

I'm Busted

USPS Sings The Congress-Ran-Off-And-Took-My-Escrow Blues

Some things in life are certain. Death. Taxes. The return of the swallows each spring to Capistrano. And, when the Postal Service is testing the political waters for another rate case, some plumb pitiful singing from USPS headquarters.

The bills are all due and my baby needs shoes

On February 9, the folks at L'Enfant Plaza issued a press release claiming that the Postal Service lost \$2.7 billion from October through December 2006 (the first quarter of Fiscal 2007), and is on track to lose \$5.2 billion by the end of the fiscal year. Time to tune up for another rate case? Not if you listen carefully to the notes in the Postal Service's financial report.

Cotton is down to a quarter a pound

\$3.0 billion of the claimed \$5.2 billion loss is the transfer of the 2006 escrow payments to the Postal Service Retiree Health Benefits Fund (PSRHBF). But the Postal Service has already paid that amount to the escrow account—and *collected the money from mailers to offset the payment*—in Fiscal Year 2006. That's what the R2005-1 rate increases were meant to cover.

Furthermore, the transfer of the \$3.0 billion to the PSRHBF is not a loss to the USPS, but the *repayment* of a debt *already* owed by the USPS at the beginning of the fiscal year. This existing obligation arose from past promises by the USPS to pay specified future health benefits to its workers after their retirement. The USPS would be obligated to keep these promises in any event, with or without the PSRHBF. Paying off \$3.0 billion of this obligation does not make the USPS poorer. While the payment reduces the Postal Service's assets, it also reduces the Postal Service's *liabilities* by an equal and offsetting amount. If A owes B \$300, and A discharges the debt by paying B the amount owed, the transaction does not change A's income or net worth by a penny.

The food that we canned last summer is gone

The accounting treatment of the \$3.0 billion transfer is complicated by the Postal Service's failure to recognize the deferred health benefit obligations as expenses on its income statement in the year when earned, or to recognize these cumulative obligations as liabilities on its balance sheets. But the expenses and liabilities existed in economic reality all along, whether or not the Postal Service chose to recognize them in its account books at the time. The belated recognition of \$3.0 billion of those liabilities in Fiscal Year 2007 does not mean that the USPS actually incurred them, in any meaningful economic sense, in that year.

This timing issue is not just a technical distinction. The test year revenue requirement in a postal rate case is a financial snapshot used to predict the future. Expenses are properly included in the test year revenue requirement only if they are reasonably good proxies for the level of expenses that

the Postal Service is likely to incur in the future. For this reason, unusual, infrequent or nonrecurring expenses should be recovered over a period of many years as a prior year loss, if not excluded from the revenue requirement entirely. The belated recognition of many years of past compensation costs is the epitome of this kind of extraordinary expense. Including the full amount of the one-year cash outflow as a test year expense would grossly overstate the Postal Service's ongoing revenue needs.

I got a cow that's gone dry and a hen that won't lay

An additional \$600 million claimed by the USPS as a loss represents the difference between the \$5.4 billion that the new law requires the USPS to pay to the PSRHBF in Fiscal Year 2007 and the total of \$4.8 billion that the old law would have required the USPS pay to the escrow fund and the old Civil Service Retirement System in the same year. Here again, the USPS is making the numbers dance. The annual PSRHBF payment required by the new law remains relatively level throughout the ten-year period 2007-2016. Payments required under the old law, although lower during the early years of this period, would escalate dramatically in the later years. (The difference is similar to the difference between a conventional mortgage and a mortgage with small initial payments but a big balloon payment at the end.) Focusing only on the larger first year payment required by the new law, while ignoring the greater cash outflow in the later years under the old law, is myopic. Homeowners that suffer from this kind of myopia can wind up seeing the county haul their belongings away.

Equally important, the \$5.4 billion payment, like the transfer of the \$3.0 billion escrow amount to the PSRHBF, consists largely of the repayment of an *existing* obligation of the USPS to its retirees. As the USPS acknowledges, these payments, after ten years, will make the PSRHBF "fully funded." Once again, paying off a debt does not make the debtor poorer.

A big stack of bills that get bigger each day

The Postal Service also suggests that the postal reform legislation will burden the Service with "additional" regulatory costs in Fiscal Year 2007. These costs, the Service claims, include the expense of "separating products and services into market-dominant and competitive components" and complying with the Sarbanes-Oxley Act. The USPS has not even tried to quantify these costs, however. The notion that postal reform legislation will cause a net increase in Postal Service costs in Fiscal Year 2007 is a mighty stretch for the following reasons.

First, the USPS isn't required to comply with Sarbanes-Oxley until 2010, well after the end of Fiscal Year 2007.

Second, while the new legislation undoubtedly will impose some new regulatory costs on the Postal Service, it is also likely to *save* the Postal Service money by eliminating much of the *existing* regulatory structure. Indeed, cost-savings associated with a new streamlined ratemaking process was one of the very purposes of the legislation.

Most amazingly, the USPS seems to have assigned no weight to the \$78 billion (present value) in relief that Congress provided by recalculating the Postal Service's pension obligations in 2003, and the \$27 billion (present value) of additional relief that Congress provided by returning responsibility

for the retirement costs that postal employees earned through service in the military to the American taxpayers. These adjustments were entirely appropriate, but they would not have occurred without very hard work by a dedicated group of Senators and Representatives, and a sustained chorus of support from the Postal Service's customers. In a press release full of financial heartaches by the number, shouldn't \$105 billion of ongoing financial relief merit at least a passing note?

Lord, I hate to beg like a dog for a bone

The USPS acknowledges that it's "important" to put its claim of financial woe "in perspective." We heartily agree. Even the Postal Service admits that the shortfall from the legislation in Fiscal Year 2007 is far short of the \$3.6 billion (i.e., \$3.0 billion + \$600 million) suggested by the press release. And the shortfall actually claimed by the Postal Service, \$600 million, is still less than the one percent contingency provision – approximately \$800 million – requested by the USPS in R2006-1. A shortfall of this magnitude would still leave the USPS with a positive net equity at the end of the fiscal year. Certainly nothing that would require the USPS to pack up and go to the Commission for another rate case under the old law.

Now Lord I'm no thief but a man can go wrong

This is not the first time that the Postal Service has waxed creative about its financial needs. In Docket No. R97-1, for example, the Commission found that the USPS had inflated its revenue requirement by \$750 million dollars, primarily by forecasting a nonexistent surge in program expenses. The Commission's staff even discovered a memo, inadvertently left in the Postal Service's workpapers, explaining the Service's strategy.

In the music world, this kind of artistic license wins Grammys. But it certainly should not drive ratemaking decisions. Otherwise the entire postal regulatory scheme could end up . . . well, busted.