

United States Postal Service

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Quarterly Financial Report

For the Three Months and Six Months Ended March 31, 2004

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

United States Postal Service Statements of Operations

(dollars in millions)

	Three Months Ended March 31,	
	2004 (unaudited)	2003 (unaudited)
Operating revenue	\$ 17,292	\$ 17,083
Operating expenses:		
Compensation and benefits	13,075	12,385
Transportation	1,275	1,187
Other	2,206	2,120
Total operating expenses	16,556	15,692
Income from operations	736	1,391
Interest and investment income	7	12
Interest expense on borrowings	(2)	(83)
Net Income	\$ 741	\$ 1,320

See accompanying notes to financial statements.

United States Postal Service
Statements of Operations

(dollars in millions)

	Six Months Ended March 31,	
	2004 (unaudited)	2003 (unaudited)
Operating revenue	\$ 35,500	\$ 35,467
Operating expenses:		
Compensation and benefits	26,205	25,040
Transportation	2,453	2,497
Other	4,290	4,164
Total operating expenses	32,948	31,701
Income from operations	2,552	3,766
Interest and investment income	16	26
Interest expense on borrowings	(11)	(203)
Net Income	\$ 2,557	\$ 3,589

See accompanying notes to financial statements.

United States Postal Service
Balance Sheets – Assets

(dollars in millions)

	March 31, 2004 (unaudited)	Sept. 30, 2003
Assets		
Current assets:		
Cash and cash equivalents	\$ 250	\$ 2,266
Receivables:		
Foreign countries	615	744
U.S. Government	436	359
Consignment	54	50
Other	148	144
Receivables before allowances	<u>1,253</u>	<u>1,297</u>
Less allowances	108	106
Total receivables, net	<u>1,145</u>	<u>1,191</u>
Supplies, advances and prepayments	<u>343</u>	<u>366</u>
Total current assets	<u>1,738</u>	<u>3,823</u>
Other assets, principally revenue forgone appropriations receivable	364	365
Property and equipment, at cost:		
Buildings	19,851	19,759
Equipment	17,318	17,166
Land	2,817	2,809
Leasehold Improvements	1,105	1,060
	<u>41,091</u>	<u>40,794</u>
Less allowances for depreciation and amortization	19,755	18,717
	<u>21,336</u>	<u>22,077</u>
Construction in progress	1,300	977
	<u>1,300</u>	<u>977</u>
Total property and equipment, net	<u>22,636</u>	<u>23,054</u>
Total Assets	<u>\$ 24,738</u>	<u>\$ 27,242</u>

See accompanying notes to financial statements.

United States Postal Service
Balance Sheets - Liabilities & Net Capital
(dollars in millions)

	March 31, 2004 (unaudited)	Sept. 30, 2003
Liabilities and Net Capital		
Current liabilities:		
Compensation and benefits	\$ 2,886	\$ 2,518
Estimated prepaid postage	1,349	1,349
Payables and accrued expenses:		
Foreign countries	871	879
U.S. Government	99	112
Unexpended appropriations	398	406
Other	1,485	1,863
Total payables and accrued expenses	<u>2,853</u>	<u>3,260</u>
Permit, metered mail and prepaid box rentals	1,911	1,925
Outstanding postal money orders	792	768
Debt	1,494	7,273
Total current liabilities	<u>11,285</u>	17,093
Other liabilities:		
Workers' compensation	7,069	6,324
Employees' accumulated leave	1,962	1,932
Other	999	1,027
Total other liabilities	<u>10,030</u>	9,283
Commitments and contingencies - Note 2, 3		
Total Liabilities	21,315	26,376
Net capital:		
Capital contributions of the U.S. Government	3,034	3,034
Retained Earnings (Deficit) since reorganization	389	(2,168)
Total Net Capital	<u>3,423</u>	<u>866</u>
Total Liabilities and Net Capital	<u>\$ 24,738</u>	<u>\$ 27,242</u>

See accompanying notes to financial statements.

United States Postal Service
Statements of Cash Flows

(dollars in millions)

	Six Months Ended March 31, 2004
Cash flows from operating activities:	
Net Income	\$ 2,557
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	1,111
Loss on disposals of property and equipment, net	15
Decrease in other assets	1
Increase in USPS workers' compensation	745
Increase in employees' accumulated leave	30
Decrease in other liabilities	(28)
Changes in current assets and liabilities:	
Decrease in receivables, net	46
Decrease in supplies, advances and prepayments	23
Increase in compensation and benefits	368
Decrease in payables and accrued expenses	(407)
Decrease in permit, metered mail and prepaid box rentals	(14)
Increase in outstanding postal money orders	24
Net cash provided by operating activities	4,471
Cash flows from investing activities:	
Purchase of property and equipment	(714)
Proceeds from sale of property and equipment	6
Net cash used in investing activities	(708)
Cash flows from financing activities:	
Payments on debt	(5,779)
Net cash used in financing activities	(5,779)
Net decrease in cash and cash equivalents	(2,016)
Cash and cash equivalents at beginning of year	2,266
Cash and cash equivalents at end of period	\$ 250

See accompanying notes to financial statements.

United States Postal Service
Statements of Changes in Net Capital

Six Months Ended March 31, 2004 and the Year Ended Sept. 30, 2003

(dollars in millions)	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital
Balance, Sept. 30, 2002	3,034	(6,036)	(3,002)
Net Income	<u>-</u>	<u>3,868</u>	<u>3,868</u>
Balance, Sept. 30, 2003	3,034	(2,168)	866
Net Income—Six Months Ended March 31, 2004 (unaudited)	<u>-</u>	<u>2,557</u>	<u>2,557</u>
Balance, March 31, 2004 (unaudited)	<u>3,034</u>	<u>389</u>	<u>3,423</u>

See accompanying notes to financial statements.

Notes to Financial Statements

Note 1. Basis of Presentation

General

This interim report reflects the operations of the United States Postal Service for the three months and six months ended March 31, 2004 and March 31, 2003. 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 our 2003 Annual Report. Significant accounting policies and other disclosures are included in our Annual Report.

For our fiscal year beginning October 1, 2003, we began to prepare interim financial reports on a calendar month basis. Previously, our interim reporting was based on a 28-day, 13 accounting period calendar that had been used since Postal Reorganization by the Postal Service and since 1957 by the former Post Office Department. As a result of the conversion to the new reporting periods, 2003 financial data are management's representation of results for the same period last year.

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of March 31, 2004, the results of our operations for the three and six months ended March 31, 2004, and our cash flows for the six months ended March 31, 2004. Operating results for the six months ended March 31, 2004 are not necessarily indicative of the results that may be expected for the year ending September 30, 2004.

Note 2. Commitments

The following section summarizes our commitments for capital purchase and our lease obligations.

Capital

At March 31, 2004, we estimate our financial commitment for approved capital projects in process to be \$2.5 billion.

Rents

Our total rental expense for the six months ended March 31, 2004 compared with rental expense for the full year ended September 30, 2003 is summarized as follows:

Rental Expense (dollars in millions)	For the Six Months Ended March 31, 2004	For the Year Ended Sept. 30, 2003
Non-cancelable real estate leases including related taxes	\$ 471	\$ 923
Facilities leased from General Services Administration subject to 120-day notice of cancellation	27	53
Equipment and other short-term Rentals	87	201
Total	\$ 585	\$ 1,177

At March 31, 2004, our future minimum lease payments for all non-cancelable leases are summarized in the table on the following page.

Most of these leases contain renewal options for periods ranging from 3 to 20 years. Certain non-cancelable real estate leases give us the option to purchase the facilities at prices specified by such leases.

Capital leases are classified as assets in the "Buildings" caption of the Balance Sheet. Capitalized leases at March 31, 2004 were \$960 million and \$963 million at September 30, 2003. Total accumulated amortization related to capital leases was \$283 million at March 31, 2004, and \$259 million at September 30, 2003. Amortization expense for capital lease assets is classified as depreciation expense under the "Other" expense caption on the Income Statement.

Future Minimum Lease Payments (\$ in millions)	March 31, 2004	
	Operating	Capital
2004	\$ 842	\$ 40
2005	842	80
2006	861	80
2007	818	80
2008	766	80
After 2008	6,320	601
	\$10,449	\$961
Less: Interest at 4.5 percent		235
Total Capital Lease Obligations		726
Less: Short-term Portion of Capital Lease Obligations		24
Long-term Portion of Capital Lease Obligations		\$702

Note 3. Contingent Liabilities

Each quarter we review pending litigation against us. We classify and adjust our contingencies for claims when we can reasonably estimate the amount of a probable, unfavorable outcome. These relate to labor claims, equal employment opportunity claims, environmental matters, traffic accidents, injuries sustained on postal properties, personal claims and claims to property damages, and suits and claims arising from postal contracts. We evaluate the materiality of cases determined to have a reasonable chance of adverse outcome. Management and General Counsel believe that we have made adequate provision for the amounts that may become due under the suits, claims and proceedings we have discussed here.

Note 4. Emergency Preparedness Funding

In October 2001, the United States was targeted by biological terrorism. These activities affected the Postal Service because infectious biological agents were sent by mail. Our viability and our value to the American people are dependent upon an open and accessible system. To maintain an open and accessible system, process changes and technology applications were implemented that can improve the safety of both employees and customers.

The President of the United States authorized an initial funding of \$175 million for 2002 to assist in paying for these safety measures. Congress approved two additional appropriations totaling \$587 million for emergency expenditures to protect postal employees and customers from exposure to biohazardous material, to sanitize and screen the mail, and to repair or replace postal facilities destroyed or damaged in New York City as a result of September 11, 2001 terrorist attacks. Through March 31, 2004, we have spent or committed \$607 million of the \$762 million appropriated.

For the six months ended March 31, 2004, emergency preparedness expenses of \$87 million were included in operating expense. Since not all emergency preparedness expenditures qualify under the current appropriations authorization categories, emergency preparedness appropriation revenues of only \$8 million were available to offset expenses. These appropriations were classified as operating revenue.

ITEM 2. MANAGEMENT DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

INTRODUCTION

The Postal Service (we) commenced operations on July 1, 1971 as an independent establishment of the executive branch of the United States government. Under the Postal Reorganization Act, we have a legal mandate to offer a “fundamental service” to the American people on a “fair and equitable basis.”

Our primary lines of business are First-Class Mail, Standard Mail, Priority Mail, Periodicals and Package Services. The Postal Service serves 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 postal services are subject to a regulatory review process controlled by the independent Postal Rate Commission.

Our products are distributed through our more than 37,000 Post Offices, Stations and Branches and a large network of consignees. Mail is delivered to 142 million city, rural, post office box and highway contract delivery points. We conduct our significant operations primarily in the domestic market, with international operations representing less than 3 percent of our total revenue.

Our labor force is primarily represented by the American Postal Workers Union, the National Association of Letter Carriers, the National Postal Mail Handlers Union and the National Rural Letter Carriers Association. Approximately 90 percent of our career employees are covered by collective bargaining agreements. By law, the Postal Service consults with management organizations representing most of the employees not covered by collective bargaining agreements. The management organizations include the National Association of Postal Supervisors, the National League of Postmasters, and the National Association of Postmasters of the United States. As an independent establishment of the executive branch of the United States Government, we participate in federal employee benefit programs covering retirement, health benefits and workers’ compensation.

The Postal Service is not subject to regulation by the Securities and Exchange Commission (SEC). However, we voluntarily comply with Securities and Exchange Commission financial reporting requirements to the extent that they are relevant to a non-publicly traded, government-owned entity with a breakeven mandate. Therefore, this report excludes certain SEC reporting elements normally included in Part II – Other Information of a standard form 10-Q. Specifically, the excluded items are: Item 2 - Changes in Securities and Use of Proceeds; Item 3 - Defaults upon Senior Securities; and Item 4 - Submission of Matters to a Vote of Security Holders.

RESULTS OF OPERATIONS

Financial results improved in the second quarter as a result of year-to-year revenue growth complemented by continuing expense control and reduced interest expense. Although volume and revenue declined for the majority of the mail classes, growing Standard Mail volume and revenue and improving international revenue combined to produce a 1.2 percent revenue increase for the quarter and edged year-to-date revenue growth barely into the positive range at 0.1 percent.

Higher Civil Service Retirement System (CSRS) contributions and increased health benefit expenses for employees and retirees, along with an extra workday due to the leap year, were the primary contributors to compensation and benefits expense increases over the same period last year. Higher average wage rates, resulting from contractual increases and cost-of-living adjustments, were largely offset by cost reduction measures. Overall operating expense increase was held to 3.9 percent for the six month period primarily as a result of continued workhour and career staff reductions and reductions in transportation and supplies and services costs. Finally, our debt reduction effort and the interest rate reduction resulting from the 2003 refinancing of long-term debt have resulted in a decrease of \$192 million in interest expense when compared to the comparable period in 2003.

The combined effect of the above is a second quarter income of \$741 million, bringing net income year-to-date to \$2,557 million. Table 1 – Summary of Interim Financial Results, below, summarizes the financial results for the three and six months ended March 31, 2004 with the comparable results for 2003.

Table 1 - Summary of Interim Financial Results

Three Months Ended March 31,			Financial Results	Six Months Ended March 31,		
2004	2003	%	(\$ in millions)	2004	2003	%
\$17,292	\$17,083	1.2	Operating revenue	\$35,500	\$35,467	0.1
16,556	15,692	5.5	Total operating expense	32,948	31,701	3.9
736	1,391	NM	Income from operations	2,552	3,766	NM
7	12	-40.2	Interest and investment income	16	26	-40.5
2	83	-98.0	Interest expense on borrowings	11	203	-94.8
\$ 741	\$ 1,320	NM	Net income	\$ 2,557	\$ 3,589	NM

Operating Revenue

Operating revenue was 1.2 percent greater for the three months ending March 31, 2004 than for the same three months in the previous year. Revenue for the six months ending March 31, 2004 was 0.1 percent greater than the same six months in the previous year. Total volumes in this quarter were 2.7 percent above last year; and year-to-date volumes were 1.1 percent higher than last year. The year-to-year comparisons are affected by the occurrence of an additional weekday in this quarter. Revenue growth in Quarter 2 was one quarter earlier than anticipated in the Postal Service's operating plan which assumed a pessimistic macro-economic scenario. Earlier than expected revenue growth relates to the growing strength of the economy and the Postal Service's solid position in the direct marketing and advertising market segments.

Standard Mail volume and revenue benefited from increased advertising spending and economic growth; Standard Mail also has benefited from the impact of the "Do Not Call" restrictions on telemarketing that were implemented last fall. Additionally, there was an increase in International Mail volume (included in "Other" in Table 2 – Volume by Class of Mail) that is coincident with indicators of increased international economic activity such as growing international freight ton-miles. Revenue growth in Standard Mail and International Mail offset continuing declines in other mail classes. Declining volume and revenues in First-Class Mail reflect the impact of electronic diversion as businesses, non-profit organizations, governments and households increasingly automate their financial transactions and divert correspondence and other communications to the Internet. Priority Mail and Express Mail are losing market share, as is Package Services. Finally, Periodicals Mail volume and revenue are declining as businesses and consumers increasingly rely on the Internet as a substitute for hardcopy publication of news, information and entertainment.

Table 2 – Volume by Class of Mail

Three Months Ended March 31,			Volume	Six Months Ended March 31,		
2004	2003	%	(millions)	2004	2003	%
24,875	25,098	-0.9	First-Class Mail	50,741	51,148	-0.8
214	219	-2.5	Priority Mail	447	454	-1.5
14	14	-3.1	Express Mail	27	28	-4.0
2,309	2,393	-3.5	Periodicals Mail	4,626	4,780	-3.2
23,329	21,715	7.4	Standard Mail	48,220	46,554	3.6
278	279	-0.2	Package Services	596	589	1.2
355	303	17.1	Other	739	655	12.9
51,373	50,021	2.7	Total Mail Volume	105,396	104,208	1.1

Standard Mail volume surged in Quarter 2, causing total mail volume to grow as well. Most of the Standard Mail volume growth was in the regular automation presort rate category. Volume for First-Class Mail, which is the largest mail class in terms of volume and revenue, declined in Quarter 2 at much the same pace as in Quarter 1. The volumes of Priority Mail, Express Mail and Periodicals Mail also continued to decline and Package Services volume declined slightly. Other volume growth was led by International Mail.

Table 3 – Revenue by Class of Mail

Three Months Ended March 31,			Revenue	Six Months Ended March 31,		
2004	2003	%	(\$ millions)	2004	2003	%
\$ 9,262	\$ 9,366	-1.1	First-Class Mail	\$18,916	\$19,136	-1.1
1,096	1,126	-2.7	Priority Mail	2,369	2,409	-1.7
213	222	-4.1	Express Mail	429	452	-5.1
545	567	-3.9	Periodicals Mail	1,107	1,149	-3.7
4,442	4,173	6.4	Standard Mail	9,128	8,868	2.9
546	549	-0.5	Package Services	1,202	1,204	-0.2
1,188	1,080	10.0	Other	2,349	2,249	4.4
\$17,292	\$17,083	1.2	Total Operating Revenue	\$35,500	\$35,467	0.1

Due to volume mix changes, total revenue grew more slowly than total volume in Quarter 2. Revenue declined for all classes of domestic mail, excluding Standard Mail. Total revenue growth of 1.2 percent was driven primarily by growth in Standard Mail revenue and International Mail revenue. Quarter 2 revenue growth was sufficient to edge year-to-date revenue growth into the positive range at 0.1 percent.

Additional detailed data on product volumes and revenues may be found in the Quarterly Revenue, Pieces, and Weights reports on www.usps.com/financials/rpw/welcome.htm.

Operating Expenses

Workhours

With the exception of rural delivery, year-to-date workhour reductions were achieved across all major functions, including mail processing, distribution, city delivery and administrative functions. However, the reductions in the second quarter were offset by the extra delivery day, which added about 5 million hours across operational functions. City delivery functions have absorbed the workload associated with an increase of about 420,000 possible deliveries, or 0.5 percent. Rural delivery is the only major function showing a growth in workhours. Initiatives in this area were offset by a 3.6 percent growth (1.2 million) in the number of possible deliveries. Year-to-year total possible deliveries have grown 1.2 percent, increasing total deliveries by 1.8 million to 142.2 million. Table 4 – Workhours by Function, on the following page, summarizes the work hour utilization in 2004 compared with 2003.

Year-to-date workhour reductions of 12.1 million provide momentum toward achieving the cost savings planned for 2004. We have developed plans to continue productivity increases and control expense growth using both cost savings programs and improvements in operational efficiencies with the majority of our savings coming from increases in operational efficiency.

Compensation and Benefits

Compensation and benefits costs for Quarter 2 were \$690 million, or 5.6 percent higher than the prior year period. Year-to-date, the increase over the prior year period was \$1,165 million, or 4.7 percent. These increases were driven primarily by contractual wage and cost-of-living increases (about \$760 million), the addition of one work day in 2004 due to the leap year (approximately \$160 million impact) and higher benefit expenses. The benefit expense increases were due chiefly to the required increase in contributions to the CSRS retirement system, from 7 percent of CSRS payroll to 17.4 percent.

Table 4 - Workhours by Function

Three Months Ended March 31,			Workhours (Thousands)	Six Months Ended March 31,		
2004	2003	%		2004	2003	%
			Operations			
2,292	2,285	0.3	-Operations Support	4,506	4,529	-0.5
84,780	86,276	-1.7	-Mail Processing	175,122	182,117	-3.8
42,256	40,753	3.7	-Rural Delivery	84,625	82,356	2.8
116,027	114,633	1.2	-City Delivery	233,291	233,458	-0.1
8,051	7,978	0.9	-Vehicles Services	16,171	16,248	-0.5
20,580	20,429	0.7	-Plant & Equip Maintenance	41,090	41,155	-0.2
58,710	58,617	0.2	-Customer Services, Retail & Sales	118,180	118,763	-0.5
31,620	35,266	-10.3	Postmasters & Installation Heads, Supervisors, Administration and Other	63,735	70,242	-9.3
364,316	366,237	-0.5	Total Workhours	736,720	748,868	-1.6

This higher contribution rate went into effect in May 2003 as a result of Public Law 108-18. We estimate that this higher contribution rate caused year-to-date compensation expenses to be about \$500 million higher than they otherwise would have been. In addition to the higher CSRS contributions, higher employee and annuitant health benefit costs, totaling \$247 million more than the same six month period last year, also impacted personnel compensation expenses.

Partially offsetting this growth in compensation and benefits costs, the number of career employees, not including the Office of the Inspector General (OIG), was reduced by 7,913 during the quarter through attrition and voluntary early retirement opportunities offered to certain employee groups in selected locations. Year-to-date, 16,375 career employees have left the rolls. The reduction in complement and other cost reduction efforts have offset over \$700 million of expense growth.

Table 5 – Personnel Compensation Expense by Function summarizes personnel compensation cost and compares 2004 compensation cost to that of 2003.

Table 5 – Compensation and Benefits Expense by Function

Three Months Ended March 31,			Compensation and Benefits (\$ millions)	Six Months Ended March 31,		
2004	2003	%		2004	2003	%
\$ 97	\$ 89	9.3	-Operations Support	\$ 189	\$ 174	8.5
2,829	2,730	3.6	-Mail Processing	5,747	5,611	2.4
1,168	1,077	8.4	-Rural Delivery	2,326	2,172	7.1
4,008	3,750	6.9	-City Delivery	7,984	7,553	5.7
290	271	7.2	-Vehicles Services	578	545	6.1
731	681	7.3	-Plant & Equip Maintenance	1,451	1,360	6.7
1,954	1,820	7.4	-Customer Services, Retail & Sales	3,915	3,693	6.0
1,233	1,253	-1.6	Postmasters & Installation Heads, Supervisors, Administration and Other	2,495	2,502	-0.3
372	364	2.2	Workers' Compensation	744	752	-1.0
330	293	12.8	Retiree Health Benefits	661	566	16.8
63	57	11.1	Other Personnel Compensation	115	112	2.0
\$13,075	\$12,385	5.6	Total Personnel Compensation	\$26,205	\$ 25,040	4.7

Workers' Compensation

Our employees are covered by the Federal Employees' Compensation Act, administered by the Department of Labor's Office of Workers' Compensation Programs (OWCP). In the second quarter we accrued \$372 million in workers' compensation expense, which is \$8 million more than last year's second quarter accrual. The year-to-date workers' compensation accrual of \$744 million is \$8 million lower than the comparable period last year. Workers' compensation liability and expense are estimated using an actuarial model that is subject to interim and end-of-year adjustment based on quarterly claims information provided by OWCP.

Retiree Health Benefits

Under the Federal Employees Health Benefits Program (FEHBP), the Office of Personnel Management (OPM) bills us for the cost of our retirees participating in the plan, and we record this cost as a current compensation and benefits expense. Our expense related to retiree health benefits was \$330 million during this quarter, compared to \$293 million in the second quarter of 2003. For the six months ended March 31, retiree health benefits expenses totaled \$661 million, compared to \$566 million during the comparable period last year.

Retirement Expense

The Postal Civil Service Retirement System Funding Reform Act of 2003 (Act) was signed by the President on April 23, 2003. This Act changed the way we fund our Civil Service Retirement System (CSRS) obligation, and transfers to us from the U. S. Treasury the responsibility for funding costs of CSRS benefits that current and former Postal Service employees have earned through military service. The Act also defines "savings" as the difference between contributions we would have made if the Act had not been enacted and the contributions we make under the Act. The Act requires "savings" after 2005 to be escrowed. According to a 2003 General Accounting Office (GAO) report, without this legislation, we were on course to over-fund our obligation by approximately \$105 billion. Without considering the transfer of military service credits, we over-funded our retirement obligations by \$10 billion as of September 30, 2002. See our Annual Report for a full discussion of the other provisions of the Act.

The Act provides an opportunity to reconsider the transfer of the CSRS military service obligation by requiring the Postal Service, Department of the Treasury, and the OPM to submit proposals "detailing whether and to what extent the Department of the Treasury or the Postal Service should be responsible for the funding of benefits attributable to the military service of current and former employees of the Postal Service." In our report we recommended that the responsibility for these costs should be returned to the U. S. Treasury. The GAO prepared a written evaluation (Report Reference: GAO-04-281) of each proposal and submitted its report to the Committee on Government Reform of the House of Representatives and the Committee on Governmental Affairs of the Senate on November 26, 2003.

As of March 31, 2004, legislation has not been enacted either to reallocate responsibility for military service retirement credits or to define the use of the escrowed "savings" beyond 2005.

Separately, we have taken issue with the methodology OPM used to calculate our CSRS obligations. Specifically, we believe that OPM used an allocation methodology to attribute CSRS pension costs of the pre-July 1, 1971 service that assigns an unreasonably large share of the burden to us for payment. We requested OPM to consider an alternative allocation methodology that is consistent with the approach OPM previously used to allocate the increase in CSRS pension costs created by annual cost-of-living-adjustments granted to retirees. In accordance with the Act, on January 26, 2004, we filed a request for reconsideration of the method used by OPM to calculate Postal Service CSRS pension liability with the Board of Actuaries of the Civil Service Retirement System. The alternative allocation methodology endorsed in our appeal results as of September 30, 2002, in an estimated overfunding of Postal Service obligations of \$81.6 billion, as opposed to OPM's estimate of \$4.8 billion underfunding using its new allocation methodology.

Transportation

Transportation expense of \$1,275 million is \$88 million, or 7.4 percent, over last year's second quarter expense of \$1,187 million. Increases in fuel prices and an extra business day are the major factors contributing to the increase. During the second quarter, average national retail gasoline prices increased from \$1.527 per gallon on December 29, 2003 to \$1.847 per gallon on March 29, 2004, according to the U.S. Energy Information Administration. This dramatic rise in fuel prices, which is not offset by fuel surcharges to our customers, has a significant adverse impact on our costs as the Postal Service uses approximately 2.6 million gallons of fuel (gasoline, diesel, and jet fuel) each day. A one cent increase in fuel prices, sustained for a year, has an approximate \$8 million annual impact on our expenses. Quarter 2 expenses do not reflect the entire 32 cent pump increase experienced in the second quarter because of ongoing efforts to integrate and realign our transportation infrastructure and to control fuel expenditures. Nonetheless, rising fuel prices present a significant expense management challenge.

Year-to-date, transportation expenses totaled \$2,453 million which is \$45 million below the comparable prior year period. Factors contributing to the year-to-date reductions include network optimization efforts, such as shifting some transportation from air carriers to highway, initiatives to control fuel expenditures, and favorable settlements of prior year international terminal dues, which collectively offset the fuel price impacts.

Supplies and Services and Other Expense

Other non-personnel expenses, including interest, of \$2,208 million were \$5 million over last year's comparable quarter. For the six month period, nonpersonnel expenses totaled \$4,301 million, which is \$66 million less than the comparable prior year period.

Within this category, interest expense decreased by \$81 million for the quarter and \$192 million year-to-date, reflecting both lower average debt balances and lower interest rates. Interest expense on our outstanding notes totaled \$13 million versus \$213 million for this same period last year and was in line with expectations. Without the debt refinancing in 2003, as described in our Annual Report, interest expense for the first six months of 2004 would have been approximately \$183 million.

Offsetting the decrease in interest expense were increases in rent (\$12 million for the quarter, \$26 million year-to-date), fuel and utilities (\$17 million for the quarter, \$21 million year-to-date), and projects expensed such as research and development and building repairs (\$26 million for the quarter, \$60 million year-to-date).

PRODUCT COST

Annually, the Postal Service prepares a detailed analysis of product cost. The analysis is summarized in the Cost Revenue Analysis Report (CRA) and is subjected to an extensive review by our independent auditors. The report for 2003 was completed and issued in April 2004, and the following summarizes the results of the analysis. The full report is available at <http://www.usps.com/financials/cra/welcome.htm>.

In 2003, declines in CSRS retirement payments and workhours combined to reduce overall costs, despite climbing wage and benefits costs. As a result, unit costs fell for most mail classes, relative to 2002. Nevertheless, the decline in volumes and continued growth in the delivery network in recent years show that the Postal Service faces a continuing challenge to its ability to finance its universal service obligation.

Total costs declined from \$67.4 billion in 2002 to \$64.9 billion in 2003. The largest component of the cost reduction was a \$3.4 billion decrease in CSRS costs that resulted from Public Law 108-18, the Postal Service Retirement System Reform Act of 2003 (Act). Even though costs per workhour (other than CSRS) rose by over 5.0 percent due to higher wages and increasing health benefit costs, a 54 million workhour reduction successfully moderated labor expense growth. In particular, mail processing unit labor cost was unchanged on net since the rise in the cost per work hour was offset by the decline in

workhours. The Postal Service also successfully cut per piece expenses in the transportation function by 4.6 percent.

Overall, unit costs fell by nearly 4 percent on average. First-Class Mail unit costs remained essentially flat, as increases in city carrier costs offset the CSRS savings. 2003 city carrier cost increases stem principally from new street cost variability estimates made in 2003. Package Services experienced the largest decline in unit costs. In addition to workhour savings, Package Service costs reduced due to an increasing share of Parcel Select in the product mix. Priority Mail unit costs increased by 1.8 percent, as workhours lagged the decline in volume (down 14 percent); Express Mail costs rose slightly. Table 6 - Comparison of Unit Costs by Mail Class, below, compares unit costs for 2002 with those for 2003 by subclass of mail.

Had Congress *not* reformed Postal Service funding of the CSRS pension fund, unit costs would have *increased* on average by 1.8 percent in 2003 instead of declining on average 4 percent. The difference in the 2003 CRA results with and without the CSRS cost reductions indicate the importance of further congressional consideration of the issues described in more detail in the *Retirement Expense* section on page 15 of this report.

The CRA data provide convincing evidence that competitive products pay their own way, belying claims by competitors that the USPS uses profits from First-Class Mail to cover losses in package delivery. Express Mail, Priority and Package Services combined to contribute \$2.5 billion to help cover the Postal Service's institutional costs.

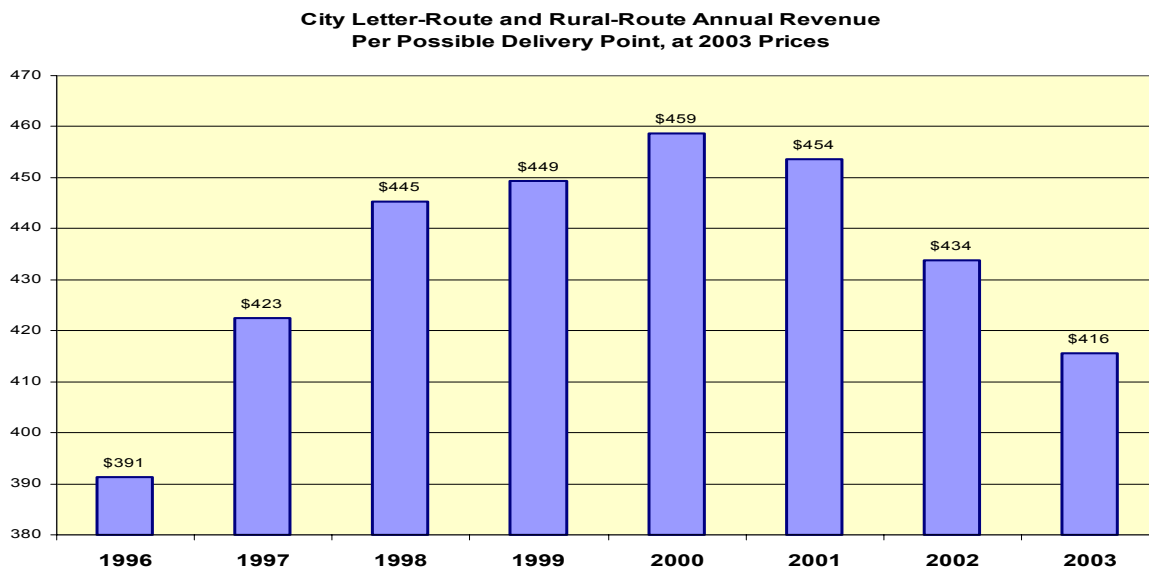
Table 6 – Comparison of Unit Costs by Mail Class

COMPARISON OF UNIT COSTS			
FY 2002 to FY 2003			
<i>Class of Mail</i>	FY 2002	FY 2003	Percentage Difference
First-Class Mail:			
Single-Piece Letters.....	\$0.247	\$0.252	1.94%
Presort Letters.....	0.101	0.098	-3.14%
Total Letters.....	0.175	0.174	-0.56%
Single-Piece Cards.....	0.185	0.183	-1.12%
Presort Cards.....	0.062	0.063	0.65%
Total Cards.....	0.122	0.121	-0.54%
Total First-Class.....	0.172	0.171	-0.54%
Priority Mail.....	3.293	3.351	1.76%
Express Mail.....	7.460	7.533	0.98%
Periodicals:			
In County.....	0.093	0.084	-9.46%
Outside County.....	0.244	0.240	-1.60%
Total Periodicals.....	0.231	0.227	-1.70%
Standard Mail:			
Enhanced Carrier Route.....	0.068	0.061	-10.30%
Regular.....	0.144	0.135	-6.12%
Total Standard Mail.....	0.116	0.109	-6.09%
Package Services:			
Parcel Post.....	2.754	2.606	-5.40%
Bound Printed Matter.....	0.917	0.809	-11.80%
Media Mail.....	1.857	1.744	-6.09%
Total Package Services.....	1.724	1.588	-7.90%
Free Mail (blind, handicapped & military)	0.503	\$0.511	1.55%
International Mail.....	1.383	1.307	-5.52%
Total Mail.....	0.182	0.174	-3.99%

Finally, recent data also show how the business environment has changed over the past decade. From 1997 to 2000, volume growth added \$5.5 billion in annual revenues, holding prices constant. During the most recent three years, volume declines have reduced postal revenues. During the period 1996 to 2003, the Postal Service delivery network grew by 12.5 million carrier delivery points, about 1.8 million a year.

The result is shown in Graph 1 –City Letter and Rural-Route Annual Revenue, below. It displays the growth in annual revenue per delivery point from 1997 to 2000, to a peak of \$459 (\$1.51/day), and then a steady decline until, by 2003, the Postal Service must fund a network of 119 million city and rural deliveries with revenues of only \$416 (\$1.37/day) per carrier delivery point.

Graph 1- City Letter and Rural-Route Annual Revenue



PRODUCTIVITY

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

Year-to-date through March, workload increased by 1.0 percent, and resource usage declined 0.6 percent, yielding a 1.6 percent increase in TFP. This productivity growth is equivalent to approximately \$539 million in year-to-date expense reductions. TFP growth has been positive in eighteen of the last nineteen quarters. The workload increase was driven primarily by the expanding delivery network, but it was also influenced to a lesser degree by mail volume workload growth. After declines for the last eighteen quarters, resource usage increased this quarter due entirely to the occurrence of an extra business day. Without the extra business day, resource usage would have been negative.

FINANCIAL CONDITION

Debt and Liquidity

In 2003 we refinanced our debt portfolio, retiring all long-term debt. We now maintain two credit lines with the U.S. Treasury's 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 the funds are requested. Currently, all of our debt consists of amounts outstanding under these two credit lines and has a weighted average annual interest rate of 1.08 percent compared to 4.97 percent on our debt portfolio one year prior.

The first half of our fiscal year typically produces strong cash flow. We used this cash flow and our year-end cash balance to reduce debt. As of March 31, 2004, we had outstanding debt of \$1.5 billion, a reduction of \$5.8 billion from both the same period last year and also from the level at fiscal year end. Public Law 108-18 calls for savings that we realize under its provisions, estimated at \$2.7 billion for 2004, to be applied to debt reduction. We ended 2003 with \$7.3 billion in debt. Therefore, debt at September 30, 2004, should not exceed an estimated \$4.6 billion. Our Integrated Financial Plan (IFP) includes repayment of between \$4.2 and \$4.7 billion of our debt this year, well beyond what is contemplated by the statute.

We expect an increase in debt outstanding from current levels for the fourth quarter as we have approximately \$1.3 billion in lump sum payments to make for workers' compensation and retirement liabilities. Further, our cash flow weakens during the summer when revenues moderate more substantially than expenses. Cash and cash equivalents amounted to \$250 million on March 31, 2004, compared to \$2.3 billion on September 30, 2003.

Capital Expenditures and Commitments

Capital commitments through the second quarter were \$825 million compared to a plan of \$888 million. This commitment rate is somewhat slower than projected due to program delays. But during the second quarter, the Board of Governors approved funding for five projects: OCR Enhancements for Letter Mail Automation; New York, NY, Church Street and Federal Office Building Phase III Development Project; Kansas City, Missouri Main Post Office/Mid-America District Developmental Project; Santa Monica, California Carrier Annex; and Labor Scheduler, Phase I Decision Analysis Report Modification Request.

The capital cash outlays year-to-date were \$714 million in 2004 compared with \$655 million in 2003. Table 7 – Capital Commitments, Expenditures, and Resources on Order, below, summarizes 2004 activity year-to-date compared to 2003.

Table 7 – Capital Commitments, Expenditures, and Resources on Order

CAPITAL INVESTMENTS (\$ millions)	COMMITMENTS		CASH OUTLAYS		RESOURCES ON ORDER	
	Year to Date Through March 31,		Year to Date Through March 31,		March 31, 2004	September 30, 2003
	2004	2003	2004	2003		
CONSTRUCTION AND BUILDING PURCHASE	\$ 39	\$ 19	\$ 65	\$ 71	\$ 202	\$ 238
BUILDING IMPROVEMENTS	91	44	113	83	156	187
MAIL PROCESSING EQUIPMENT	449	467	290	346	1,567	1,410
VEHICLES	162	20	67	32	166	72
RETAIL EQUIPMENT	27	3	39	5	166	178
POSTAL SUPPORT EQUIPMENT	58	111	140	119	226	311
TOTAL	\$825	\$664	\$714	\$655	\$2,483	\$2,395

Note: Totals may not sum due to rounding.

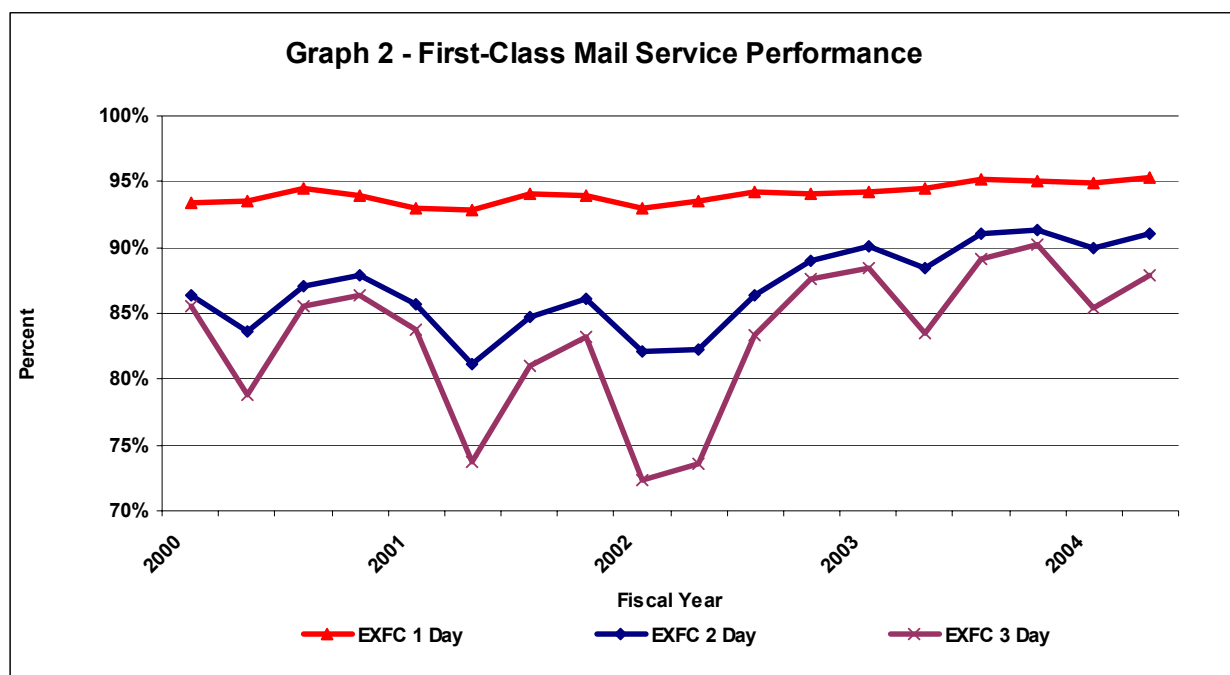
SERVICE AND PERFORMANCE

The Postal Service management monitors several key statistics to determine performance against service standards, public perception of our service, and employee perceptions of the workplace.

Performance

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 as it actually happens.

Graph 2 – EXFC Performance, below, summarizes EXFC results by quarter since 2000. Even with the reductions in career employees and workhours, the Postal Service has maintained a high level of service in the 1-day category and improving service for both the two and three day categories.



Customer Satisfaction

Independently measured customer satisfaction for residential household customers for Quarter 2 showed that 93 percent of these customers rated their experience with the Postal Service as “excellent”, “very good” or “good.”

Employee Perception

Every three months, a quarter of career employees receive the Postal Service's Voice of the Employee (VOE) survey at their work location. Surveys are voluntarily and anonymously completed on the clock and returned to an independent contractor which develops reports based on quarterly results that help monitor perceptions and trends. Of 34 survey questions, six form an index score that gauges employees' attitudes on key workplace issues.

Second quarter results were favorable with the VOE survey index reaching 61.3 which showed continuous improvement over the four previous second quarter scores. The 2004 year-to-date national VOE survey index was 61.0 compared to 60.6 for the comparable 2003 period, a 0.7 percent advance.

RATE AND CLASSIFICATION ACTIVITY

The Postal Rate Commission is an independent establishment of the executive branch of the Government of the United States. The Commission reviews Postal Service proposals to establish and change domestic mail rates, fees and mail classifications. Upon request by the Postal Service, the Commission holds public hearings, and issues recommended decisions to the Governors of the Postal Service, who approve, reject, or, in some cases, modify the Commission's recommendations. The PRC is also authorized to issue advisory opinions concerning proposed changes in the nature of postal services that affect service on a nationwide or substantially nationwide basis, recommended decisions regarding rate complaints by interested parties, and reports regarding complaints that parties are not receiving postal services in accordance with the policies of the Postal Reorganization Act. The PRC is also responsible for promulgating rules and regulations and establishing procedures deemed necessary and proper to carry out their functions and obligations.

Currently there is one classification case pending, the *Experimental Periodicals Co-Palletization Dropship Discounts for High Editorial Publications*, PRC Docket No. MC2004-1, filed February 25, 2004. This request proposes to establish on an experimental basis rate categories and discounts for high-editorial content, heavy-weight, small-circulation Periodicals mail that is copalletized and dropshipped. The Postal Service is proposing discounts that would be available only as an alternative to the existing co-palletization discounts. They would be limited to Periodicals mail that has, at most, 15 percent advertising matter, that weighs at least 9 ounces per copy, that has a mailed circulation of not more than 75,000 copies, and that lacks the density to prepare single-publication pallets.

There are two proposed rulemaking hearings in process. The first concerns defining the term "postal service", and the second involves new procedural rules concerning the information related to nonpostal products that will be required to be submitted as a part of a rate filing. Four complaint cases are also open concerning removal of collection boxes, the Electronic Postmark, cost-based rates for Periodicals Mail, and alleged service level changes. Specific information on these pending dockets can be obtained at the PRC web site <http://www.prc.gov/main.asp?Left=contents.asp&Right=home.asp>.

OUTLOOK

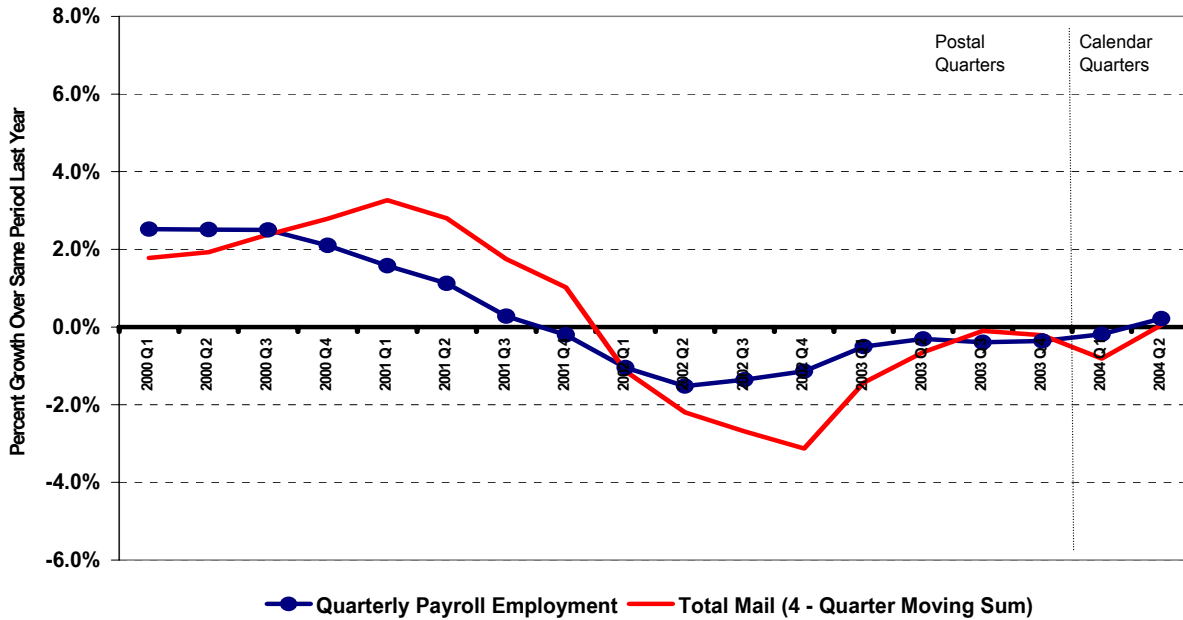
Revenue

The revenue outlook for the remainder of the year is positive in view of the growth experienced year-to-date and the generally positive economic outlook.

Mail volume growth and revenue growth depends on the economy, the underlying demand for our services and the attractiveness of competitive alternatives. The economy has gradually exhibited signs of residual strength over the last eighteen months. Growth in economic activity, as measured by Gross Domestic Product and Retail Sales, began to pick up in 2003 and has continued to build in 2004. Global Insight expects GDP growth to hold at annualized rates of around four percent for the remainder of this year and projects continued gains in retail sales.

In Quarter 2, year-over-year payroll employment grew for the first time in almost three years. Payroll employment is a useful indicator of total mail volume growth as shown in Graph 3 – Total Mail Volume and Payroll Employment, on the following page.

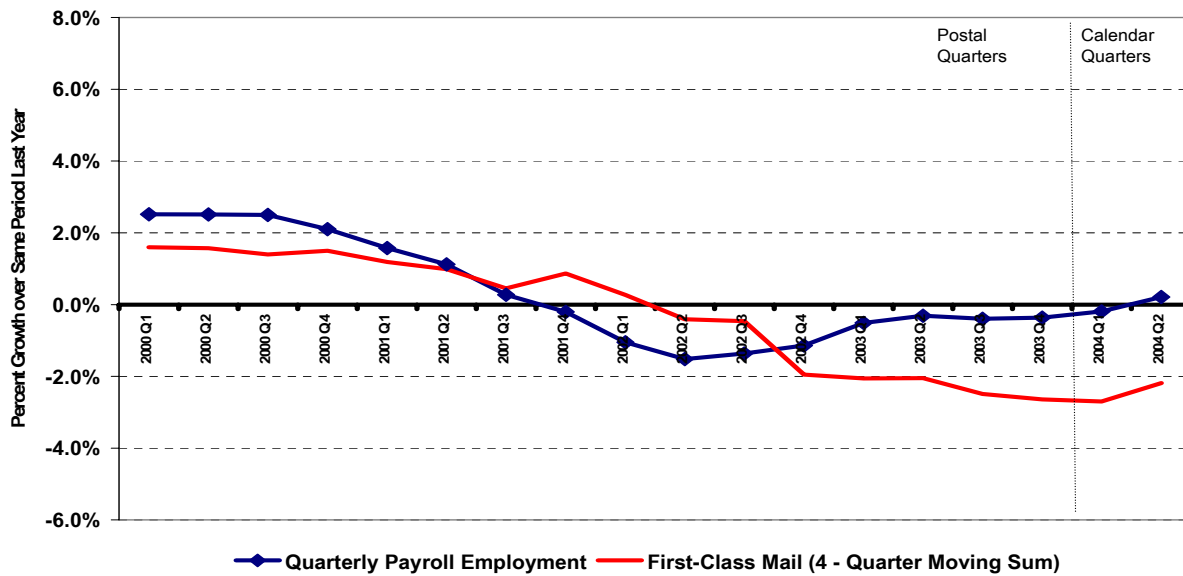
Graph 3 - Total Mail Volume and Payroll Employment



Global Insight expects jobs to grow at a sustained rate of 200,000 per month by the summer. If this growth occurs, it will be a positive indicator for total mail volume for the remainder of this year. However, the outlook is very different as between First-Class Mail and Standard Mail.

First-Class Mail has been and continues to be affected by electronic diversion. Graph 4 – First-Class Mail Volume and Payroll Employment, below, tracks First-Class Mail volume growth in relation to payroll employment.

Graph 4 - First-Class Mail Volume and Payroll Employment

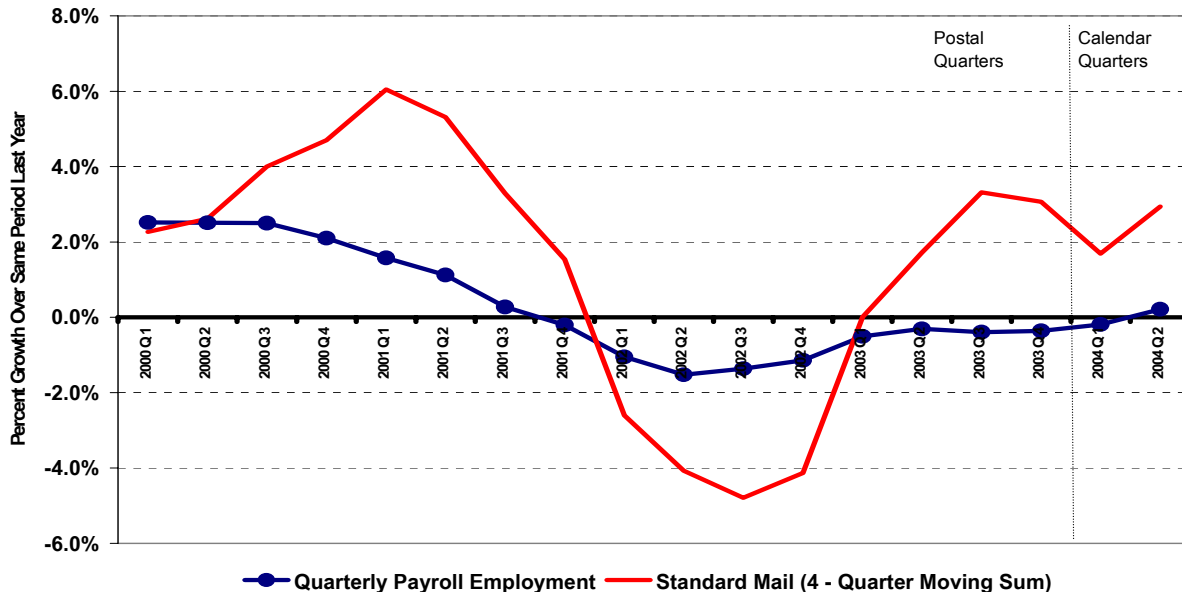


First-Class Mail volume continues to decline despite increased employment and strengthened economic growth. Economic growth is now attenuating the declines in First-Class Mail volume and revenue to the

point where volume and revenue may finish the year at or above the annual operating plan projection. But the Postal Service is not projecting a reversal of the multi-year downward trend in First-Class volume.

Standard Mail has been little affected by electronic diversion. In contrast to First-Class Mail, Standard Mail's growth has been quite strong relative to the payroll employment indicator, as displayed in Graph 5—Standard Mail Volume and Payroll Employment, below.

Graph 5 - Standard Mail Volume and Payroll Employment



We project strong Standard Mail volume growth to continue through the remainder of this year based on the positive economic outlook and the boost that Standard Mail is receiving from “Do Not Call” telemarketing restrictions. We expect Standard Mail volume and revenue to finish the year close to the annual operating plan projection despite having been well short of the operating plan projection in the first quarter.

We expect Priority Mail and Express Mail volumes to continue to decline due to competitive alternatives. Also, our Package Services volume growth is weakening, with the exception of the Media Mail subclass. We expect the long-term decline in Periodicals Mail volume to continue. But we are changing the short term outlook for International Mail; based on recent data, we expect International volume and revenue to grow for the remainder of this year.

In total, we expect to finish the year close to or above the annual operating plan revenue projection of \$68,906 million.

Expense

The outlook is also mostly positive on the expense side. Our total expense plan for 2004 is \$66,796 million, which represents 2.9 percent growth over 2003. Year-to-date total expenses through Quarter 2 are \$560 million below plan and have grown 3.3 percent compared to the same period last year. As the higher contribution level for CSRS retirement cycles out in May of this year, personnel compensation expense growth compared to last years levels will moderate. If mail volume continues to grow at the anticipated rate, then the opportunity for volume-related workhour reductions becomes more difficult. However, the outlook for achieving our targeted \$1.4 billion in cost savings for the year remains good.

While there appears to be increasing risk of accelerated inflation, the Postal Service's greatest exposure to inflation is in salary and benefits, and the risk relates primarily to 2005. The next set of COLA

adjustments for craft personnel occurs in September and will have little impact on 2004 results. Likewise, health benefits premiums for postal employees and retirees will not increase again until January 2005.

The current high level of fuel costs and the potential for further increases remains a concern. The Postal Service does not hedge any of its costs, thus it is exposed to market price fluctuations. The U.S. Energy Information Administration warned in a recent report that the domestic gasoline supply system is vulnerable to "severe price shocks" if a major refinery or pipeline outage were to occur. Some private forecasts for the summer months call for further fuel price increases from current levels. Currently, we estimate that transportation costs for the year will be at or below last year's level; however, this projection could be problematic if any sustained price increases occur.

In addition to transportation, increased energy costs would negatively affect a variety of other nonpersonnel items, including utility expenses, vehicle servicing costs and rural carrier equipment maintenance allowances.

As discussed in the Operations section and our 2003 Annual Report, the Postal Civil Service Retirement System Funding Reform Act of 2003 changed our funding requirements for CSRS retiree benefits. As required by the Act, we have submitted reports giving our recommendations on two issues. First, we recommended that the obligation to fund the military service costs of postal employees' CSRS retirement benefits revert to the Department of the Treasury. Second, we recommended that the escrow provisions of the Act be eliminated and that the "savings" be used to fund retiree health care benefits, retire debt or fund capital expenditures. On May 11, 2004 H.R. 4341, the "Postal Accountability and Enhancement Act" was introduced in the House of Representatives. The provisions of this bill, if enacted, could have a significant impact on the future operations and finances of the Postal Service.

In accordance with our Emergency Preparedness Plan, the Board of Governors approved the Biohazard Detection System and the Ventilation and Filtration System, which totaled \$573 million. We have scheduled deployment of these systems to begin in 2004 and to be completed by mid-2005. We requested a \$350 million Congressional appropriation for 2004, which has not been authorized. Failure to receive this appropriation will impact our financial results.

In total, absent unforeseen events, we expect to finish 2004 below the annual expense plan budget of \$66,796 million.

Our discussion in the Management Discussion and Analysis represents our best estimate of the trends we know about, the trends we anticipate and the trends we think are relevant to future operations. However, actual results may be different.

ITEM 3. 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 natural gas for heating facilities. We have foreign currency exchange rate risk related to the settlement of terminal dues and transit fees and other transportation and delivery arrangements with foreign postal administrations and/or their affiliates 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.

ITEM 4. CONTROLS AND PROCEDURES

As noted in Quarter 1, we are voluntarily complying with those portions of Section 404 of the Sarbanes-Oxley Act of 2002 that relate to documentation and testing of controls over financial reporting. The Postal Service will use the Committee of Sponsoring Organizations of the Treadway Commission (COSO) control framework to document, test and report on our reporting controls.

As noted in Quarter 1, financial processes and control documentation are being updated. Processes in eight major focus areas were selected for examination, specifically: cash, money orders, meter revenue, payroll expense, transportation expense, real estate expense, contract payments, and accounting closings. These processes are under review and existing documentation will be revised to conform to the COSO framework.

No material control weaknesses were identified or reported during the quarter ending March 31, 2004.

Part II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See foot note 3, Contingent Liabilities, March 31, 2004 financial statements.

ITEM 5. OTHER INFORMATION

Regulatory Filings Approved by the Board of Governors

On May 13, 2004 the Board of Governors approved three filings with the Postal Rate Commission. One is to conduct an experiment establishing a convenient flat rate for Priority Mail parcels of a standard size. The other two are to implement Negotiated Service Agreements (NSAs) with financial institutions to encourage their greater use of First-Class Mail. These NSAs are patterned after a similar agreement with Capital One now in effect. Details of the filings will be released when they are submitted to the Commission.

ITEM 6. EXHIBITS AND REPORTS

Since the last quarterly report, the Postal Service released Quarter 1 results in a press release titled "Postal Service Posts 1st Quarter Income Gain Despite Mail Decline" on February 3, 2004. The text of this announcement is available at http://www.usps.com/communications/news/press/2004/pr04_009.htm.