United States Postal Service

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Quarterly Financial Report

For the Three Months and Six Months Ended March 31, 2007

May 11, 2007

United States Postal Service
Quarterly Financial Report Index

United States Postal Service
Statements of Operations

(Dollars in millions)	Three Months Ended March 31, 2007 (unaudited)	Three Months Ended March 31, 2006 (unaudited)	Six Months Ended March 31, 2007 (unaudited)	Six Months Ended March 31, 2006 (unaudited)
Operating revenue	$ 18,292	$ 18,615	$ 37,955	$ 37,113
Operating expenses:				
Compensation and benefits - current employees	13,600	13,452	27,379	27,154
Compensation and benefits - retiree benefits	1,786	426	6,520	828
Transportation	1,563	1,527	3,369	3,036
Other	2,482	2,336	4,606	4,453
Total operating expenses	19,431	17,741	41,874	35,471
(Loss) Income from operations	**(1,139)**	**874**	**(3,919)**	**1,642**
Interest and investment income	62	37	114	64
Interest expense on deferred retirement obligations	-	(65)	-	(131)
Other interest expense	(1)	-	(5)	(1)
Net (Loss) Income	**$ (1,078)**	**$ 846**	**$ (3,810)**	**$ 1,574**

See accompanying notes to the financial statements

United States Postal Service
Balance Sheets - Assets

(Dollars in millions)	March 31, 2007 (unaudited)	September 30, 2006 (audited)
Assets		
Current Assets		
Cash and cash equivalents	$ 1,222	$ 997
Cash - restricted	2,958	-
Receivables:		
Foreign countries	447	527
U.S. government	113	150
Other	270	210
Receivables before allowances	830	887
Less allowances	47	48
Total receivables, net	783	839
Supplies, advances and prepayments	144	205
Total Current Assets	**5,107**	**2,041**
Cash - Restricted	-	**2,958**
Appropriations Receivable - Revenue Forgone	**394**	**394**
Property and Equipment, at Cost:		
Buildings	21,330	21,083
Equipment	20,272	19,729
Land	2,891	2,887
Leasehold improvements	849	1,232
	45,342	44,931
Less allowances for depreciation and amortization	24,312	23,951
	21,030	20,980
Construction in progress	2,073	2,115
Total Property and Equipment, Net	**23,103**	**23,095**
Total Assets	**$ 28,604**	**$ 28,488**

See accompanying notes to the financial statements

United States Postal Service
Balance Sheets - Liabilities and Net Capital

(Dollars in millions)		March 31, 2007		September 30, 2006
		(unaudited)		(audited)
Liabilities and Net Capital				
Current Liabilities:				
Compensation and benefits - current employees	$	3,281	$	3,214
Compensation and benefits - retiree benefits		5,663		10
Payables and accrued expenses:				
Trade payables and accrued expenses		1,032		1,481
Foreign countries		596		567
U.S. government		89		111
Total payables and accrued expenses		1,717		2,159
Customer deposit accounts		1,604		1,647
Deferred revenue - prepaid postage		1,137		1,187
Outstanding postal money orders		913		885
Prepaid box rent and other deferred revenue		437		454
Debt		-		2,100
Total Current Liabilities		**14,752**		**11,656**
Non-Current Liabilities:				
Workers' compensation costs		7,395		6,869
Employees' accumulated leave		2,158		2,116
Deferred appropriations revenue		631		631
Long term portion capital lease obligations		632		637
Deferred revenue - real estate transactions		302		123
Other		268		180
Total Non-Current Liabilities		**11,386**		**10,556**
Total Liabilities		**26,138**		**22,212**
Net Capital				
Capital contributions of the U.S. government		3,034		3,034
Retained (deficit) earnings since reorganization		(568)		3,242
Total Net Capital		**2,466**		**6,276**
Total Liabilities and Net Capital	$	**28,604**	$	**28,488**

See accompanying notes to the financial statements

United States Postal Service
Statements of Changes in Net Capital

(Dollars in millions)			Capital Contributions of U.S. Government		Retained (Deficit) Earnings Since Reorganization		Total Net Capital
Balance, September 30, 2006	(audited)	$	3,034	$	3,242	$	6,276
Net (Loss) - Six months Ended March 31, 2007	(unaudited)		-		(3,810)		(3,810)
Balance, March 31, 2007	(unaudited)	$	3,034	$	(568)	$	2,466

See accompanying notes to the financial statements

United States Postal Service
Statements of Cash Flows

(Dollars in millions)	Six Months Ended March 31, 2007 (unaudited)	Six Months Ended March 31, 2006 (unaudited)
Cash flows from operating activities:		
Net income	$ (3,810)	$ 1,574
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,035	1,074
(Gain) Loss on disposals of property and equipment, net	(23)	4
Increase in appropriations receivable revenue forgone	-	(12)
Increase in workers' compensation liability	526	576
Increase in employees accumulated leave	42	28
Increase in other non-current liabilities	82	2
Changes in current assets and liabilities:		
Decrease in receivables, net	56	5
Decrease in supplies, advances and prepayments	61	40
Increase in compensation and benefits-current employees	67	192
Increase in compensation and benefits - retiree benefits	5,653	3
(Decrease) Increase in deferred revenue - prepaid postage	(50)	21
Decrease in payables and accrued expenses	(442)	(392)
Decrease in customer deposit accounts	(43)	(23)
Increase in outstanding postal money orders	28	19
Decrease in prepaid box rent and other deferred revenue	(17)	(40)
Net cash provided by operating activities	3,165	3,071
Cash Flows from investing activities:		
Purchase of property and equipment	(1,057)	(1,098)
Proceeds from sale of property and equipment	35	12
Net cash used in investing activities	(1,022)	(1,086)
Cash flows from financing activities:		
Proceeds from building financing activity	180	-
Issuance of debt	-	-
Payments on debt	(2,100)	-
Payments for capital lease obligations	(24)	(25)
U.S. government appropriations - received	-	-
U.S. government appropriations - expended	26	17
Net Cash used in financing activities	(1,918)	(8)
Net increase in cash and cash equivalents	225	1,977
Cash and cash equivalents at beginning of year	997	930
Cash and cash equivalents at end of period	$ 1,222	$ 2,907

See accompanying notes to the financial statements

Item 1 – Notes to Financial Statements

Note 1 – Basis of Presentation

These interim financial statements reflect the results of operations of the United States Postal Service for the three and six months ended March 31, 2007 and 2006 and our financial position as of March 31, 2007 and September 30, 2006. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and should be read in conjunction with the significant accounting policies and other disclosures in our 2006 Annual Report. As in the annual report, all references to years, unless otherwise stated, refer to our fiscal year beginning October 1 and ending September 30. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. The accounting estimates that require management's most difficult and subjective judgments include: workers' compensation liability, estimated prepaid postage, and contingent liabilities.

Certain comparative prior year amounts in the financial statements and accompanying notes have been reclassified to conform to the current year presentation. These reclassifications had no effect on our previously reported results of operations or our financial position.

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of March 31, 2007 and September 30, 2006, the results of our operations and our cash flows for the three and six months ended March 31, 2007 and 2006. Operating results for the six-month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending September 30, 2007.

Note 2 – Public Law 109-435 (P.L. 109-435), Postal Accountability and Enhancement Act

P.L.109-435, enacted December 20, 2006, made significant reforms in the governance of the Postal Service and significantly altered some of our financial responsibilities, particularly in respect to the funding of Civil Service Retirement System (CSRS) benefits and retiree health benefits. The legislation does not change our parent-subsidiary type relationship as an independent establishment of the U.S. government. Our employees and retirees continue to participate in all federally sponsored retirement and health benefit plans. The U.S. government determines the extent and nature of these employee benefits and the funding requirements of these plans. Therefore we continue to account for our participation in U.S. government sponsored health benefit and retirement plans using multi-employer plan accounting rules in accordance with Financial Accounting Standards Board Statement (FAS) 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* and FAS 87, *Employers' Accounting for Pensions*.

A number of major provisions of P.L.109-435 directly impact our financial statements. The anticipated financial impacts are further discussed in Item 2, *Management's Discussion and Analysis* in this document; however, for a complete understanding of the new law, one must consult the full text of P.L.109-435, which can be found at www.Thomas.gov.

P.L.109-435 returned to the U.S. Treasury the obligation to fund the portion of the retirement benefit for postal employees in CSRS that was earned while serving in the military. This obligation, originally estimated by the Office of Personnel Management (OPM) at $27 billion, was transferred from the U.S. Treasury to us in 2003 with the enactment of Public Law 108-18 (P.L.108-18). With the return of this obligation to the U.S. Treasury, it has been estimated by OPM that we have fully funded our CSRS pension obligation. Recognizing this, the law exempts us from making the employer contribution to CSRS that would otherwise be required under Title 5, Section 8334(a)(1), of the United States Code. This provision was effective October 14, 2006. See Note 9, *Retirement Programs,* for further discussion of this accounting treatment.

Under Section 8348 of Title 5, United States Code as revised, OPM is required by June 15, 2007 to determine the Postal Service's CSRS surplus or "supplemental liability" as of September 30, 2006. The "supplemental liability" represents the excess of the actuarial present value of future benefits over the actuarial present value of plan assets, future contributions, earnings, and other actuarial factors related to postal participants in the CSRS plan. Any over-funded amount will be transferred to the newly created Postal Service Retiree Health Benefits Fund (PSRHBF).

The PSRHBF was established under P.L.109-435 and beginning in 2007 the Postal Service will make payments into the PSRHBF. The PSRHBF, which is held by the U.S. Treasury and controlled by OPM, will be used, commencing in 2017, to pay our share of the health insurance premiums for our current and future Postal Service retirees. The payment schedule in the law requires us to pay on average, $5.6 billion per year into the fund for ten years, beginning in 2007. This is in addition to our regularly allocated cost of premiums for current retirees. After these payments are complete, OPM will make an actuarial valuation and determine whether any further payments into the PSRHBF are required. If further payments are required, OPM will design an amortization schedule to provide sufficient balance in the fund by September 30, 2056, to pay our share of the health insurance premiums for retired Postal Service employees. We expensed $2.7 billion, representing half of the required $5.4 billion 2007 payment through Quarter II. We will expense $1,350 million in each subsequent quarter of 2007. See Note 9, *Retirement Programs,* for further discussion of this accounting treatment.

P.L.109-435 repealed the escrow provisions of P.L.108-18 which required us to place into an escrow account by September 2006, any “savings” from the change in the retirement provisions created by P.L.108-18 and pay these “savings” into the PSRHBF. OPM calculated the savings at $2,958 million as of September 30, 2006. P.L.109-435 requires that the Postal Service pay the 2006 escrowed “savings” to the PSRHBF. We expensed the entire amount payable to the PSRHBF in our Quarter I Statements of Operations as a component of *compensation and benefits – retiree benefits*. On April 6, 2007, these “savings” were transferred to the PSRHBF.

Finally, P.L.109-435 also defers until 2017 the provision of P.L.108-18 that required us to pay an additional annual amount known as a “supplemental liability,” if necessary, each September, as determined by OPM. The “supplemental liability” payment anticipated for 2007 was $257 million. However, due to enactment of P.L.109-435, no “supplemental liability” payment, principal or interest, will be made in 2007. The following table summarizes the impacts of the new legislation on our statement of operations at March 31, 2007.

P.L. 109-435 Comparison Six Months ended March 31, 2007 (Dollars in millions)		Prior to Public Law 109-435		P.L. 109-435 Impact		After Public Law 109-435 (unaudited)
Line on Statement of Operations:						
Compensation and Benefits:						
Current Employees *	$	28,094	$	(715)	$	27,379
Retirees * *		876		5,644		6,520
Total Compensation and Benefits		28,970		4,929		33,899
Deferred Retirement Interest		115		(115)		-
Net Income (Loss)	$	1,005	$	(4,815)	$	(3,810)
Explanation of impact on Compensation and Benefits expense						
* Discontinuance of CSRS employer contributions			$	(715)		
** Repeal of 2007 "Suplemental Liability" principal			$	(14)		
Postal Service Retiree Health Benefit Fund expense (6 months)				2,700		
Postal Service Retiree Health Benefit Fund expense (escrow transfer)				2,958		
Subtotal			$	5,644		

Note 3 – Debt and Related Interest

Under the Postal Reorganization Act, as amended by P.L.101-227 and P.L.109-435, we can issue and sell debt obligations. However, we are limited to total debt outstanding of $15 billion and to net annual increases of $3 billion.

We continue to maintain two credit lines with the Federal Financing Bank. One credit line enables us to draw up to $3.4 billion with two days notice, the other up to $600 million on the same business day that funds are requested. In addition, we can also use a series of other notes with varying provisions to draw upon with two days notice.

At March 31, 2007, we had no outstanding balances on our lines of credit with the Federal Financing Bank. At September 30, 2006, our debt consisted of $2,100 million drawn on our lines of credit at the Federal Financing Bank.

Interest expense during Quarter II was $1 million and for the six month period ending March 31, 2007 was $5 million.

Note 4 – Property and Equipment

We record property and equipment at cost, including the interest we pay on the money we borrow to pay for the construction of major capital additions. We had no interest capitalized or newly impaired assets during the six months ended March 31, 2007 and 2006.

On March 30, 2007, we sold the James A. Farley building in New York City to the Empire State Development Corporation (ESDC) for $180 million and additional proceeds of up to $55 million, contingent upon the achievement of certain development and leasing criteria by the developer of the property. The agreements included a provision that we would provide an environmental clean up fund of up to $10 million funded with the transaction proceeds. This building formerly housed retail, carrier and mail processing operations. Mail processing operations formerly housed in this facility had been transferred to other facilities in 2004. The Postal Service continues to conduct retail and carrier operations at this facility under the terms of an interim lease with annual rentals of $5.6 million per year. Once the carrier operations are relocated to other facilities, we will continue to conduct retail and some administrative functions in a smaller portion of the building under a 99-year lease, with a rental fee of $1. The Postal Service has an option to require the building owner to change the legal structure of the building ownership into condominium units, with the Postal Service being given the right to purchase the space subject to the 99-year lease.

The required accounting for this transaction is governed by the provisions of FAS 66 *Accounting for Sales of Real Estate* and FAS 98 *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases* Under the provisions of these accounting standards, the form of the lease and purchase option and the contingent sales proceeds in the transaction preclude accounting for the transaction as a sale of real estate and accordingly, we have accounted for the transaction as a direct financing lease under the provisions of FAS 98. The gain will not be recognized in our Statement of Operations until the lease and other continuing involvement in the building have expired. If the condominiumization of the building is legally completed prior to that time, and the contingent payments are satisfied, or we completely move out of the facility, then the gain could be recognized earlier.

A long-term liability related to this transaction of $180 million was included on our balance sheets under Non-Current Liabilities as deferred revenue-real estate transactions.

Additionally ESDC will pay us $10 million which we would use for an environmental clean up fund. Our environmental liability is limited to $10 million and is included on our balance sheet under trade payables and other accrued expenses.

Note 5 – Foreign Currency Translation

We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail. The majority of our international accounts are denominated in special drawing rights (SDRs). The SDR exchange rate fluctuates daily, based on a basket of currencies comprised of the euro, Japanese yen, pound sterling, and the U.S. dollar. Changes in the relative value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation reported in the results from operations. The actual currency used to settle accounts varies by country. The impacts on our financial statements from foreign currency fluctuations were insignificant for the three and six-month periods ended March 31, 2007 and 2006.

Note 6 – Commitments

Each year we establish new capital commitments and expense commitments. Capital commitments consist of capital lease obligations for buildings and contracts for capital items such as equipment, building construction and improvements, and vehicles. Expense commitments consist of operating lease obligations for buildings, contracts for normal operational expense items, inventory and research and development contracts.

Since prior year capital and expense commitments are not normally fully expended within one year, we track our total resources on order for capital and expense commitments. The total resources on order being reported in a given period would equal outstanding commitments from prior years, plus new commitments, less expenditures.

CAPITAL COMMITMENTS, EXPENDITURES, RESOURCES ON ORDER

In Quarter II of this year we added new capital commitments of $1,208 million compared to $313 million in the same period last year. The majority of the new commitments were for Flat Sequencing Systems, $860 million. In Quarter II we also had a de-commitment of funds for the Distribution Quality Improvement System. As a result, our March 31, 2007 balance of resources on order for capital items was $3,005 million. The schedules presented below reflect our capital commitments, capital expenditures, capital resources on order and our future minimum lease payments for all non-cancelable capital leases.

Capital Commitments and Expenditures	Commitments Three Months Ended March 31,		Expenditures Three Months Ended March 31,		Commitments Six Months Ended March 31,		Expenditures Six Months Ended March 31,	
(Dollars in millions)	2007	2006	2007	2006	2007	2006	2007	2006
Construction and Building Purchase	$ 34	$ 105	$ 30	$ 34	$ 47	$ 120	$ 83	$ 82
Building Improvements	80	88	152	133	140	166	307	242
Mail Processing Equipment	803	75	209	218	852	129	425	448
Vehicles	101	9	3	67	101	13	12	117
Retail Equipment	-	-	-	1	-	-	-	1
Postal Support Equipment	190	36	179	75	234	38	230	208
Total	$ 1,208	$ 313	$ 573	$ 528	$ 1,374	$ 466	$ 1,057	$ 1,098

Capital Resources on Order	March 31,
(Dollars in millons)	2007
	(unaudited)
Mail Processing Equipment	$ 1,914
Postal Support Equipment	434
Building Improvements	330
Construction and Building Purchase	182
Vehicles	107
Retail Equipment	38
Total	$ 3,005

Capital Lease Obligations	March 31,
(Dollars in millions)	2007
	(unaudited)
2007	$ 50
2008	100
2009	98
2010	96
2011	93
After 2011	677
Total Lease Obligations	$ 1,114
Less: Interest	463
Total Capital Lease Obligations	$ 651
Less: Short-term portion of capital lease	20
Long-term Portion of Capital Lease	$ 631

EXPENSE COMMITMENTS, RESOURCES ON ORDER

At March 31, 2007, we estimate our expense resources on order to be $5,110 million. Our future minimum lease payments for all non-cancelable operating lease obligations and our rental expense on operating leases are also shown below.

Expense Resources on Order (Dollars in millons)		March 31, 2007
		(unaudited)
Operational Contracts	$	4,974
Inventory Contracts		93
Research and Development Contracts		43
Total	$	5,110

Operating Leases (Dollars in millions)		March 31, 2007
		(unaudited)
2007	$	390
2008		748
2009		720
2010		669
2011		610
After 2011		5,203
Total Lease Obligations	$	8,340

Rental Expense	Three Months Ended March 31,				Six Months Ended March 31,			
(Dollars in millions)		2007		2006		2007		2006
Non-cancelable real estate leases including related taxes	$	240	$	239	$	476	$	471
Facilities leased from GSA subject to 120-day cancellation		11		12		22		23
Equipment and other short-term rentals		36		25		90		51
Total Rental Expense	$	287	$	276	$	588	$	545

Note 7 – Contingent Liabilities

Our contingent liabilities consist mainly of claims and suits resulting from labor issues, equal employment opportunity issues, environmental issues, property damage claims, injuries on postal properties, issues arising from postal contracts, personal claims and traffic accidents.

Each quarter we review significant new claims and litigation and evaluate the probability of an adverse outcome. If the claim is deemed “probable” for an unfavorable outcome and the amount of payout is estimable, we record a liability. Each quarter we also review and adjust any prior contingencies for settlements, or revisions to prior estimates. No individual claim is material to our financial statements when taken as a whole. The table summarizes our contingent liabilities provided for in the financial statements.

Management and the General Counsel believe that adequate provision has been made for the probable liabilities from claims and suits. The current portion of this liability, $293 million, is included on the balance sheets under the heading *Trade payables and accrued expenses*. At September 30, 2006 this amount was $267 million. The long-term portion of $240 million is accrued under the heading *Other Non-Current Liabilities* in our balance sheets compared to $151 million at September 30, 2006.

Contingent Liabilities (Dollars in millions)		March 31, 2007		September 30, 2006
		(unaudited)		(audited)
Labor Cases	$	375	$	254
Equal Employment Opportunity Cases		66		66
Tort Cases		53		57
Environmental Cases		25		25
Contractual Cases		14		16
Total	$	533	$	418

We also have similar claims and suits which we deem reasonably possible and for which we cannot yet determine the amounts or a reasonable range of potential losses, if any. No provisions for these are included in our financial statements.

Note 8 – Current Employee Health Benefits

Substantially all of our current employees are covered by the Federal Employee Health Benefits Program (FEHBP). The OPM administers the program and allocates the cost of the program to the various participating government agencies. We cannot direct the costs, benefits, or funding requirements of the federally sponsored plan.

Health benefit costs for our current employees were $1,358 million during the second quarter of this year compared to $1,341 million in the same period last year. For the six months ending March 31, 2007, current employee health costs were $2,707 million compared to $2,645 million in the same period last year.

Long-term care insurance is available through the federal government at the employee's expense.

Note 9 – Retirement Programs

RETIREE HEALTH BENEFITS

Employees who participate in the FEHBP for at least the five years immediately before their retirement may participate in the FEHBP during their retirement. We are required to pay the employer's share of health insurance premiums for all employees and their survivors who participate in the FEHBP and who retire on or after July 1, 1971. However, we do not include the costs attributable to federal civilian service before that date. We account for our participation in FEHBP using multi-employer plan accounting rules in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

Postal Service Retiree Health Benefit Fund Schedule of Future Payments (Dollars in millions)		Expense
2007	$	5,400
2008		5,600
2009		5,400
2010		5,500
2011		5,500
After 2011		28,400
10-Year Total	$	55,800

With passage of P.L.109-435, we continue to make monthly payments to OPM for FEHBP. Additionally, we will be making payments into the new PSRHBF held by the U.S. Treasury and controlled by OPM. For 2007, the required contribution to the fund is $5.4 billion, which we are expensing at the rate of $450 million per month. Also as stated in Note 2, *Public Law 109-435,* with the passage of P.L.109-435, the funds held in escrow, $2,958 million, were expensed in Quarter I, and were transferred to the PSRHBF on April 6, 2007. During Quarter II we expensed $1,786 million for retiree benefits; $436 million was for retiree benefits invoices from OPM for current retirees and $1,350 million for the PSRHBF. For the same period in 2006 we expensed $426 million for retiree benefits. Year-to-date total expenses for retiree benefits were $6,520 million, $862 million for retiree benefits invoiced by OPM for current retirees and $5,658 million for the PSRHBF. For the six months ending March 31, 2006, retiree benefits were $828 million.

We will be making an average annual payment of approximately $5.6 billion to the PSRHBF through 2017, as shown in the schedule above. At that point, the fund will begin to pay our employer share of FEHBP premiums for postal retirees. During the ten-year period ending 2017, we will continue to pay our employer share of the health care premiums for current retirees as invoiced by OPM.

PENSION PROGRAMS

Our employees participate in one of three pension programs based upon the starting date of their employment with the Federal Government. Employee contributions are made to CSRS, the Dual CSRS/Social Security (Dual/CSRS), or the Federal Employees Retirement System (FERS), all of which are administered by OPM. Employees may also participate in the Thrift Savings Plan (TSP), which is a defined contribution retirement savings and investment plan. The Plan is administered by the Federal Retirement Thrift Investment Board.

The following table reflects our contributions for retirement compared to last year:

Retirement Contribution (Percentage)	Six Months Ended March 31, 2007	2006
CSRS Employer	-	17.4
CSRS Employee	7.0	7.0
Dual CSRS Employer	-	18.0
Dual CSRS Employee	0.8	0.8
FERS Employer	11.2	11.2
FERS Employee	0.8	0.8

P.L.109-435 exempts us from making the employer contribution to the CSRS, otherwise required under Title 5, chapter 83, of the United States Code. This provision was effective October 14, 2006. We continue to make employer contributions for FERS employees. As a result, our retirement expense for Quarter II was $1,386 million, compared to $1,731 million for the same period last year. Year-to-date, our expense was $2,887 million compared to $3,460 million in the same period last year.

P.L.109-435 also defers until 2017 the provision of P.L.108-18 that required us to pay an additional annual amount known as a “supplemental liability”, if necessary, each September as determined by OPM. The "supplemental liability" represented the excess of the actuarial present value of future benefits over the actuarial present value of plan assets, future contributions, earnings, and other actuarial factors related to postal participants in the CSRS plan. The “supplemental liability” payment, including principal and interest, anticipated for 2007 was $257 million. Due to the change to this provision by P.L.109-435, there was no expense associated with the supplemental liability in Quarter II of 2007, compared to $73 million in the same period last year. During the six-month period ending March 31, 2007 we had no “supplemental liability” expense compared to $145 million for the same period in 2006.

Note 10 – Workers’ Compensation

We pay for workers’ compensation costs under a program administered by the Department of Labor (DOL). These costs include employees’ medical expenses, payments for continuation of wages and DOL administrative fees. We record these costs as an operating expense. Our quarterly expense for workers’ compensation was $275 million during Quarter II of 2007, compared to $299 million for the same period last year. For the first half of the fiscal year workers’ compensation expense was $550 million compared to $598 million for the same period in 2006.

Note 11 – Revenue Forgone

Revenue Forgone is an appropriation from Congress which covers our cost of providing free and reduced rate mailing service to groups designated by Congress. During Quarter II of 2007, we recognized $21 million for Revenue Forgone appropriations, compared to $27 million during the same period last year. For the first half of the fiscal year revenue forgone was $43 million compared to $54 million for the same period in 2006.

Note 12 – Emergency Preparedness Funding

We recognize revenue from Emergency Preparedness Program (EPP) Appropriations as we depreciate the capital equipment purchased with the appropriation. The EPP Appropriations revenue and corresponding depreciation expense recognized during Quarter II was $13 million, compared to $20 million in the same period last year. Through March 31, our year-to-date appropriation revenue was $26 million compared to $37 million in the same period of 2006. A re-evaluation of the expected useful life of the Bio-Detection System equipment from five years to ten years resulted in a reduction of depreciation.

Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statements

The *Management's Discussion and Analysis of Financial Condition and Results of Operations* and other parts of this report include statements representing our expectations about our business and financial results that may be affected by risks and uncertainties we discuss here and in our Annual Report, such as economic conditions, regulatory and legislative changes, changes in actuarial assumptions, trends we know about, trends we anticipate and trends we believe are relevant to future operations. Some of these factors may cause our actual results to differ materially from those contemplated. This report should be read in conjunction with our 2006 Annual Report. As in the Annual Report, all references to years, unless otherwise stated, refer to our fiscal year beginning October 1st and ending September 30th.

Introduction

The United States Postal Service (we) commenced operations on July 1, 1971, as an independent establishment of the executive branch of the United States government. We are governed by an eleven member Board of Governors. The Board is composed of nine Governors appointed by the President of the United States with the advice and consent of the Senate, the Postmaster General and the Deputy Postmaster General. Under the Postal Reorganization Act, we have a legal mandate to offer a "fundamental service" to the American people. We fulfill this legal mandate by offering a variety of classes of mail services without undue discrimination among our many customers. This means that within each class of mail our price does not unreasonably vary by customer for the levels of service we provide.

We have a very diverse customer base and we are not dependent upon a single customer or small group of customers. We do not report revenue from individual customers. No single customer represents more than 2% of our revenue.

Our primary lines of business are First-Class Mail, Standard Mail, Priority Mail, International Mail, Express Mail, Periodicals and Package Services. We serve individual and commercial customers throughout the nation. Our services compete for business in the communications, distribution and delivery, advertising and retail markets. The rates and fees for our services are subject to a regulatory review process controlled by the new independent Postal Regulatory Commission (PRC), formerly the Postal Rate Commission. See the *Postal Accountability and Enhancement Act* section on the following page for a discussion of changes to the PRC and their role in the rate setting process.

Our mailing services (products) are sold through our almost 37,000 Post Offices, stations, branches, contract postal units, our website www.usps.com and a large network of consignees. We deliver mail to almost 147 million city, rural, Post Office box and highway delivery points. We conduct our operations primarily in the domestic market, with international operations representing less than 3% of our total revenue.

We operate and manage an integrated retail, distribution, transportation and delivery network. As such, our physical infrastructure and our labor force are not dedicated to individual products or separate product lines, with limited exceptions. Expenses are incurred and managed by functional groupings that align with the integrated network structure. Reporting of expenses on a functional basis in this report comports with the management of and structure of expense incurrence within our organization.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Over 85% of our career employees are covered by collective bargaining agreements. Refer to Item 5, *Other Information*, in Part II for additional information.

By law, we consult with management organizations representing most of the employees not covered by collective bargaining agreements. These consultations provide the organizations an opportunity to participate directly in the planning, development, and implementation of programs and policies affecting non-bargaining employees in the field. Our management organizations include the National Association of Postal Supervisors, the National League of

Postmasters and the National Association of Postmasters of the United States. We participate in federal employee benefit programs as required by statute, for retirement, health benefits and workers' compensation.

Beginning in 2008, we will be required to produce, publish and file financial reports with the PRC that comply with certain Securities and Exchange Commission (SEC) rules and regulations on financial reporting. Currently, we are guided by SEC reporting requirements to the extent deemed practical for a non-publicly traded, government-owned entity. Additionally, we make disclosures not required by SEC reporting rules through the publication of certain reports that we either must make, or choose to make public. These additional disclosures on our organization and finances, including our *Cost and Revenue Analysis* reports, *Integrated Financial Plan*, and *Revenue, Pieces, and Weight* reports, may be found on our website, at www.usps.com/financials.

Rate and Classification Activity

On May 3, 2006, the Postal Service filed a request with the PRC to increase prices. The request was not an across-the-board increase, but was intended to align our prices with our costs, in addition to generating additional revenue. The filing included numerous innovative classification proposals.

The most sweeping of these classification proposals was more extensive shape-based pricing. Under the new classification, the dimensions of the mail piece determine pricing, in addition to the weight under the former rate structure. For example, under the new shape-based pricing model a mail piece that weighed one ounce mailed in a large envelope would have a price of 80 cents, but if the contents were folded and mailed in a letter size envelope the price would be 41 cents.

The PRC issued its recommendation for new rates on February 26, 2007 which modified some of the original proposed rate structure, reducing the proposed First-Class one ounce rate of 42 cents to 41 cents and reducing the proposed additional ounce rate from 20 cents to 17 cents. To compensate for the revenue reductions from these changes the PRC's recommended decision increased the rates for flats and periodicals well above our original request. On March 19, 2007 the Board of Governors (BOG) authorized the PRC recommended First-Class one ounce mail rate of 41 cents and the additional ounce rate of 17 cents, issuance of the "forever stamp" and approved shape-based pricing. These rate changes take effect May 14, 2007. The BOG delayed implementation of new prices for periodicals until July 15, 2007 and requested reconsideration by the PRC of the Standard Mail flat rates.

Consumers are now able to purchase the new "forever stamp" for the 41 cents one ounce First-Class single-piece rate, but will be able to use it forever to mail a one ounce First-Class mail piece, even if rates increase in the future.

Postal Accountability and Enhancement Act, Public Law 109-435

The postal legislation signed into law by President Bush on December 20, 2006, is intended to benefit both residential and business customers by seeking to achieve predictable price increases under a price cap linked to the rate of inflation for most products. The new law, called the Postal Accountability and Enhancement Act, is the first major change to the statute governing the Postal Service since 1971.

For our retail customers, the new law anticipates that universal service can be preserved at affordable rates. For commercial mailers it is intended to provide rate predictability. And for employees, ratepayers and taxpayers it is designed to provide assurance that the employer portion of the Postal Service's health and retirement benefits obligations are fully funded.

The new law, once fully implemented, will divide our services into two broad categories: market-dominant and competitive. Market-dominant services include, but are not limited to, First-Class Mail, Standard Mail and Periodicals. Future rate increases for these services will be subject to a price cap based on the Consumer Price Index for urban consumers. Competitive product services, such as Priority Mail and Express Mail, Bulk Parcel Post and Bulk International Mail will have greater pricing flexibility.

The Law also directs the Department of the Treasury to resume financial responsibility for the portion of the CSRS pensions of postal employees attributable to military service. This takes the financial burden added by P.L.108-18, estimated at approximately $27 billion by OPM, off of the Postal Service. Our CSRS obligations are now estimated to be fully funded, pending future actuarial revaluations by OPM. The Law abolishes a federally mandated escrow requirement (the purpose of which was unspecified) and directs that money be placed into a new Postal Service Retiree Health Benefits Fund (PSRHBF). Over the next ten years we anticipate making payments into the PSRHBF that average $5.6 billion per year. By 2017, we expect our retiree health benefits will be substantially fully funded. We estimate the effect on our cash flow will be a reduction of $600 million to $700 million in 2007, which in turn may increase our anticipated debt at the end of the year.

P.L.109-435 also reconstitutes the former Postal Rate Commission into a regulatory body, renamed the Postal Regulatory Commission (PRC). The PRC has until June 2008 to develop regulations for both market-dominant and competitive products.. The Postal Service is allowed by P.L.109-435 to file one last rate case under the current rules, not later than December 20, 2007. We have not yet been determined whether to file such a case.

The PRC will now have its own Office of the Inspector General (OIG). The Postal Service will continue to be required to provide the funding for our Office of Inspector General, the PRC and the PRC's OIG.

Additionally, P.L.109-435 requires the Postal Service, beginning in 2008, to file with the PRC a number of financial reports not previously required. These include quarterly reports containing information required by the SEC to be filed on Form 10-Q within 40 days after the end of each quarter, an annual report containing the information required by the SEC on Form 10-K within 60 days of the end of each fiscal year, and periodic reports containing the information prescribed by the SEC on Form 8-K within the prescribed time frames. Further, P.L.109-435 requires that the Postal Service comply with the rules prescribed by the SEC implementing Section 404 of the Sarbanes-Oxley Act of 2002. The requirement to comply with Section 404 is effective beginning with the 2010 annual report. The exact cost of complying with Section 404 of the Sarbanes-Oxley Act is not yet known. Our external auditor's professional fees are also expected to increase in order for us to comply with the requirements under this act, as well as with our requirements to file SEC 10-Q and 10-K reports with the PRC.

On April 6, 2007, we transferred $2,958 million, representing the entire amount of funds held in escrow to the PSRHBF. Since we will no longer hold these funds, it is anticipated that there will be a substantial decrease in interest income for the remainder of the year and into the future.

Financial Impacts under P.L.109-435 (Dollars in millions)	Three Months Ended March 31, 2007	Six Months Ended March 31, 2007
	(unaudited)	(unaudited)
Net (Loss) Income before legislation	$ (195)	$ 1,005
P.L.109-435 Impacts:		
2006 escrow transfer to PSRHBF	-	(2,958)
2007 PSRHBF expense	(1,350)	(2,700)
CSRS savings	467	843
Net Loss	$ (1,078)	$ (3,810)

Finally, we cannot yet estimate the additional costs associated with modifying any of our systems that will be required to separate the business into market dominant and competitive products and services, but have dedicated resources to identify these costs. Additional costs as a result of the new financial reporting requirements, costs of complying with new PRC regulations, and the cost of compliance with the requirements of Section 404 of the Sarbanes Oxley Act have not been determined. The extent of any systems changes and costs are dependent on the outcome of the regulatory process during which specific requirements will be developed. We have hired a technical advisor for the Section 404 compliance effort and have jointly been developing a process plan to help define the added cost of compliance.

Results of Operations

Overall, our financial result in Quarter II of 2007 was a net loss of $1,078 million compared to net income of $846 million for Quarter II of last year. Revenue was down while operating expenses have increased, in large part due to the effects of P.L.109-435.

Quarter II operating revenue was $18,292 million, compared to $18,615 million in the corresponding quarter of last year, a decrease of $323 million. The decrease was driven by decreased mail volume and revenue for First-Class Mail, Periodicals Mail, Package Services and Priority Mail. Express Mail volume was flat, but revenue increased in Quarter II due to increases in the average weight per piece. International volume was up, but revenue was down. Only Standard Mail showed any real growth, with increases in both volume and revenue.

Year-to-date operating revenue was $37,955 million, compared to $37,113 million for the same period last year. The increase in year-to-date revenue over last year was largely driven by the final quarter of last year's rate increase and an increase in Standard Mail volume. Revenue increased in every service category except Periodicals. Although revenue was up year-to-date, First-Class Mail, Periodicals, Package Services, Priority Mail and Express Mail had volume decreases for the first six months of 2007, when compared to the same period last year.

Quarter II operating expenses were $19,431 million, compared to $17,741 million in the corresponding quarter of last year, an increase of $1,690 million. Almost all of our operating expense categories increased during Quarter II, relative to last year. Compensation and benefits for current employees increased by $148 million while retiree benefits increased by $1,360 million, driven by the impact of P.L. 109-435. Transportation expenses increased $36 million and all other expenses increased $146 million.

Year-to-date operating expenses were $41,874 million, compared to $35,471 million in the same period last year. The increase of $6,403 million was driven mainly by compensation and benefit increases of $5,917 million, of which $4,929 million was required under P.L.109-435 for the PSRHBF. Transportation increases of $333 million and other operating expense increases of $153 million also contributed to the growth of expenses over the comparable period last year.

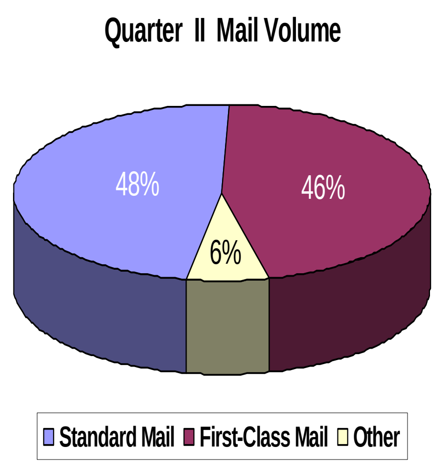
Summary Interim Financial Results	Three Months Ended March 31,		Six Months Ended March 31,	
(Dollars in millions)	2007	2006	2007	2006
Operating Revenue	$ 18,292	$ 18,615	$ 37,955	$ 37,113
Operating Expenses:				
Compensation and benefits - current employees	13,600	13,452	27,379	27,154
Compensation and benefits - retiree benefits	1,786	426	6,520	828
Transportation	1,563	1,527	3,369	3,036
Supplies and services	681	662	1,246	1,186
Depreciation and Amortization	535	544	1,035	1,074
Other expenses	1,266	1,130	2,325	2,193
Total Operating Expenses	19,431	17,741	41,874	35,471
Income (loss) from Operations	(1,139)	874	(3,919)	1,642
Interest and investment income	62	37	114	64
Interest on deferred retirement obligations	-	(65)	-	(131)
Other interest expense	(1)	-	(5)	(1)
Net (Loss) Income	$ (1,078)	$ 846	$ (3,810)	$ 1,574

Volume

Mail volume from the *Revenue, Pieces and Weight* report are preliminary for each quarter and are finalized at the end of each year. There is some slight recasting of 2006 numbers compared to the preliminary results presented at March 31, 2006. Our volume decrease reflects a slow down in the economy. Growth in economic activity as measured by real Gross Domestic Product (GDP) in 2006 averaged 3.3%. Growth slowed to 2.5% in Quarter I and 1.3% Quarter II. This economic slowdown, coupled with the rate increase effects, is the main driver in the decrease in volume for this quarter.

Mail Volume by Type	Three Months Ended March 31,		Six Months Ended March 31,	
(Pieces in millions)	2007	2006	2007	2006
Standard Mail	25,285	24,976	53,689	52,048
First-Class Mail	24,421	25,051	49,772	50,419
Periodicals	2,248	2,299	4,421	4,592
Package Services	291	299	621	625
Priority Mail	228	241	481	492
Express Mail	14	14	28	28
International	207	189	452	426
Other *	326	251	650	485
Total	53,020	53,320	110,114	109,115

* Postal Service mailing volume and free matter for the blind included in the "Other" category.



Standard Mail, which represents almost 48% of our volume, grew 1.2% in the second quarter. Automation Presort was the largest growth subclass in Quarter II with an increase of 3.2%. Nonprofit Standard Mail increased by 0.1%, but was restrained by a decrease of 3.6% in Nonprofit ECR mail in Quarter II. This decrease in Quarter II followed a first quarter increase of 32.6% in Nonprofit ECR mail. Standard Nonprofit ECR is strongly influenced by election cycles corresponding to our first quarter. Year-to-date, Standard mail is up 1,641 million pieces overall with Nonprofit ECR mail up 15.9%.

First-Class Mail, which represents an additional 46% of our volume, declined 630 million pieces in the second quarter compared to the same period last year. Single-piece First-Class letters declined 798 million pieces or 7.5% for the quarter. The growth in workshare letters and cards was not enough to offset the loss of Single-piece First-Class letters. Year-to-date, First-Class Mail volume declined 647 million pieces or 1.3%, with a decline of over one billion pieces in Single-piece First-Class letters and cards and an increase of 405 million pieces in workshare letters and cards. This is a result of continued diversion of First-Class mail to electronic media and continuing utilization of workshare discounts by our customers.

Periodicals, which make up 4% of our volume, decreased 51 million pieces or 2.2% in the second quarter compared to the same period last year. Periodicals volume is trending downward over the long term, reflecting trends in reading behavior. Year-to-date Periodicals volume is down 3.7%.

Other classes of service, each of which represents less than 1% of our volume, experienced the following changes in volume. Package services decreased 8 million pieces or 2.7% in Quarter II. A volume decline of 6.7% in Parcel Post was the sixth straight quarterly decline and reflects the disruptive impact of bankruptcies in the consolidator industry in early 2006. Year-to-date, Package services volume decreased approximately 4 million pieces or 0.7%.

After 10 consecutive quarters of growth, Priority Mail volume decreased in Quarter II by 13 million pieces, or 5.3%. This decrease is in comparison to Quarter II 2006 performance that saw growth of 10.6%. We continue to work to improve Priority Mail service performance and make Priority Mail easy to use. Customers can purchase postage and print mailing labels with free delivery confirmation on-line at http://www.usps.com/onlinepostage/, through Click-N-Ship, while Carrier pickup saves customers a trip to the post office and our flat rate packaging materials simplify Priority Mail use further. Year-to-date Priority Mail has decreased 11 million pieces or 2.2%.

In Quarter II, Express Mail volume was flat compared to the same period last year. Express Mail had benefited from the impact of surcharges imposed by private sector competitors and the small short term boost from passport fulfillment. The Quarter I Express Mail volume decline coupled with flat results this quarter has resulted in a year-to-date volume decline of less than one million pieces, or 1.6%.

International mail originating in the United States increased 9.6%, or approximately 18 million pieces in Quarter II of 2007. Most of this growth can be attributed to the continued robust growth of International Surface Airlift Mail; this volume increased by 37.3% during the second quarter. Year-to-date International Surface Airlift Mail volume has increased by 30.9% driving a 6% increase in total International Mail.

Other volume, in the table, includes mail sent by the Postal Service and Free Mail for the Blind and Handicapped. Postal Service volume grew approximately 73 million pieces or 31.4% in Quarter II, mainly as a result of a continuing promotional campaign. Year-to-date growth in this category of 38.6% is a function of the continuing promotional campaign.

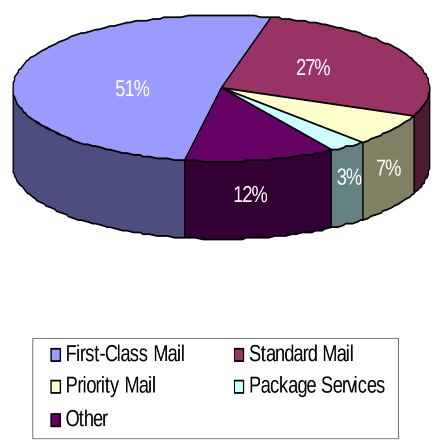
Revenue Analysis

Operating revenue for Quarter II was $323 million less than the comparable period last year. As with volume, the revenue decrease also reflects the slow down in the economy. As previously stated, GDP growth slowed to 2.5% in Quarter I and 1.3% Quarter II. Year-to-date operating revenue was in the aggregate $842 million greater than the first six month of 2006, as shown in the schedule below:

Revenue	Three Months Ended March 31,		Six Months Ended March 31,	
(Dollars in millions)	2007	2006	2007	2006
Standard Mail	$ 4,989	$ 4,919	$ 10,532	$ 10,003
First-Class Mail	9,345	9,617	19,092	18,919
Periodicals	537	560	1,083	1,114
Package Services	557	590	1,216	1,214
Priority Mail	1,255	1,313	2,733	2,690
Express Mail	232	231	469	462
International	452	476	1,012	1,000
Other *	925	909	1,818	1,711
Operating Revenue	$ 18,292	$ 18,615	$ 37,955	$ 37,113
Interest Income	62	37	114	64
Total Revenue	$ 18,354	$ 18,652	$ 38,069	$ 37,177

* Included in the "Other" category are special service revenue and other income.

Quarter II Revenue By Type



Standard Mail revenue increased $70 million or 1.4% in Quarter II compared to the same period last year. The effect of rate increases in January 2006 for all classes of mail have cycled out. As a result, revenue changes are a function of volume changes in conjunction with weight changes. The Standard Mail revenue increase of 1.4% is a function of a 1.2% volume increase and a 0.2% increase in average weight per piece. Year-to-date Standard Mail is up by $529 million or 5.3%. The Automation Presort subclass accounts for over 1.1 billion pieces and $343 million of the Standard Mail increase.

First-Class Mail revenue decreased $272 million or 2.8%, in Quarter II which is larger than the 2.5% decline in volume because of the shifts in the mail mix away from single-piece mail toward workshare mail. Year-to-date First-Class Mail has a revenue increase of 0.9% on a volume decrease of 1.3%. The 2006 rate increase effect still present in Quarter I provided positive revenue growth on slightly lower volume. The second quarter's lower volume in conjunction with the shift away from single-piece mail toward workshare mail has had a dampening effect on results.

The volume decline for Periodicals resulted in a decrease in revenue of $23 million or 4.1%, when compared to the same period last year. The decline is a function of the volume decrease of 2.2% and the weight decrease of 5.0%.

Year-to-date Periodicals revenue has decreased by $31 million or 2.7%. Periodicals volume has been trending lower and the average weight per piece is declining.

Package services revenue decreased $33 million or 5.6% in Quarter II compared to the second quarter of 2006. Nearly $29 million of the $33 million decrease comes from Parcel Post. Parcel Post revenue was down on a volume decrease of 6.7% and a weight decrease of 11.2%. Year-to-date Package services volume is approximately 4 million pieces lower while revenue is $2 million higher, benefiting from the January 2006 rate increase during the first quarter.

Priority Mail revenue decreased $58 million or 4.5% in Quarter II compared to the same period last year. The decrease is a result of the decreased volume offset by a slight increase in average weight per piece. Similar to several other classes of mail, year-to-date, Priority Mail has a modest increase in revenue of 1.6% and a modest decrease in volume of 2.2% year-to-date.

Express Mail revenue grew by 0.2% in Quarter II compared to the same period last year. This reflects the marginal increase in weight per piece of 0.4%. Year-to-date Express Mail revenue results are driven by higher prices from the January 2006 rate increase. Express Mail has increased revenue of 1.6% while producing lower volumes of 1.6% year-to-date.

Revenue from International Mail decreased $23 million or 4.9% in Quarter II compared to the same period last year. Revenue from mail-related volume increased by approximately $35 million or 9.3%. Healthy increases in Quarter II and year-to-date in International mail volume and mail-related revenue have been offset by large decreases in revenue from foreign postal transactions and international mail fees related to terminal dues settlements. Year-to-date, International Mail volume is up 6% and revenue from that mail is up 10.1%. However total International Mail revenue is only up 1.2% because of the decreases in foreign postal transactions and international mail fees.

Other Revenue, increased $16 million or 1.8% in Quarter II compared to the same quarter last year driven by passport fees and box rents. Passport fees driven by new Homeland Security passport requirements grew by $54 million or 83% in the second quarter. Offsetting the increase was a decline in terminal dues of $58 million. Special Services also decreased 1.1% in Quarter II. Year-to-date, other revenue is $107 million or 6.3% more than the prior year. This robust growth is the result of passport applications which increased $82 million and real estate sales.

Additional detailed data on product volume and revenue may be found in the Quarterly *Revenue, Pieces and Weight* reports on www.usps.com/financials/rpw.

When we determine that our funds on hand exceed our current needs, we invest those funds with the U.S. Treasury's Bureau of Public Debt in overnight securities issued by the U.S. Treasury. During Quarter II, we earned $62 million from our short-term investment activity, compared to $37 million for the same period last year. Increased cash on hand and higher interest rates compared to the Quarter II of last year were the reasons for the growth. Year-to-date we earned $114 million from our short-term investment activity, $50 million greater than the same period last year. However, the robust growth in short-term investment activity will not continue for the remainder of the year. The required payment to OPM, for the transfer of the escrow to the PSRHBF, will result in lower interest income during the second half of the year.

Operating Expenses – Compensation and Benefits

COMPENSATION AND BENEFITS – CURRENT EMPLOYEES

Compensation and benefits for our current employees for Quarter II was $13,600 million, $148 million higher than the prior year amount of $13,452 million. The increase was driven by normal cost-of-living adjustments and contractual wage increases. The increase was mitigated by a reduction in the employer share of the CSRS contribution and a reduction of work hours. The reduction in the CSRS contribution is a direct result of P.L.109-435, which eliminated employer contributions to the CSRS fund since we are now estimated to be fully funded. Our cost of providing health benefits to current employees increased by $17 million over the same quarter last year.

Total compensation and benefits increased in the first half of 2007 to $27,379, 0.8% higher than the prior year period amount of $27,154. This increase was lessened by a reduction in the employer share of the CSRS contribution of $715 million. As stated in the preceding paragraph, the reduction is a direct result of P.L.109-435.

Compensation, Benefits and Work Hour Analysis	Work Hours Three Months Ended March 31, 2007	Work Hours Three Months Ended March 31, 2006	Salaries and Benefits Three Months Ended March 31, 2007	Salaries and Benefits Three Months Ended March 31, 2006	Work Hours Six Months Ended March 31, 2007	Work Hours Six Months Ended March 31, 2006	Salaries and Benefits Six Months Ended March 31, 2007	Salaries and Benefits Six Months Ended March 31, 2006
	(Work Hours in thousands)		(Dollars in millions)		(Work Hours in thousands)		(Dollars in millions)	
City Delivery	114,919	114,964	$ 4,422	$ 4,263	233,310	234,397	$ 8,907	$ 8,618
Mail Processing	78,617	82,567	2,879	2,914	165,247	172,197	5,972	5,984
Customer Services & Retail	58,699	62,094	2,233	2,085	120,419	125,533	4,525	4,199
Rural Delivery	47,125	44,998	1,461	1,334	93,740	91,278	2,904	2,696
Plant & Equipment Maintenance	20,150	20,390	807	780	40,559	40,693	1,630	1,559
Vehicle Services	7,945	7,989	318	308	16,134	16,134	647	621
Operations Support	2,474	2,549	114	117	4,877	4,907	227	224
Postmasters, Managers, Supervisors, Administration and Other	24,700	25,715	980	1,250	49,311	51,022	1,766	2,457
Subtotal	354,629	361,266	13,214	13,051	723,597	736,161	26,578	26,358
Other Compensation								
Workers' Compensation			275	299			550	598
Other			111	102			251	198
Total	354,629	361,266	$ 13,600	$ 13,452	723,597	736,161	$ 27,379	$ 27,154

WAGES

Wages increased $458 million in Quarter II compared to same period last year. This is due to increases in wage rates. In November 2006, Mail Handler bargaining unit employees received pay increases of 1.2%, while Clerk bargaining unit employees received an increase in pay of 1.3%. In addition, eligible bargaining unit employees received annualized COLA increases ranging from $791 to $812 per employee effective September 2006.

Wages increased in the first half of 2007 by $773 million compared to the same period last year for the same reasons mentioned above. The increase in wage expense was partially mitigated by a reduction in work hours in Quarter II, discussed below.

QUARTER II WORK HOURS

A change in work hours is usually created by a change in workload, a change in productivity, or both. The two major workload factors that impact our operations are changes in mail volume and changes in delivery points. In Quarter II, mail volume decreased by 300 million pieces, or 0.6%, and we added almost 1.8 million new delivery points compared to the same quarter last year. Beside the decline in mail volume, the National Day of Mourning for President Ford also contributed to the reduction of work hours. Management initiatives and a focus on reducing overtime hours has helped total work hour usage decline 7 million hours or 1.8% from the comparable period last year. Mail processing work hours declined by almost 4 million, and customer service and retail work hours decreased by 3 million work hours.

YEAR-TO-DATE WORK HOURS

In the first half of 2007, mail volume increased by almost 1 billion pieces, or 0.9% as compared to the same period last year. Total work hour usage declined 13 million hours, or 1.7% from the comparable period last year, partially as a result of the management initiatives mentioned above. Mail processing, customer service and city delivery all experienced a decrease in work hour usage, rural delivery with most of the new delivery points had an increase in work hours.

Also due to a continued effort to reduce costs, work hours in administrative functions are almost 2 million less than the same period last year.

RETIREMENT EXPENSE – CURRENT EMPLOYEES

Our employees participate in one of three retirement programs based on their date of employment. These programs are the CSRS, the Dual CSRS/Social Security System Plan, and the FERS Plan. Each of these programs is described in further detail in Note 9, *Retirement Programs* in Part I, *Financial Information*. The programs are administered by OPM. The expenses of all of our retirement programs are included in compensation and benefits expense.

Retirement expenses remain a significant portion of our total expense. During Quarter II, our retirement expense for the CSRS, Dual/CSRS and FERS plans was $1,386 million compared to $1,731 million for the same period last year. This was $345 million below the same period last year or 20%. The reduction was due to the passage of the P.L.109-435 which reduced the employer contributions for CSRS employees. However, this reduction in retirement expense is offset by the increases we are now required to pay for retiree health benefits. For the six months ending March 31, 2007, our retirement expense was $2,887 million compared $3,460 million in the same period last year, again driven by the changes from PL 109-435. Retirement expenses for current employees are included in compensation and benefits – current employees on our Statements of Operations.

WORKERS' COMPENSATION

Our employees are covered by the Federal Employees' Compensation Act, administered by the DOL Office of Workers' Compensation Programs (OWCP). The current year workers' compensation liability and expense accruals are estimated using an actuarial model based on the number of cases, severity of the injury, the age of the injured employee, the trend of our experience with such an injury and other factors. The primary drivers for our Workers' Compensation expense are the number of claims reported and the cost per claim. In Quarter II of 2007 we experienced an increase in paid medical claims of 2,945, or 2.7%, and increase in paid compensation claims of 344 or 0.8% compared to Quarter II of 2006. Year-to-date, we experienced a decrease in paid medical claims of 4,653, or 2.2%, and increase in paid compensation claims of 1,001 or 1.1% compared to the first half of 2006.

Workers compensation expense for Quarter II was $275 million compared to the same period last year at $299 million. For the first six months of 2007, workers' compensation expenses were $550 million compared to $598 million in 2006.

We are in the process of developing a replacement for the actuarial model that we are currently using to determine the workers' compensation liability and annual expense. In addition to updating the technology platform, this new model will use state-of-the-art actuarial practices. This new model will be completed in time for use in estimating our year-end workers' compensation liability. It is possible that the adoption of this new liability estimation model will significantly impact our financial results in the quarter in which it is adopted.

EMPLOYEE COMPLEMENT

Employee complement was reduced by 5,802 during Quarter II. The total number of career employees at the end of the quarter was 688,540. This represents a reduction of 7,667 employees from the same quarter last year, all through attrition.

COMPENSATION AND BENEFITS – RETIREE BENEFITS

Benefit expenses for our retirees were $1,786 million for the quarter ended March 31, 2007 compared to $426 million in the same period 2006. This increase of $1,360 million was driven by P.L.109-435 and the additional expenses for the new PSRHBF of $1,350 million, offset by the reduction in principal payment of $7 million for the "supplemental liability". Without the legislation, retiree benefit expenses for Quarter II would have been $443 million compared to $426 million for the same period last year. Year-to-date without the legislation, retiree benefit expenses would have been $876 million compared to $828 million for the same period last year.

Retiree Benefits	Three Months Ended March 31,		Six Months Ended March 31,	
(Dollars in millions)	2007	2006	2007	2006
Retiree Benefits	$ 436	$ 426	$ 862	$ 828
Postal Service Retiree Health Benefit Fund	1,350	-	5,658	-
Total	$ 1,786	$ 426	$ 6,520	$ 828

P.L.109-435 includes a ten year payment schedule, which requires that we pay $5.4 billion into the PSRHBF by September 30, 2007. We are expensing the $5.4 billion in equal amounts during each quarter throughout the year, at a rate of $1,350 million per quarter. In addition, we expensed the $2,958 million held in escrow under provision of P.L.108-18 in Quarter I. These items combine to total $5,658 million in new expense through Quarter II that are not reflected in the comparative statements of Quarter II, 2006. See the *Postal Accountability and Enhancement Act* section above, Note 2, *Public Law 109-435* and Note 9, *Retirement Programs* in the Financial Information section for further discussion of this accounting treatment.

Under the FEHBP, the OPM charges us for the cost of our retirees currently participating in the plan. The major drivers of Retiree Health Benefits expense are the number of current participants on the rolls and premium costs. As of March 31, 2007, we had approximately 448,000 participants on the rolls, an increase of about 1,000 over the prior year. The increase in participants, as well as premium increases, drove the additional $24 million in expense.

Operating Expenses – Transportation

Transportation expenses were $1,563 million, an increase of $36 million, or 2.4% for Quarter II. Transportation costs are largely made up of highway and air transportation. When compared to the same period last year, our expenses for transportation increased by $333 million for the first half of this year.

Transportation Expense	Three Months Ended March 31,		Six Months Ended March 31,	
(Dollars in millions)	2007	2006	2007	2006
Highway Transportation	$ 796	$ 755	$ 1,589	$ 1,516
Air Transportation	673	685	1,577	1,386
Other Transportation	94	87	203	134
Total	$ 1,563	$ 1,527	$ 3,369	$ 3,036

Highway transportation expenses of $796 million in Quarter II increased by $41 million or 5.4% over the same quarter last year. The increase was driven primarily by an increase in the number of miles driven by highway contractors, which added $24 million. Contractual wage increases for contract drivers added $11 million and increases in the number of deliveries added $4 million to the increase for Quarter II. Year-to-date, highway transportation expenses increased by $73 million or 4.8% over the first half of 2006. Increases in miles driven added $32 million of expense, contract wage increases of $29 million, and delivery growth of $12 million drove the $73 million increase over the same period last year.

Air transportation expenses of $673 million were relatively flat in Quarter II, decreasing $12 million or 1.8% from the same quarter last year. Year-to-date, air transportation increased $191 million, or 13.8% over the same period last year. This was driven by increases in expense to our dedicated air carriers of $81 million, which included a $21 million increase in fuel costs. Holiday peak service increased $74 million over the same period last year. Increased terminal dues for air transportation and International air transportation cost of $44 million added to the increase for the first half of 2007. These were offset slightly by a reduction in commercial air carrier expenses.

Other transportation expenses including rail service increased $7 million or 8% in Quarter II over the same period last year. The quarterly increase was due to an increase in terminal dues. For the first half of 2007, other transportation expense increased by $69 million or 51.5% over the same period last year. The year-to-date increase was driven by additional charges for terminal dues which increased by $56 million in Quarter I, with Canada accounting for $40 million of the increase and another $7 million in Quarter II.

Other Operating Expenses

Other operating expenses of $2,482 million for Quarter II were $146 million higher than last year's comparable quarter. An increase in contingent liabilities (included in other in the table below) added an additional $105 million to operating expenses. See Part II *Other Information,* Item 1 – *Legal proceedings for additional information.*

Other Operating Expenses (Dollars in millions)	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	Six Months Ended March 31, 2007	Six Months Ended March 31, 2006
Supplies and Services	$ 681	$ 662	$ 1,246	$ 1,186
Depreciation and Amortization	535	544	1,035	1,074
Rent and Utilities	450	451	860	854
Vehicle Maintenance Service	206	169	369	339
Information Technology and Communications	154	143	306	284
Rural Carrier Equipment Maintenance Allowance	126	126	243	237
Other	330	241	547	479
Total	$ 2,482	$ 2,336	$ 4,606	$ 4,453

SUPPLIES AND SERVICES

Supplies and services expenses of $681 million were $19 million or 2.9% higher than the same period last year. The increase in supplies and service expenses largely reflect an increase in supplies of $37 million, offset by a decrease in services by $15 million. Year-to-date, supplies and services have increased $60 million over the same period last year. Supplies increased $51 million, while professional services increased $16 million. Engineering projects, mainly Bio-Detection System cartridges are the driver of the increase in supplies expense both for the quarter and year-to-date.

DEPRECIATION AND AMORTIZATION

Depreciation and amortization expense of $535 million was $9 million less than last year's comparable quarter. This reduction was driven by a $10 million decrease in equipment deprecation for POS ONE terminals as some of them became fully depreciated. An increase in the estimated useful life of bio-detection equipment, based on its performance to date, also contributed to the reduction in depreciation expense. Year-to-date, for the reasons noted above, depreciation and amortization expense decreased $39 million.

VEHICLE MAINTENANCE SERVICE

Vehicle maintenance was $206 million in Quarter II of 2007 compared to $169 million in the same period of 2006. The increase of $37 million was driven by a $25 million increase in repair parts expense due to an accounting policy change for vehicle repair parts. Commercial fuel purchases of $8 million more than last year and commercial repair services at $3 million more than last year contributed to the increase. Year-to-date, vehicle maintenance increased by $30 million, again due to the change in vehicle repair parts policy.

INFORMATION TECHNOLOGY AND COMMUNICATIONS

In Quarter II our cost in this category increased $11 million, or 7.7% when compared to Quarter II of 2006. Year-to-date, this category increased by $22 million compared to the first half of 2006. Our increases for the quarter and year-to-date were driven by increased maintenance costs to support our communications and network systems.

OTHER EXPENSE

In Quarter II our other expense category increased by $89 million when compared to Quarter II of 2006. The increase was driven by a $105 million increase in contingent liabilities. This was offset by decreases in our research & development and repairs and maintenance expenses. Year-to-date, our other expense increased by $68 million when compared to the same period last year. Contingent liability increases in Quarter II were the driver of the year-to-date increase. As was the case in Quarter II, the increase was offset by decreases in our research & development and repairs and maintenance expenses.

Interest Expense

Interest expense of $1 million in Quarter II was $64 million lower than last year's comparable quarter. Year-to-date interest expense for 2007 was $5 million compared to $132 million in the same period of 2006. Our interest expense in 2007 consists of interest on borrowing and mortgage interest expense. The passage of P.L.109-435 abolished the "supplemental liability" payment and its associated deferred retirement interest expense for 2007, which was $65 million in Quarter II last year, and $131 million year-to-date.

Debt and Liquidity

As of March 31, 2007, we had no outstanding debt with the U.S. Treasury's Federal Financing Bank versus $2.1 billion on September 30, 2006. Cash and cash equivalents were $1,222 million, $225 million higher than the September 30, 2006 balance of $997 million. Year-to-date, cash flow from operating activities was $95 million higher this year, while net cash used in investing activities (capital outlays) was $243 million lower. This year, we used the net cash flow from operations, after paying for capital investments, to pay off $2.1 billion in debt. Last year, with no debt to repay, the net cash flow increased cash and cash equivalents.

On April 6, 2007 we transferred $2,958 million from restricted cash to the new PSRHBF. We do not anticipate borrowing until the end of the fiscal year. In September, we have a workers' compensation payment of approximately $1 billion and a payment to the PSRHBF of $5.4 billion. Given these payments, this year's cash flow from operations will not supply enough cash to fund both the new PSRHBF payment requirement of $5.4 billion and our capital investments. Our financing projection entering the year was originally for a net increase in debt of $1.2 billion over the September 30, 2006 level of $2.1 billion. We estimate that the passage of P.L.109-435 negatively impacted cash flow for the year by $600 million to $700 million. Consequently, we now anticipate an increase in debt outstanding for the year of $1.8 to $1.9 billion and an ending debt balance of approximately $4 billion.

Real Property - Sales

On March 30, 2007, we sold the James A. Farley building in New York City to the Empire State Development Corporation (ESDC) for $180 million. This building formerly housed retail, carrier and mail processing operations. Mail processing operations formerly housed in this facility had been transferred to other facilities in 2004. The Postal Service continues to conduct retail and carrier operations at this facility under the terms of an interim lease with annual rentals of $5.6 million per year. Once the carrier operations are relocated to other facilities, we will continue to conduct retail and some administrative functions in a smaller portion of the building under a 99-year lease, with a rental fee of $1. The sales agreement also contains provisions for additional proceeds of up to $55 million, contingent upon the achievement of certain development and leasing criteria by the developer of the property. We have an option to require the building owner to change the legal structure of the building ownership into condominium units, with the Postal Service being given the right to purchase the unit we occupy.

Although under the provisions of accounting standards FAS 66 and FAS 98, the transaction does not meet the criteria for recording the gain on the sale (discussed more fully in Note 4 – *Property and Equipment*), we have realized an economic gain. We have sold excess space to Empire State Development Corporation (ESDC) for $180 million with a contingency to receive up to an additional $55 million based on future leasing of retail space to the public by ESDC. We are also retaining space to use for our retail operations and some administrative offices at a bargain rental price of $1 for a term of 99-years.

Since we have an on-going interest in the building as defined by GAAP, the accounting standards preclude us from recognizing the gain in our Statement of Operations until the lease has expired. If the condominiumization of the building is legally completed prior to that time, and the contingent payments are satisfied, or we completely move out of the facility, then the gain could be recognized earlier.

A long-term liability related to this transaction of $180 million was included on our balance sheets under Non-Current Liabilities as deferred revenue-real estate transactions.

Capital Commitments and Expenditures

Commitments consist of capital resources on order and expense resources on order. Capital resources on order consist of capital lease obligations for buildings and contracts for capital items such as equipment, building improvements, construction, and vehicles. Expense resources on order consist of operating lease obligations for buildings, and contracts for normal operational expense items. Expense resources on order also include inventory and research and development contracts.

CAPITAL COMMITMENTS, RESOURCES ON ORDER AND EXPENDITURES

Total capital resources on order were $3,005 million at March 31, 2007, see Note 6, *Commitments* in Part I of the Financial Information section of this report. New capital commitments during Quarter II were $1,208 million, driven by the commitment for the Flat Sequencing Systems of $860 million compared to $313 million in the same period last year. In Quarter II we also had a de-commitment of funds for the Distribution Quality Improvement System. During Quarter II of 2007, the Board of Governors approved funding for one project, the purchase of 5,856 new carrier route vehicles. Of these, 226 will be used as maintenance reserve vehicles. The remainder of the new vehicles will be deployed to city delivery routes, with the old city delivery vehicles being deployed to targeted rural routes.

Capital expenditures year-to-date were $1,057 million in 2007 compared with $1,098 million in the same period of fiscal year 2006.

Productivity

Total Factor Productivity (TFP) measures the change in the relationship between outputs or workload, and all the resources used in producing these outputs. The main outputs are mail volume, special services, and carrier services to an expanding delivery network. TFP calculations include inputs for all resources including labor, materials, and capital investments.

In Quarter II, TFP increased by 0.6% compared to the same quarter last year. Although workload decreased by 0.5% in the quarter, resource usage decreased by or 1.1%. The workload reduction was driven by a 1.9% decrease in weighted mail volume growth, due to decreases in First-Class Single Piece and Priority Mail. Weighted mail volume represents 65% of total workload. Also on the workload side, delivery points increased 1.5% compared to the same quarter last year.

On the resource usage side, labor decreased by 1.8% compared to the same quarter last year. Labor input represents 77% of total resource usage. Capital usage was 2% higher compared to the same quarter last year and materials usage increased by 1.3%. Transportation, primarily air transportation, is responsible for most of that 1.3% increase.

For the first six months of 2007, TFP increased by 1.3% compared to the first six months of 2006. Workload increased by 0.5% during this period, even though weighted mail volume decreased by 0.3%. The decrease in weighted mail volume is substantially different than the change in total volume, due to significant volume increases for Standard Mail Regular and Standard Mail Enhanced Carrier Route (ECR). However, First-Class Single Piece Letters, a high-cost mail subclass, decreased. This decrease was more than offset by a 1.4% increase in delivery points and a 5.4% increase in other output.

Total resource usage for the first six months of 2007 decreased by 0.7% compared to the first six months of 2006. Labor decreased by 1.8%, capital increased by 3.2%, and materials usage increased by 2.8%. Labor was driven by a decrease in workhours. Capital was driven by increases in postal support equipment and automated handling equipment. An increase in air transportation drove our materials usage.

Service and Performance

Management monitors several key statistics to determine performance against service standards and monitor public perception of our service.

EXFC

The External First-Class Mail measurement system (EXFC) is an independently administered system that provides an external measure of collection box to mailbox delivery performance. Although not a system-wide measurement of all First-Class Mail performance, EXFC continuously tests a panel of 463 3-digit ZIP Code areas selected on the basis of geographic and volume density, thereby providing a measure of service performance from the customer's point of view.

Our EXFC scores improved in Quarter II of 2007 compared to Quarter II of 2006. Overnight delivery scores remained constant at 95%, 2-day service scores improved from 89% in 2006 to 91% and 3-day scores increased from 86% to 88%.

CUSTOMER SATISFACTION

CSM is an independently administered survey of customer opinions of key areas of service to customers. In Quarter II of 2007, customer satisfaction increased to 92% of our customers rating our service excellent, very good or good. In Quarter II of 2006 the satisfaction percentage was at 91%.

Outlook

The outlook for the remainder of 2007 continues to be challenging. Revenue growth for the remainder of the year may be impacted by the May 2007 rate increase and slow economic growth.

REVENUE OUTLOOK

The long-predicted slowdown in macroeconomic growth arrived in 2006 and is expected to continue into Quarter III of 2007. The rate increase in May may depress mail volume growth for the last four and a half months of the fiscal year. However, since the demand for many of our services tends to be inelastic with respect to price, our revenue should increase. The new shape-based rates will depress flat and parcel volumes and positively influence letter volumes to the extent that it offsets letter rate increases. The extent and timing of these changes is uncertain because of the magnitude of the shape-based rate changes.

Growth in economic activity as measured by real Gross Domestic Product (GDP) in 2006 averaged 3.3%. Growth slowed to 2.5% in Quarter I and 1.3% Quarter II. According to Global Insight, real GDP growth is expected to be 2.2% in Quarter III and 2.4% in Quarter IV. In FY 2008 GDP is expected to increase to 2.9% growth but our revenue performance may be tempered by the dampening effect of the May 2007 rate increase. Although real GDP is the bellwether macroeconomic measure, three other economic variables tend to influence demand for our services more directly: private sector non-farm employment, real retail sales and real gross domestic investment spending. Of these measures, employment has most closely tracked mail volume growth over time. The new business caution on capital equipment spending has not led to a pullback in hiring in the labor market, which would threaten the growth in consumer spending that is sustaining the expansion.

Domestic payroll growth rates have passed their peak, slowing from just over 2.0% year-on-year in the second quarter of 2006 to just 1.5% in the second quarter of FY 2007. Global Insight expects growth rates to fade below 1.0% by year-end.

Trends in the macro economy are expected to be dominated by major factors in 2007. Volatility in energy prices has made forecasting economic growth and inflation challenging. The problems in the sub-prime mortgage market have created instability in the residential housing market, and the stricter lending standards that follow will place a new drag on demand. These two events may both reflect and affect the actions of the Federal Reserve with regard to interest rates. A slowdown in the economy may coincide with our rate increase. Although this increase should generate significant additional revenue, it is expected to suppress mail volume growth well into 2008.

Revenue growth is needed to support our ever expanding delivery network. Declines in single-piece First-Class Mail volume, which represent higher contribution margins, pose a challenge for meeting our revenue goals going forward.

Single-piece First-Class letters contribute about $9 billion to cover institutional costs annually, about 28% of the total contribution. As this mail volume falls, other lower margin products must grow at ever-increasing rates in order to replace the lost contribution. With the exception of workshare First-Class Mail, the mail categories that must grow are much more sensitive to price changes and cyclical economic variations than single-piece First-Class Mail.

There are other factors that could significantly impact our financial performance for the remainder of this fiscal year. Delaying the implementation of the new rate structure from May 6, 2007 until May 14, 2007 is expected to have a negative financial impact on our Quarter 3 net income of $100-150 million. Additionally, because of the significant changes in the new rate structure, there is more uncertainty surrounding the direction of revenue and volume trends compared to previous rate increases.

EXPENSE OUTLOOK

With the Quarter II decline in work hour usage, we are on track to reduce work hours for the seventh year out of the last eight. Fuel prices continue to be volatile, causing instability in our fuel related costs. Management is committed to a continued focus on reducing both work hours and overtime hours.

For the remainder of 2007, the passage of P.L.109-435, will place additional upward pressure on our expenses. The PSRHBF will add another $2.7 billion of expense for the remainder of the year, which will only be partially offset by the elimination of the 17.4% CSRS contribution and the supplemental liability payment.

Long-term, P.L.109-435 will continue to add incrementally to our expenses, as we incur costs relating to Sarbanes-Oxley compliance, system changes that may be needed to support segregation of competitive and market dominant business lines, required SEC-style financial reporting and other costs associated with the new law.

The exact cost of complying with section 404 of the Sarbanes-Oxley Act is not yet known. Our external auditor's professional fees will also increase in order for us to comply with the requirements under this act, as well as with our requirements to file SEC 10Q, 10K and other reports with the PRC. There may also be increased borrowing in future years to cover the additional cash outlays which would increase our interest expense.

There are also uncertainties concerning the outcome of the unresolved labor negotiations with the National Association of Letter Carriers (NALC) and the National Rural Letter Carriers Association (NRLCA), and with the results of the aforementioned update to the actuarial model used to determine our workers' compensation liability and annual expense.

Pending Legislation

AVIATION SECURITY

On March 13, 2007, the Senate passed S.4, which would implement many of the recommendations of the 9/11 Commission. The bill contains a provision that would require the Secretary of Homeland Security to establish a system to screen all cargo transported on passenger aircraft. The House-passed version of the bill, H.R.1, contains a similar provision. A conference committee will now work out the differences between the bills. If passed, the Postal Service would be impacted in the movement of mail on passenger airlines.

ENERGY

Several bills have been introduced by the Senate and House that would impact federal agencies by requiring the purchase of alternative fuel vehicles. At this time, none of the bills have made it out of committee, but it does reflect the resolve in Congress to impact fuel usage. As one of the nation's largest vehicle fleet operators, the Postal Service may be impacted if any of these bills were to become law.

Item 3 – Quantitative and Qualitative Disclosures about Market Risk

In the normal course of business, we are exposed to market risks from changes in commodity prices, certain foreign currency exchange rate fluctuations, and interest rates. Our commodity price risk is primarily exposure to changes in prices for diesel fuel, unleaded gasoline and aircraft fuel for transportation of the mail, and fuel for heating facilities. We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail.

We did not use derivative commodity or financial instruments to manage market risk related to commodities, foreign currency exchange or interest rate fluctuations for debt instruments. Additionally, we do not purchase or hold derivative financial instruments for speculative purposes.

See our 2006 Annual Report, Financial Section Part II, Item 7A-*Quantitative and Qualitative Disclosures about Market Risk*.

Item 4 – Controls and Procedures

We maintain a system of internal control that is designed to provide reasonable assurance that transactions are executed as authorized and accurately recorded, that assets are safeguarded, and accounting records are sufficiently reliable to permit the preparation of financial statements that conform to accounting principles generally accepted in the United States. We maintain disclosure controls and procedures designed to ensure that information to be disclosed by us is recorded, processed, summarized, and reported within the time periods specified by our Board of Governors and the Office of Management and Budget. We monitor our internal controls over financial reporting, disclosure controls and procedures through internal self-assessments.

With the passage of P.L.109-435, the Postal Service must comply with section 404 of the requirements of the Sarbanes-Oxley Act of 2002 by September 30, 2010.

Part II Other Information

Item 1 – Legal proceedings

Our contingent liability and related expense increased by $105 million during the second quarter of 2007. The increase was due to the re-evaluation of estimated liabilities for existing cases based on new information that came to light during Quarter II of 2007. After the close of the quarter we received an adverse decision on a contingent liability case relating to the use of casual labor in lieu of career employees. We are assessing the effect that this case will have on our financial statements for the third quarter of 2007.

See our 2006 Annual Report, Notes to the Financial Statements, Note 8, *Contingent Liabilities*.

Item 1A – Risk Factors

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities. Therefore, we have no risk related to initial stock offerings.

Item 2 – Unregistered Sales

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities.

Item 3 – Defaults on Securities

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities.

Item 4 – Submission of Matters to a Vote of Security Holders

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities.

Item 5 – Other information

Labor Agreements

Because our workforce is heavily unionized, our costs are largely determined by the provisions of existing labor agreements. Labor agreements with our four major unions expired during Quarter I of 2007. As of the date of this report, we have signed new labor agreements with two of our four major unions.

In January 2007, the American Postal Workers Union (APWU) approved a new four-year contract with the Postal Service. The new contract will remain in effect through November 20, 2010. Highlights of the agreement include:

- Semi-annual COLAs will continue for the duration of the contract
- November 25, 2006 – 1.3% salary increase
- February 16, 2008 – eligible members will receive a one-level upgrade in position
- November 21, 2009 – 1.2% salary increase

In January 2007, the National Postal Mail Handlers Union (NPMHU) signed a new five-year contract with the Postal Service. The new contract will remain in effect through November 20, 2011. Highlights of the agreement include:

- Semi-annual COLAs will continue for the duration of the contract
- General Salary increases of 1.2% in November each year
- February 16, 2008 – 0.6% salary increase

The National Rural Letter Carriers (NRLC) union members rejected the tentative agreement reached in December 2006 and have entered into the dispute resolution process.

We have not reached an agreement with The National Association of Letter Carriers and have entered into the dispute resolution process.

Other Financial Information

Other financial information such as *Annual and Quarterly* reports, *Comprehensive Statements on Postal Operations* and *Revenue, Pieces and Weight* reports can be obtained at http://www.usps.com/financials/

Press Releases

The following are press releases relevant to events discussed in this report. The full text of these releases can be obtained at http://www.usps.com/communications/news/press/welcome.htm.

May 2, 2007
Governors Accept PRC's Revised Rate Recommendations

April 19, 2007
Statement of Postmaster General John E. Potter before the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security of the Committee on Homeland Security and Governmental Affairs; United States Senate

April 17, 2007
Statement of Postmaster General John E. Potter before the Subcommittee on Federal Workforce, Postal Service and the District of Columbia of the Committee on Oversight and Government Reform; United States House of Representatives

April 5, 2007
Proposed New Standards for Periodicals Mailing Services Available at USPS.com

March 27, 2007
Postal Service Helps Drive Development of Alternate-Fuel Technologies

March 27, 2007
USPS to Build on $1.9 Billion Share of International Shipping Market

March 19, 2007
USPS Governors Approve Majority of Postal Regulatory Commission's Price Recommendations, Including Forever Stamp

March 1, 2007
Postal Service to Employ State-of-the-Art Technology to Improve Delivery Capabilities

February 14, 2007
Updated Proposed Mailing Standards Available at USPS.com

February 7, 2007 - News Release #07-011
Rural Letter Carriers' Union Members Reject Tentative Contract

February 5, 2007 - News Release #07-010
Postal Service Again Honored As Most Trusted Government Agency

January 25, 2007 - News Release #07-008
Mail Handlers Union Members Approve Five-Year Contract

January 16, 2007 - News Release #07-005
Postal Workers Union Members Approve Four-Year Contract

January 10, 2007 - News Release #07-003
Postal Service Board Of Governors Authorizes Purchase Of 5,856 Delivery Vehicles

January 4, 2007 - For Immediate Release
Comment on President's signing statement accompanying Postal Accountability and Enhancement Act

Item 6 – Exhibits

None