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REPORT BY THE U.S. Office of Congressional Relations

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# General Accounting Office

## Postal Service's Fiscal Year 1981 Workers' Compensation Adjustments



The Postal Service's calculations and accounting treatment of the workers' compensation adjustments in its fiscal year 1981 financial statements are accurate and proper.



GAO/GGD-83-29  
JANUARY 6, 1983

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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT  
DIVISION

B-209242

The Honorable William D. Ford  
Chairman, Committee on Post  
Office and Civil Service  
House of Representatives

The Honorable William Clay  
Chairman, Subcommittee on Postal  
Operations and Services  
Committee on Post Office  
and Civil Service  
House of Representatives

The Honorable Mickey Leland  
Chairman, Subcommittee on Postal  
Personnel and Modernization  
Committee on Post Office  
and Civil Service  
House of Representatives

As requested in your March 22, 1982, letter, we have reviewed the Postal Service's adjustments to its estimated workers' compensation liability in its fiscal year 1981 financial statements. These adjustments increased the fiscal year 1981 net loss by \$538,380,000--from \$49,359,000 to \$587,739,000.

In responding to your request, we addressed the following questions:

- Were the methods used to effect the adjustments technically correct?
- Was the accounting treatment of the adjustments properly reported in the fiscal year 1981 annual report?
- When and why did the Service decide to make the adjustments?
- Did the Board of Governors and the Postal Rate Commission (PRC) know of the adjustments when their final recommended rate decisions were made?
- Would the PRC's rates have been adequate to meet the test year revenue requirement if the adjustments had not been made?

--What impact will the changes in estimating workers' compensation liability have on Service finances and future postal rates?

In summary, our review showed that (1) the calculations and accounting treatment of the workers' compensation adjustments in the Service's fiscal year 1981 financial statements are accurate and proper; (2) all rate decisions were made prior to having information on the adjustments; (3) the Commission's original rate proposals would, for reasons beyond its control, have produced a revenue shortfall; and (4) future workers' compensation liability estimates should be more accurate, causing smaller year-end adjustments.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

The Service made three year-end adjustments to its fiscal year financial statements because of changes in its method of estimating the workers' compensation liability. These adjustments substantially increased the net loss for fiscal year 1981.

Our objectives were to determine the propriety of the accounting treatment and the rationale/methodology underlying the adjustments to the workers' compensation liability. Our review was conducted at Service headquarters, Washington, D.C., and performed in accordance with generally accepted Government auditing standards.

We reviewed the Service's financial statements and discussed the adjustments with Service, Board, and PRC officials and the public accounting firm that audited these statements. We also reviewed the computer model used in developing the workers' compensation liability estimates and various consulting actuarial and accounting firms' reports on the model.

#### WORKERS' COMPENSATION CALCULATIONS AND ACCOUNTING TREATMENT OF ADJUSTMENTS ARE ACCURATE AND PROPER

The Service has accurately calculated each of the workers' compensation liability adjustments and properly treated these adjustments in its fiscal year 1981 financial statements.

The Service uses an accrual basis of accounting which requires an expenditure to be recorded when it is incurred even if it will not actually be paid at that time. Under an accrual system, the total expected cost for a worker's

compensation claim is recorded in the fiscal year in which the accident occurs. Because many cases are paid over several years, the Service typically accrues more workers' compensation expenses in a fiscal year than are actually paid out in that year. The total workers' compensation liability includes all future year payments.

The Service employs an actuarial model to calculate future liabilities. The model notes the total active cases at the end of a given fiscal year and calculates several factors relevant to each claim (particularly the probability that it will continue to be active in the future).

On the basis of these factors, the model estimates the total future payments for each active claim. The Service, at the end of every fiscal year, calculates the discounted present value of this total liability using a rate which estimates future return on investments, less inflation.

In addition to this long-term liability, the Service reimburses the Department of Labor (DOL) for Service-related claims actually paid during the year. The total amount charged for workers' compensation in a fiscal year is the change in long-term liability plus the DOL payment.

The Service's "Statement of Operations" (income statement) shows three figures which result from workers' compensation changes made in fiscal year 1981. The largest is a \$1,515,000,000 increase in the long-term liability which represents the cumulative effect of using a lower discount rate on prior years. The second is an \$812,600,000 decrease in current year costs, resulting from four refinements to the model which estimates future workers' compensation liability. The last one is a \$164,020,000 decrease in current year costs, resulting from a change in the discount rate being applied to 1981 liabilities. A technical analysis and discussion of the accounting treatment for each adjustment follows.

Lowering the discount  
rate increases prior  
years' liabilities

The \$1.515 billion increase in liability represents the cumulative effect of a lower discount rate on prior years' liabilities. This is a change in accounting principles and is properly shown in the fiscal year 1981 financial statements as an adjustment to net income/loss.

The accounting change results from using a 2.5, rather than a 6.5 percent discount factor to compute the estimated

long-term workers' compensation liability. The effect of this change is to recognize that future workers' compensation payments are tied to changes in the Consumer Price Index. The previous discount rate of 6.5 percent, which the Service had used since 1974, did not recognize this relationship.

The 2.5 percent discount rate represents the difference between estimated rate of return (future interest rates) and estimated inflation--yielding a "real" rate of return. Merrill Lynch Econometrics, Inc. estimated that this real interest rate has historically been between 2 and 2.5 percent. A Service study also contained a similar rate. On the basis of these studies and anticipated real interest rates throughout the 1980's, the Service switched to a 2.5-percent rate for discounting its workers' compensation liability. The Service believes this change will stabilize the impact of fluctuating interest rates and better reflect the present value of this long-term liability.

Over recent years, real interest rate assumptions in pension valuations have been between 1 and 3 percent. The Social Security Administration's 1982 official cost estimates use a real interest rate that starts at 5.7 percent in 1982, declines to 1.2 percent by 1986, and climbs back up to 2 percent by 1995. The 1981 Civil Service Retirement System's valuation assumed a uniform 1-percent spread between future interest rates and inflation.

The Service considered the change in the basic method of estimating the workers' compensation liability--to recognize inflation in future benefit payments--a change in accounting principles. The Service determined, and we agree, that such a change constitutes a change in actuarial cost methods and is a proper change in accounting principles. The cumulative effect of changes in accounting principles, with a few specific exceptions, should be recognized in the net income for the year of the change. The \$1,515,000,000 decrease in income is the cumulative effect of adopting this change in accounting principles and is properly described in the fiscal year 1981 financial statements.

Refinements to calculating  
future costs reduce long-term  
liability

The second adjustment to workers' compensation is an \$812,600,000 decrease in liability resulting from four revisions in calculating future costs.

These revisions, which are described in a note to the Service's fiscal year 1981 financial statements, are as follows:

- Use of a more appropriate age distribution to estimate the life expectancy for permanent disability cases.
- Use of the life annuity method in place of the former annuity certain method for calculating liabilities associated with permanent disability cases.
- Use of a more accurate method to adjust prior years' data into constant year dollars.
- Use of separate calculations for the medical and compensatory components of the long-term liability.

Our review of the computer model incorporating these changes showed that they had been made. We believe that all changes were beneficial. Similar refinements were informally suggested by our actuaries in 1978. The dollar impact associated with each refinement is as follows.

<u>Change</u>	<u>Impact</u> (millions)
Refined age distribution	\$250.6
Use of life annuities	153.7
Change in constant dollar method	20.0
Medical/compensation payments	<u>388.3</u>
Total	<u>\$812.6</u>

The Service considers, and we agree, that these four refinements are changes in accounting estimates. (See app. I.) Accounting estimates change as new events occur, and as more experience or additional information is acquired. Such changes in estimates are properly shown as separate line items which affect the net income in the fiscal year in which they are implemented.

Changing the discount rate reduces the current year's expense

The final adjustment was a \$164,020,000 decrease in operating costs resulting from a discount rate change that

reflects, for the first time, the effect of inflation on future/current liabilities.

This decrease is the difference in the change in the liability obtained by calculating the change first at 6.5 percent and then at 2.5 percent. The difference--a \$341,000,000 decrease--was reduced by the actual payment to claimants in fiscal year 1981 (about \$177 million) leaving a net reduction of \$164,020,000. Such changes in accounting principles are properly disclosed in the current year's financial statements. The Service reported the \$164,020,000 as a separate item in its Statement of Operations. This change could also have been properly included as a reduction of operating expenses and disclosed in the notes to the financial statements.

#### THE PUBLIC ACCOUNTING FIRM'S AUDIT

The public accounting firm that audited the Service's financial records expressed an unqualified opinion that the financial statements fairly presented the Service's financial position as of September 30, 1981. The accounting firm, as required by generally accepted auditing standards, also concurred with the changes in accounting principles concerning the workers' compensation liability discount rate implemented during fiscal year 1981. Such an unqualified opinion on the Service's fiscal year 1981 financial statements signifies that the auditors believe the information presented is in accordance with generally accepted accounting principles.

#### DECISION TO ADJUST WORKERS' COMPENSATION LIABILITY

For several years, the Service had been considering the need to improve the methods used to calculate workers' compensation liability estimates. For example, in 1978, we suggested to the Service that several changes in the estimation model be made in order to develop a more accurate estimate of the workers' compensation liability. During the same year, the Service received similar suggestions in an independent consultant's report. The need for improvements was also noted in various independent auditors' letters. In fiscal year 1980, the Service considered adjusting the workers' compensation liability, but, because of many uncertainties concerning the accuracy, completeness, and reliability of DOL data, these adjustments were not made.

According to Service officials, several things happened during fiscal year 1981 which made adjustments to workers'



compensation liability feasible. A GAO report <sup>1</sup> issued in September 1981 on DOL's workers' compensation processing operations confirmed that certain suspected data problems existed. It was not until October 1981 that the Service was satisfied with the DOL data accuracy and reliability. The Postmaster General approved the workers' compensation changes in early November 1981, and, with the concurrence of its independent auditors, the Service proceeded to make the changes. Service officials believe that the adjustments will stabilize the model's estimates and smooth out the yearly expenses. Previously there had been wide variances at the end of each fiscal year between accrued workers' compensation liability and the model's estimated liability.

PRC officials told us that they learned of the adjustments in January 1982 when they received the 1981 annual report. The Chairman, Board of Governors, told us in a letter dated July 8, 1982, that the Board learned of the adjustments on December 3, 1981, when the draft financial statements for fiscal year 1981 were received. Prior to that time, the Board had been told that changes in the method of calculating the workers' compensation liability were under consideration. Thus, the Board did not know of the specific adjustments or their impact when it issued its final decision on the 20 cent first class rate on September 29, 1981.

It is speculative to reconstruct, after the fact, how different information might have affected the determination of the rate case. However, we did ask the Board and the Commission whether earlier knowledge of the adjustments would have changed their views on the current postage rates. According to the Chairman of the Board, he and two members believe that such knowledge would not have changed the need to implement the current rates. Three other members said it was too difficult to judge whether knowing about the adjustments would have affected their decisions. Similarly, Commission officials said that they were unsure of the effect knowledge of the adjustments would have had on their decision.

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<sup>1</sup>"Injury Compensation Process Delays Prompt Payment of Benefits to Federal Workers" (HRD-81-123, Sept. 25, 1981).

TEST YEAR ANALYSIS SHOWS THAT COMMISSION'S ORIGINAL RATE PROPOSALS WOULD--FOR REASONS BEYOND ITS CONTROL--HAVE PRODUCED A REVENUE SHORTFALL

If the Commission's recommended rates had been in effect during the test year <sup>2</sup> (March 21, 1981, to March 20, 1982) and adjustments for calculating the workers' compensation liability had been made using the 1980 estimation methodology, we estimate that the Service would have shown about a \$369 million adjusted net income. Despite this result, there still would have been a revenue shortfall.

Our adjusted net income includes certain Commission-recommended rates for second and third class mail that were based on changes to mail classifications that did not exist. The Board of Governors rejected these recommended rates and initiated their own set of rate increases. In a May 1981 ruling, the U.S. Court of Appeals for the District of Columbia Circuit ruled that the Commission recommended rate changes in second and third class mail were void and could not legally be implemented by the Board of Governors. The court reasoned that the rate classifications were initiated by the Commission rather than the Service, a procedure that violates the requirements of the Postal Reorganization Act (39 U.S.C. §§ 3622 (a), 3628). We estimate that if the Commission's recommended rates were implemented they would have produced \$292 million more revenue than the rates initiated by the Service.

We estimate that, for the test year, revenues would have been about \$22.340 billion and expenses would have been about \$21.971 billion, yielding an adjusted net income of about \$369 million. After adjusting net income for \$292 million for the second and third class rates that the court ruled could not be implemented and applying the recovery of prior year losses (\$339 million), the Service's revenue shortfall would be about \$262 million. A statement of revenues and expenses for the test year is included in Schedule I.

The expense for workers' compensation liability was computed using the 1980 estimation methodology, which produced a negative expense of \$49 million. This occurred largely because of the vast reduction in the number of compensation cases. When the rate case was filed in April 1980, DOL data showed that the number of compensation cases had continued to increase over the previous year as it had for the past 4

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<sup>2</sup>A period of time (1 year) that the Service uses to project revenues and expenses for purposes of formally requesting a change in postal rates.

years. In June 1980 it reached a peak of about 101,000 cases and then started to drop sharply. The DOL data shows that as of June 30, 1982, there were about 84,000 cases.

The Service is concerned about the validity of this data and the downward trend which results from the significant decline in the number of paid cases. It is therefore currently evaluating the data. A portion of the decline in cases can be directly related to the success of the Service's rehabilitation program and improvements in administrative controls. Service-initiated actions, however, do not fully account for the decline in cases. For example, the Service is concerned that hiring freezes and the DOL conversion to a new system may have affected the 1982 data. In addition, the Service believes that the results of its current data analysis will lead to an increase in workers' compensation expense during the test year.

#### IMPACT OF CHANGES IN ESTIMATING WORKERS' COMPENSATION LIABILITY

We believe that the changes the Service has made are based on sound actuarial principles and will help to stabilize the impact of fluctuating interest rates and consequently better reflect the present value of the estimated long-term workers' compensation liability. These refinements in the estimates are consistent with our 1978 suggestions, and the movement to a discount rate that takes inflation into account is a preferred methodology. The separation of the medical and compensation cost components also removes a key source of fluctuation in past estimates. (See app. I, p. 3.)

The changes in estimating workers' compensation liability should also facilitate the Service's ability to forecast revenue needs and the amount of any future postal rate increases.

#### AGENCY COMMENTS AND OUR EVALUATION

The Postmaster General, in commenting on the draft report, stated that he had no substantive comments to offer. He commented that it might be helpful if the reader understood that a negative workers' compensation expense represented a "worst case" scenario and that in constructing a revenue requirement to set rates for the future, a negative expense brought about by the application of one-time accounting changes or unusual actuarial gains or losses would never be used. He stated that a negative expense level would not fairly represent a normal year.

The Board of Governors commented that they had no changes to recommend to our draft report.

The Chairman of the Postal Rate Commission focused her comments on the adequacy of the Commission's recommended postal rates for the test year. The Commission agreed with our estimate of the test year revenue shortfall but believes that the text in the report and Schedule I do not clearly show that the Commission recommended revenue levels were sufficient to meet the Service's needs. The Commission stated that the court's ruling dealt with the legal shortcomings of its recommended rate decision but did not make it impossible for the net revenue level the PRC had recommended to be achieved.

The report clearly states that the court ruled that the Commission recommended rate changes for second and third class mail could not be legally implemented because the rate changes were initiated by the PRC. At that point, the potential revenue that could be produced by these recommended rates is negated. In view of the court's ruling, we think it is clear that attaining the net revenue targets proposed by the PRC would have required development of a rate package different from that recommended by the PRC or implemented by the Service. It was not within the scope of our review to devise alternative rate packages not recommended by the PRC or implemented by the Service.

With the passing of time, events occurred that affected actual test year revenues and expenses--events that could not have been foreseen at the time the rate case was deliberated. We believe that the report accurately and clearly describes these events and their effect on the test year.

One Commissioner, in providing separate comments, stated that the test year revenue shortfall of \$262 million as shown in the report is consistent with his conclusions in his dissent from the Commission's rate decision. He also stated that the report properly discounted any hypothetical increase in revenues resulting from Commission-recommended rates since they were held to be illegal.

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B-209242

As arranged with your Committee, we plan no further distribution of this report until 30 days from the date of the report unless you publicly announce its contents earlier. At that time we will send copies to interested parties and make copies available to others upon request.

A handwritten signature in black ink, appearing to read "W. J. Anderson". The signature is written in a cursive style with a long, sweeping underline.

William J. Anderson  
Director

ADJUSTED TEST YEAR BASED ON  
COMMISSION-RECOMMENDED RATES  
STATEMENT OF REVENUES AND EXPENSES  
MARCH 21, 1981 to MARCH 20, 1982  
(millions)

TOTAL REVENUES	\$22,580.0
Adjustment for estimated revenue loss that would be associated with reduced rates	-326.2
Adjustment for estimated revenue increase associated with increased mail volume	<u>86.3</u>
Total adjusted revenues	<u>22,340.1</u>
OPERATING EXPENSES (net of workers' compensation expense)	21,983.3
Adjustment for estimated increased cost associated with increased mail volume	36.7
Adjustment for workers' compensation using former model	<u>-49.0</u>
Total adjusted expenses	<u>21,971.0</u>
Adjusted net income at Commission- recommended rates	<u>369.1</u>
Less:	
Revenue from certain recommended rates not implemented (note a)	<u>292.0</u>
ADJUSTED NET INCOME	<u>77.1</u>
Less:	
Provision for recovery of prior year losses	<u>339.0</u>
NET REVENUE SHORTFALL	<u>\$ -261.9</u>

a/The Board of Governors rejected certain second and third class rate increases on the basis that they were for mail classifications that did not exist and therefore could not be implemented. The court subsequently upheld the Board's position. (See p. 8.)

Explanation of the Four Fiscal Year 1981 Refinements  
to the Model Used in Estimating Workers' Compensation  
Liability

Using a more appropriate  
age distribution

In estimating the liability for permanent disabilities, the age distribution for active disability cases was revised to include only cases which had existed for at least 4 years. Previously, all cases were included in this estimate. Experience has shown that basing long-term workers' compensation liability estimates on cases which are at least 4 years old provides more reliable information. This change reduces the variability of the estimates caused by short-term fluctuations in the number or cost of new cases.

Adopting a more appropriate  
actuarial methodology

Actuarial cost methods were changed from the annuity certain method to the life annuity method, which actuaries consider a more precise estimate of the present value of estimated future payments to a claimant. The Service's independent auditors advised us that the annuity certain method was initially employed because of the relative ease in programming the computer applications, and, when the Service was created, management believed there would not be many permanent disability cases. The Service's independent auditors stated that subsequent legislation liberalized eligibility criteria and increased benefits, thus creating significant increases in both claims filed and benefits paid. The Service evaluated this change for 3 years before implementing it in fiscal year 1981.

Adjusting prior years' data  
into constant dollars

The Service model used to calculate the workers' compensation liability into constant dollars has eight different claim age classes and seven severity classes which result in 56 different cost cells. The Service had been using a single factor to convert the projected dollar liabilities in all 56 cells to constant dollars. However, beginning in fiscal year 1981, the Service had accrued sufficient data to apply a separate factor to each cost cell and thus get a more accurate estimate of future liabilities.

Separating medical and compensatory  
components of long-term liability

The final change was to make separate calculations for the medical and compensatory components of the long-term liability. These calculations were previously made on an aggregate basis combining both the medical and compensatory components. The Service's independent auditors informed us that the DOL began providing the information necessary to make separate medical and compensatory calculations during fiscal year 1978. However, the Service waited several years before doing separate calculations to be sure the data provided were reliable.





THE POSTMASTER GENERAL  
Washington, DC 20260-0010

November 16, 1982

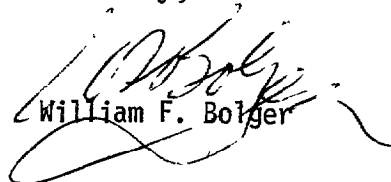
Dear Mr. Anderson:

This is in response to your request that we review and comment on your draft report: Postal Service's Fiscal Year 1981 Workers' Compensation Adjustments (GAO/GGD-83- ). We appreciate the opportunity and we have no substantive comments to offer.

It might be helpful for the reader to better understand your attempt to construct an after-the-fact response to the hypothetical question of what would have been the results if the PRC rates had been in effect throughout the test year if it were made clear that the estimates you used for workers' compensation expense represent a "worst case" scenario. In constructing a revenue requirement to set rates for the future, a negative expense brought about by the application of one-time accounting changes or unusual actuarial gains or losses would never be used because they would distort the results and mean that the expense level did not fairly represent a normal year.

We take no issue with your after-the-fact use of the "worst case" since it also leads to the conclusion that the PRC rates would have been inadequate. However, the reader should understand that a more typical expense estimate would have worsened the estimated loss dollar for dollar.

Sincerely,



William F. Bolger

Mr. William J. Anderson  
Director, General  
Government Division  
U.S. General Accounting Office  
Washington, D. C. 20548



BOARD OF GOVERNORS  
Washington, DC 20260-1000

October 25, 1982

Mr. William J. Anderson  
Director  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Anderson:

Thank you for providing the Board of Governors of the United States Postal Service with copies of your draft report entitled "Postal Service's Fiscal Year 1981 Workers' Compensation Adjustments."

The Members of the Board have reviewed this draft and we have no changes to recommend.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert L. Hardesty". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Robert L. Hardesty  
Chairman

RLH:lh

xc: Board of Governors

## POSTAL RATE COMMISSION

Washington, D.C. 20268

Janet D. Steger  
CHAIRMAN

November 23, 1982

Mr. William J. Anderson  
Director  
General Government Division  
General Accounting Office  
441 G Street, N.W.  
Washington, D.C.

Dear Mr. Anderson:

We appreciate the invitation to comment on GAO's draft report, Postal Service's Fiscal Year 1981 Workers' Compensation Adjustments. The draft report addresses six questions, and with regard to the first four we have no improvements to propose to GAO's treatment. Our comment on the treatment of the sixth question--impact of the workers' compensation liability estimating changes on postal finances and future rates--is minor. On question five, which asks whether the PRC's rate recommendations would have yielded enough revenue to meet test year revenue needs, absent the workers' compensation adjustments, we have more to say. Most of our comments on that question, however, represent not material disagreement with the outlines of GAO's treatment, but rather amplifications which we think are needed to make that treatment clear and complete.

One item, on page 2, does require comment and supplementation, if not actual correction. In the first full paragraph, conclusion (3) is that "there was a test year revenue shortfall because certain Commission-recommended rates were not implemented." Appendix II, on which the answer to the fifth question is based, shows a net income, at the Commission's recommended rates, of \$369.1 million. The deduction of \$339.0 million for recovery of prior year losses (a nonoperating item) would still yield a revenue surplus of \$30.1 million, at PRC rates. Thus the fifth question, literally read, should be answered in the affirmative. GAO's conclusion (3) implies such an affirmative answer, but explicitly addresses only the reason -- not essentially related to the PRC's recommended revenue levels -- why a shortfall occurred. That GAO's calculation shows a revenue deficiency of \$261.9 million is due to a further adjustment reflecting the fact that some of the rates actually put in effect by the Postal Service were not PRC recommendations but a different set, recovering less revenue. In terms of the question asked, therefore, we would suggest that a second sentence be added to conclusion (3), along these lines:

Note: Appendix II has been changed to Schedule I.

Commission-recommended rates, had they all been put in effect, would have met the test year revenue needs.

In explaining the revenues associated with Commission-recommended rates, GAO has correctly analyzed the effect of the rates the Commission recommended: an operating surplus of \$369.1 million for the test year. Similarly, the calculations in Appendix II, down to and including the line for "Adjusted net income at Commission-recommended rates" -- where the \$369.1 million is shown--are quite clear and, in our view, appropriate. It is from that point on, where GAO undertakes to adjust for the non-effectuation of the PRC second- and third-class rates (and for the prior year loss recovery item) that we think the description in the text of the report should be supplemented.

On page 8, GAO explains the reasons for the non-implementation of the PRC recommendations for second- and third-class rates. The discussion is substantially accurate analytically, as far as it goes, but could leave the reader with the impression that the Governors' action in substituting temporary rates in these classes, and the subsequent court decisions sanctioning the Governors' action, made it impossible for the net revenue level the PRC had recommended for those classes to be achieved. This is not the case, and should not be left as a possible inference from GAO's discussion.

The Governors found, and the courts agreed, that because the Commission had entered on an area legally reserved to the Governors it had not recommended a decision on second- and third-class rates in the manner the Postal Reorganization Act requires. When this occurs, the Board of Governors have the right to institute temporary rates, under 39 U.S.C. § 3641(a), until a proper recommended decision is sent to them. They did so here, and for a substantial part of the test year second- and third-class rates so chosen were in effect. The court did not in any way invalidate the Commission's recommendations as to the net revenue levels appropriate for these classes; its perception of the legal shortcomings of the Commission's recommended decision, in respect of second and third class, went to questions of procedure and jurisdiction.

As a result of those legal shortcomings, however, the Governors were led to install their own rates on a temporary basis; and the \$292 million which GAO refers to on page 8<sup>1</sup> represents the difference between these two different rate

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<sup>1</sup> Noting, in particular, that "[w]e estimate that if the Commission's recommended rates were implemented they would have produced \$292 million more revenue than the rates initiated by the Service."

schedules. The Governors are free, within limits set by the Postal Service's original request, to fix temporary rates at the level they consider appropriate; the Commission does not review these rates, which may be challenged only in the courts. We do not, of course, intend to "second-guess" the Governors' March 10, 1981 decision on temporary rates, but merely to point out that no legal obstacle existed to their having recovered the same net revenue target as the Commission recommended.

The presentation which GAO makes in Appendix II strikes us as sound in its essentials, although, as we note below, there is a useful and perhaps preferable alternative way of showing the adjustments applied to the \$369.1 million operating surplus.

In Appendix II, GAO, after arriving -- correctly, as we noted above -- at an adjusted net income of \$369.1 million at the PRC's rates, subtracts the revenue associated with the rates not implemented. This adjustment, which recognizes the outcome of the Governors' temporary rate decision, leaves an adjusted net income, at the rates actually implemented, of \$77.1 million. GAO then subtracts \$339.0 million as a provision for prior year loss recovery, a nonoperating item, based upon the actual cumulative loss up to the start of the test year, and arrives at an adjusted revenue shortfall of \$261.9 million.

We think this approach makes it possible to discern the results attributable to the PRC's rate recommendations, which is the desideratum expressed in the fifth question. It is possible that a different method of expressing the adjustments GAO has chosen to make, subsequent to arriving at the \$369.1 million, would be superior in terms of analytical clarity. This alternative, like the presentation GAO employs, would begin with the adjusted net income at PRC rates of \$369.1 million. However, it would then deduct the same provision for prior year loss recovery (\$339.0 million), leaving a revenue surplus of \$30.1 million. Only then would the \$292.0 million GAO has calculated as suitably representing the effect of the nonimplementation of certain rates be subtracted. The end result, a revenue shortfall of \$261.9 million, would be the same as in GAO's table.

This alternative presentation would (a) underscore the distinction between the effect of the PRC's recommended rates and the subsequent effects of the adjustments GAO considers are needed, and (b) place together -- as a basis for the \$30.1 million revenue surplus -- the items which the Commission either recommended in fact or, on the basis of the court decision regarding prior year loss recovery, can be regarded as obligated to recommend. Following the \$30.1 million figure, this presentation would show the independent effect of the temporary rates instituted by the Board of Governors.

It will be seen from these remarks that our suggestions for improvement do not call for change so much as for descriptive expansion in the text: we think some warning is needed against

the unjustified potential conclusion that the PRC's revenue recommendations (as opposed to specific rates) could not be legally implemented. In the Appendix II calculations, we offer a suggestion for improvement but do not find GAO's tabular presentation inaccurate. Apart from these suggestions, we believe that GAO has, first, satisfactorily answered the question of the adequacy of the PRC's recommendation, and then enterprisingly tackled the difficult further task of analyzing subsequent independent developments that may have affected the rates and revenue levels actually in effect.

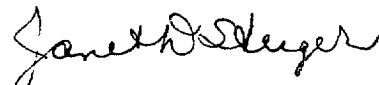
The sixth question and GAO's proposed answer to it also call for comment.

The question is, "What impact will the changes in estimating workers' compensation liability have on Service finances and future postal rates?"

The draft report falls short of fully responding to this question, by disregarding the impact of the changes on future postal rates. The net effect of these changes was the workers' compensation adjustments addressed earlier in the report, which increased the FY 1981 loss by \$538 million. It appears that future postal rates will have to be set slightly higher for the next nine years, barring any other financial infusions, so as to recover the additional prior year's loss.

We appreciate the opportunity to convey our comments on this report, and would likewise appreciate their being reproduced with the finished document. Please let us know if we may be of further assistance.

Sincerely yours,

  
Janet D. Steiger

POSTAL RATE COMMISSION  
Washington, D.C. 20268

James H. Duffy  
COMMISSIONER

November 22, 1982

Mr. William J. Anderson  
Director  
General Government Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Anderson:

As one of the three remaining Postal Rate Commissioners who participated in the R80-1 Rate Proceeding, and as the dissenter from that Commission decision, I wish to commend you on GAO's draft report on the 1981 Workers' Compensation Adjustments.

Although I realize how difficult it is to reconstruct past hypothetical financial figures, your conclusions of an approximate \$262 million Postal Service revenue loss for the R80-1 test year (had the Commission's inadequate recommended rates remained in effect) comports with the conclusions reached in my dissent, three Postal Service Governors' decisions, and the findings of the Federal Court of Appeals. This becomes clear once the \$655.7 million for unforeseen contingencies is considered.

Fortunately, positive unforeseen events during the actual test year (the Congress reinstated large public service subsidies not even requested by the Postal Service and, contrary to prevailing opinion, inflation was cut by more than half) canceled out negative unforeseen events and the contingency was not used. Had it been needed, as anticipated during the rate proceeding, the revenue shortfall would, consistent with your calculations, have approached the \$1 billion mark.

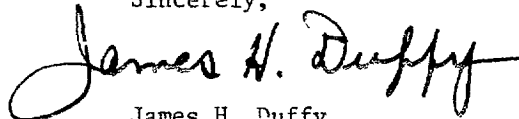
You properly discounted any hypothetical increase in revenues resulting from the Commission's recommended second and third-class rates since they were held to be illegal. Moreover, the drastic negative impact which the Commission's recommended "red tag" surcharge would have had on second-class volumes raises serious questions as to whether the net revenue impact would have been positive or negative.

Mr. Anderson  
November 22, 1982  
Page Two

Your findings that the Commission's recommended rates would have resulted in a significant revenue shortfall is consistent with the findings in my dissent, the report of one of the nation's most prestigious accounting firms, three Governors' decisions, and the unanimous decisions of the Federal Court of Appeals.

Frankly, I have been appalled at the excessive expenditures of public funds to prove otherwise. Hopefully, this professionally written GAO report will permanently lay this matter to rest.

Sincerely,

A handwritten signature in cursive script that reads "James H. Duffy". The signature is written in black ink and is positioned above the typed name and title.

James H. Duffy  
Commissioner



23933

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