STATEMENT OF
NANCY H. KICHAK
ASSOCIATE DIRECTOR FOR STRATEGIC HUMAN RESOURCES POLICY
U.S. OFFICE OF PERSONNEL MANAGEMENT

before the

SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

on

FUNDING OF POST-RETIREMENT HEALTH BENEFITS FOR EMPLOYEES OF THE UNITED STATES POSTAL SERVICE

AUGUST 6, 2009

Chairman Carper, Senator McCain, and Members of the Subcommittee:

I appreciate this opportunity to provide the Office of Personnel Management's (OPM's) views regarding the funding of Federal Employee Health Benefits (FEHB) for retired employees of the Postal Service. We understand there are challenges facing the Postal Service in meeting the financial obligations for the costs of health insurance for current and future retirees. Therefore, we welcomed the introduction of S. 1507, which is intended to provide relief to the Postal Service in meeting its obligations to fund its share of retiree health benefits costs.

Background

Subject to the same qualifying criteria that apply to all Federal retirees, Postal employees are permitted to continue their FEHB coverage after retirement. The Postal Service is responsible for the Government contribution toward the retirees' FEHB premiums based on the portion of service accrued after 1971. Due to its unique status as an independent establishment, the Postal Service funds its pension costs differently than other Federal agencies. Prior to Public Law 109-435, the "Postal Accountability and Enhancement Act," enacted December 20, 2006, the employer contributions made by the Postal Service were on an annual "pay-as-you-go" basis. That is, each year the Postal Service paid the amount of FEHB Government premium contributions actually made that year for Postal retirees.

Public Law 109-435 established a funding mechanism where the Postal Service pays the employer share of post-retirement FEHB premiums for its employees in advance of when the actual payments are required. This pre-funding mechanism is similar in concept to the way that Federal agencies fund employee retirement costs under the Federal Employees' Retirement

System (FERS). Under FERS, employing agencies pay the cost of future retirement benefits into the Civil Service Retirement and Disability (CSRD) Fund while individuals are employed. Pre-funding retirement benefits assures there is sufficient money set aside for the retirement benefits to be paid without further agency contributions. In the same way, the purpose of pre-funding post-retirement FEHB premiums by the Postal Service is to ensure Postal employees will have employer funding available for their health insurance after retirement.

Public Law 109-435 also established a new Postal Service Retiree Health Benefit Fund (PSRHB), administered by OPM, to provide for transfer from the CSRD Fund to the PSRHB Fund certain specified surpluses related to the Civil Service Retirement System. This, plus an amount held in escrow as a result of prior legislation (Public Law 108-18), established an initial balance in the PSRHB to pre-fund the post-retiree health benefit costs for the Postal Service.

Public Law 109-435 established separate Postal payment structures through Fiscal Year 2016 and created a different payment structure thereafter. During the initial transition period, which continues through Fiscal Year 2016, the Postal Service will make the annual "pay-as-you-go" costs for current Postal retirees. The Postal Service will also make annual payments into the PSRHB in amounts specified by 5 U.S.C. 8909a(d)(3)(A) that range from $5.4 to $5.8 billion per year.

Beginning with Fiscal Year 2017, a different structure is implemented. First, the "pay-as-you-go" costs will no longer be paid directly from the Postal Service, but will be paid from the Fund. The Postal Service's annual payments to the PSRHB will no longer be on the basis of a statutory schedule, but will be based upon the net amount of two parts. First, OPM actuaries will annually compute the amount, attributable to that year's Postal employment, necessary to pay the future employer share of employees' post-retirement FEHB premiums. That amount, referred to as the "normal cost payment," will constitute the first portion of the annual payments for the current Postal employees. The second part will be based on an amortization schedule providing for the liquidation by September 30, 2056, or within 15 years, whichever is later, of any liability or surplus including interest. However, while the law makes provision for liquidation of either a surplus or unfunded liability, current projections are that, for the foreseeable future, there will be a substantial unfunded liability, which will result in an increase required for the post-Fiscal Year 2016 annual Postal Service payments.

<u>The Postal Service Inspector General's Report</u>

You specifically requested that we address the retiree health funding issues raised in the recent report from the Postal Service's Office of Inspector General (OIG) entitled "Estimates of Postal Service Liability for Retiree Health Care Benefits" (Report Number ESS-MA-09-001). Our views differ from the conclusions in that report, and I will explain why we believe our conclusions are sound.

The Postal OIG position is based upon a study by the Hay Group, which used different assumptions from those used by OPM. In particular, the Hay report takes issue with the health benefits trend assumption used by OPM in its valuation. The most significant difference between the two views is that the Postal Service OIG assumes health insurance costs will increase at 5 percent per year, a lower rate than our current estimate of 7 percent.

We believe OPM's 7 percent trend is reasonable and appropriate. This assumption is based on careful consideration of historical trends of the FEHB Program. The FEHB Program differs from other retiree medical programs in several respects. Most retiree medical plans are stand-alone, with active employees covered under a different program. In the FEHB Program, retirees and employees are covered under a single program. Participation in Medicare is also a requirement in many retiree medical plans, although this is not the case in the FEHB Program.

In the Postal-OIG report, Hay selected a 5 percent trend based on a survey of ultimate trend rates used in the valuation of public and private sector retiree medical plans. Hay used an average ultimate trend rate projection based on substantially higher trend rates in the initial years, graded down to 5 percent in the later years. However, Hay's assumption as applied to the Postal Service appears to use a level 5 percent assumption even in the initial years of its projection.

Last week, the Postal Regulatory Commission (PRC) released a report on this issue prepared by Mercer Health & Benefits, a major private sector consulting firm in the field of health and benefits. In its valuation for the PRC, Mercer applied a variable select and ultimate trend rate, with increases higher than 7 percent until 2016, and lower thereafter. Use of the Mercer select and ultimate trend assumption is a reasonable approach and produces results that are similar to the level 7 percent trend assumption used by OPM. The Mercer report finds the OPM approach reasonable and states that "a 7% trend rate or higher would be a reasonable trend assumption and is indeed consistent with the historical results achieved."

In summarizing the Hay projection, the PRC report notes "Mercer considers a selection of a static trend rate of 5% for the entire valuation to be too much reliance on a recent occurrence where it is known that reserve reductions have been incorporated in the overall increase." That is, reserve funds have been used to hold down recent premium increases, and this has contributed to recent trend rates being lower than historical averages. The Mercer report went on to state that "[i]n short, we deem the static 5% trend assumption for all years to be optimistic and not likely a best estimate assumption."

With regard to income return on investments, both OPM and Hay employ an assumed discount rate of 6.25%. However, had Hay applied the same methodology in selecting a discount rate for their analysis as they did for their trend assumption, they should have used something substantially less than the 6.25 %. A lower discount rate would have resulted in a larger liability. We believe it is extremely important to make and apply assumptions consistently.

<u>Potential Legislative Changes</u>

Under current law, the selection of assumptions has no effect until 2017. The Postal Service funding for its retiree medical costs is established in statute, and it must pay according to a fixed schedule, plus the "pay-as-you go" costs for its retiree FEHB Program premiums.

Beginning in 2017, the "pay-as-you-go" premiums are paid from the PSRHB and the Postal Service must pay the accruing "normal cost" of retiree health benefits for its employees plus an amortization of its unfunded liability as determined by OPM. OPM's determination of these amounts will be based on actual cost experience and Postal populations through that date – not on determinations made today.

OPM has no objections to legislative changes that provide for a solution in a manner that does not jeopardize the funding for employee and retiree benefits S. 1507 meets that requirement. In other words, it is our view that S. 1507 would provide temporary relief to the Postal Service in a financially responsible manner. It provides that the Postal Service would begin paying the "normal cost" for its employees today, along with a stream of payments that represents the amortization of the existing unfunded liability.

Under the bill, the "pay-as-you-go" costs of FEHB premiums for Postal retirees would immediately begin to come from the PSRHB. During the period from Fiscal Year 2009 through Fiscal Year 2019, the Postal Service would pay the "normal-cost" of retiree health benefits for its employees, plus specified scheduled payments that represent payments toward the existing unfunded health benefits liability. The specified schedule of payments would be constructed to provide the Postal Service financial relief in the early years, but the Postal Service would have to pay more in the later years to make up for the lower initial payments. Beginning in Fiscal Year 2020, the Postal Service would pay the "normal cost" of retiree health benefits for its employees, plus a 40-year level amortization of the remaining unfunded liability for future retiree FEHB premiums. It is estimated that the net effect would be reduced Postal Service payments for the period through Fiscal Year 2013. While this is a temporary reprieve, it would provide additional time to allow the Postal Service to develop longer term solutions to the financial viability challenges it faces.

Thank you for the opportunity to represent Director Berry on this important issue. I would be happy to answer any questions.