS

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<sup>26</sup> From 1972 through 2000, OPM assessments for pay increases was \$42.1 billion. During that period, the Postal Service paid \$16.2 billion in principal plus interest of \$21.6 billion, for total payments of \$37.8 billion. Since its annual principal payments have been less than the new liability added each year, the unpaid balance is growing, as is the interest charged annually on the unpaid balance. *GAO Retirement Report* at 18. As to the portion of liability attributable to increases in retiree COLAs, the Postal Service had recorded a total liability of \$11.1 billion from 1990 through 2001. Of that amount, as of 2001, the Service had paid OPM \$4.8 billion, plus interest of \$2.3 billion, for a total of \$7.1 billion. Again, since its payments have generally been less than the additional liabilities added each year, the balance, as well as interest on it, continues to grow. *Id.* at 19. Even with low inflation, the total liability for retiree COLAs is expected to grow overtime until most of the CSRS retirees or survivors are deceased.

<sup>27</sup> The most recent figures of costs are from the 2002 USPS Annual Report. It states, “[f]rom postal reorganization in 1971 through the end of 2002, we have made cash payments totaling \$55 billion on CSRS retirement liabilities associated with pay increases and retiree COLAs. Current postage rates include approximately \$4 billion per year for payments of these costs.” *USPS 2002 Annual Report* at 28.

payment of \$740 million and an additional \$3.873 billion for the surcharged amounts, including \$1.601 billion in interest charges.<sup>28</sup> The combined annual payment for these liabilities will increase steadily to approximately \$8 billion in 2010 and then decrease as the number of employees, retirees, and survivors under CSRS decrease.<sup>29</sup> The Postal Service's remaining CSRS liability is \$32.2 billion, not including \$16.5 billion of future related interest charges over thirty years.<sup>30</sup>

In FY 2002, the Postal Service reported an overall loss of \$676 million, even though income from postal operations was a positive \$1.229 billion. It was the \$1.6 billion interest payment on the unfunded CSRS liability that pushed the Postal Service from surplus into deficit. In fact, the Postal Service has had a positive income from operations over the past ten years.

Table 1 shows the effect of the CSRS payments on net income from operations for fiscal years 2000, 2001, and 2002. In each year, the interest expense on the pension liability changed an operating surplus into an overall loss. Regulatory reform, privatization, productivity improvements, cost containment, and other efforts to reduce the Postal Service's costs going forward cannot succeed while the legacy of unfunded pension liability hangs over the Postal Service.<sup>31</sup>

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<sup>28</sup> In contrast, for FY 2000, the CSRS standard annual payment was \$795 million, and the installment payment for the surcharged amounts (including incremental liability for pay increases and retirees' COLAs) was \$3.6 billion, of which \$1.6 billion was interest. *GAO Retirement Report* at 11.

<sup>29</sup> *Id.*

<sup>30</sup> *GAO Major Management Challenges Report* at 20, Table 3.

<sup>31</sup> The Postal Service was designed to be financed by income from postal operations paid for by the postal ratepayers. The ratepayers should not be responsible for the extraordinary expenses of this unfunded pension liability, above and beyond the costs of postal operations. They will respond by moving away from the Postal Service to other delivery options, such as email or private delivery services, thus decreasing the volume of Postal Service mail and requiring yet another rate increase, which will in turn have the same effect.

### **3. On a Parallel Track, Retirees' Health Benefits Payments**

On a parallel track downhill is the Postal Service deferred liability for its retirees' health care benefits. Although the federal government initially assumed responsibility for all federal retirees' health care costs, in 1986 Congress transferred to the Postal Service its share of these costs. Since then it has steadily increased the Postal Service burden of these costs by enlarging the scope of liability and requiring the Postal Service to make periodic installment payments for the costs of its retirees' benefits. To understand this second part of the Postal Service's deferred liabilities problem, it is necessary to examine (1) the statutory framework and (2) the legislated increases in the Postal Service liability for retirees' health benefits.

#### **a) The Statutory Framework of the Federal Employees Health Benefit Plan**

The retirement health benefits program is a separate benefit available to all federal employees, including Postal Service employees. It is in addition to and distinct from the retirement programs under the CSRS, FERS, and CSRS Offset Plans previously discussed. Retirement health benefits are available through the Federal Employees Health Benefit Plan ("FEHBP"), established under the Federal Employees Health Benefits Act of 1959 ("FEHBA"). All federal retirees, including postal retirees, who participated in FEHBP for at least five years immediately preceding retirement and who are entitled to a federal pension, are eligible.<sup>32</sup> The costs of retirees' health benefit premiums are covered through a combination of deductions from retirees' pensions and contributions by the government employer.<sup>33</sup>

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<sup>32</sup> 5 U.S.C. § 8905.

<sup>33</sup> *Id.* § 8906.

Initially, all government contributions, including the Postal Service's portion, were paid through annual appropriations. This arrangement was consistent with the Postal Reorganization Act of 1970. Under that Act, the federal government remained responsible for all the liabilities of the former Post Office Department.<sup>34</sup> In 1986, however, Congress amended the FEHBA to make the Postal Service liable for the government's share of its retirees' health benefit premiums.<sup>35</sup> Under current law, the government's share for all retirees except Postal Service retirees is paid through an annual appropriation.<sup>36</sup> Only the Postal Service must pay the employer's share of the costs for its retirees.<sup>37</sup>

Amounts contributed by retirees and by the Postal Service are paid into the Federal Employees Health Benefits Fund ("FEHB Fund").<sup>38</sup> Like the CSRD Fund, this Fund is maintained by Treasury and administered by OPM. Amounts in the Fund are used to pay FEHBP expenses. The Secretary of the Treasury is authorized to invest Fund amounts in Treasury securities. Interest and other proceeds earned on these funds are reinvested in the Fund.<sup>39</sup>

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<sup>34</sup> Pub. L. No. 91-375, 84 Stat. 719 (1970).

<sup>35</sup> Pub. L. No. 99-272, § 15202(b), 100 Stat. 82 (1986 at Pt. 6).

<sup>36</sup> 5 U.S.C. § 8906(g)(1) & (2).

<sup>37</sup> Pursuant to the FEHBA, OPM determines the weighted average of the health benefit premiums that will be in effect each year. *Id.* § 8906(a). The government contribution is 72 percent of this amount for each of its retirees on a biweekly basis. *Id.* § 8906(b).

<sup>38</sup> *Id.* § 8909.

<sup>39</sup> *Id.* § 8909(c).

**b) Increases in the Postal Service’s Liability for Retirees’ Health Benefits Imposed by Congress**

Since 1986, Congress has substantially increased the Postal Service’s liability for its retirees’ health benefits by extending the timeframe for Postal Service liability and by mandating several installment payments.

*Changes to the Scope of Postal Service Liability.* In 1986, Congress imposed a unique requirement on the Postal Service to pay the health benefit premiums for postal employees who retired after October 1, 1986.<sup>40</sup> Even today, no other agency has ever been required to pay the employer’s portion of its retirees’ health care costs.<sup>41</sup>

In 1989, Congress extended the Postal Service’s liability to cover survivors of retirees. The Omnibus Budget Reconciliation Act (“OBRA”) of 1989 mandated payment by the Postal Service for the employer’s share of the health insurance premiums for survivors of those postal employees who retired or died on or after October 1, 1986.<sup>42</sup> In doing so, Congress noted that “the Postal Service is the only governmental entity that makes any payment for the health insurance premiums of its retirees or their survivors.”<sup>43</sup>

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<sup>40</sup> Pub. L. No. 99-272, § 15202(b), 100 Stat. 82 (1986).

<sup>41</sup> H.R. Rep. No. 101-881, at 172 (1989), *reprinted in* 1990 U.S.C.C.A.N. 2017, 2180 (1989).

<sup>42</sup> Pub. L. No. 101-239, § 4003(a), 103 Stat. 2106 (1989).

<sup>43</sup> H.R. Rep. No. 101-247, at 876 (1990), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2353. Congress also observed that the cost to the Postal Service for the retirees’ and survivors’ health insurance premiums was expected to exceed \$190 million in fiscal year 1990, and \$2 billion over the period from 1990 through 1994. Based on an assumption that the number of survivors would grow at the rate of 800 per year, and taking into account the average cost of benefit premiums, Congress expected Postal Service payments to total \$6 million in 1990, and to increase to \$20 million in 1994. *Id.* at 888.

In the OBRA of 1990, Congress again increased the Postal Service's liability by pushing back the effective date from 1986 to 1971.<sup>44</sup> With the 1990 OBRA, "the largest deficit reduction package in history,"<sup>45</sup> Congress required the Postal Service to begin paying for the health benefits of all those who retired after June 30, 1971, the effective date of the Postal Reorganization Act.

***Additional Liability in the Form of Installment Payments.*** In addition to enlarging the scope of the Postal Service's liability for retirees' health benefits, Congress obligated the Postal Service to make several installment payments to the FEHB Fund. In 1987, Congress imposed an additional obligation on the Postal Service to pay to the FEHB Fund \$160 million in 1988, and \$270 million in 1989.<sup>46</sup> The law specified that the total of \$430 million represented a partial payment for retirees' benefits for which the FEHB Fund had not previously been reimbursed.<sup>47</sup> The Postal Service was required to pay these additional amounts from its operating budget and was not permitted to increase postal rates to finance the payments.<sup>48</sup>

In 1990, the OBRA, which required the Postal Service to begin covering the health benefit costs of those who had retired as early as 1971, also made the Postal Service pay for retirees' health benefits retroactively to July 1, 1971.<sup>49</sup> The result was to commit the Postal

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<sup>44</sup> Pub. L. No. 101-508, § 7102(a), 104 Stat. 1388 (1990).

<sup>45</sup> *Statement by President George Bush upon Signing H.R. 5835*, 26 Weekly Comp. Pres. Doc. 1764 (Nov. 12, 1990), reprinted in 1990 U.S.C.C.A.N. 2930-1, at 2930-1.

<sup>46</sup> Pub. L. No. 100-203, § 6003(a), 101 Stat. 1330, 1330-277 (1987).

<sup>47</sup> *Id.* § 6003(a).

<sup>48</sup> *Id.* § 6003(b).

<sup>49</sup> The House Report accompanying the 1990 OBRA expressed concern that these "massive" additional liabilities would break the promise made to Postal Service employees before the 1971 Postal Reorganization that their benefits would be covered by the federal government and thus that the promised benefits would not be entirely dependent on the success of the new Postal Service that emerged from reorganization. See H.R. Rep. No. 101-881, at 351-52 (1990), reprinted in 1990 U.S.C.C.A.N. 2017, 2179-80.

Service to a series of installment payments to cover the amounts it would have paid had the new provisions been in effect since the creation of the Postal Service.<sup>50</sup> Specifically, the Postal Service was required to pay \$455 million to the FEHB Fund over a five-year period beginning in FY 1991.<sup>51</sup>

Finally, in 1994, Congress imposed additional payments, which were characterized as corrected calculations for past health benefits.<sup>52</sup> These amounts included an interest charge of 5 percent on past benefit costs.<sup>53</sup> These provisions required the Postal Service to pay \$348 million into the Fund over a three-year period beginning in 1996.<sup>54</sup> As with previous legislation, these amounts were in addition to any other amounts owed for health benefit premiums.

**c) Impact of the Postal Service's Liability for Retirees' Health Benefits**

The Postal Service incurs significant costs for retirees' health benefit premiums, which are expected to increase in the future along with rising health care costs.<sup>55</sup> The costs for FEHBP

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<sup>50</sup> Pub. L. No. 101-508, § 7103(c), 104 Stat. 1388, 1388-333 (1990) (codified as amended at 5 U.S.C. §§ 8348-8906).

<sup>51</sup> The amendment specified that the Postal Service must pay the following amounts into the Fund: (1) \$56,000,000 by September 30, 1991; (2) \$47,000,000 by September 30, 1992; (3) \$62,000,000 by September 30, 1993; (4) \$56,000,000 by September 30, 1994; and (5) \$234,000,000 by September 30, 1995. *Id.*

<sup>52</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 11101(b), 107 Stat. 312 (1993).

<sup>53</sup> U.S. GAO, GAO/AIMD-93-11, *Financial Management: Estimate of Interest on Selected Benefits Received by Postal Service Retirees* 1 (1993).

<sup>54</sup> Pub. L. No. 103-66, § 11101(b), 107 Stat. 312 (1993). One-third of this amount was due at the end of 1996, two-thirds at the end of 1997, and any remaining balance was to be paid by the end of fiscal year 1998. *Id.*

<sup>55</sup> *GAO Retirement Report* at 20.

amounted to \$744 million in 2000, \$858 million in 2001, and \$987 million in 2002.<sup>56</sup> The Postal Service estimates that the annual cost will reach \$2 billion by FY 2010.<sup>57</sup>

The projected increase in health benefit costs will further restrict the cash flow available to the Postal Service for its operating expenses and thus threatens to lead to postal rate increases, which in turn may drive more ratepayers to alternative delivery systems.<sup>58</sup> The substantial costs of retirees' health benefits was an important factor influencing the Comptroller General's decision in April 2001 to place the Postal Service's long-term financial outlook on GAO's "high-risk" list.<sup>59</sup> In February 2002, GAO again determined that the Postal Service's retirement and health benefits contributed significantly to the Postal Service's precarious financial condition.<sup>60</sup>

**d) Accounting Treatment of the Postal Service's Costs for Retirees' Health Benefits**

A further issue is raised by the accounting method the Postal Service uses to book the costs of its retirees' health benefits. Presently, the Postal Service uses the pay-as-you-go method commonly applied to multi-employer health plans. However, since 1992, GAO has argued that the single-employer, accrual accounting method is more appropriate.<sup>61</sup> GAO interprets the Statement of Financial Accounting Standards No. 106<sup>62</sup> to require accrual accounting because it

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<sup>56</sup> *USPS 2002 Annual Report* at 44.

<sup>57</sup> *GAO Retirement Report* at 20.

<sup>58</sup> *Id.* at 21.

<sup>59</sup> U.S. GAO, GAO-01-598T, *U.S. Postal Service: Transformation Challenges Present Significant Risks* (Apr. 4 2001).

<sup>60</sup> U.S. GAO, GAO-02-355, *U.S. Postal Service: Deteriorating Financial Outlook Increases the Need for Transformation 2*, 20 (2002) ("GAO Deteriorating Financial Outlook Report").

<sup>61</sup> U.S. GAO, GAO/AFMD-92-32, *Financial Reporting: Accounting for the Postal Service's Post-retirement Health Care Costs* 13 (1992) ("GAO Accounting for Post-retirement Benefits Report").

<sup>62</sup> FASB, *Employer's Accounting for Post-retirement Benefits Other Than Pensions, Statement of Financial Accounting Standards No. 106* (Dec. 1990); ("FASB Statement No. 106") *see also* Jan

characterizes the Postal Service's participation in the FEHBP as a single-employer rather than a multi-employer situation. Since 1992, when GAO first proposed the change of accounting methods, the Postal Service has rejected GAO's suggestion that it disclose accrual information in its financial statements.<sup>63</sup> As will be discussed, both the CBO and OPM have joined with GAO to urge the Postal Service to switch to accrual accounting for retirees' health benefits.

With pay-as-you-go accounting, expenses are determined through a simple assessment of the amount of cash paid out for a particular period.<sup>64</sup> By contrast, the accrual method recognizes costs when the benefit is earned. This method assumes that employees earn retirement health benefits throughout the course of their careers, rather than simply when they retire. Thus, under the accrual basis, actuarial techniques and present value calculations are necessary to estimate the amount of future payments that will be made for benefits earned during a particular period. On a practical level, employers using the accrual method are required to recognize an expense in the amount of the benefits earned during the employment period, regardless of when paid out, and a liability in the amount of the benefits owed for the current period and for any parts of prior periods that are unfunded.<sup>65</sup> The 1992 GAO study concluded that if the accrual method were adopted, postal rates would likely increase more dramatically in the short term, but in the long term the rate increase would be significantly less than under the pay-as-you-go method. The 1992 GAO Report explained:

[T]he pay-as-you-go basis would require less of an increase in the short run, needing only a 1-cent increase in 2003; in contrast, the accrual basis would require an estimated 3-cent rate increase immediately in 1994. However, in the long-term, the fully funded

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R. Williams, *2002 Miller GAAP Guide 35.04* (2002).

<sup>63</sup> *GAO Accounting for Post-retirement Benefits Report* at 13.

<sup>64</sup> *Id.* at 4.

<sup>65</sup> *Id.*

accrual basis would require only an estimated additional 1-cent increase in 2011, and a 2-cent decrease thereafter through 2034, resulting in a net 2-cent increase over the 41-year period. However, the pay-as-you-go approach could require an estimated additional 13-cent increase over the same period.<sup>66</sup>

In reaching its conclusion in 2002 that the accrual method is more appropriate for the Postal Service, GAO noted that the FASB Statement No. 106 exemption from accrual accounting is based on the assumption that in multi-employer plans it would be difficult to determine the liability of individual employers. GAO did not believe this exemption applied to the Postal Service.<sup>67</sup> Unlike typical participants in multi-employer plans, the Postal Service is effectively prevented by statute from terminating its participation in its retirement health plan. Moreover, in contrast to multi-employer plans, the Postal Service is required to make contributions only toward the health costs of its own retirees, not toward the costs of other employers' plans.<sup>68</sup> GAO has consistently urged the Postal Service to consider adopting the accrual method of accounting because the accrual method would result in fuller disclosure of the Postal Service's true financial condition and would better reflect economic reality.<sup>69</sup>

As an alternative, GAO has recommended that the Postal Service at a minimum utilize accrual-based costs to represent its retirement health benefit obligations when devising future rate requests. This would prevent the sharp rise in rates that would otherwise be necessary to cover these obligations on a pay-as-you-go basis.<sup>70</sup> GAO has also recommended that the Postal

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<sup>66</sup> *Id.* at 11.

<sup>67</sup> *Id.* at 2.

<sup>68</sup> *Id.* at 3.

<sup>69</sup> *Id.*

<sup>70</sup> *GAO Accounting for Post-retirement Benefits Report* at 3.

Service include a discussion and an estimate of its retirement health obligations in the footnotes to its 2002 financial statements.<sup>71</sup>

#### **4. Resulting Total Unfunded Retirement-Related Liabilities**

In FY 2002, when the cost of the post-retirement health benefits of \$987 million is added to the CSRS pension retirement costs of \$4.6 billion, the total is \$5.6 billion.<sup>72</sup> This constitutes 11 percent of the Postal Service's total compensation and benefits expenses and over 60 percent of its retirement-related expenses.<sup>73</sup> The Postal Service projects that these costs will grow to \$2 billion and \$14 billion respectively, for a total of \$16 billion by 2010.<sup>74</sup> The future minimum payments the Postal Service must make to fund the CSRS pension liability are \$32 billion, plus interest. The post-retirement health benefits obligation is approximately \$45 billion, plus interest. The cumulative retirement liability continues to grow each year even though the Postal Service has been making significant, annual installment payments.<sup>75</sup>

##### **B. Before November 2002, All Proposed Reform Models Were Either Politically Unacceptable or Too Limited in Effect**

Before issuance of the OPM Report in November 2002, projecting a potential overfunding of \$71 billion in the Postal Service portion of the CSRS Fund, the Postal Service explored a variety of ways to solve its unfunded liabilities problem. Recognizing the urgency of

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<sup>71</sup> *Id.* at 1. It should be noted that the annual cost to the Postal Service of its retirees' health benefits has previously been disclosed in the "Service's Total Compensation and Benefits" expense section of the Postal Service's annual financial statements, as well as in the footnotes to those statements.

<sup>72</sup> *GAO Major Management Challenges Report* at 2.

<sup>73</sup> The remaining costs include FERS-related, dual CSRS, and Social Security payments. *USPS 2002 Annual Report* at 47.

<sup>74</sup> *GAO Retirement Report* at 21.

<sup>75</sup> *Id.* at 2.

the problem, the industry suggested several approaches to reform the pension system in late 2001 and 2002. While these proposals reflect the participants' sincere desire to do something immediately, they all fall short of what is needed, especially in light of developments since November 2002. The suggested approaches to pension reform are either politically unacceptable or too limited in scope to address the entire problem. In contrast, the plan proposed in Section II(D) below, a modified version of OPM's proposed legislation, is both politically acceptable and adequately addresses both the pension and health care components of the deferred liabilities problem. If neither that proposal nor OPM's proposed legislation is adopted, the Postal Service will be left with inadequate reform efforts. In order to highlight the critical need to adopt some form of the OPM legislation, we briefly examine the alternative reform approaches and then point out their limitations.

### **1. The 1997 District of Columbia Plan**

In 1993 the District of Columbia had an unfunded pension liability of \$4.9 billion that was expected to grow to between \$6 and \$8 billion by 2005.<sup>76</sup> By 2005, the District's contribution was predicted to be 85 percent of payroll.<sup>77</sup> The liability had arisen in 1979 when pension liability was shifted to the District at the adoption of Home Rule. At that time, the federal government should have transferred \$2.7 billion to fund the plan but only promised twenty-five years of \$52 million payments for a then-present value of \$646 million.<sup>78</sup> Because of the initial under-financing in 1979, the unfunded liability grew to \$4.9 billion by 1993, crippling

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<sup>76</sup> U.S. GAO, GAO/HEHS-95-40, *District Pensions: Federal Options for Sharing Burden to Finance Unfunded Liability* 20 & n.18 (Dec. 1994).

<sup>77</sup> *Id.* at 20.

<sup>78</sup> *Id.* at 18-19.

the District and ensuring that it could never emerge from its financial crisis until this problem was solved.<sup>79</sup>

The District of Columbia Retirement Protection Act of 1997<sup>80</sup> (“1997 Act”) finally resolved this problem. Because the federal government recognized that it had caused the problem in the first place, and because it was the only one with the resources to solve the problem, the federal government assumed responsibility for the District’s liabilities.<sup>81</sup> Congress had come to realize that the question was not whether the federal government would assume responsibility for the District’s insolvent plan but when it would act.

The 1997 Act established two new federal trust funds for pension plans managed by the Treasury Department.<sup>82</sup> The D.C. Federal Pension Liability Trust Fund was to be funded by all but \$1.275 billion of the District Retirement Fund plus the income earned on the assets.<sup>83</sup> The Federal Supplemental D.C. Pension Fund was to be funded by annual federal payments based on the original unfunded liability, amortized over thirty years, plus income on the assets and any future appropriations.<sup>84</sup> The Supplemental Fund was envisioned as a back-up in the event that the Pension Liability Fund was exhausted.<sup>85</sup> Finally, the District was to establish its own replacement plan for future pensions costs, initially funded by the remaining \$1.275 billion.<sup>86</sup> The federal government’s decision to step in and reform the pensions program in 1997 was

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<sup>79</sup> *Id.* at 20.

<sup>80</sup> Pub. L. No. 105-33, Title XI, §11001 *et seq.*, Stat. 712 (1997).

<sup>81</sup> *Id.* § 11002(a).

<sup>82</sup> *Id.* § 11031.

<sup>83</sup> *Id.* §§ 11031, 11033(a)-(b).

<sup>84</sup> *Id.* §§ 11051(a), 11053.

<sup>85</sup> *Id.* § 11054.

<sup>86</sup> *Id.* § 11042.

propelled by the fear that waiting for the crisis to grow larger would only make the solution more costly.

If the OPM legislation, modified or not, should founder, the Postal Service would find itself in the same situation as the District in 1997. The financial crisis will continue to grow and the federal government will be the only one capable of stepping in to bail out the Postal Service. By making the Postal Service retirement plan part of the CSRS, the federal government has in fact guaranteed payment of benefits. As CBO recognized, “[e]ven if the Postal Service failed or lost a major portion of its business, its employees’ retirement benefits would be protected in full by the federal government.”<sup>87</sup> Again, the issue is not whether the federal government will step in but when. Fortunately, the OPM Report provides the federal government an opportunity to act now, to cure the unfunded liability problem at much less cost to it than a full bailout would entail.

## **2. State Plans**

A more limited approach to pension reform has been attempted in some states, such as Michigan. In order to reduce future costs, these states have attempted to add the option of a *defined contribution* plan, similar to the 401(k) plan used in the private sector, to their traditional *defined benefit* plans. The State of Michigan in 1997 created a new defined contribution pension plan for recently hired state employees and offered employees the option to participate in the new plan or to continue in the existing defined benefit pension plan.<sup>88</sup> The defined contribution plan was made more attractive by allowing full vesting after only four years rather than ten years

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<sup>87</sup> U.S. CBO, *Proposal to Reduce Payments by the Postal Service to the Civil Service Retirement System 12* (Jan. 27, 2003) (“CBO Report”).

<sup>88</sup> Sally Roberts, *Benefit Beat: Michigan Overhauls Retirement Benefit Plans*, Dow Jones & Reuter (Jan. 20, 1997), available at <http://global.factiva.com/en/arch/display.asp>.

and portability of benefits if the employee left.<sup>89</sup> Although offering a defined contribution plan might reduce future costs, it would do little to ameliorate the Postal Service's CSRS unfunded liability problem, which applies to employees hired before 1986. It is unlikely that many of them would opt to move from the CSRS defined benefit plan to a defined contribution plan.

### **3. The Railroad Trust**

In 2001, Congress passed legislation creating the National Railroad Retirement Investment Trust ("Trust") which was established pursuant to section 105 of the Railroad Retirement Survivor's Improvement Act of 2001<sup>90</sup> to manage and invest pension assets. The Secretary of the Treasury transferred the funds from the former Railroad Retirement Supplemental Account into the new Trust. A seven-member Board of Trustees was authorized to retain independent advisors to develop investment guidelines and independent investment managers to invest the assets of the Trust under those guidelines.<sup>91</sup> The statute also specified certain auditing and reporting requirements.<sup>92</sup> For the Postal Service, reorganization of the pension fund format would not fully address its deferred liabilities problem and might run afoul of Civil Service retirement statutes.

### **4. Piecemeal Approach to Postal Service Pension Reform – Modifying the Interest Payment**

If Congress fails to recognize the CSRS overfunding, it is also unlikely that the federal government would step in to bail out the Postal Service financially or to reorganize the pension

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<sup>89</sup> *Id.* Under certain circumstances, a governmental entity may need to obtain a waiver to adopt a defined contribution plan that is similar to a 401(k) plan.

<sup>90</sup> 45 U.S.C. § 231n.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

fund format at this time. The Postal Service's only recourse would be to take a piecemeal approach to solving its pension problem and turn to its creditors, OPM and Treasury, to modify its debt obligations. Just as an insolvent debtor would seek to refinance its loans, the Postal Service might ask for a modification of the 5 percent interest payments that accompany the special installments for pay increases and COLAs. The interest component could be addressed in a variety of ways:

- Eliminate the interest rate payment on the special installment payments; or
- Reduce the 5 percent interest to the current CPI rate, now around 2 percent; or
- Return to the Postal Service a pro rata share of the investment income received by the federal government from the Postal Service pension payments. (A variation on this would be to return the pro rata share of the investment income received by the federal government based only on the Postal Service's interest payments); or
- Establish a separate Postal Service Pension Trust Fund for the Postal Service total pension payments, including interest payments. The investment income from this trust fund could be returned to the Postal Service to pay down the unfunded liability.

Interest rate modification would only give short-term relief and would not result in fully funding the pension fund or the retirees' health care benefits fund. Under this piecemeal approach, longer term problems of pension reform would remain unsolved.

In conclusion, three of these proposals do not adequately solve the unfunded liabilities problem, either for pensions or retirees' health benefits. Only the D.C. plan would address the entire problem. However, it is highly unlikely that the federal government would assume the Postal Service's unfunded liability at this time. This dearth of alternatives emphasizes the need for the parties to compromise and to adopt some form of the OPM proposal discussed below.

**C. OPM’s Finding of a Projected \$71 Billion in CSRS Overfunding Provides the Postal Service an Extraordinary Opportunity to Resolve Both the Pension and Health Care Parts of the Deferred Liabilities Problem**

While the Postal Service was searching for an answer to its deferred liabilities problems, GAO requested that OPM, the administrator of the CSRD Fund, analyze the Postal Service’s CSRS contributions as if a separate retirement account had been established for income and benefit payments since 1971.<sup>93</sup> OPM had not previously segregated or tracked the contributions or returns on investment earned by the separate agencies. Its analysis of the “Postal Fund” portion of the CSRS Fund was thus entirely “hypothetical.”<sup>94</sup> On November 1, 2002, OPM issued its analysis, which had been approved by the Board of Actuaries for the CSRD Fund as well as the Department of the Treasury and OMB.

**1. The Findings of the OPM Analysis—Unexpected Good News**

OPM, OMB and Treasury jointly endorsed the finding that:

Due to a number of factors, but primarily higher than expected yields on pension investments, our actuaries project that *future payments required under current legislation will overfund your estimated CSRS liability by approximately \$71 billion.*<sup>95</sup>

OPM’s report was accompanied by proposed legislation to modify current statutes to lower the Postal Service’s payments and to make certain other adjustments discussed below. Existing statutes require the Postal Service to pay \$91.5 million even if such payments will overfund the Postal Service’s portion of the CSRD Fund. The CSRD Fund currently possesses

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<sup>93</sup> The OPM findings discussed here apply only to the *pension* liabilities, not to the retirees’ health care liabilities. However as explained in Section II(D), some of the overfunding in the pension fund might be used to solve the underfunding of the health care benefits fund.

<sup>94</sup> U.S. GAO, GAO-03-448R, *Review of OPM Analysis of USPS CSRS Costs* (2003) (“GAO Report on OPM Analysis”).

<sup>95</sup> Letter from OPM to Postmaster General 1 (Nov. 1, 2002) (emphasis added).

\$152.1 billion attributable to Postal Service payments since 1971, including interest and net of benefits paid. The \$91.5 billion of future payments added to the current assets of \$152.1 billion would total \$243.6 billion. See Figure 5. OPM has projected future CSRS benefits for post-1971 service to total \$172.6 billion, thus producing \$71.0 billion in overfunding. Stated differently using these same figures, the Postal Service only needs an additional \$20.5 billion before its portion of the CSRS will be fully funded. See Figure 6.<sup>96</sup>

Of the \$20.5 billion, \$5 billion represents the current unfunded accrued liability of CSRS benefits.<sup>97</sup> This \$5 billion results from subtracting the net assets of the Postal Fund (\$152.1 billion) from the actuarial accrued liability (\$157.1 billion), a figure calculated in present value terms based on what postal employees and annuitants have earned in future CSRS benefits as of September 30, 2002.<sup>98</sup>

OPM proposed a new two-part payment structure to reflect the decreased liability: (1) \$15.5 billion of “normal cost” payments to cover the future CSRS benefits being earned by current employees on a dynamic basis; and (2) \$5 billion of amortized payments to eliminate the remaining unfunded liability over 40 years.<sup>99</sup> For 2003, the “normal cost” would rise from the \$0.7 billion required under current law, to \$1.3 billion under the proposed law. In 2004, the “amortization payments” would be set at \$0.4 billion for 40 years in order to recover the \$5 billion in unfunded benefits, plus interest.

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<sup>96</sup> *Id.* at 2. These estimates are expressed in 2002 dollars.

<sup>97</sup> *Id.* at 4.

<sup>98</sup> *CBO Report* at 4 Table 2.

<sup>99</sup> Prior to the OPM Report, the Postal Service had projected future minimum payments of \$32.2 billion, plus additional interest of \$15.7 billion in interest. *USPS 2002 Annual Report* at 47.

The immediate practical effect of this proposal would be to reduce the Postal Service's total payment to the CSRD Fund in 2003 from \$4.8 billion to \$1.3 billion, and in 2004, from \$4.8 billion to \$2.1 billion. Annual payments would then decrease until they reached \$1.0 billion in 2013.<sup>100</sup> The special surcharges for pay increases and COLAs, detailed in Section II(A)(2) above, would be totally eliminated. Thus, OPM's proposed reduction in payments would result in savings to the Postal Service of \$3.5 billion in 2003 and \$2.7 billion in 2004. Table 2 sets forth the difference between the current and proposed payments from 2003 to 2013 and the resulting savings.

**TABLE 2**  
**PROPOSED CHANGES IN THE POSTAL SERVICE'S PAYMENTS TO THE CIVIL SERVICE RETIREMENT SYSTEM, 2003 – 2013**

(By fiscal year, in billions of dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Current Payments</b>											
Agency's Contribution	0.7	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.3	0.3	0.2
Payments for Unfunded Liability	<u>4.0</u>	<u>4.1</u>	<u>4.3</u>	<u>4.3</u>	<u>4.4</u>	<u>4.6</u>	<u>4.8</u>	<u>5.1</u>	<u>5.4</u>	<u>5.6</u>	<u>5.9</u>
Total	4.8	4.8	4.9	4.9	4.9	5.1	5.3	5.5	5.7	5.9	6.2
<b>Proposed New Payments</b>											
Agency's Contribution	1.3	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.6
Amortization Payments	<u>0</u>	<u>0.4</u>									
Total	1.3	2.1	2.0	1.9	1.8	1.7	1.5	1.4	1.3	1.2	1.0
<b>Difference Between Current and Proposed Payments</b>											
Change in Payments	-3.5	-2.7	-2.9	-2.9	-3.1	-3.5	-3.7	-4.1	-4.5	-4.7	-5.1

SOURCE: CBO, *Proposal to Reduce Payments by the Postal Service to the Civil Service Retirement System* (Jan. 27, 2003) (citing Postal Services). NOTE: Numbers may not add up to totals because of rounding.

<sup>100</sup>CBO Report at 5.

## 2. The Subsequent GAO Report—The News Gets Even Better

On January 31, 2003, the GAO issued a follow-up report requested by Congress, upon review of the OPM's analysis and legislative proposal. In contrast to OPM's findings, GAO determined that the *projected* overfunding of the Postal portion of the CSRD Fund was ***\$103.1 billion, not just \$71 billion***. GAO also found a *current* overfunding of \$4.1 billion versus the \$20.5 billion underfunding found by OPM. This difference was principally attributable to how OPM handled the costs of military service for postal employees. OPM included the costs of military service for postal employees first hired into civilian service after June 30, 1971,<sup>101</sup> and a portion of the costs for employees hired before July 1, 1971, even though current law requires the Department of Treasury, not other government agencies or entities, to bear responsibility for these costs.<sup>102</sup> OPM disposed of this fact by including a provision in its proposed legislation requiring the Postal Service to pay these costs going forward and retroactively to June 30, 1971, as well as a portion of the costs for employees hired before 1971. When GAO applied the current law regarding military service funding to OPM's figures, it reached the higher \$103.1 billion of projected overfunding.<sup>103</sup>

GAO also highlighted the treatment of a \$285 million special payment that the Postal Service made in 1975 with appropriated funds. OPM had credited the Postal Fund with this

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<sup>101</sup> June 30, 1971, was the effective date of the Postal Reorganization Act of 1970.

<sup>102</sup> A similar issue regarding OPM's treatment of certain spousal benefit payments and payments for CSRS offset benefits was noted. OPM's analysis held the Postal Service responsible for these costs even though under current law, Treasury must pay for them. "OPM has not analyzed the feasibility of determining the effect of these issues on its calculations, but believes the amounts would be insignificant." *GAO Report on OPM Analysis* at 2.

<sup>103</sup> Pushing back the Postal Service's responsibility to pre-1971 service increases its liability by \$7.1 billion. If the Postal Service were to fund only the military service of employees hired after June 30, 1971, it would result in \$16.6 billion yet to be funded by the Postal Service (versus \$23.7 billion under OPM's legislation) and a projected overfunding of \$0.8 billion (versus an underfunding of \$6.3 billion under the OPM legislation as adjusted). *Id.* at 3.

payment, which effectively increased the balance by \$2.9 billion, including compound interest. GAO left it to Congress to decide whether to accept this credit.

Finally, GAO made specific adjustments to improve the accuracy of OPM's calculations, which resulted in an increase of about \$5 billion in the Postal Fund net assets. Specifically, GAO changed the basis of accounting for employee withholdings and Postal Service contributions from cash to accrual, reflected certain employee voluntary and civilian service deposits and redeposits that had not appeared in OPM's analysis, substituted actual data on 30-year and 15-year payments by the Postal Service rather than the estimated payments OPM had used, and adjusted several other miscellaneous items.

GAO raised the following policy issues to be decided by Congress:

- Treatment of the military service costs, both post-1971 and pre-1971, as described above.
- Treatment of payments made with the appropriated \$285 million, as described above.
- Treatment of underfunded/overfunded amounts and future refinements: GAO suggested a shorter amortization period than the 40-year period in the OPM proposal, although the 40-year period is consistent with the schedule other agencies follow. "A shorter amortization period that more reasonably reflects the average remaining working lives of CSRS employees may be more appropriate."<sup>104</sup> In addition, GAO noted that the proposed legislation did not indicate how to treat an overfunded situation or how to adjust future payments.
- Choice of demographic assumptions: If CSRS-wide demographics were used, instead of the Postal Service-specific ones employed by OPM, the overfunded amount would decrease by \$1.5 billion.

GAO also raised the issue of the relationship of the CSRS overfunding situation to the Postal Service's unfunded obligations for retirees' health benefits (estimated at \$40 – \$50

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<sup>104</sup> *Id.* at 3.

billion) as well as its outstanding debt to the federal government (\$11.1 billion as of September 30, 2002). The GAO Report stated:

The Congress needs to decide (1) whether some or all of the difference in current versus proposed future contributions should be used to reduce outstanding debt to the federal government or address Postal Service's unfunded post-retirement health obligations, and (2) what, if any, other restrictions should be placed on the use of these funds.<sup>105</sup>

GAO seemed to assume that Congress could dictate to the Postal Service how it could use the funds saved from reduced CSRS payments. The Postal Service's reaction to this statement was voiced by Richard Strasser, CFO of the Postal Service:

I was a little bit disappointed that GAO indicated that Congress needed to determine what to do with these funds. . . . We've already gone on record indicating that we would like to use [the funds] to pay down debt<sup>106</sup>. . . . I'd like to think that Congress would, as they have in the past, delegate financial matters to the Postal [Service] Board [of Governors] and postal management.<sup>107</sup>

### 3. CBO Enters the Fray

That same week, on January 27, 2003, the Congressional Budget Office ("CBO") issued its report on the effect of OPM's proposed legislation on the federal budget. It concluded that the Postal Service's reduced CSRS payments would increase deficits in the unified budget by as much as \$10 – \$15 billion over the next five years and by as much as \$36 – \$41 billion over the next ten years. The impact would depend on whether the Postal Service used its improved

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<sup>105</sup> *Id.*

<sup>106</sup> According to the Postal Service, lowered CSRS contributions will enable it "to reduce debt by more than \$3 billion FY 2003, compared to the planned debt reduction of \$800 million." The Postal Service also projects that lower contributions will allow it to postpone a rate increase until 2006. U.S. POSTAL SERVICE, FACT SHEET: CSRS RETIREMENT LIABILITY (Nov. 5, 2002), available at [http://www.postcom.org/public/csrs/csrs\\_fact\\_sheet.htm](http://www.postcom.org/public/csrs/csrs_fact_sheet.htm).

<sup>107</sup> Christopher Lee, *Larger Postal Pension Fund Surplus Predicted*, WASH. POST, Feb. 1, 2003, at A4.

financial position to delay a rate increase, to increase spending, or to repay the debt owed to the Treasury.

Because the reasoning behind CBO’s finding of a negative impact on the unified budget is counterintuitive, it is necessary to explain briefly the budget process as it pertains to the Postal Service. First, because the Postal Service is an independent agency, its operations are shown in the budget on a net basis (*i.e.*, the difference between the agency’s collections – postage receipts – and its expenditures.)<sup>108</sup> If expenditures exceed collections, the amount is shown as a positive outlay. If collections exceed expenditures, the amount is a “negative outlay” (*i.e.*, surplus). For example, in 2002, the Postal Service collected \$68.1 billion and expensed \$67.4 billion, for a negative outlay (or positive net income) of \$0.7 billion. Technically, the Postal Service’s outlay effect is deemed “off-budget” – the amount is not included in the formal budget but is included in the unified budget.<sup>109</sup>

The Postal Service’s payment to the CSRD Fund for pensions and to the FEHB Fund for retirees’ health benefits are “intragovernmental payments.” Although the payments are outlays of the Postal Service, they are recorded as offsetting receipts of OPM, and the two transactions have no net impact on the unified budget.<sup>110</sup> Pensions and retirees’ health benefits for postal

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<sup>108</sup> Congress specifically excluded the Postal Service from the budget. It was given “off-budget” status to prevent diversion of its assets for other purposes, such as deficit reduction. In 1968, Congress adopted the principle of a “unified” budget, which includes all spending and revenue (both on- and off-budget) so that the budget would be more useful in formulating economic policy. The unified (or consolidated) budget totals up both on- and off-budget accounts and is the more widely reported figure. Bruce Wetterau, *DESK REFERENCE ON THE FEDERAL BUDGET* 168-69 (1998).

<sup>109</sup> The Social Security program’s outlay effects are also “off-budget.” For other purposes, however, these figures are included in budget totals with other government programs to help assess the effect of these federal activities on the economy. *CBO Report* at 6-7.

<sup>110</sup> Note that both on-budget and off-budget totals are affected. The Postal Service’s payments are off-budget outlays; OPM’s receipts are on-budget offsetting receipts, or negative outlays.

employees are paid from the same on-budget accounts as the benefits for other federal workers.<sup>111</sup> Consequently, “if nothing else changed, [OPM’s] proposal would reduce receipts to CSRS and outlays of the Postal Service by exactly the same amount, resulting in no net effect on the unified budget.”<sup>112</sup>

The impact of OPM’s proposal on the unified budget “is entirely a function of the agency’s transactions with the public.”<sup>113</sup> The question for budget purposes is what the Postal Service does with the savings resulting from the CSRS overfunding. The action that would have the greatest negative impact on the budget would be for the Postal Service to delay an upcoming increase in postage rates – in effect, returning the savings to postage ratepayers. In contrast, budgetary totals would not be affected in the short run if the Postal Service used some of its savings to redeem its outstanding debt with Treasury. Presumably, if the Postal Service used its savings to increase its FEHB Fund payments to shore up the retirees’ health benefits fund, these intragovernmental transfers would also not affect the unified budget.<sup>114</sup>

CBO provided estimates under two scenarios, both based on the assumption that a 3-cent increase in the first class stamp would be implemented in late FY 2004. The first alternative hypothesized that Postal Service used its initial savings to redeem part of its outstanding Treasury debt and then applied subsequent savings to prevent rate increases until early 2007.

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<sup>111</sup> The distinctions between on-budget and off-budget transactions can be important for certain budget enforcement rules, such as the pay-as-you-go (PAYGO) rules that have recently expired. Under those rules, a reduction in on-budget receipts would have had to be offset by legislated increases in other receipts or reductions in spending. Although those rules have expired, the Senate extended a separate PAYGO legislative procedure through April 2003, which applies only in that body. *Id.* at 7.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

The second alternative assumed that the entire savings were used to delay or reduce rate increases or to boost spending for other purposes. Under the first approach, there would be no significant budgetary impact in 2003 or 2004 while the agency's savings are allocated to paying off some of its Treasury debt (thus producing no direct change in the budget). However, in late FY 2004, the budget would reflect the loss of receipts from the postponement of the assumed 2004 postage increase. The loss would start at \$0.1 billion in 2004 and increase to \$3.5 billion in 2005 and 2006, with a total of \$10 billion over the next five years. This would be reflected as a \$10 billion deficit in the unified budget over the next five years. The long-term effect would be \$35.8 billion over the 2003 – 2013 period.

Under the second approach, all of the savings would be used to delay rate increases or to increase spending, resulting in a \$15 billion negative effect on the budget through 2007 and a long term effect of \$40.7 billion from 2003 to 2013.<sup>115</sup> From 2007 to 2013, the lowered CSRD Fund payments would affect the unified budget by the same amount under both alternatives.<sup>116</sup>

A significant portion of the CBO report addressed the need for the Postal Service to change its accounting method for retirees' health insurance benefits from pay-as-you-go to accrual accounting.<sup>117</sup> CBO offered the accounting change as another way to minimize the negative effect on the budget:

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<sup>115</sup> Compared to the first approach, the impact would be larger in 2003 through 2004, but only slightly smaller in 2005 and 2006, because all of the savings would be used to delay rate increases or incur higher spending.

<sup>116</sup> On-budget totals would worsen by the same amount from 2003 – 2013 under both alternatives. As to the effect on interest costs, “[t]he Postal Service could accrue interest savings by reducing its Treasury debt, but that bookkeeping ‘exchange’ between government accounts would not have an impact on the unified budget. However, because under either alternative unified deficits would increase (or surpluses would fall), total debt held by the public would rise, resulting in higher government interest payments on that debt.” *CBO Report* at 10.

<sup>117</sup> See discussion at Section I(A)(3)(d).

The Postal Service accounts for pension obligations as they are earned by its employees, but it does not do the same for retiree health benefits. Those benefits are paid for when its workers become retirees. Although that is true for all federal agencies, it is particularly important for the Postal Service, which is required to set postal rates to cover its full costs. Failure to recognize retiree health insurance benefits as workers accrue them will only push those costs into the future. If the Postal Service accounted for and funded both retiree pensions and health benefits as they were earned by its employees, its operating costs would be higher, and some combination of increased postal rates or cost savings would be required. Those changes would reduce overall budget deficits.<sup>118</sup>

**D. The Commission Should Urge the Postal Service to Endorse a Compromise Plan That Would Minimize the Effect on the Budget Deficit and Resolve Both the Pension and Health Care Parts of the Deferred Liabilities Problem**

First, we summarize the interests at stake:

- The Postal Service is in a financial crisis, with decreasing volumes of mail and two particularly serious problems: \$32 billion of unfunded pension liability and \$45 billion of unfunded retirees' health care liability.
- Postal employees face uncertainty about the financial soundness of their retirement funds.
- Another rate increase to cover these retirement costs will drive Postal Service ratepayers to other providers of delivery service and accelerate the trend of declining mail volume.
- Due to a greater than expected return on investments, OPM has discovered a projected overfunding of the Postal Fund portion of the CSRS Fund in the amount of \$71 billion.
- GAO has estimated that this amount is actually \$103.1 billion under current law which makes Treasury and not the Postal Service responsible for the costs of military service pensions.
- Congress must pass legislation to amend current statutes to lower the Postal Service's annual CSRD Fund payments, but CBO has determined that depending on how the Postal Service uses its savings from the reduced payments, the unified budget deficit may be negatively impacted by \$10 – \$15 billion over the next five years. The negative effect arises because savings from the reduced payments will allow the Postal Service to postpone the assumed 2004 three-cent rate increase. Congress is understandably concerned about further deficits in the budget.

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<sup>118</sup> *CBO Report* at 1.

The following proposal would require a compromise from each party but would result in an overall win-win situation for the federal government, postal employees, ratepayers, and most importantly the Postal Service itself:

1. Congress should refrain from imposing the additional costs of military service on the Postal Service.<sup>119</sup> Consequently, the overpayment amount would be approximately \$103.1 billion.
2. In exchange, the Postal Service would use the amount attributable to the military, service issue to pay down its FEHB Fund obligations, thus ensuring that retirees health care costs will be adequately funded. A portion of this amount should be allocated to changing the Postal Service's accounting method from pay-as-you-go to accrual accounting as urged by both GAO and CBO. Because the Postal Service's payment to the FEHB Fund is an intragovernmental transfer, there would be no negative impact by this transaction on the unified budget.
3. Assuming the remaining \$71 billion of projected overpayment is recovered under OPM's proposed schedule, the Postal Service will have available \$3.5 billion in 2003 and \$2.7 billion in 2004 in the form of savings from reduced payments. It should use a portion of this (*i.e.*, the first year's savings of \$2.7 billion) to redeem part of its outstanding debt of \$11.1 billion to Treasury.<sup>120</sup> To further decrease the negative effect on the budget, the Postal Service may also choose to use part of the 2004 savings to pay down the Treasury debt or even increase payments to the FEHB Fund. The Postal Service will realize further savings from eliminating the interest payments on the debt amounts it pays off in advance.
4. The assumed 2004 rate increase should be postponed to prevent further migration of users from the rate base. As the Postal Service undertakes its Transformation Plan, aided by the savings from reduced CSRD Fund payments, it will develop new

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<sup>119</sup> This would be consistent with the fact that Treasury has always been responsible for these costs and that no other agency is required to pay for military service pensions costs. Furthermore, at least \$7.1 billion of the \$32 billion in military costs would be attributable to pre-1971 service, before the creation of the Postal Service. The COLAs and pay increase surcharges imposed retroactively on the Postal Service at least related to costs incurred by employees for their service in *postal operations*, and even they were not imposed for service prior to 1971. The legislative history of the *Postal Reorganization Act of 1970*, Pub. L. No. 91-375, 84 Stat. 719, shows Congress' original intent to refrain from imposing liability for pre-1971 retirement-related debts on the new Postal Service. "Section 204 [presently 39 U.S.C. § 1005] does not make the Postal Service liable for unfunded liabilities of the Civil Service retirement program related to postal employees." *Postal Reorganization Act*, H.R. 91-1104, 91st Cong. § 204 (1970), *reprinted in* 1970 U.S.C.C.A.N. 3649, 3367. Generally, section 2002 also ensured that the Postal Service would not carry forward liability from the Post Office when it was created in 1971.

<sup>120</sup> The Postal Service has already indicated that it intends to redeem part of its Treasury debt.

products and services, increase efficiency and productivity, and become more competitive in the delivery services market. This in turn will result in increased volumes of mail and greater receipts, thus having a long-term positive effect on the federal government and the budget. Foregoing a destructive rate increase in 2004 in order to restore the financial health of the Postal Service will benefit not only the Postal Service and its users but also the federal government, which will no longer have to face the specter of a future bailout of the Postal Service retirement programs.

The costs and benefits of this arrangement to the parties are listed below:

- The Postal Service will resolve both of its unfunded liabilities problem at one time; pay down its Treasury debt and reduce its interest payments thereafter; and have a fighting chance to implement its Transformation Plan and become a competitive player in the market. Its costs are that it foregoes using the entire savings in 2003 (or 2004) for operating expenses.
- Postal employees will be able to rely on solid retirement funds for both pension and health care benefits.
- Ratepayers will have a reprieve from a rate increase in 2004. After implementation of the Transformation Plan, they will enjoy a more efficient and competitive Postal Service.
- Congress will be trading off a \$10 billion negative short run effect on the budget for (1) relief from bailing out the Postal Service retirement funds at a much greater future cost and (2) restoring the Postal Service to a competitively stronger, financially sound position.

## **E. Conclusion**

Although the problem is complicated, the solution is simple. The President's Commission meets at a crucial moment in the Postal Service's history. It is presented with an unprecedented opportunity to effectuate the resolution of the Postal Service's primary financial dilemma, one with disastrous consequences if left unresolved. The parties do not appear to be far from an agreement on how to handle the Postal Service's overpayments to the CSR Fund. We have proposed a compromise that would benefit all of the parties involved. However, the stakes are high for the Postal Service, and the vagaries of the political process are well known. Therefore, the EMA Foundation urges the Commission to do everything it can to broker an

agreement with Congress and not to rest until Congress has passed some form of legislation implementing the OPM and GAO findings of CSRS overfunding.

### **III. EMPLOYMENT AND LABOR ISSUES**

The Postal Service currently employs approximately 850,000 employees (including approximately 750,000 career employees), and is the second largest civilian employer in the United States. Personnel costs regularly account for well over 75 percent of the Postal Service's annual operating expenses and are rising steadily. Hence, controlling the Service's overall operating costs will depend in large part on controlling labor costs.

Growing competition from other carriers and electronic communications has only increased the urgency of this task. The era when the Postal Service could simply pass its labor costs onto mailers is rapidly ending. Accordingly, whatever approach the Commission otherwise takes to its mandate and whatever the future form and organization of the Postal Service, personnel costs must be confronted directly and managed appropriately.

#### **A. The Basic Issues**

For the Postal Service, like most organizations, overall personnel costs are a function of two basic variables: the unit cost of labor (wage rates and benefits costs) and the size of the workforce (which, in turn, depends on productivity). There is considerable evidence that the Postal Service is not operating efficiently in either respect.

*Labor unit costs.* The current unit cost of labor appears to be above market levels. We recognize that market comparisons are only as reliable as the assumptions made in identifying the relevant labor market, and we understand that there is wide disagreement about the relevant benchmark for assessing postal wage rates. Postal unions have suggested that the wage levels of employees in other large, unionized workforces are the best measure of private sector comparability. This standard inevitably produces comparisons to relatively high-paid employee

groups (in the automobile, steel, and heavy production industries) and appears to be unjustified by the nature of the work and skill levels of postal employees. By the same token, it would not be fair or appropriate to assess Postal Service wage rates by reference to the wages in minimum-wage service industries.

The Bureau of Labor Statistics (“BLS”) classifies entry-level positions in the Postal Service under the category “Office and Administrative Support Occupations,” which encompasses 52 separate occupations, including Customer Service Representative, Teller, Hotel Clerk, Legal Secretary, and Brokerage Clerk. According to the BLS’s most recent figures, the wage rates for the postal positions are between 18 and 56 percent higher than average rates for other employees in the same category.<sup>121</sup> Although the comparability of occupations in the survey category may not be free from doubt, the sheer magnitude of the differential suggests that postal wage rates may well be above market.

Further evidence that Postal Service compensation exceeds market-clearing levels are the number of applicants for Postal Service positions and the low rates at which current employees voluntarily leave Postal Service employment. Despite the adversarial relationship between labor

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<sup>121</sup> BLS collects and publishes wage data for 52 separate “Office and Administrative Support Occupations,” including Postal Service Clerks (“Postal Clerks”), Postal Service Mail Carriers (“Mail Carriers”), and Postal Service Mail Sorters, Processors, and Processing Machine Operators (“Mail Processors”). The most recent data (available at [http://www.bls.gov/oes/2001/oes\\_43Of.htm](http://www.bls.gov/oes/2001/oes_43Of.htm)) cover calendar year 2001, in which the mean annual wages for Postal Clerks, Mail Carriers, and Mail Processors were \$38,210, \$37,860, and \$32,190, respectively, all well above the mean for the support occupations group (\$27,230). The differentials were similar when wage rate estimates were expressed on an hourly basis. The median and mean hourly rates for Postal Clerks (\$18.78 and \$18.37, respectively) were as much as 56 percent above the median and mean hourly rates for the group (\$12.04 and \$13.09, respectively). The corresponding rates for Mail Carriers (\$18.61 and \$18.20) and Mail Processors (\$16.95 and \$15.48) also were well above the national figures. By all measures, the postal crafts out-earned all other clerical and administrative occupations except “First-Line Supervisors/Managers of Office and Administrative Support Workers” (with mean annual wages of \$40,920) and Legal Secretaries (\$35,970).

and management (discussed below), the Postal Service has consistently large applicant queues for entry-level positions and an extraordinarily low quit rate.<sup>122</sup>

***The size of the workforce.*** The Postal Service appears also to have an inefficiently large workforce. Developments in postal automation over the last three decades (particularly in connection with mail processing) have made it possible for the Postal Service to perform certain work functions with far fewer employees and, accordingly, should have enabled the Postal Service to achieve marked improvements in workforce productivity. More recent reductions in mail volumes also should have permitted the Postal Service to trim the size of its workforce. However, it appears that the Postal Service has not realized the labor cost savings made possible by these trends.<sup>123</sup>

The GAO has observed that “postal productivity . . . increased only about 11 percent in the past three decades – despite vast changes in automation and information technology.”<sup>124</sup> More to the point, productivity *declined* 3.3 percent from fiscal years 1993 to 1999 (and improved only modestly thereafter).<sup>125</sup>

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<sup>122</sup> According to data presented in the most recent interest arbitration between the Postal Service and the largest of the postal unions, the American Postal Workers Union (“APWU”), the APWU full-time employee quit rate averaged less than one percent per year from 1991-2000. Although no current private sector data were available, the most current BLS data reported that the quit rate in the manufacturing sector was approximately 15 percent in 1981 (a year when the quit rate for full-time Postal Service employees was only 1.5 percent). *United States Postal Service v. American Postal Workers Union, AFL-CIO*, 2000 National Agreement, slip op. at 3 (Jan. 11, 2002) (Goldberg Arb.).

<sup>123</sup> *GAO Major Management Challenges Report* at 12.

<sup>124</sup> *Id.* at 23.

<sup>125</sup> *Id.*

One of the factors underlying the Postal Service’s unimpressive productivity record may be the poor state of its labor-management relations. A series of GAO reports over the last decade has documented persistent problems in the corporate culture and workplace environment, including low employee morale, adversarial relationships between postal management and union leadership at the local and national levels, an “autocratic” management style, and an inappropriate and inadequate performance management system.<sup>126</sup> According to the GAO reports, the widely held view among employees is that the Postal Service management fails to recognize high performance and tolerates poor performance. Whether justified or not, these are perceptions and attitudes that inevitably impede efforts to improve labor productivity.

## **B. Proposed Reforms**

The Commission should recommend reform proposals that will permit the Postal Service to reduce its personnel costs by enhancing employee productivity, reducing the number of postal employees, and controlling the wage rates and employer-paid benefits costs of its workforce. Progress in these areas will require new approaches and tools and the willingness and flexibility to use them.

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<sup>126</sup> *GAO Major Management Challenges Report at 28* (2003) (citing the Postal Service’s “long-standing adversarial labor-management relations”); U.S. GAO, GAO/GGD-98-1, *U.S. Postal Service: Little Progress Made in Addressing Persistent Labor-Management Problems* (1997); U.S. GAO, GAO/T-GGD-98-7, *U.S. Postal Service: Little Progress Made in Addressing Persistent Labor-Management Problems* (1997); U.S. GAO, GAO/GGD-95-77, *D.C. Area Mail Delivery Service: Resolving Labor-Relations and Operational Problems Key to Service Improvements* 41 (1995) (documenting relationship between low employee morale and poor Postal Service performance); U.S. GAO, GAO/GGD-94-201A *U.S. Postal Service: Labor-Management Problems Persist on the Workroom Floor 2*, 7-9 (1994) (describing, *inter alia*, “highly structured system of work rules and a highly autocratic management style,” and low employee morale).

## **1. Optimizing the Size of the Postal Workforce**

The Postmaster General of the Postal Service has taken steps in the right direction since taking charge in June 2001. Under PMG Potter's direction, the Postal Service has reduced forces in a number of operations, primarily by abolishing positions vacated through normal attrition. These actions are a good start, and the EMA Foundation commends the Postal Service's initiative. Reducing the size of the workforce is the most direct and effective way of reducing operating costs. And doing so through the elimination of vacant positions is a relatively painless way of moving toward a properly-sized workforce.

But it is also clear that such incremental progress is not enough. More fundamental change is needed, and that will be more difficult. Hence, the Commission should consider reforms that will encourage the Postal Service to further reduce the size of its workforce. The Postal Service should be encouraged to take full advantage of any unrealized labor cost savings made possible by automation and the reduction in mail volumes.

One of the most promising opportunities for labor cost savings lies in closing unneeded and inefficient postal facilities, a matter addressed fully in Section IV below. Relocating postal operations to more efficient facilities should enable the Postal Service to achieve substantial labor cost savings. Likewise, closing and consolidating retail outlets offers opportunities to reduce overall employment levels, including management.

We also believe that steps can be taken to minimize the hardship to employees from attaining a more efficiently sized workforce. Much of the necessary downsizing can be achieved through normal attrition. When layoffs are necessary, the effects of employee displacement can be mitigated in appropriate ways, using any one or more of the various approaches that have

been employed in other down-sizing industries, such as severance payments, insurance continuance programs, job retraining, and relocation allowances.

## 2. Outsourcing

The Postal Service also should be encouraged to make wider use of outsourcing. Experience in both the public and private sectors indicates that outsourcing can help the Postal Service manage the size of its workforce, reduce overall operating costs, and maintain the flexibility necessary to react to changing market conditions.

Although the Postal Service's labor agreements apparently do not prohibit outsourcing, they impose conditions and procedural requirements that can generate conflict and otherwise discourage or impede the cost-effective use of third-party contractors.<sup>127</sup> Other obstacles arise out of statutory and regulatory requirements that are vestiges of the Postal Service's pre-reform public monopoly status. Although the Postal Service is exempt from other government

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<sup>127</sup> The Postal Service's experience with remote barcoding is a case in point. In 1991, the Postal Service announced plans to outsource remote barcoding, on the basis of a cost analysis showing this would produce a savings of some \$4.3 billion over a 15-year period. Two unions challenged the Postal Service's decision. In mid-1993, an arbitrator ruled that under its labor agreements, the Postal Service could outsource the work only after first offering jobs at remote barcoding sites to existing postal employees. The unions and Postal Service had conflicting views as to how the arbitration award should be implemented. In late 1993, the Postal Service decided to bring the barcoding work back in-house, on the basis of an agreement with the APWU that only 30 percent of the barcoding work hours had to be performed by career, bargaining unit employees, with the other 70 percent being performed by transitional employees receiving lower pay and limited benefits. The Postal Service took this step in the expectation that it would produce the long-term benefit of improving relations with APWU. In fact, this did not occur. Indeed, APWU in effect quickly disavowed the economic cornerstone of the barcoding agreement—the 70/30 ratio—by seeking substantially higher wages and benefits for transitional employees, which would have unacceptably reduced the Postal Service's return on investment. The Postal Service's abandonment of its effort to outsource remote barcoding did not lead to constructive relations with APWU on other labor matters, as the Postal Service had hoped. All of this is explained by the GAO, in a study which finds that having postal employees do the work of remote barcoding — even at the 70/30 ratio — costs significantly more than having contractors do the work. See U.S. GAO, GAO/GGD-95-143, *Performing Remote Barcoding In-House Costs More Than Contracting Out* (1995).

procurement laws, for instance, it remains subject to the Service Contract Act of 1965,<sup>128</sup> which significantly limits its ability to expand outsourcing. The Service Contract Act virtually precludes the cost-effective use of contractors for any function other than those expressly exempted from the Act's coverage (including certain postal transportation).<sup>129</sup> We urge the Commission to recommend that the Postal Service be fully exempt from all federal procurement standards, including the Service Contract Act, so that it will have the same flexibility as private sector competitors to outsource functions that can be performed more efficiently by others.

We emphasize that outsourcing does not necessarily mean displacement of existing Postal Service employees. Existing employees should be permitted to bid against private vendors to perform the outsourced functions. Experience with outsourcing by other public sector employers indicates that public sector employees not only can bid successfully for such work, but also can perform it in a cost-effective fashion. The competitive spur created by the bidding process, however, is critical to realization of these benefits.

### **3. Reform of Collective Bargaining Framework**

Whether or not the Commission recommends more fundamental changes in the Postal Service's legal framework, the Commission should consider and address reform of the current collective bargaining regime. The Postal Service, with by far the largest unionized federal workforce, appears to have the most acrimonious labor-management relations of any federal agency or employer. Reforming the process and procedures under which postal collective bargaining agreements are made is likely to yield large additional cost savings.

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<sup>128</sup> 41 U.S.C. §§ 351-56.

<sup>129</sup> *Id.* §356.

Well over 85 percent of the Postal Service's workforce is covered by collective bargaining agreements, negotiated or imposed in binding arbitration under the procedures specified in 39 U.S.C. § 1207. By operation of 39 U.S.C. § 1004(e)(1), wage increases under those agreements in turn drive corresponding wage increases for the more than 70,000 supervisory and management personnel represented by recognized management associations.

The Postal Service's collective bargaining agreements also govern the allocation of health benefit costs and prescribe work rules and procedures that restrict the Postal Service's operational flexibility in various ways (for instance, by limiting the Postal Service's ability to use certain employees on reduced or split shifts). Managing conflict under these agreements is itself costly, requiring the processing and handling of thousands of employee claims and grievances each year.

A threshold question is what role collective bargaining should play in the future Postal Service. Outside the Postal Service, most federal employees have no right to bargain collectively over rates of pay, hours of work, or benefits. A number of employees (including airline baggage screeners, law enforcement personnel, and members of the armed forces) have no collective bargaining rights at all. The poor state of postal labor-management relations and the resulting drain on productivity suggest that broad-based collective bargaining may be unsuited to postal operations and that a narrower model like that applicable to most federal employees,<sup>130</sup> should be considered. Such fundamental reform of the collective bargaining scheme could be coupled with initiatives, such as the creation of joint labor-management committees and work groups, designed to foster direct and constructive dialogues and relationships between postal labor and management.

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<sup>130</sup>5 U.S.C. §§ 7101 *et seq.*

At a minimum, however, the Commission should revisit the procedural framework for collective bargaining in the Postal Service. If postal employees are to retain their broad collective bargaining rights, the governing procedures should be modified to promote more balanced outcomes. The Commission should consider and recommend reforms that will foster meaningful opportunities for negotiated resolutions, while also ensuring cost-effective and peaceful outcomes in the event of impasse.

**a) Problems with the Current Procedures**

The existing collective bargaining scheme fails to strike the right balance or provide needed incentives for compromise. Currently, when the Postal Service and a union fail to reach agreement in negotiations, the statute provides for an initial voluntary fact-finding process, conducted by a panel of three individuals selected from a list provided by the Director of the Federal Mediation and Conciliation Service (“FMCS”). If fact-finding does not produce an agreement (or if the parties choose to forego the fact-finding stage), the dispute goes to binding interest arbitration, in which the arbitrator fashions a labor agreement for the parties. The arbitration takes place before a three-person board consisting of two partisan members (one representing the Postal Service and one the union), and a neutral arbitrator chosen by the partisan members (or appointed by the Director of FMCS, if need be), who is the real decision maker.

In making its decision, the arbitration board has unlimited discretion. The statute itself suggests a single standard: the general “policy of the Postal Service to maintain compensation and benefits for all officers and employees on a standard of comparability to the compensation and benefits paid for comparable levels of work in the private sector of the economy.”<sup>131</sup>

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<sup>131</sup> 39 U.S.C. § 1003(a).

This regime, by all accounts, has proven a roadblock to constructive negotiation and meaningful bargaining. Indeed, the entire process appears to have operated on autopilot for far too long, with each side staking out extreme positions and resisting compromise—leaving themselves literally billions of dollars apart—in expectation of an arbitrator sorting out the differences. More often than not, the parties simply bypass the fact-finding stage altogether, and with that any prospect of a negotiated solution, and head straight to binding arbitration. Since 1981, some thirteen of the twenty labor contracts with three major postal unions (the American Postal Workers Union, the National Association of Letter Carriers, and the Mail Handlers Union) have been the product of arbitration.

By their very nature, these are extremely high-stakes contests, in which the sheer magnitude of the workforces and dollars at issue all but precludes any meaningful focus on reform of work rules or other aspects of the labor-management relationship. The single standard now prescribed by law—private sector comparability—certainly has a place in setting wage rates. But it should not be the only or even the central consideration. The focus on comparability, in effect, has functioned as a one-way ratchet, contributing to spiraling labor cost increases.

In the final analysis, decisions on workplace issues that are critical to the Postal Service’s ability to carry out its responsibilities are left to arbitrators who are not publicly accountable in any way for the effects of their decisions and, indeed, are not required even to consider the interests of the Postal Service, ratepayers, or the public.

#### **b) Proposals for Change**

Some have suggested replacing the existing interest arbitration arrangement with the scheme generally applicable in private industry governed by the National Labor Relations Act,

which culminates in the parties' resolving bargaining disputes strictly through economic warfare (strikes and lockouts), without any external mechanism for arriving at a contract. Such a model, however, appears to be ill suited to the Postal Service's role in our economy. The nation will not tolerate leaving the vital service of mail delivery vulnerable to extended periods of interruption in repeated tests of economic will. More to the point, the very prospect of service interruptions would hand employees excessive leverage in negotiations, minimizing prospects for balanced, even-handed outcomes.

Instead, the Commission should adopt reforms that will both create incentives for meaningful negotiations and foster responsible, cost-efficient outcomes, even absent agreement. Toward this end, the Commission might consider a number of reforms within the framework of interest arbitration.

***Mandatory Mediation.*** In connection with other reform proposals, the Commission should consider substituting compulsory mediation for the voluntary fact-finding process now in place. The goal of any collective bargaining scheme is to foster constructive negotiation, compromise, and voluntary agreement on contractual terms. By that standard, the current fact-finding process has been a failure. More often than not the parties simply skip over this step. Even when they go through the motion of fact-finding, it accomplishes little, as both sides hold back their ammunition waiting for arbitration.

Prescribing mediation would require (and permit) the parties to work together with the aid of a neutral facilitator, who would assist them in reaching a settlement of their own choosing. Unlike fact-finders, mediators are expected to play an active, aggressive role in trying to bring about agreement, facilitating communication, proposing compromises, and suggesting solutions. An effective mediator would be mindful of the governing arbitration standards and capable of

fostering compromise by forcing the parties to consider how their more extreme proposals might later be evaluated (and rejected) in arbitration.

The Commission should also require that mediation continue for a meaningful time period before an impasse may be declared and arbitration invoked. Although, of course, there can be no guarantee that the parties will not simply elect to bide their time, knowing that arbitration ultimately is available, the reforms to the arbitration process we have proposed should make that tactic less likely. So, too, would an enforceable requirement that the parties mediate in good faith.

***Reforming Arbitration Standards.*** At a minimum, the Commission should prescribe standards to govern arbitrated outcomes that reflect the public interest in affordable, efficient, universal mail service. The Commission should consider adopting standards that expressly direct arbitrators to take into account the Postal Service's financial health and ability to pay for any future increases in wages and benefits, and the economic environment in which the Postal Service operates, including its past and present revenues and its prospects for future revenues. Arbitrators should be directed explicitly to consider the interests and welfare of postal ratepayers, including the effect that adoption of particular labor agreement terms (wages, benefits, or work rules) is likely to have on the Postal Service's ability to discharge its responsibilities efficiently and cost-effectively. It must be clear that arbitrators cannot simply assume that any increases in compensation will be readily passed through to the mailing public.

The Commission might also direct arbitrators to take into account the overall compensation that employees already receive, including wages and benefits,<sup>132</sup> as well as changes

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<sup>132</sup> Under the Postal Reorganization Act, 39 U.S.C. §§ 101-5605, the collective bargaining process does not apply to Civil Service Retirement benefits, which are provided under the Civil Service Retirement program. Although postal workers can bargain for *supplemental* retirement

in the average consumer prices for goods and services (*i.e.*, the BLS' Consumer Price Index) or in the average cost of employment (specifically, the wage component of the BLS' Employee Cost Index). Further, given the Postal Service's current financial condition and the fact that postal workers' current compensation levels appear out of line with market realities, the Commission might recommend placing a temporary cap on any future wage increases based on the wage component of the ECI or the CPI (*e.g.*, 2 percent less than ECI or CPI, whichever is lower).<sup>133</sup>

Formalizing the standards to govern interest arbitration should impose needed discipline, resulting in more balanced arbitral outcomes. This reform might well contribute to fewer cases being taken to arbitration in the first place, as both sides may be less confident of holding an advantage in arbitration and therefore more willing to compromise beforehand.

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benefits, the Postal Service "has absolutely no control over the substance or administration of the civil service retirement act, to which postal workers are subject." *American Postal Workers Union, AFL-CIO v. U.S. Postal Service*, 707 F.2d 548, 556 (D.C. Cir. 1983). As we explained earlier in these comments, the Postal Service is facing a serious financial crisis with respect to the Civil Service Retirement fund, which may threaten the security of postal employees' retirement benefits.

<sup>133</sup> Arbitral schemes of this sort are familiar in public sector interest arbitration. A number of the states that permit public employees to bargain collectively also statutorily prescribe standards similar to those we have identified to govern arbitrations involving an array of state or municipal employees, from clerks to police officers. For example, Delaware provides that in establishing labor agreements for its public employees, arbitrators are to take into account the following: the interest/welfare of the public; a comparison of wages and benefits earned by comparable employees in similar communities; the overall compensation received by the employees; the stipulations of the parties; the authority of the public employer; the financial ability of the public employer, based on existing revenues, to pay for the cost of any proposed settlement; and other relevant factors usually considered in the wage determination process. Del. Code Ann. tit. 19, §§ 1315, 1615. Delaware further provides that an arbitrator may reject a proposed settlement solely on the grounds that the public employer cannot afford the cost. Consideration of similar factors is prescribed by various other states, including Connecticut, Illinois, Iowa, New Jersey, and Ohio.

*Reforming the Arbitration Process.* For similar reasons, the Commission should consider modifying the existing scheme to provide for arbitration by a panel of three neutral arbitrators, experts in the area. Discussion among three such neutral decision makers, as well as the need for at least two of them to concur on final contract terms, is likely to produce a more balanced and reasoned outcome than the current scheme, in which the fate of the Postal Service is entrusted to the predilections of a series of individual arbitrators. (If it were thought desirable to continue to have “advocates” on the arbitration board, the Commission could recommend the establishment of a 5-person board, with a partisan member from each side.)

In this same vein, to impose further discipline on the process, the Commission might also propose judicial review of interest arbitration awards (and perhaps initial administrative review of such awards). In particular, to give force to substantive arbitration standards, any labor agreement imposed in arbitration could be made subject to being set aside if it were found that the board’s decision did not conform or confine itself to the prescribed standards. The arbitration award would also be subject to being set aside if the board exceeded its jurisdiction or rendered a decision that had no foundation in fact, or if the award was a product of fraud or corruption. Such relatively limited (but meaningful) judicial (and, in some cases, administrative) review of arbitration awards is a commonplace occurrence and recommends itself here.

An additional reform for the Commission to consider is replacing the current conventional interest arbitration scheme with some form of final offer arbitration (often called “baseball-style arbitration”). As its name suggests, in final offer arbitration, the arbitration board is required to select between the final offers submitted by each side; the board is not empowered to fashion a compromise. Because this turns arbitration into a winner-take-all affair, final offer arbitration provides a forceful incentive for the parties to reach a negotiated agreement: Parties that face the prospect of losing entirely in arbitration are more likely to bargain to reach their

own agreement. Moreover, even if the parties proceed to arbitration, they will have a greater incentive to moderate their final offers for fear that the arbitration board will choose the other side's proposal as the more reasonable. A potential disadvantage to final offer arbitration of the entire collective bargaining package, of course, is that the arbitration board may be forced to select the proposed agreement that it deems better overall, even though that agreement contains some detrimental terms.

A possible variant on this model is so-called issue-by-issue final offer arbitration, in which the arbitration board chooses between each side's final proposals on an issue-by-issue basis, rather than choosing between each side's overall final package. This approach introduces some flexibility by allowing the arbitration board to pick and choose terms (though not to fashion terms of its own as in conventional interest arbitration), which eliminates the problem of bad terms being swept up in a package that is otherwise more desirable overall. And it might be a more manageable approach. On the other hand, reducing the all-or-nothing nature of the arbitration could well dilute the urgency for the parties to reach a settlement beforehand, a principal reason to adopt final offer arbitration in the first place. Yet a third option to consider is a hybrid arbitration: arbitration in which some issues—notably wages and benefits, which are perhaps the most suitable for an up-or-down choice—are resolved by choosing between the parties' final offers, while other issues (*e.g.*, work rules) are subject to resolution through conventional interest arbitration.<sup>134</sup>

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<sup>134</sup> At least ten states currently use some form of final offer arbitration for resolving disputes with various categories of state and municipal employees: Connecticut, Delaware, Hawaii, Illinois, Iowa, Michigan, Nevada, New Jersey, Ohio, and Wisconsin. Connecticut, Illinois, Iowa, and Ohio use issue-by-issue final offer arbitration; in New Jersey, non-economic terms are decided on an issue-by-issue basis, while economic terms are decided as a package. After Michigan enacted a final offer arbitration statute (covering economic issues) for certain public employees, the rate of pre-arbitration settlements rose from 40 percent to 70 percent. Paul Gordon, *Submitting "Fair Value" To Final Offer Arbitration*, 63 U. Colo. L. Rev. 751, 772 (1992).

In connection with other reforms, the Commission might also consider adopting a so-called “Med-Arb” scheme—that is, a scheme in which the neutral (the “med-arb”) acts as a mediator initially, but, if an impasse is reached, turns into an arbitrator and renders a final and binding settlement. An advantage of this system is that it causes both sides to consider the suggestions made by the mediator even more carefully than they might otherwise, as these suggestions may become the final settlement given by the mediator-turned-arbitrator. (This advantage would lose its force in winner-take-all final offer arbitration, though it would still carry some weight in issue-by-issue final offer arbitration.) This approach could also end up leaving the decision in the hands of a single individual (though it would be possible, if not conventional, to use multiple mediators).

***Railway Labor Act Model.*** Finally, in addition to the reforms proposed above, the EMA Foundation urges the Commission to consider drawing on elements of the Railway Labor Act (“RLA”) collective bargaining scheme.<sup>135</sup> The RLA immediately recommends itself because it is a longstanding, tested regime balancing the interests of labor, management, and the public in industries that, like the Postal Service, perform functions vital to the nation’s economy and society (the railroads and airlines). Moreover, the RLA itself is the product of agreement between railroads and rail labor unions as to how collective bargaining could be made workable in such a context, which was then codified by Congress (and later extended to the airline industry).

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It has been suggested (mostly in connection with baseball salaries) that final offer arbitration exerts an upward pressure on compensation terms. But any such effect could well be tempered by a requirement that, in choosing between final offers, the arbitration board must take into account (among other factors) the Postal Service’s ability to pay and the interests of the public and postal customers.

<sup>135</sup> 45 U.S.C. §§ 152 First, 155-159, 160.

The RLA is designed to foster good faith negotiations and voluntary agreements over compensation, work rules, and working conditions, while also expressly recognizing and advancing the public interest in avoiding interruptions to commerce.

To this end, the RLA prescribes a deliberately protracted process of bargaining, mediation, conciliation, voluntary arbitration, and, potentially, intervention by an Emergency Board appointed by the President of the United States to propose solutions. Throughout the bargaining process, management is required to adhere to the terms of existing agreements, and the union may not strike or exercise other economic self-help. The duty to make and maintain agreements is judicially enforceable and at the heart of the RLA scheme.

If voluntary negotiation fails to produce an agreement, either side may invoke mediation, to be conducted under the auspices of the National Mediation Board (“NMB”), an independent federal agency consisting of three members appointed by the President of the United States. If the mediator concludes that the parties are at impasse, the NMB will attempt to induce the parties to engage in voluntary interest arbitration.

At this point under the RLA process, if binding arbitration is rejected, the parties obtain the right to exercise self-help (after a cooling off period). Economic self-help is not the inevitable next step, however. If the NMB determines that an unresolved bargaining dispute threatens “substantially to interrupt interstate commerce to a degree such as to deprive any section of the country of essential transportation service,” the NMB can so advise the President of the United States, who may appoint an Emergency Board to investigate the dispute and make a report to him (suspending the right to engage in self-help).<sup>136</sup> Such a Presidential Emergency Board (“PEB”) is typically composed of three persons, appointed by the President, who are

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<sup>136</sup> 45 U.S.C. § 160.

usually well-respected labor-management arbitrators familiar with the RLA and industry practices.

The parties may elect to make an agreement on the basis of the terms recommended by the PEB in its report, but they are not required to do so. If the parties do not accept the PEB's recommendations, they may obtain the right to engage in self-help. As a practical matter, however, this may not occur. Although not provided for in the RLA itself, once the PEB process has run its statutory course, Congress itself may choose to step in and pass special legislation to end any threatened or actual self-help and to require the parties to submit the dispute to a second PEB, to submit the dispute to binding interest arbitration, or to accept the PEB's recommendations as binding on them as though they had been arrived at by agreement under the RLA.<sup>137</sup>

Though hardly perfect, there is no question that the RLA bargaining process has promoted stability and voluntary agreement. The experience of the railroad industry is particularly instructive, as the large railroads negotiate nationally with their unions over wages and benefits, as does the Postal Service. The former Chairman of the National Mediation Board has observed that in the last twenty years some 99 percent of all collective bargaining disputes (including those involving airlines) have been resolved without any interruptions in commerce.<sup>138</sup>

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<sup>137</sup> The RLA provides special procedures the resolution of disputes between publicly funded commuter rail carriers and their employees. If disputes are not otherwise resolved through the usual RLA process, then either party or the governor of any affected state can *require* the President to create a PEB. If the PEB's report does not result in resolution of the dispute, then the NMB must hold a public hearing. If this does not lead to agreement, then either party or a governor of an affected state can require the President to create a second PEB to select between the final offers of each side. The parties are not required to accept the final offer selected by the PEB, but failure to accept the recommended terms may result in loss of certain benefits in the event either side resorts to self-help. 45 U.S.C. § 159a.

<sup>138</sup> See Laurence Zuckerman, *Ernest W. DuBester: In Defense of the Oldest Labor Law*, N.Y. TIMES, July 1, 2001; *DuBester Says PEBs Should Remain Tool Of 'Last Resort,' Sees Gain In Mediation*, DAILY LABOR REPORT, July 30, 2001.

And this continues: Just last year several major rail unions (representing train service employees and maintenance of way employees) negotiated national agreements with the railroads, while the union representing railroad clerical employees agreed to voluntary binding interest arbitration with the railroads. In the past dozen years, only some fifteen PEBs were actually appointed, and only six of these (the last in 1997) involved freight railroads or Amtrak. (Of the others, six involved commuter railroads and three involved airlines.)

The EMA Foundation suggests that the Commission consider incorporating some elements of the RLA model into a new collective bargaining regime for the Postal Service. The procedures for mandatory and meaningful mediation and for appointment of a PEB seem particularly well suited to resolution of collective bargaining disputes in the Postal Service. In this connection, the Commission might also consider amplifying the RLA procedures by, for example, requiring a postal PEB to consider the same factors that we have suggested an interest arbitrator should consider.

Some critics of the RLA have complained that the PEB procedure (including the possibility of Congressional intervention) tends to “politicize” the resolution of collective bargaining disputes. This criticism reflects a preference for the status quo that we do not share. If any process should offend our democratic values it is the current one—which authorizes a single, unelected, and unaccountable arbitrator, acting with virtually no standards and no public scrutiny, to issue a final, binding, and unreviewable award prescribing multi-billion dollar costs to be born by postal ratepayers. This regime, if ever justified, no longer is. Postal reform cannot succeed without a fundamental change in the mechanisms for resolving collective bargaining disputes. Given the stakes, it seems perfectly appropriate that future bargaining disputes be resolved, if necessary, at the highest levels of our political system, with all of the visibility and political attention that these matters deserve.

#### IV. RATIONALIZING THE POSTAL SERVICE'S PHYSICAL PLANT

This section explores the potential for savings to the Postal Service from streamlining the process of closing uneconomic post offices and mail processing facilities. It is widely believed that much of the Postal Service's existing physical plant is redundant, obsolete, or otherwise uneconomic in its size, location, configuration, or design. In sparsely populated rural areas, the Postal Service may be able to serve its patrons—and meet its universal service obligations—equally effectively and far more economically by consolidating local post offices. In large metropolitan areas, the replacement of multi-story central processing facilities that have been obsolete for decades with modern one-story plants in industrial parks could reduce both mail processing and transportation costs. More generally, it is believed that a rationalized network of mail processing and distribution facilities would have fewer but larger facilities than the existing legacy network.<sup>139</sup>

Efforts to rationalize the Postal Service's physical plant face both legal and political obstacles, however. Residents of rural communities, along with their elected representatives, generally oppose the closing of rural post offices, which are often regarded as linchpins of local community life. Proposals to consolidate redundant, undersized or obsolete processing facilities meet comparable objections. We do not intend to address here the appropriate tradeoff between economic efficiency and cost minimization versus non-efficiency goals such as universal service, preservation of local communities, historic preservation, and the like. That tradeoff is a question of public policy beyond the scope of these comments. Rather, we address here the specific issue of what *procedures* should be followed in applying the general policies on a neutral basis to

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<sup>139</sup> See generally U.S. GAO, GAO-02-694, *U.S. Postal Service: Moving Forward on Financial and Transformation Challenges* 18-19 (2002) (Statement of David M. Walker, U.S. Comptroller General) (“Statement of David M. Walker”).

particular facilities that are candidates for closure or consolidation. Here, we believe, there is great potential for improvement.

#### **A. Current Restrictions on Closing Postal Service Facilities**

Post office closings are governed by two sections of the Postal Reorganization Act of 1970, 39 U.S.C. §§ 101 and 404. Section 101(b) provides that “No small post office shall be closed solely for operating at a deficit.” Section 404(b) further requires consideration of the following factors before any post office may be closed:<sup>140</sup>

- (i) the effect of such closing or consolidation on the community served by such post office;
- (ii) the effect of such closing or consolidation on employees of the Postal Service employed at such office;
- (iii) whether such closing or consolidation is consistent with the policy of the Government, as stated in section 101(b) of this title, that the Postal Service shall provide a maximum degree of effective and regular postal services to rural areas, communities, and small towns where post offices are not self-sustaining;
- (iv) the economic savings to the Postal Service resulting from such closing or consolidation; and
- (v) such other factors as the Postal Service determines are necessary.<sup>141</sup>

The USPS must provide notice of and opportunity to comment on the proposed closure or consolidation to those served by the office at least sixty days prior to the closure.<sup>142</sup> The determination to close or consolidate any office must be in writing and must provide the

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<sup>140</sup> *Knapp v. United States Postal Service*, 449 F. Supp. 158, 161 (E.D. Mich. 1978); *see also Milner v. Bolger*, 546 F. Supp. 375, 379 (E.D. Cal. 1982) (an “obvious way in which Congress moderated the ability of the Postal Service to operate as a private business [is] the prohibition on the closing of deficit-ridden rural post offices, 39 U.S.C. § 101(b)”).

<sup>141</sup> Compliance with the Occupational Safety and Health Act is not required, however. 39 U.S.C. § 404(b)(2).

<sup>142</sup> *Id.* § 404(b)(1).

Service’s findings as to the permitted reasons for closure. The written determination must be made available to those served by the office sixty days prior to closure.<sup>143</sup> Within thirty days after the written determination is made available, any person served by the office may appeal the determination to the Postal Rate Commission.<sup>144</sup> The Rate Commission has 120 days to make its decision, but it may only set aside a decision on limited grounds, such as failure to comply with required procedure.<sup>145</sup> The regulations implementing this system do not add any substantive requirements to those just described, although they spell out the procedure in greater detail.<sup>146</sup>

The Postal Service has imposed additional criteria to guide closure decisions. “[T]hree circumstances may prompt the Service to initiate a feasibility study to determine whether to close a post office: (1) a postmaster vacancy; (2) the emergency suspension of the operations of a post office; or (3) special circumstances, such as the incorporation of two communities into one.”<sup>147</sup> Of the 93 post offices closed or whose proposed closures were appealed in fiscal years 1995 – 1996, 91 were closed because of postmaster vacancies and two were closed because the office space became unavailable. Of those 1995-96 closures for which information was available, the average community whose post office was closed had a population of 206, six businesses, 28 hours of window service per week, and 13 transactions per day.<sup>148</sup>

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<sup>143</sup> *Id.* § 404(b)(3) and (b)(4).

<sup>144</sup> *Id.* § 404(b)(5).

<sup>145</sup> *Id.*

<sup>146</sup> *See generally* 39 C.F.R. § 241.3; *see also* USPS *Transformation Plan* at App. N (Apr. 2002) (“*Transformation Plan*”) (describing the process at length).

<sup>147</sup> U.S. GAO, GAO/GGD-97-38BR, *U.S. Postal Service: Information on Post Office Closures, Appeals, and Affected Communities* 3 (1997).

<sup>148</sup> *Id.* at 30-33.

In March 1998, the USPS imposed a “voluntary” moratorium on post office closings.<sup>149</sup> The moratorium was lifted in April 2002.<sup>150</sup> However, lifting the moratorium was not intended to usher in wholesale post office closings; it was merely intended to allow the previous process to resume.<sup>151</sup>

Finally, labor agreements such as the Collective Bargaining Agreement between the Postal Service and the American Postal Workers’ Union, AFL-CIO, also impose restrictions on laying off and transferring workers which may be relevant to office closures. Informal agreements between the Postal Service and unions may restrict the Postal Service’s flexibility further.<sup>152</sup>

Behind all of these “voluntary” actions is the implicit threat of intervention by Congress, either through investigations or legislation.<sup>153</sup> The most important constraints on the Postal Service’s modernization of its infrastructure are non-statutory. GAO has summarized some of these as follows:

As a practical matter, members of Congress and other stakeholders have often intervened in the past when USPS has attempted to close post offices or consolidate postal facilities. Proposed post office closures have provoked intense opposition because local post offices (1) have long been a critical means of obtaining ready

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<sup>149</sup> Thomas Farragher, *Forwarding Address: Post Offices’ Growing Pains Are Problem*, BOSTON GLOBE, March 26, 1998, at A1 .

<sup>150</sup> Katherine M. Skiba, *Postal Service to Close Small Offices: Communities where Service Had Already Stopped*, MILWAUKEE JOURNAL SENTINEL, Apr. 6, 2002, at 2B.

<sup>151</sup> John E. Potter, *The Postal Service in the 21st Century: Statement of John E. Potter before the Subcommittee on International Security, Proliferation and Federal Services of the Committee on Senate Governmental Affairs 4* (May 13, 2002).

<sup>152</sup> E.g., William Burrus, *Stealth Transformation*, AMERICAN POSTAL WORKER (July/Aug. 2002), available at <http://www.apwu.org/usptrans/stealthtransformation.htm>.

<sup>153</sup> E.g., *Transformation Plan* at Appendix at N-9; Editorial, *Postal Service Has to Cut Back*, ATLANTA JOURNAL & CONSTITUTION, Apr. 5, 2002, at 15A; Stephanie Stassel, *Postal Service Urged to Reverse Building Freeze*, L.A. TIMES, April 10, 2001, at B4.

access to postal retail services, (2) are a part of American culture and business, and (3) are viewed as critical to the viability of certain towns and/or central business districts. Similarly, changes to USPS's mail-processing infrastructure have been difficult to implement. Although there are no legal requirements relating directly to closing or consolidating mail-processing facilities, as a practical matter, such efforts have been opposed because of the potential effects on jobs and mail delivery service in local communities, their proximity to facilities of large mailers, and congressional interest in the location of mail-processing facilities.<sup>154</sup>

## **B. Possible Reforms**

Models for reform may be found in the laws that govern the abandonment of unprofitable railroad branch lines and the closing of redundant or uneconomic military bases.<sup>155</sup> Like post office closings, railroad abandonments and military base closings are often perceived to have major impacts on their communities, and thus are often highly controversial. As with the Postal Service, the rationalization of the railroad network and the military base infrastructure is universally applauded—as long as the facilities closed are located somewhere else. Congress has developed two quite different, but highly workable solutions to these problems in other contexts. Either solution, or a combination of the two, could be applied to the postal context. In the railroad setting, any financially responsible person, including government entities, may offer to buy or subsidize a line that would otherwise be closed.<sup>156</sup> In the military setting, the passage of the Defense Base Closure and Realignment Act of 1990 (“1990 Act”),<sup>157</sup> made it possible to close large numbers of military bases and realize corresponding savings.

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<sup>154</sup> U.S. GAO, GAO-02-355, *U.S. Postal Service: Deteriorating Financial Outlook Increases Need for Transformation* 37-38 (2002) (“GAO Deterioration Financial Outlook Report”) (citation omitted).

<sup>155</sup> See, e.g., Statement by David M. Walker 19.

<sup>156</sup> 49 U.S.C. § 10904(c).

<sup>157</sup> Pub. L. No 101-510, 104 Stat. 1485 (codified as amended at 10 U.S.C. § 2687 note) (“1990 Act”).

## 1. Financial Assistance for Railroad Lines

A rail carrier wishing to abandon or discontinue transportation over part of its railroad lines must file an application with the Surface Transportation Board.<sup>158</sup> The application must include a statement that the line is available for sale or subsidy and the name and address of a person who can provide and discuss an estimate of the subsidy or sale price.<sup>159</sup> The application must be sent to the chief executive officer of each state affected, posted in all affected stations, and otherwise widely publicized.<sup>160</sup> The carrier must provide to both the Board and to any person considering making an offer an estimate of the annual subsidy and minimum purchase price to keep the line open, its most recent reports on the physical condition of the line, traffic, revenue, and other data needed to calculate the required amount of financial assistance, and any other information the Board considers necessary.<sup>161</sup>

Within four months of the application's filing, any person may offer to buy or subsidize the line.<sup>162</sup> If the Board finds that a financially responsible person has made such an offer, discontinuance is postponed until the offeror reaches agreement with the carrier, or the Board establishes a compensation amount.<sup>163</sup> For subsidies, the Board must set the compensation amount at “the *difference between the revenues* attributable to that part of the railroad line *and the avoidable cost* of providing rail freight transportation on the line, *plus a reasonable return* on the value of the line.”<sup>164</sup> If an offeror buys a rail line, it may not discontinue the line for at least

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<sup>158</sup> 49 U.S.C. § 10903(a)(1). The procedural requirements are spelled out in much greater detail at 49 C.F.R. § 1152.27.

<sup>159</sup> *Id.* at (a)(2).

<sup>160</sup> *Id.* at (a)(3).

<sup>161</sup> *Id.* § 10904(b).

<sup>162</sup> *Id.* § 10904(c).

<sup>163</sup> *Id.* at (d)-(f).

<sup>164</sup> *Id.* at (f)(1)(c) (emphasis added).

two years, and may not transfer the line for at least five years. However, subsidy agreements are limited to a single year unless otherwise agreed upon.<sup>165</sup>

A similar system could easily be established for the Postal Service. There is no need for an application process; the Service could simply publicize its intent to close a post office. If a local or state government, coalition of businesses, or another interested person then submitted an offer to subsidize the office, that person could either reach agreement with the Postal Service directly or submit its offer for consideration by the Postal Rate Commission. The Commission could determine the subsidy rate using standards and procedures analogous to those applied by the Board. This mechanism would enable states, localities, or other entities to keep open post offices that play a significant community role, without forcing mailers to subsidize these very localized benefits.

## **2. Description of the Military Base Closing Legislation**

The approach specified by the 1990 Act for the military base closures from 1991 – 1995 is considerably more elaborate than even the post office closure process and sharply limits elected officials' involvement in decisionmaking. The initial planning is conducted by the Department of Defense.<sup>166</sup> The Defense Base Closure and Realignment Commission then reviews the Secretary's plan in depth and may make changes to the plan if statutory criteria are met.<sup>167</sup> The revised plan is transmitted to the President, who may approve or disapprove it in its entirety.<sup>168</sup> If the President disapproves the plan, he must give reasons for his approval and the

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<sup>165</sup> *Id.* at (f)(4).

<sup>166</sup> *Id.* § 2903 (a) – (c).

<sup>167</sup> *Id.* § 2903 (d).

<sup>168</sup> *Id.* § 2903 (e).

Commission must revise and resubmit the plan.<sup>169</sup> Finally, once the President has approved the plan, Congress may enact a joint resolution disapproving the Commission’s recommendation.<sup>170</sup> If it does not do so, the closures may go forward.<sup>171</sup> A key aspect of this scheme is that elected officials may not *modify* the plan; they may only approve or disapprove it in its entirety.

The Defense Base Closure and Realignment Commission, which is central to this scheme, is composed of eight members appointed by the President with the advice and consent of the Senate.<sup>172</sup> The Commission is expected to be bipartisan: The President “should consult” with the Speaker of the House and the majority leader of the Senate as to the appointment of two members each, and with the minority leaders as to one member each.<sup>173</sup> Each Commission member serves for the remainder of the Congressional term in which he or she was appointed (up to two years), and is paid at government rates.<sup>174</sup> Staff and funding for the Commission is also contemplated, but the Commission controls its own hiring, and funding is left up to Congress and, as a fallback, the Secretary of Defense.<sup>175</sup>

The 1990 Act spells out the decision-making process in some detail. First, as part of its federal budget justification, the Department of Defense must submit a detailed six-year “force-structure plan for the Armed Forces” based on probable threats.<sup>176</sup> The plan must include an assessment of probable threats, a description of the needed force structure at the beginning and

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<sup>169</sup> *Id.*

<sup>170</sup> *Id.* § 2904(b).

<sup>171</sup> *Id.*

<sup>172</sup> *Id.* § 2902(a) – (c).

<sup>173</sup> *Id.* at (c)(1)(C)(2).

<sup>174</sup> *Id.* at (d), (g).

<sup>175</sup> *Id.* at (h) – (k).

<sup>176</sup> *Id.* § 2903(a)(1).

end of the six years, and an implementation plan.<sup>177</sup> The Department must then develop, publish for public comment, and transmit to the Congressional defense committees criteria for base closures and realignments. Those criteria become effective unless Congress disapproves them by joint resolution. The criteria must be finalized by January 15 of the year concerned, and Congress only has until February 15 to disapprove them.<sup>178</sup> In fact, the Department has used the same criteria in all three rounds of base closures under the Act. The criteria are:

1. Current and future mission requirements and the impact on operational readiness of DOD's total force.
2. The availability and condition of land, facilities, and associated airspace at both the existing and potential receiving locations.
3. The ability to accommodate contingency, mobilization, and future total force requirements at both the existing and potential receiving locations.
4. Cost and manpower implications.
5. The extent and timing of potential costs and savings, including the number of years, beginning with the date of completion of the closure or realignment, for the savings to exceed the costs.
6. The economic impact on communities.
7. The ability of both the existing and potential receiving communities' infrastructures to support forces, missions, and personnel.
8. The environmental impact.<sup>179</sup>

Priority is to be given to the first four of these criteria, which concern military value.

Once the criteria have been promulgated, the Department may select military bases for closure. In 1995, the deadline for selection was March 1—only two weeks after the deadline for

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<sup>177</sup> *Id.* at (a)(2).

<sup>178</sup> *Id.* at (b).

<sup>179</sup> U.S. GAO, GAO/NS IAD-95-133, *Military Bases: Analysis of DOD's 1995 Process and Recommendations for Closure and Realignment 21-22* (1995).

Congress to disapprove the criteria. The closure recommendations must be based on the force-structure plan and on the final criteria.<sup>180</sup> Together with the recommendations, the Department is required to submit a justification for each selection and to make available to Congress, the Commission, and the U.S. Comptroller General all information used to prepare the recommendations.<sup>181</sup> Most persons submitting information to the Department to use in making recommendations must certify that it is accurate and complete.<sup>182</sup>

After the Department has made its recommendations, the Commission reviews them. First, it conducts public hearings under oath on the recommendations.<sup>183</sup> By July 1, the Commission must report its findings and conclusions to the President, with a list of bases recommended for closure.<sup>184</sup> The Commission may make changes in the list of bases, but only if it determines that the Department “deviated substantially” from the force-structure plan and final criteria. In order to add a base to the closure or realignment list or to expand a realignment the Commission must also (1) determine that its change is consistent with the force-structure plan and final criteria; (2) publish a notice of the proposal in the Federal Register at least 45 days before it reports to the President (*i.e.*, by mid-May); and (3) conduct public hearings on the proposed change.<sup>185</sup> To the extent the Commission’s recommendations differ from the Department’s, the Commission must explain and justify the changes in its report to the President, and must send a copy of the report to the congressional defense committees.<sup>186</sup> The Commission

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<sup>180</sup> 1990 Act at § 2903(c).

<sup>181</sup> *Id.* at (c)(2), (c)(3)(C)(4).

<sup>182</sup> *Id.* at (c)(3)(C)(5).

<sup>183</sup> *Id.* § 2903(d)(1).

<sup>184</sup> *Id.* at (d)(2)(A).

<sup>185</sup> *Id.* at (d)(2)(B) – (D).

<sup>186</sup> *Id.* at (d)(3).

must provide the information it has used to any member of Congress on request.<sup>187</sup> The Comptroller General is directed to assist the Commission, and to report to Congress and the Commission on the Secretary's recommendations and selection process.<sup>188</sup>

Finally, the President must provide a report to the Commission and to Congress approving or disapproving the Commission's recommendations by July 15.<sup>189</sup> If the President disapproves, the Commission has until August 15 to provide a revised list.<sup>190</sup> If the President's approval has not been obtained by September 1, the process ends for the year.<sup>191</sup> If the President does approve the list, however, it is sent to Congress.<sup>192</sup> The only way for Congress to disapprove the recommendations is by a joint resolution within 45 days of the President's report (*i.e.*, by mid-October at the latest).<sup>193</sup>

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<sup>187</sup> *Id.* at (d)(4).

<sup>188</sup> *Id.* at (d)(5).

<sup>189</sup> *Id.* § 2903(e)(1).

<sup>190</sup> *Id.* at (e)(3).

<sup>191</sup> *Id.* at (e)(5).

<sup>192</sup> *Id.* at (e)(2), (e)(4).

<sup>193</sup> *Id.* § 2904(b). The 1990 Act also includes a process for a 2005 round of base closures. *Id.* §§ 2912-14. Although similar to the procedures described above, the modifications make the process more elaborate and somewhat limit the power of the Department and the Commission. For example, the force-structure plan must cover twenty years, not six, *id.* § 2912(a); the process includes consideration of foreign bases, *id.* §§ 2912(a)(1)(B), (a)(2)(C)(3); the Secretary of Defense must certify the need for base closures, *id.* § 2913(b); the Commission is expanded to nine members, *id.* § 2913(d)(3); the Department is required to promulgate entirely new criteria, and minimum criteria are spelled out in detail in the Act, *id.* § 2913(b), (f); local government views must be considered, *id.* § 2914(b)(2); and the Commission's authority to make changes is limited, *id.* § 2913(d)(3). In short, the 2005 process appears to be more cumbersome and more exposed to political pressures than the prior process. It remains to be seen how well it will work in practice.

### 3. Adapting the Model to the Postal Service Setting

The process just described has been effective in breaking the political stalemate over base closures and permitting substantial savings to the Department of Defense.<sup>194</sup> A modified version of this process could be applied to post office closures. The Postal Service would submit an overall network rationalization plan, including a list of specific facilities to be closed or downsized, to the Postal Rate Commission or some other neutral expert tribunal. Interested parties could intervene and submit comments in a manner akin to proceedings before the base closing commission.

Applying the criteria of 39 U.S.C. §§ 101(b) and 404 to the record, the Rate Commission would recommend a specific list of post offices for closing. The Rate Commission's decision would be subject to judicial review and could be overridden only by an up-or-down vote in Congress. It would be essential to impose strict timelines and to require that the Congress accept or reject the closure list in its entirety.

In conclusion, rationalization of the Postal Service's physical plant could potentially save the Postal Service large amounts without impairing universal service. The military base closure procedure offers a useful model. Although such a procedure would have to be implemented by statute, it could be harmonized with current statutory requirements for post office closures.

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<sup>194</sup> E.g., U.S. GAO, GAO/NSIAD-99-17 *Military Bases: Review of DOD's 1998 Report on Base Realignment and Closure* (1998); Dale Penneys Levy, *Military Base Closures: Developing the Peace Dividend*, 8 PROBATE & PROPERTY 32 (1994).

## **V. UNBUNDLING AND PRICING FOR EFFICIENT MAKE-OR-BUY DECISIONS (OUTSOURCING, WORK-SHARING AND NSA'S)**

The most urgent problems facing the Postal Service involve its cost structure, not its rate structure. Nevertheless, two rate-related issues also warrant the Commission's attention. First, what retail lines of business should the Postal Service enter—and what criteria should be used to decide this? Second, what rules should the Postal Service follow for unbundling its intermediate outputs (mail collection, sorting, transportation and delivery) and for pricing the unbundled services? We discuss each issue in turn.

### **A. In Which Retail Lines of Business Should the Postal Service Compete?**

In recent years, controversy has erupted over the Postal Service's plans to expand beyond its regulated postal business by marketing a variety of non-postal goods and services. These new lines of business have included prepaid phone cards, remittance processing services, electronic postmarks, and packaging services as well as clothing, greeting cards, and other gift items.<sup>195</sup>

Critics of these initiatives have assailed them on two grounds. First, existing suppliers of those services have argued that the Postal Service's entry would amount to unfair competition for those competitive services because the Postal Service can deliberately subsidize its competitive forays with profits or revenue from its monopoly services. Alternatively, some mailers fear that the Postal Service will mismanage its competitive efforts, and that the monopoly mail classes will be forced to make up the lost revenue.<sup>196</sup>

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<sup>195</sup> U.S. GAO, GAO/GGD-99-15, *U.S. Postal Service: Development and Inventory of New Products* 9, 17-19 (1998) (“*Development & Inventory*”).

<sup>196</sup> See J. Gregory Sidak & Daniel F. Spulber, *Protecting Competition from the Postal Monopoly* (1996); GAO *Deteriorating Financial Outlook Report* 34. Other competitors argue that, even when competitive services make money for the Postal Service, the competition is unfair because the Postal Service enjoys tax exemption and other benefits not available to private firms. This

Sound oversight of this area must recognize the policy tradeoffs involved. It is certainly possible that entry into competitive markets poses the risk that monopoly mail classes will be required, whether deliberately or through inadvertence, to subsidize competitive non-postal offerings. The track record of diversification out of the core competitive area of business management is not always encouraging. Many of the Postal Service's non-postal ventures in recent years have lost money.<sup>197</sup> This is hardly surprising. The same is often true of diversification in the private sector—so much so that Peter Lynch, the former manager of the Fidelity Magellan mutual fund, has dubbed the phenomenon “deworseification.”<sup>198</sup>

On the other hand, diversification, when well conceived, can genuinely benefit consumers while still earning a profit. This is most likely to be so when the new goods or services are complementary with existing ones. The Postal Service has both a well-known brand name and an extensive retail network that is likely to yield economies of scope in the sale of other products. It is telling that FedEx, a competitor of the Postal Service, has chosen to partner with it by placing its drop boxes at thousands of post office locations.<sup>199</sup> Under the circumstances, an arbitrary restriction on diversification into competitive markets could make

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argument is difficult to assess. The Postal Service is also subject to a variety of statutorily-imposed costs not incurred by its private competitors. *See Transformation Plan* at 72 n. 41 (listing various legislatively-imposed costs). Perhaps the greatest cost of all is the hardest to quantify – the competitive lethargy or inefficiency that almost inevitably results from cost-of-service rate-of-return regulation.

<sup>197</sup> For fiscal year 2001, the Postal Service budgeted \$104 million for e-commerce revenues, but actual e-commerce revenues were only about \$2 million. *GAO Deteriorating Financial Outlook Report* at 50. Likewise, according to unaudited Postal Service figures, the 19 new products marketed or announced by the Postal Service in fiscal years 1995, 1996 and 1997 generated \$148.8 million in revenue and \$233.5 million in expenses through the end of fiscal year 1997. *Development & Inventory* at 3-4. In fairness, the GAO Report notes that “it may not be reasonable to expect all new products to become profitable in their early years, because new products generally take several years to become established and recover their start-up costs.” *Id.* at 20.

<sup>198</sup> Peter Lynch, *One Up on Wall Street* 146-150 (1989).

<sup>199</sup> *Transformation Plan* at 18.

consumers worse off.<sup>200</sup> There is no reason to assume that legislators or regulators, no matter how well enlightened, can predict the appropriate markets for diversification with more foresight than Postal Service management.

While the issue is not without uncertainty, the most appropriate rule of decision here may be a cost test: Non-regulated postal services should be required to cover their attributable and average incremental costs. These price floors have well established precedent in both public utility regulation and antitrust law.<sup>201</sup> A service whose prices cover these floors is not, by definition, being subsidized by other services.<sup>202</sup> Subject to that price floor, the best test of whether the Postal Service can provide a non-regulated good or service more cheaply or more effectively than private competitors is likely to be the market itself.

We do not propose that the Postal Rate Commission, or any other oversight body, regulate the prices that the Postal Service charges for non-regulated services. Rather, the rule should be enforced by requiring the Commission and the Governors of the Postal Service, in setting regulated postal rates, to exclude from the Postal Service's overall revenue requirement all revenues and costs that are attributable to (or incremental to) the non-regulated services.

Critics may respond that this safeguard is inadequate because the Postal Service, lacking shareholders whose equity can be diminished when the enterprise loses money, ultimately cannot

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<sup>200</sup> See Robert W. Mitchell, *Postal Administrations and Non-Postal Products*, in *Postal and Delivery Services: Productivity, Regulation, and Strategy* 321, (Michael A. Crew and Paul R. Kleindorfer, eds., 2002).

<sup>201</sup> JULIAN O. VON KALINOWSKI ET AL., *ANTITRUST LAWS AND TRADE REGULATION*, §§ 27.02[b]-[c] (2002).

<sup>202</sup> 3 PHILLIP AREEDA AND DONALD E. TURNER, *ANTITRUST LAW* ¶ 719 (1978) at 182; *Cost Standards for Railroad Rates*, 364 I.C.C. 898, 904 (1981), *aff'd*, *Water Transport Ass'n v. ICC*, 684 F.2d 81, 85 (D.C. Cir. 1982); *Direct Marketing Ass'n, Inc. v. USPS*, 778 F.2d 96, 105 (2nd Cir. 1985).

be allowed to become insolvent or bankrupt. Hence, the argument goes, the political pressure for requiring monopoly rate classes to subsidize any major losses resulting from ill-advised ventures into non-regulated markets is likely to be irresistible.<sup>203</sup> To date, however, both the profits and losses from the Postal Service's entry into new non-regulated markets have been small, and the risk of such a scenario appears remote. Should the scale of the Postal Services' non-postal businesses increase dramatically, the issue of further standards can be revisited in light of the Postal Service's track record at that point.

### **B. Rules for Unbundling Intermediate Postal Outputs and for Pricing Those Unbundled Outputs**

Like most large businesses, the Postal Service is a vertically integrated enterprise whose retail outputs—mail services—are actually bundles of intermediate outputs. The main intermediate outputs of the Postal Service are (1) acceptance, (2) sorting, (3) transportation, and (4) delivery.<sup>204</sup>

Like vertically integrated private firms, the Postal Service faces make-or-buy choices for most of its intermediate outputs. Except for final delivery—over which the Postal Service has a legal monopoly for letter mail and (arguably) a natural monopoly for some other mail classes—most of the Postal Service's other intermediate outputs are provided, or could be provided, by third party vendors or by postal customers themselves. This raises the obvious issues of (1) to what extent the Postal Service's intermediate outputs should be unbundled and (2) how those unbundled outputs should be priced.

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<sup>203</sup> See Robert W. Mitchell, *supra* n.200, at 326-27.

<sup>204</sup> Robert W. Mitchell, *Preparing the Postal Service's Rate Structures for Competition in Future Directions in Postal Reform* 67, 77 (Michael Crew and Paul Kleindorfer, eds., 2001).

The Postal Service has moved a long way toward unbundling in the past two decades. Today, over 60 percent of USPS mail volume receives some type of work-sharing discount.<sup>205</sup> Mail sorting can be largely bypassed through pre-sorting by the mailer or automated through pre-barcoding. Transportation can be bypassed through destination entry. Nevertheless, we believe that major areas for improvement remain. The following are examples:

***Retail Sales of Stamps:*** Stamp purchases account for about 450 million transactions in post offices each year. On average, the Postal Service incurs 24 cents in counter costs for every dollar of revenue from stamp sales. At contract postal units, the average cost is ten cents. At an ATM—or a supermarket, drug store, or other large retailer—the average cost to the Postal service is only *1.6 cents*.<sup>206</sup> Yet the Postal Service has only recently begun large-scale efforts to partner with private retailers—and to advertise the availability of those retail alternatives to consumers.<sup>207</sup>

***Discounts for Bypass of Mail Collection:*** No discounts are available to mailers for bypassing the Postal Service’s collection function.

***Discounts for Bypass of Transportation:*** There are no destination entry discounts offered for Express Mail, First Class Mail, or Special Standard or Library Rate Mail, and discounts for Periodicals Mail are limited.<sup>208</sup> Even for Standard A Mail, the discounts are

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<sup>205</sup> Robert H. Cohen et al., *Universal Service without a Monopoly*, in *Current Directions in Postal Reform 69*, (Michael Crew and Paul Kleindorfer, eds. 2000).

<sup>206</sup> *GAO Major Management Challenges Report* at 15-16.

<sup>207</sup> *Id.* at 16-17; *Transformation Plan* at 13-18 & App. K-1 through K-4.

<sup>208</sup> Robert W. Mitchell, *supra* n.204, at 76.

limited: “mail traveling 2,000 miles to get to a destination facility gets the same dropship discount as similar mail traveling 200 miles.”<sup>209</sup>

For each make-or-buy choice, the same pricing rule should apply: The implicit price for the unbundled service (in postal parlance, the “work-sharing discount”) should at least cover the estimated costs attributed to the provision of that service by the Postal Service itself.<sup>210</sup> Potential opportunities for work-sharing should be adopted if the potential savings appear large enough to justify the transaction costs of designing and implementing the work-sharing classification and rates.

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<sup>209</sup> *Id.*

<sup>210</sup> See PRC Docket No. MC95-1, *Mail Classification Schedule, 1995—Classification Reform I*, PRC Opinion & Recommended Decision (Jan. 26, 1996) ¶¶ 4237-38 (discussing “efficient component pricing rule”).

## VI. CONCLUSION

The most important issues facing the Commission involve the Postal Service's cost structure. The Commission should recommend the following actions:

- The Commission should give the strongest possible support to some form of the proposed legislation that would alleviate the Postal Service's deferred liabilities crisis by recognizing the projected overfunding of the pension fund and reducing the Postal Service's CSRS payments. Without quick relief from this acute problem, efforts to solve the Postal Service's longer-term issues may be moot.
- Any meaningful effort to rein in the Postal Service's operating costs must deal with its escalating personnel costs, which now account for well over 75 percent of the Postal Service's annual operating expenses. The Commission should recommend reforms that focus on the root causes of the problem: a wage rate structure that appears to be out of line with market conditions; a workforce that is larger than necessary for productive operations; and a working environment that breeds acrimony and conflict.
- The Commission should urge adoption of a streamlined process for closing uneconomic post offices and mail processing facilities. Many facilities in the postal network appear to be inefficiently sized, obsolete or redundant. The most significant constraints on infrastructure rationalization are political, including the threat of congressional intervention. The military has faced similar problems in connection with base closures, and the Defense Base Closure and Realignment Act of 1990 provides a workable solution as a model for the Postal Service.

- Although pricing and classification issues are less urgent than cost control, it would be useful for the Commission to recommend appropriate standards for deciding (1) what prices the Postal Service should charge for nonregulated postal services and (2) what implicit prices should be set for unbundled intermediate outputs of the Postal Service, such as mail acceptance, sorting, and transportation.

Respectfully submitted,

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